

The Case for Emerging Market Debt

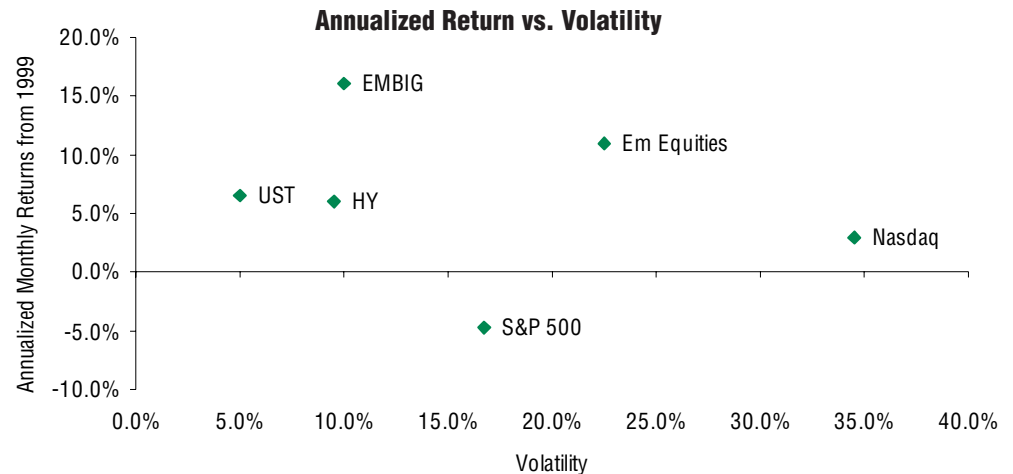
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Emerging Market Debt: A Growing Strategic Asset Class for Institutions

Over the past several years, emerging market debt has become firmly established as a strategic asset class — one that has been accepted by an increasingly wide circle of institutional investors. Over the past five years, the EMBIG Index has been the top performing asset class, on both an absolute and risk-adjusted basis, returning 16%, with a standard deviation of 10%. The growth of the market has been fueled by the convergence of several interrelated trends, which we highlight in this paper.

Exhibit 1

Over the Past 5 Years, EM Debt has Had the Best Risk-Adjusted Return



Source: Bloomberg; DB Global Markets Research

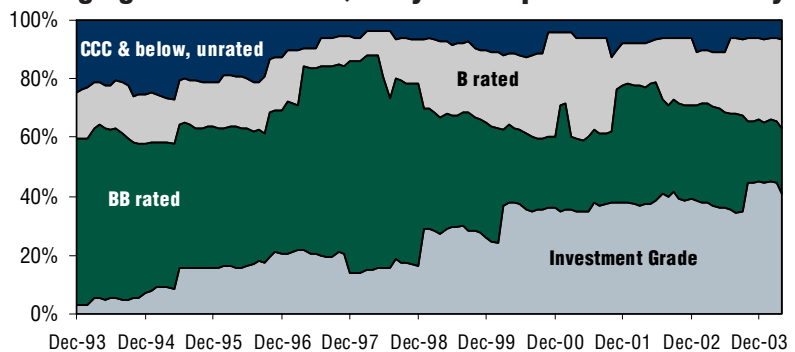
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Improving credit quality

Many emerging market nations, often with IMF support, have gradually improved their credit standing through the pursuit of economic and political reform, free market policies, greater accounting transparency, and floating exchange rate regimes. Since 1998, six of the largest emerging market nations have increased their foreign reserves by an average of 106%, according to a JP Morgan study. The upshot of these trends is that since the end of 1993, the investment grade portion of the EMBIG has increased from 3% to 41% (Exhibit 2).

Exhibit 2

Emerging Market Credit Quality Has Improved Dramatically



Source: JP Morgan

Author

John Peta, Portfolio Manager,
Emerging Markets Strategies

A broader market and investor base brings lower volatility

In recent years, dominance of the emerging market investor base has shifted from leveraged, “hot money” short-term players, such as hedge funds, to a broader class of institutional investors with a longer term investment horizon. And in the past 10 years, the number of countries in the EMBI has grown to 31 from 15. As a result, volatility in the market has subsided significantly, especially the spikes that occur from negative events in one country — the so called emerging markets “contagion.” The comparison in Exhibit 3 between the major pick up in volatility during the Russian default of 1998 and Argentina’s default of 2001, which caused a small bump, illustrates this.

Exhibit 3

Emerging Market Volatility Has Subsided Markedly Six-month volatility of EMBIGD, daily returns

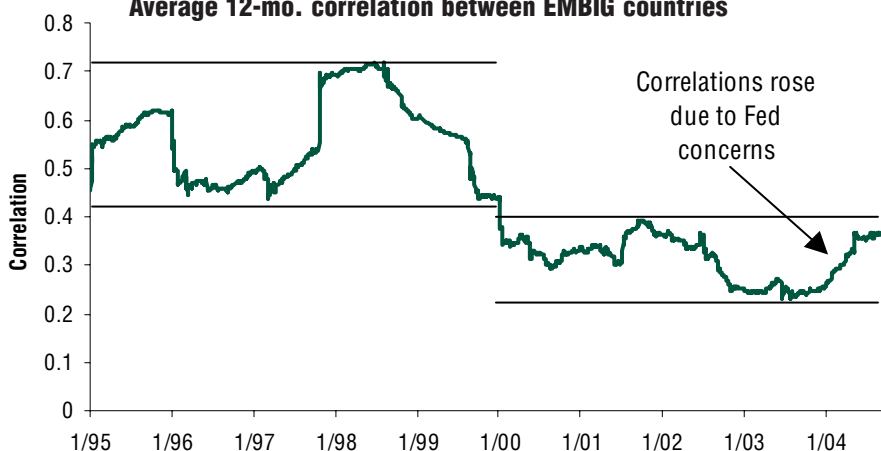


Source: JP Morgan

The reduction in volatility is a telling sign of the market’s maturity. The broader investor base and greater number of countries have led to more discriminating analysis — countries are increasingly evaluated on their own strengths and weaknesses rather than as one asset class. Exhibit 4 illustrates this phenomenon, with the decline in correlations among emerging market countries over the past ten years.

Exhibit 4

Correlations Have Fallen Among Emerging Market Countries: Average 12-mo. correlation between EMBIG countries



Source: JP Morgan

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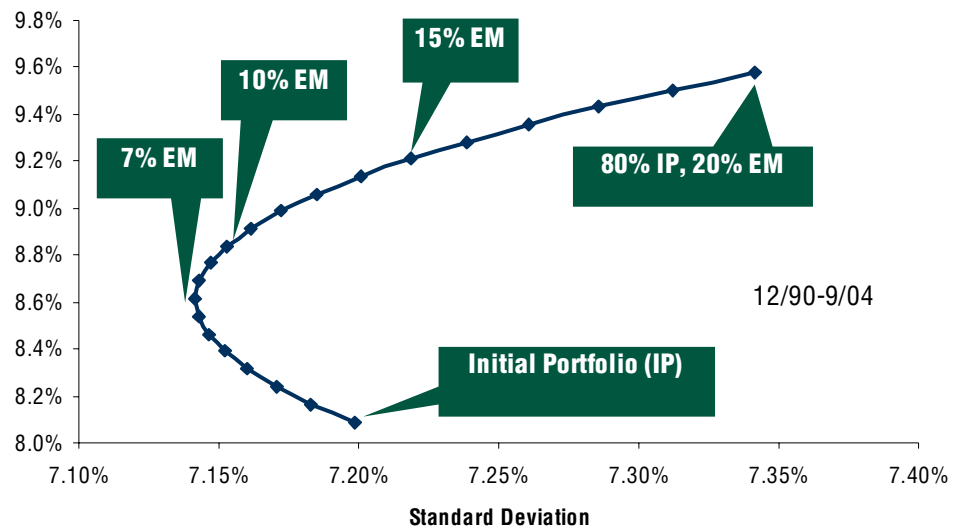
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Multi-level diversification

While emerging market economies have made great strides toward convergence with developed nations, their economic cycles are still sufficiently distinct to generate low return correlations with other asset classes. Correlations range from 19% with U.S. Treasuries to 50% with the S&P 500. Exhibit 5 shows the risk/reward benefits of adding emerging markets to a typical global portfolio (in this instance, with a European bias).

Exhibit 5

Adding EM Debt Can Add Return, Reduce Risk in a Global Portfolio



Global Balanced Portfolio: 40% Equities / 60% Fixed with European bias	
Weight	
Europe Eq	20%
US Eq	12%
Pacific Eq	8%
Global Agg Fixed	40%
European Govts	20%

Source: JP Morgan

In addition, because emerging markets represent sovereign, rather than corporate, exposure they provide diversification from corporate risk. This is welcomed by many institutions who seek additional sources of alpha without increasing their allocation to the corporate sector. Sovereigns, of course, need to be carefully analyzed, and contain their own, unique risks, but they have some inherent advantages over corporations. Unlike companies, countries don't disappear or get absorbed by their competition, and over time emerging markets have offered a better upgrade/downgrade ratio than corporate bonds. Additionally, emerging markets permit international diversification, without taking on foreign currency risk — most issues are dollar denominated.

The road ahead

Because of the positive secular trends we have highlighted, spreads on emerging market bonds have contracted in recent years, resulting in returns that have significantly outpaced other asset classes. Clearly, one can't extrapolate the past five years out over the next. Standish Mellon believes, however, that emerging market debt still offers value as a newly established asset class in which credit quality and investor acceptance continue to grow, while volatility is diminishing. Additionally, in a modest allocation, the countercyclical nature of the emerging debt has tended to reduce overall portfolio volatility.

Emerging market debt still frequently yields more than comparably rated U.S. corporate credit. For example, numerous issues, such as the Brazil, Columbia, Poland and Mexico often trade at attractive levels over their U.S. counterparts. Exhibit 6 shows the historical spread of Mexican debt versus U.S. BBB debt over the past two years.

Exhibit 6: Mexican Debt Yields Vs. U.S. BBB Debt



Source: DB Global Markets Research

The bottom line

The market for emerging market debt has matured considerably in the past five years, having made significant strides in liquidity, credit quality, transparency and reduced volatility. At the same time, the traditional appeal of the sector remains intact, through the benefits of diversification and attractive valuations versus the corporate sector. Standish Mellon believes that emerging market debt deserves consideration by all sophisticated investors as a strategic allocation in globally balanced portfolios.



John L. Peta, CFA

John is a Portfolio Manager for Emerging Market Strategies, overseeing the entire emerging market investment process. He also serves as the emerging market sector strategist. In that role, John recommends emerging market exposures for the domestic, international and world high yield products. He joined the company in 1997 from Chancellor-LGT Asset Management. He also worked at the Frank Russell Company and Merrill Lynch Capital Markets. John has an M.B.A. from the University of Washington and a B.S. from South Dakota State University.

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Boston ■ Pittsburgh ■ San Francisco

One Boston Place, Boston MA 02108
617.248.6000 www.standishmellon.com

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