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Going Local in Emerging Market Debt: A Dozen Questions

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Introduction

Emerging market local currency-denominated debt (EMLCD) is a relatively new asset class that has only recently begun to attract the attention of institutional investors. Its positive attributes include a large market capitalization that can afford liquidity even during times of global financial stress, still limited participation by foreign investors, broad geographical diversification, and the expectation of strong returns with low correlations to the returns of other major asset classes. Because of its relative newness, however, even sophisticated investors have questions about EMLCD – about the reasons for its recent prominence, about its sources of return and their long-term viability, and, therefore, about its prospects for continued strong performance. For example, is EMLCD overly dependent on commodities? Following are some of the questions most commonly asked by institutional investors, along with our responses to them.

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QUESTION 1:

What explains the recent surge in issuance and interest in EMLCD?

Emerging market local currency debt barely existed ten years ago and has achieved legitimate asset-class status only in the past couple of years. Its remarkable growth and increased prominence result from a happy coincidence of supply and demand factors.

A decade ago, when emerging market sovereigns needed to raise capital, most had little choice but to issue bonds denominated in foreign currencies, primarily in US dollars. Hyperinflation and the occasional high-profile currency crisis had made both local and foreign investors wary of exposure to assets denominated in emerging market currencies. More recently, however, governments of emerging market countries have moved their economies onto much firmer financial footing. In particular, central banks have had considerable success in fighting the hyperinflation that had long ravaged local investment returns. Most emerging market countries have also reduced the risk of catastrophic currency crisis by transitioning from fixed to more flexible and even completely floating exchange rate regimes, which are less prone to sudden and severe devaluations. The result has been a generalized improvement in sovereign creditworthiness, a widespread rise in credit ratings, and an increase in investor appetite for assets denominated in local currencies. The global financial crisis of 2008 may have paused these positive trends, but it has not reversed them.

In fact, these trends constitute a kind of self-perpetuating virtuous cycle. With more buyers for local bonds, emerging market governments have reduced unnecessary exposure to exchange rate risk by issuing more debt in local currencies and with increasingly longer maturities. Reduced reliance on USD-denominated debt and on short-term borrowing has led, in turn, to improved debt profiles, further gains in creditworthiness, and interest from still additional investors. Local bond yields – in some cases, significantly higher than those on USD-denominated debt – have attracted growing numbers of foreign buyers who find value in exposure to emerging market currencies as well. Additional demand for local bonds, particularly in longer maturities, has also come from pension funds recently established in emerging market countries themselves. The aggregate effect of this virtuous cycle has been rapid growth in local currency debt relative to USD-denominated bonds. The market for local currency bonds is now twice the size of the original dollar-denominated market, whose growth has remained flat for years.

Initially, emerging market debt managers reacted to the increased prominence of local currency bonds by including them as out-of-the-benchmark holdings in traditional USD-denominated portfolios. In January of 2006, JPMorgan responded to the changing composition of the world debt markets by introducing its first index devoted exclusively to emerging market local currency debt. A few months later, Standish began managing one of the first “pure” emerging market local currency bond funds.

QUESTION 2:

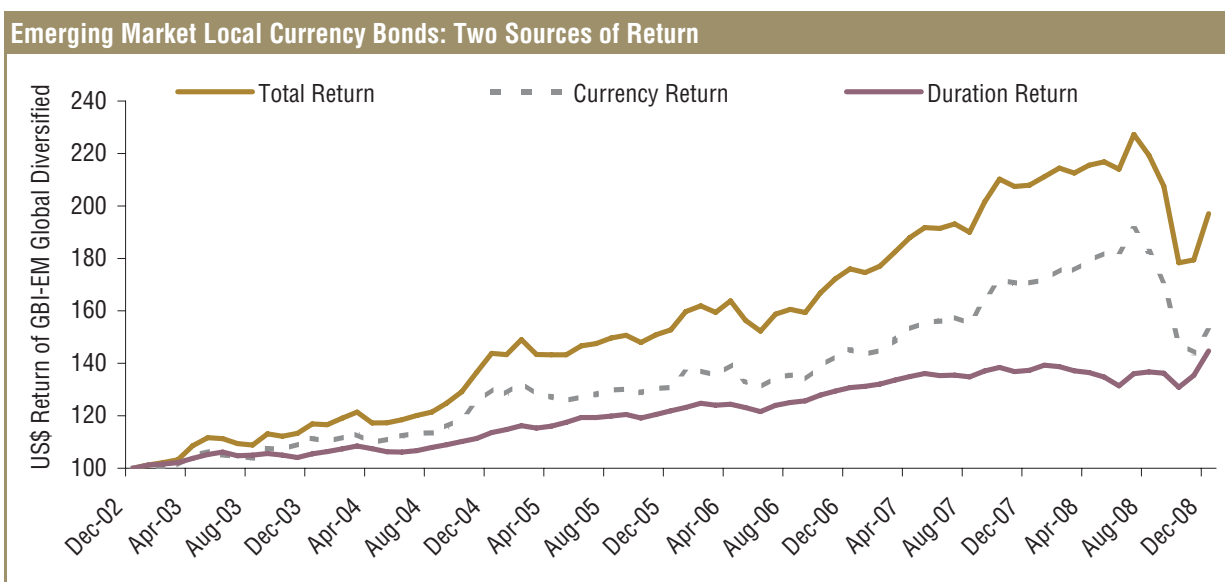
How does EMLCD differ from traditional USD-denominated debt – in its sources of return, for example?

Emerging market local currency and USD-denominated bonds are two very different asset classes. The two reflect different credit quality and regional composition and, more importantly, respond to very different drivers of return. Just like high-yield or investment-grade corporate bonds in the US, emerging market USD-denominated debt is ultimately a “spread product.” The prospective returns of USD-denominated bonds are measured by their spreads over US Treasury bonds, an indication of relative creditworthiness, and, of course, by underlying Treasury yields. As in the case of corporate bonds, spreads over US Treasuries consist of two parts: (1) the expected loss spread, and (2) the risk premium. Expected loss spread is the compensation demanded for anticipated credit losses, which may be approximated by multiplying the probability of default by the expected loss from default. The risk premium – the extra compensation for remaining uncertainty – is the difference between this expected loss spread and actual spreads. Normally,

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the risk premium is positive; otherwise, rational investors would simply hold US Treasuries of similar duration.

By contrast, emerging market local currency debt has important structural similarities to “global bonds” – bonds issued by foreign governments of developed countries and denominated in their respective local currencies. In particular, EMLCD enjoys two distinctly different sources of returns: (1) currency, or the local cash yield plus changes in the spot rate, and (2) duration, or the extra return that local bonds earn relative to local cash – a currency-hedged bond return. As the graph below indicates, both sources have contributed substantially to the total return of EMLCD over the last six years.



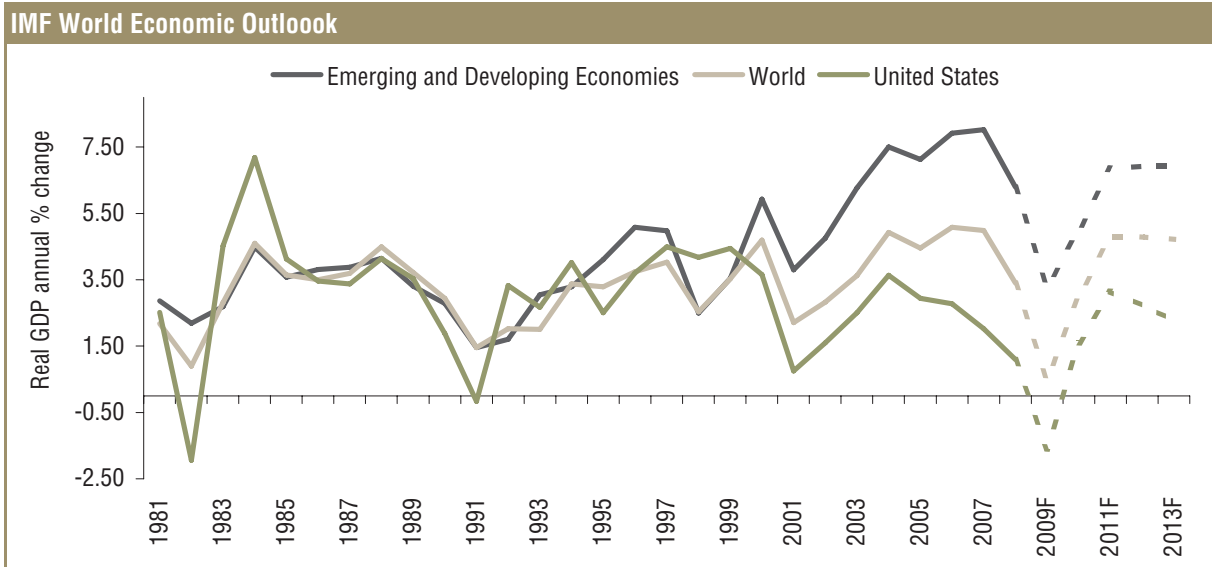
Source: JPMorgan, Standish, as of December 2008

Importantly, the drivers of currency and duration returns are not exactly the same as the drivers of spreads on USD-denominated bonds. True, changes in sovereign creditworthiness – the principal driver of spreads – can also have a significant impact on both currency values and bond yields. This relationship applies more to countries with lower credit ratings, however, and relatively less as one moves up the ratings scale. Entering 2009, the average credit rating of emerging market local currency bonds (as represented by the JP Morgan GBI-EM benchmarks¹) is A-, or solidly investment-grade. By contrast, the average rating of USD-denominated bonds (as represented by the JP Morgan EMBI benchmarks²) is some three or four notches lower. In any case, factors other than changes in the sovereign risk assessment drive currencies and interest rates in most emerging market countries. These factors include the net supply of hard currency (e.g., USD, Euro, and Yen), the level of carry, central bank policy, inflation expectations, and local demand for fixed income assets – to name just a few.

Take hard currency for example. As long as there is an excess supply of hard currency – meaning an excess of demand for local currencies – these local currencies are more likely to appreciate than otherwise. With a few exceptions, emerging market currencies have benefited from sizeable inflows of hard currency in recent years. Some of these flows abruptly reversed in the second half of 2008 as the global financial crisis intensified and investors reduced their emerging market exposure. This resulted in the pronounced weakening of emerging market currencies. While volatile portfolio flows (e.g., foreign purchases of local equities) are difficult to predict, it is likely that many emerging economies will continue to attract more stable hard currency inflows such as foreign direct investment. In general, as the developed economies have plunged into a synchronized recession, the growth rate of emerging economies is likely to slow relatively less. As a group, emerging economies should also resume expanding at higher rates later. This positive

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growth differential should continue to attract long-term capital flows from the developed to the emerging world, thus supporting local currency valuations.



Source: IMF, as of January 2009

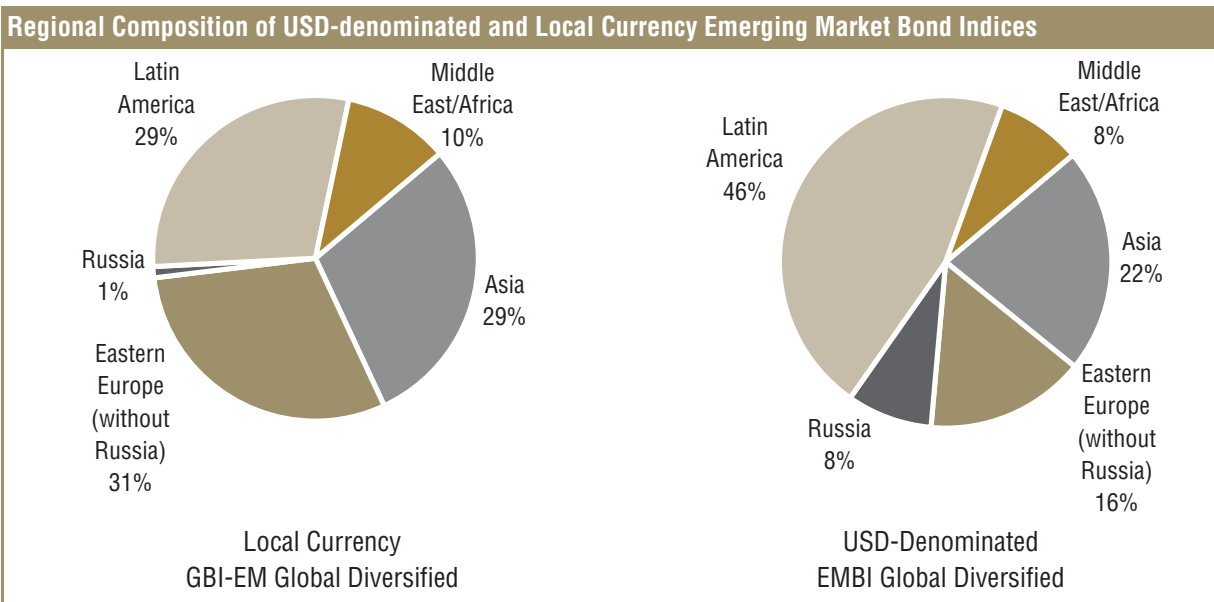
Several emerging market countries also present attractive duration opportunities. Over the past few years, governments of most emerging market countries have practiced increasingly responsible fiscal and monetary policies, which have led to disinflation and boosted local duration returns. In the first half of 2008, structural progress was stalled temporarily by the rise in global food and energy prices and by strengthening domestic demand, which led to an increase in inflation expectations. Bond yields backed up almost across the board, from Latin America and Asia to Eastern Europe, the Middle East, and Africa. However, the same central banks credited with curing hyperinflation a decade ago seem well aware of the risks of its re-entrenchment in the new millennium. Their continued vigilance, combined with the expected weakening in domestic demand and the recent decline in commodity prices, should create supportive conditions for local bond yields.

QUESTION 3:

Are there regional or country differences that have investment implications for USD-denominated versus local currency debt?

There are indeed substantial differences in the countries and regions that comprise the USD-denominated and local currency markets, and in the indices that represent the two. The countries with the largest local fixed income markets are not necessarily those with the largest amounts of USD-denominated debt outstanding. In fact, the opposite is often true, for all the reasons that explain the development of local currency markets in the first place. A country with a large USD-denominated market may not have solved its inflation, currency, or credit problems sufficiently to satisfy and attract investors to debt denominated in its local currency. Conversely, a country with a well-developed local debt market may no longer feel (or may never have felt) the need to issue debt denominated in US dollars – and may even be actively retiring foreign issues. In any case, the EMBI benchmarks representing USD-denominated debt have much larger weights in Latin America and Russia, at the expense of Eastern Europe and Asia. By contrast, the GBI-EM benchmarks representing local currency debt give much larger weights to Asia and particularly Eastern Europe, and they shrink the representation of Latin America by almost half.

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Source: JP Morgan, as of December 2008

Different regional and country composition means different investment sensitivities as well. With larger weights in Russia and Latin America, the USD-denominated EMBI benchmarks are heavily skewed towards commodity exporters, particularly the oil-producing nations. Thus the performance of the EMBI exhibits stronger correlations with commodity prices than do the local currency GBI-EM benchmarks. The latter give greater representation to Eastern Europe, which is home to more commodity-importing countries. For local currency markets and their indices, therefore, the “commodity effect” is more muted and balanced. On the one hand, falling prices clearly hurt the currencies of commodity exporters like Russia and Colombia. On the other hand, falling prices benefit the trade balances of commodity-importing countries in Asia and Eastern Europe. Also, lower commodity prices tend to reduce inflation expectations, increasing the attractiveness of local duration exposure.

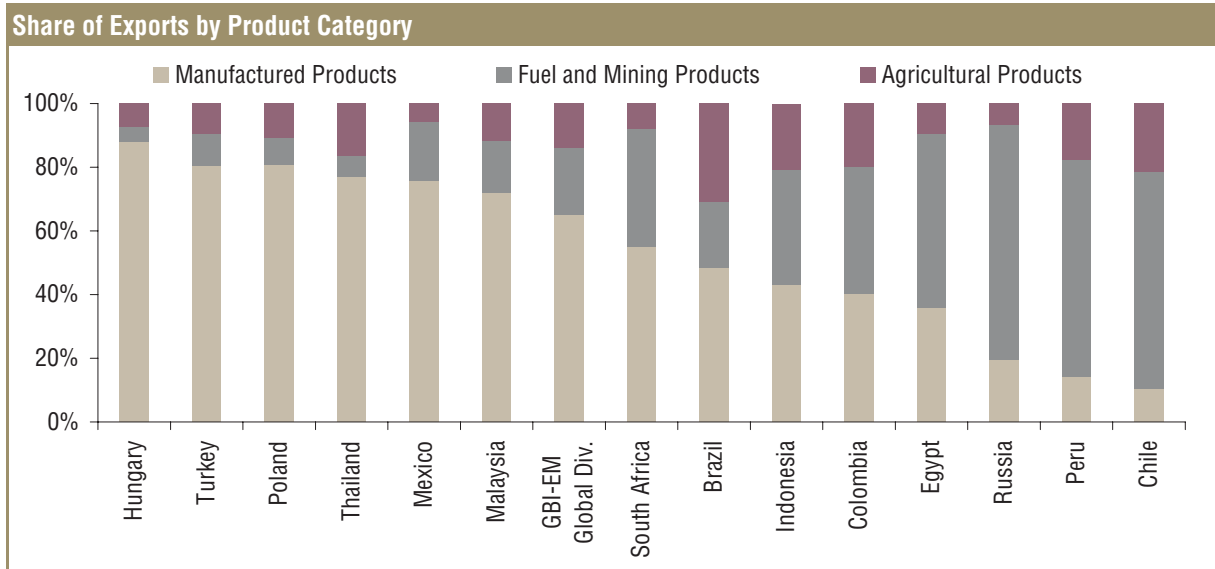
QUESTION 4:

Are emerging market exports overly dependent on commodity prices?

Actually, the high growth rates of emerging market exports are supported only partially by strong commodity prices. Contrary to widespread popular opinion, not all emerging market countries are exporters of commodities. Like their developed market counterparts, emerging countries represent a broad mix of economic types; and many countries – in Eastern Europe and Asia, for example – are actually net importers of commodities. To be sure, rising commodity prices boost hard currency receipts for oil-and-gas-exporting Russia and for copper-exporting Chile, but they hurt the balance of payments of commodity-importers like Turkey and China.

More important, the exports of emerging market countries are not limited to commodities. Rather, they represent a diversified array of both raw materials and finished goods. The bar graph following shows the share of exports by broad product category for each of the countries included in the GBI-EM Global Diversified, which (remember) includes only countries with local currency markets and thus a healthy mix of commodity importers and exporters. As the center bar indicates, manufactured goods represent, on average, two-thirds of the exports of emerging market countries issuing local currency debt. And commodities actually represent only a third of total exports from these same countries. Clearly, the popular notion that all emerging economies rise and fall in line with commodity prices is a bit overdone, or at least outdated.

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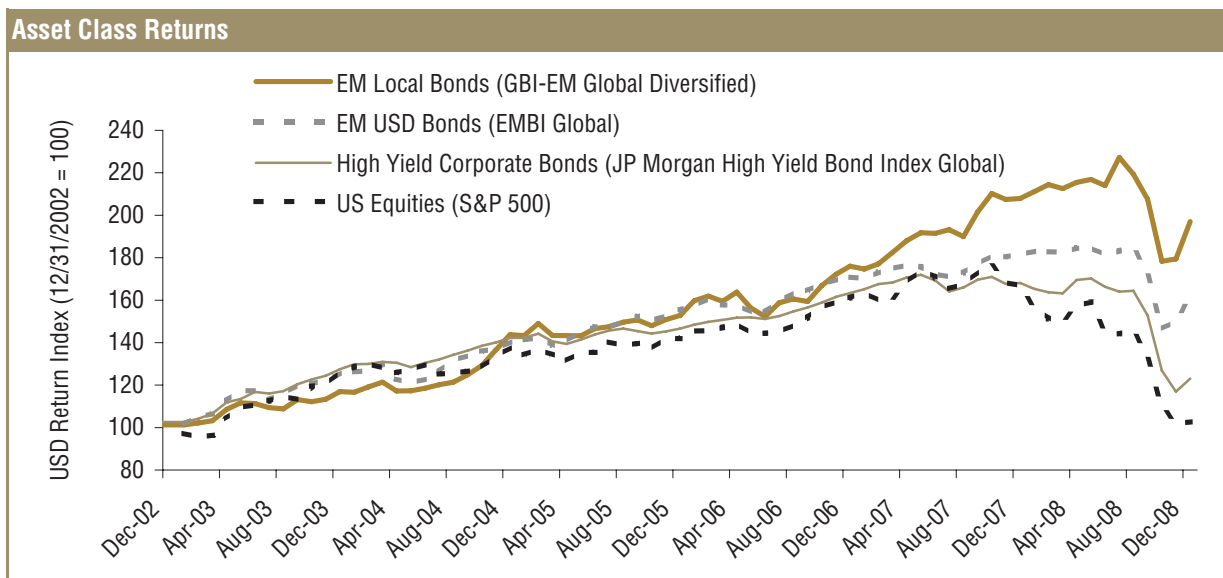


Source: Standish, World Trade Organization, as of 2008

QUESTION 5:

Why has EMLCD held up relatively well through the latest global financial crisis?

EMLCD has been the last “domino” to fall as the credit crisis spread outside the United States, morphed into a crisis of financial intermediaries, and raised serious obstacles to global economic growth. The reason for the relative resilience of EMLCD is the same as the reason for expecting the asset class to perform well going forward. Very simply, emerging market countries are in a much better shape today than they were a decade ago, at the time of the last severe capital markets crisis; and they are also in much better shape today than most developed economies. There are exceptions, of course: Korea with its aggressive build-up of corporate liabilities, or Argentina with its rapidly deteriorating institutional environment. But these outliers do not negate the general improvement in emerging sovereign fundamentals, policy, and transparency.



Source: Bloomberg, Standish, as of December 2008

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For example, the depreciation of the Brazilian Real, instead of posing a lethal threat to debt sustainability as it did in the mid-1980s, actually reduces the country's net public debt to GDP ratio (Brazil's public sector is a net external creditor). Likewise, while there are reasons to be concerned about the effect of lower oil prices on Mexico's finances, the country's balance sheet is in a much better shape today than it has been in a long while. In Asia, Malaysia's competitiveness will enable it to continue generating an impressive trade surplus, even as the developed economies plunge into synchronized recession.

The present situation stands in stark contrast to the "Asian Crisis" of just a decade ago, when most emerging market countries still ran substantial current account deficits financed by heavy external borrowing. Ironically, it was this collapse in global risk appetite and closure of the capital markets to emerging economies that laid the foundation for their resilience today. Subsequent currency devaluations and adjustments to current accounts constituted a kind of cleansing that prepared the way for today's better health. Today, the average rating of countries in the GBI-EM is solidly investment grade. Almost across the board, debt ratios are lower and foreign exchange reserves are significantly higher.

QUESTION 6:

What about the liquidity of EMLCD? How tradable are these bonds?

With a few exceptions, emerging market local currency bonds are a very liquid asset class. According to EMTA (Trade Association for the Emerging Markets), local-currency-denominated bonds accounted for more than two-thirds of total reported emerging market debt trading in 2008. Bid-ask spreads, a generally accepted measure of market liquidity, are tighter for most emerging market sovereigns than for US investment-grade corporate bonds.

To be sure, the latest global financial crisis has worsened liquidity for all asset classes. Yet EMLCD remains uniquely supported by the structural bid from local investors – pension plans and banks located in emerging market countries themselves. For example, JP Morgan estimates that in Chile, Colombia, Mexico, and Peru alone, net inflows to pension funds during 2009 will amount to USD 11.6 billion, or 5.5% of the total stock of local debt in these four countries. Importantly, only a small portion of EMLCD is owned by foreign investors. According to Emerging Portfolio Research, assets under management in local currency bond mutual funds currently represent less than 10% of the total market capitalization of EMLCD.

QUESTION 7:

How is EMLCD affected by changes in the value of the USD against other major currencies?

From the perspective of a USD-based investor, EMLCD tends to benefit from a weakening US dollar. There are both direct and indirect reasons for this. Directly, EMLCD returns in USD terms are boosted when the USD weakens against the Euro; this is due to the increase in the USD value of East European currencies, which trade primarily against the Euro. For example, assuming no change in the Polish zloty/Euro rate, the Polish zloty would strengthen against the USD when the USD depreciates against the Euro. The indirect reasons stem mostly from the fact that the majority of emerging market currencies trade primarily against the USD. The weakness of the USD against other major currencies allows most emerging market currencies to strengthen against the USD without sacrificing competitiveness. This is because the United States is not the major trading partner for most emerging market economies. For example, Brazil trades as much with the European Union as it does with the United States. By implication, then, if the USD weakens against the Euro, the Brazilian Real has at least the potential to strengthen against the USD without detracting from its competitiveness in trade-weighted terms.

By contrast, from the perspective of a Euro-based or Yen-based investor, USD weakness tends to dampen EMLCD returns. As noted, most emerging market currencies trade against the USD. Hence when emerging currencies appreciate against the USD, any contemporaneous depreciation of the USD against the Euro or Yen reduces EMLCD returns in Euro or Yen terms.

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QUESTION 8:

Will EMLCD underperform when “carry” strategies falter?

The “carry” strategy involves buying currencies with high yields and selling those with low yields. Since emerging market local yields are generally high, investing in EMLCD can be considered a kind of positive carry strategy. However, not all emerging market local currencies are high-yielding. While EMLCD clearly contains its fair share of high-carry currencies (e.g., the Turkish Lira, the South African Rand, the Brazilian Real, the Colombian Peso), the GBI-EM benchmarks also include sizeable allocations to currencies that are anything but high-carry (e.g., the Malaysian Ringgit, the Thai Baht, the Peruvian Nuevo Sol). These latter currencies tend to hold their own when carry strategies fall from favor, which happens typically during periods of rising global risk aversion. The downside protection afforded by these currencies is one reason for the relatively stronger performance of EMLCD during periods of high volatility.

QUESTION 9:

Why invest in EMLCD if one can buy emerging market equities?

The answer is simple: EMLCD offers exposure to emerging markets but without the risk of equities. The returns of EMLCD, derived from currencies and local bond yields, are relatively independent of, and therefore do not exhibit high correlations with, the returns of global equity markets. Even including the October 2008 spike in correlation of returns among virtually all asset classes, EMLCD still exhibits a long-term correlation of only approximately 0.6 with the S&P 500. Emerging market equities, by contrast, exhibit understandably higher correlations with the returns of US and global equities. As a result, EMLCD offers significant diversification benefits over emerging market equities, especially for portfolios that already have large stock allocations.

QUESTION 10:

What is the appropriate benchmark for EMLCD?

For emerging market local currency bonds, JP Morgan maintains the GBI-EM family of benchmarks, which are actually a series of six different indices, all generally widely accepted. We prefer the three so-called “Diversified” versions, which cap the weights of the largest countries at 10%. Among these three, however, the choice is less clear, as it involves a trade-off between breadth and replicability – as suggested in the table below.

		Breadth		
		14 Countries 163 Instruments	15 Countries 202 Instruments	19 Countries 269 Instruments
10% Country Constraint	No	GBI-EM	GBI-EM Global	GBI-EM Broad
	Yes	GBI-EM Diversified	GBI-EM Global Diversified	GBI-EM Broad Diversified

Source: Standish, JP Morgan, as of December 2008

The GBI-EM Diversified (lower left box above) is fully replicable from a portfolio management standpoint but contains somewhat fewer countries and securities than the other two versions. The GBI-EM Global Diversified, with 15 countries and 202 instruments, is a broader index but includes bonds subject to local taxation. The GBI-EM Broad Diversified is the broadest of the three indices but also the least investable,

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as it includes countries with regulatory restrictions on foreign purchases of local bonds. The GBI-EM Global Diversified – the middle of the three above – represents perhaps the best compromise between breadth and replicability. Standish, of course, can manage EMLCD portfolios against any GBI-EM benchmark of the client’s choosing.

Note: It is important to distinguish these six newer GBI-EM benchmarks both from the older JP Morgan EMBI, which represents only USD-denominated debt, and, equally important, from the JP Morgan ELMI+³. The latter consists exclusively of emerging market currency forwards (not local currency-denominated bonds) and thus offers no duration exposure.

QUESTION 11:

How does Standish manage EMLCD?

Standish has an experienced team dedicated to the management of portfolios invested in emerging market local currency debt. Our investment process is largely top-down, fundamental in nature, but also supported by the discipline of quantitative models. It is geared toward overweighting countries experiencing deep positive fundamental changes, and toward underweighting or avoiding outright those countries whose currencies and bonds are supported primarily by short-term capital flows, which may reverse quickly in the future. Finally, we strive to maintain well-diversified portfolios of local currency bonds, consistent with our diversified index benchmarks.

Country selection constitutes the most important source of alpha in our investment process. Overall, our goal is to identify shifts in country fundamentals a few months before they are priced in by the market. For each country, we consider separately the risk-adjusted attractiveness of currency and duration returns, in the manner suggested by the diagram below.

Two Decisions per Country		Risk/Return Analysis		Basis for Forecast
Two Components of Total Returns:	Investment Question:	Market Input:	Proprietary Input:	Factors Analyzed:
Currency	Is there value in the currency forward?	Carry	Currency spot forecast	Balance of payments, sovereign risk, Central Bank FX policy, global environment, market technicals
Duration	Is there value in the currency-hedged bond?	Term Premium	Bond yield forecast	Inflation expectations, monetary policy, sovereign risk, market technicals, global environment

Source: Standish

The “currency” portion of the process determines whether there is value in the currency forward, while the “duration” portion assesses value in the currency-hedged bond. In those countries where we like the currency but not prospective duration returns, we invest in currency forwards. Conversely, in countries where we decide that we want duration but no currency exposure, we invest in local currency-denominated bonds while hedging the currency. In addition to bonds and currency forwards, we may decide to invest

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in inflation-linked bonds, where they are available and offer value. The choice between nominal bonds and currency forwards depends on our view of the attractiveness of duration returns. Similarly, the choice between nominal bonds and inflation-linked bonds depends on the assessment of breakeven rates relative to our long-term inflation forecasts.

We pride ourselves on rigorous risk management. Even the best risk system provides no fail-safe guarantee against underperformance, of course. But strong “overlapping” systems can help to ensure that neither we nor our investors are surprised by the magnitude or the source of any underperformance. Conceptually, we distinguish among three types of risk controls: (1) country limits (notional and beta-adjusted) and issuer constraints (e.g., limits on corporate exposures); (2) tracking error relative to the benchmark (200-300 bps); and (3) total portfolio risk using Value-at-Risk (VaR) methodology. With the exception of tracking error, which is calculated on a monthly basis, we monitor all other risk parameters daily.

QUESTION 12:

What is your outlook for EMLCD?

We have a positive long-term view on emerging market local currency debt. It is an asset class that represents some of the higher-rated countries in the emerging markets universe, offers two distinct sources of return (currency and local bond yields), and provides the potential to generate equity-like returns without taking on direct equity risk. Prospective returns from local bonds are supported both by their relatively high yields and by the potential for their currencies to appreciate. The diversification benefits of EMLCD are further enhanced by the steady bid for long-dated local fixed income instruments from rapidly growing pension plans domiciled in emerging market countries themselves, where they are also supported by favorable demographics. Pension plans in Europe, Asia, and the US now seem to have discovered the local currency asset class as well.

¹ *Government Bond Index-Emerging Markets (GBI-EM): The GBI-EM is JPMorgan’s registered name for the first comprehensive, global local emerging markets index, and consists of regularly traded, liquid fixed-rate, domestic currency government bonds to which international investors can gain exposure. Variations of the index are available to allow investors to select the most appropriate benchmark for their objectives.*

² *Emerging Markets Bond Index (EMBI): The EMBI benchmarks are JPMorgan’s registered name for the indices that track total returns for US-dollar-denominated debt instruments issued by emerging market sovereign and quasi-sovereign entities.*

³ *Emerging Local Markets Index Plus (ELMI+): The ELMI+ is the JPMorgan registered index that tracks total returns for local-currency-denominated money market instruments in emerging markets.*

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