Jeff Grills

Episode 198: A Deep Dive into EMD with Aegon AM's Jeff Grills

GUEST Q & A

Stewart: Welcome to another edition of the InsuranceAUM.com podcast. My name's Stewart Foley. I'll be your host. Today's topic is emerging markets debt, and we're joined by Jeff Grills, CFA, head of US cross markets and emerging markets debt at Aegon Asset Management. Jeff, thanks for taking the time. It's great to have you on.

Jeff: My pleasure. It's great to be here.

Stewart: You've been infected with the EMD bug for many, many moons, and I'm looking forward to learning and getting your take on this asset class. But before we do, where did you grow up? What was your first job? Not the fancy one. And then, what makes insurance asset management so cool?

Jeff: Well, thank you again for having me today. I grew up in New Canaan, Connecticut, which is a suburb about 50 minutes outside of New York City. The first job that I had that, aside from being sports director or sports management type things, was being a painter. My freshman year after college was painting. I learned even then how to do some management as I was promoted to a team leader. So that got the roots, but the real official first job was at JP Morgan Asset Management about just over 30 years ago.

Stewart: Wow. And what about insurance asset management? At Aegon you're neck deep in the insurance side of asset management. What do you think's interesting about that?

Jeff: Well, I think you'll hear about this when I talk about emerging markets debt, but I think one of the best things is the ability to have very long-term views, which is getting harder and harder to do in today's asset classes with fund flows and Morningstar, and all the rating agencies or the rankings, people want to see your performance on a quarterly basis. I think insurance is exciting to me because I've managed insurance assets before, prior to joining Aegon. But for the last four years, I feel that you really can take the longer-term view and find the right type of investments that are suitable for insurance portfolios.

Stewart: It's definitely a unique perspective that insurers have. Jeff, as I think about our listener base, for those who are less experienced in this asset class in particular, can you roll back the clock a bit on EMD for insurers over the past couple of decades, and specifically, what periods were the strategy most attractive and why?

Jeff: From an attractiveness standpoint, and I think about this with regard to an insurance investor, I think it really was the 2000s that started the appropriate period for insurance companies to be invested. That was a period that saw most of these issuers coming out of what was a defaulted period really. The 1980s and early 1990s were high levels of default.

So you had a period that showed high yields, which is similar to what we have today, and we'll talk about that later. You had a massive commodity boom that started in the 2000, and went through much of that decade and continued on really into the last decade, and you had a maturation of the asset class. So, one of the big things is just looking at sovereigns, in the mid 1990s, there were 18 different sovereigns that you could invest in. By the 2000s, it was 30. Today, it's 76 alone. So I think just the growth of the asset class creates the great opportunity, but when you get to high levels of yields, yields tend to dictate the return that you're going to get, and so we're close today with the types of yields that we're seeing. Those are the types of periods that I think we should be looking out for.

I do think that the other thing to highlight, just what's different over the last 15 years, is the transparency. So again, if you go back to just prior to my starting to managing emerging market assets, which I started managing assets in '97-'98, but you go back to the Mexican peso crisis in 1994, they reported their international reserves twice a year. They defaulted in December of 1994. The reason that happened is that everybody started to figure out that they had run out of reserves. The last report was from June. Today, you get central bank reserves on a weekly/daily basis.

So, to me, there's been just a broad evolution, which I can spend tons of time on and we can dig into if you want to. But that's the other things that have just changed for the listeners out there, is EMD is not the same asset class it was 20 years ago, much less 10 years ago.

Stewart: And just reflecting on insurance companies in particular, what can you talk about with regard to the quality profile yield versus total return NAIC RBC considerations, things like that?

Jeff: Well, I think one of the big things, I talked about the maturation of the asset class. I think it's important to note that just credit quality alone is the big thing that has changed over the last 30 years. If you go back to when I first started in this industry, almost 100% of EM issuers were BB, or below, rated. They were considered high yield issuers.

Today, that stat has changed quite a bit. In fact, 58% of the emerging market sovereign index is investment grade. It got as high as close to 70%, so there's a big opportunity for insurance companies to own emerging markets, which offers a higher yield or spread, generally, than many of the other alternatives, but at ratings that aren't necessarily punitive to an insurance company from a credit quality standpoint. So necessarily having to have the right types of reserves or the NAIC types of considerations that we used to have.

The other part is that, generally speaking, although we're not quite there today, EM tends to have a premium to most of the other developed market options. So you tend to get this spread pickup because there's this perception, that I think still exists, that EM is going to be ruled by dictators, and there's going to be lots of coups, and there's going to be lots of risk. Some of that is true. There are some parts of our market that do have problems. You've seen coups that have been proliferating Africa, but that doesn't mean there's not great opportunities. As long as they're priced appropriately and an insurance investor has the timeframe to make sure that they can underwrite that view for the time needed to see it play out, you can see a lot of fundamental improvement in EM asset class.

So I think that's the big starting point for an insurance company to think about, is that it offers an increase in yield and now offers an increase in return and, to a certain extent, some diversification, just with the better credit quality.[1]
Stewart: Jeff, that's great. So my attention focuses right now on central banks. There's been a lot going on with the Fed and other central banks. How does central bank activity impact emerging market debt? Is it a different set of facts? Is it the same set of facts? Can you help me through the central bank issue for EMD?

Jeff: It's a great question. I think central bank policy has been one of the big changes over the last 20-plus years that I've been doing emerging markets. Central banks used to run very procyclical policies. So when their currencies underperformed, they needed to hike rates in order to keep outflows from going. That's really changed as the fundamentals have improved for these issuers and for these countries.

We saw this as most recent as COVID. They were able to ease their policy to really stimulate growth. Aside from Central Bank, even just on the government side, we saw them issue.. run very large fiscal deficits and support their economies. Interestingly, central banks in emerging markets were first to start raising their rates ahead of what we saw in the US and in other developed markets, so they actually took a page out of the US playbook and responded more proactively. In countries like Brazil, for example, they were hiking in late 2021, early '22, and that's created a great virtuous cycle for countries like Brazil and Latin America. I think it's a testament to just how mature these asset classes have gotten.

One last, point I mentioned on the corporates. One of the big themes that we've seen for the last three years is that because these governments have been able to be very proactive and very quick to stimulate their economies, corporates were the big beneficiaries. One of the big reasons why these corporates were able to delever the numbers that I talked about is that they didn't have to go to markets because their economies didn't collapse; they didn't have this massive impact. So again, a great testament to the improvement of the asset class over the last two decades.

Stewart: That's great. So let's jump forward to today. A lot has happened in the rate environment over the last two years. There's been significant outflows in EMD. What does EMD look like for the next year and should insurers be having their eye on it?

Jeff: Well, I think they should. One of the challenges I think that all investors are going to have in fixed income is that all asset classes have seen a rise in yield. So where EM is close to 8%, high yield is above 8%, asset backs are at historical high[2]. So from a relative value standpoint, the one struggle that you have in EM is the spread differential is near the tighter end of the range that you've seen over the last 20 to 30 years. Some of that's justified, but that's going to create some challenges where you can likely get into either double A, single A, or triple B type of assets that are near the similar type of levels that you get in emerging markets.

So in 2024, it would be nice to see that relationship widen to really love emerging markets at these types of yields. Stewart: It's interesting though because I mean you've highlighted how the market has evolved and it's not surprising that some of that historical premium might come off a little bit, right? It stands to reason, to me at least, that that's not completely unreasonable.

Jeff: No, it's not. It's funny, maybe this is where my gray hairs date me a little bit. I think one of the biggest challenge-

Stewart: I feel you, man. Believe me, I feel you.

Jeff: One of the big challenges is that we really haven't seen these types of yields for 15 years. So you had a brief period in the GFC, the great financial crisis, where yields got above almost up to 10%, but you really have to go back to 2004 to see where the asset class offered you something similar to what we're seeing today.

And so my view is today, we're having a little bit of that adjustment issue. Many of the investors that have been around for 10-plus years or in haven't seen rates at these types of levels. They haven't seen yields at these types of levels, so they've been willing to buy and allocate and want to capture that high level of coupon and yield. I think that's where we're having this adjustment period.

So in 2024, what I'm hoping for is something that allows a little bit of the risk premium to go up, moreso for low-rated triple B minus, but double B type of issuers where you're seeing some tightness that probably is not going to be as well-earned out over the period. I think you almost have this really good strategy where the very high-rated issuers continue to dominate and have the fundamentals to support those valuations, and it's where the flows are going. Somewhat on the BBBs, you have to be more selective when you get down into the high yield segment, in my opinion.

Stewart: That's really helpful. We're here to learn, but we're not here to give away the secret sauce. So without giving away the secret sauce of your EMD strategy at Aegon Asset Management, what elements are important for insurers when considering adding or augmenting to an allocation to EMD?

Jeff: So I think there's a couple of things to answer in that. One is just the selection of the index. When people think about emerging markets, they typically look at the JP Morgan emerging markets global or global diversified, which is the entire market cap universe. The good news in that is that, as I mentioned before, almost 60% of the index is investment grade today, but when you get to the high yield segment, 25% of that index is single B or below. And so you have this phenomenon of what I call, and many people are calling, the have versus the have-nots.

In the last couple of years. Those low-rated credits can't run the types of fiscal deficits that their fundamentally more sound credits can do. They can't get access to capital markets, so I think you have a challenge for insurers when they think about that. One of the ones that we do, again, without giving away the secret sauce, is we do tend to bias us towards more high quality investors, so we're anywhere from 70% to 80% in investment grade rated issuers. That's different than the index. We still selectively will find the high yield issuers, but I think you do need to have a thought about just what is the index.

The second part then is you need to think about what is the overall ability for a credit to maintain its credit quality and, ultimately, service its debt. It's one of the two big things that have gotten emerging markets in trouble is ability to pay and willingness to pay. Willingness to pay has gotten much better. I think most of these countries want to stay engaged in the capital markets. It's that ability to pay. And when you start getting down to single B or below, that ability to pay, you have to be very, very specific and selective about what type of an investment you're going to put into those credits.

Stewart: That's really helpful. In response to my first question, you mentioned some interesting things. Historically, regarding the asset class, and you gave us a great backdrop there, but I want to book in that just a little bit. What is new or impactful that you find exciting about EMD right now?

Jeff: Well, one of the things that's definitely new and impactful is just the expansion of the asset class. As I mentioned, 20 years ago it was a sovereign-only asset class. Today, you have local, which isn't used as much by insurance companies, but you also have the expansion of corporates.

When you look at EMD managers out there today, blend is a concept that's been around now for about 10 years, but it really highlights what the opportunity set is in emerging markets: the ability to asset allocate just within emerging markets. It used to be that you either were in emerging markets or out relative to some of your other investment choices. Today, you have the option to think, "Do I want sovereign, do I want corporate? Do I want along the rating spectrum?" So I think that's a big difference.

Just to highlight an example on the corporates, again, 20 years ago in the mid-2000 there were under 100 corporate issuers, really closer to 50, that were liquid. Today, we have over 800, so that means you do have to do your credit work, but it creates just a great opportunity. And so for insurance companies where you can be selective and find the right types of opportunities, I think that's a big example.

Continuing along on corporates, corporates have also, as I mentioned, you have this premium pickup that you can get. So one of the big terms that you'll hear and that we use is the concept of how much spread per turn of leverage can you get. It's very pronounced in the A-rated. If you take that for an example, in corporates, the average EM corporate has a leverage ratio of about 0.3 to 0.5 times levered, which is very, very low levered. That compares to US corporates, and this is data from Bank of America Merrill Lynch, of around 1.7. When you look at the spread per turn of leverage that you get, that's almost four-and-a-half times you'll pick up because you're getting close to almost 300 basis points quote-unquote "spread per turn of leverage" you're dividing by a number of lower than 1.0. So keep in mind you're not getting that absolute spread, but it's a big pickup. You see it also in double B. Double B, it's almost double the amount of spread per turn of leverage you're getting in BB-rated corporates relative in EM relative to us.

The other part is you get duration, right? If you get back to sovereigns, they are able to issue long-term debt. A number of these issuers have actually issued a 100-year debt. Mexico was one of the first ones. Back around 2010, they issued a bond out to 2110. You even had a country like Argentina issue a 100-year bond after they've been one of the prolific defaulters, so that one didn't work out too well. That one defaulted 3 years later, so you do have to be selective. You do have to know your issuers. But at least when it comes to an insurance account where you're thinking about, "How do I lock in yields?" duration is an option. Corporates, typically, are shorter duration, but again, I think they offer that yield premium pickup that is very exciting and an opportunity for insurance investors.

Stewart: I really like this concept of yield spread per turn of leverage. That's interesting. That's really good, you're not just looking at the spread per letter rating so much as getting a little bit more detailed and a little bit more granular, which appeals to my spreadsheet geeky self - loves that metric. But let's talk about the elephant in the room, which is country selection. With so much going on around Russia, Ukraine, Israel, Gaza, China, Taiwan, and others for that matter, how should insurance companies think about this so they can still sleep well at night and still have an EMD exposure?

Jeff: Well, the good news is that when you look at those risks that you highlighted, things like war or coup or the rule of law, they've all improved. With the exception of the Russia invasion in Ukraine, which created a very negative cycle for both Russia and Ukraine, skirmishes tend not to be quite as pronounced. And so even things like war don't have a long-term dramatic impact.

What you've seen here in the last two months, the conflict that's going on in Israel, really, it hasn't escalated to some of people's concerns. But I think getting back to what makes people be able to sleep at night is the market has been able to differentiate very well between what's going on in a specific country and what it's doing to the asset class.

When you had the Mexican peso crisis, which I mentioned before, back in 1994, Mexico came under severe pressure. The entire asset class sold off. In 1998, when Russia defaulted, the entire asset class got hit. Same for Brazil in '99; Argentina in 2001. Since that time, the market has gotten fortunately very good at differentiating to, what are the actual impacts? So take the Middle East example. Okay, maybe it would have some impact on oil. Maybe it has some impact on trade through that region, but you didn't see a reaction much in the region and definitely didn't see it outside of that. So I think what does allow people to sleep at night is that you're going to value these things based on their merits. Now, the one negative to that is when those big shocks did happen back in the 1990s and 2000s, it created a great buying opportunity because the market missed that. There shouldn't be a correlation between something going on in Asia and having it affect Latin American issuers, so that's a big difference.

In terms of the types of conflicts, I do think that's where you get into some of the ESG type of concerns. It's funny people talk about. "How do you incorporate ESG into your analysis?" We've always incorporated the ESG into emerging market, and I think that's true across the sector, but the G, governance, is a big one. So understanding who you're dealing with, both on the sovereign and corporate side, their willingness to pay and what's the stability of that, I think that's paramount to understanding and getting to a point where there aren't many dictatorships. There are dictatorship-like regimes, but most of them are really democratically elected. We tend not to go into investments in pure dictatorships. Again, there's not many left, but most of them don't have market access. War and conflict, it's there, but you definitely have to understand what is the risk and where are things priced.

Stewart: That's really helpful. So, as we wrap, Jeff, what are the key takeaways from today's podcast that you want our listeners to leave with?

Jeff: I actually have three things, if you don't mind. One is that emerging markets continues to grow. It passed 50% of the world population in the last decade. It now accounts for more than 50% of GDP when you take it collectively, so EM is only going to continue to grow over the next 50 years. Take Nigeria alone. Nigeria's forecasted to be the highest percentage population growth (percentage, not outright population growth) in the world over the next 30 to 50 years, and that's going to create opportunities. You're continuing to see the number of issuers increase and you're seeing the number of opportunities increase. So I think that's one where my opinion is it's still under invested relative to those types of figures, just because of the slightly more complicated aspect of having to understand what goes on in countries around the world than maybe just having to understand your US.

The other thing that's very interesting is you're also seeing a lot more focus and awareness by these issuers of things like the social and sustainability, and other types of frameworks that are coming in. And so you're seeing a lot more in the social issuance. One of the things that's really interesting on the insurance side is these insurance-backed blue bonds. We saw Ecuador issue a blue bond earlier this year. Gabon issued one back in August and actually had a coup a month later and that bond has continued to price very stably. It's a triple-A-rated bond, came at 200 over and has insurance from the DFC, which is a US agency. So there are also offshoots of EM that are very interesting that allow these issuers to get issuance, but insurance companies to take advantage of protections that can get them invested in EM.

Stewart: I want to show my ignorance here. What is a blue bond and why is it called a blue bond?

Jeff: A blue bond typically is about water preservation. So in Ecuador it was around the Galapagos Islands. A certain percentage of the proceeds would go to continue to support the conservation and protections that are around the Galapagos Islands. They do also use it for part of their funding needs and refinancing needs. Gabon, very similarly, with their proximity with ocean.

So again, it achieves the multifaceted aspect of helping to improve the world, which is something that's very important. EM is going to be at the epicenter, in my opinion, of where we need to see things like carbon improvement and social improvement just given the growth that we have there. And so, these are great opportunities and again, they have very strong protections and are very highly rated issues that trade very wide relative to other similarly rated issues.

Stewart: That is fantastic. I've learned a great deal on this from you and I really appreciate you being on. We've got a couple of fun ones out the door. You can answer either of these. Well, you can answer neither of these. That's one option. You can answer either or both. Lots of our guests choose both, no pressure. First one is what is some advice that you've gotten that you'd like to share? And the second one is, who'd you most like to have lunch with alive or dead?

Jeff: Well, I got to tell you the number one rule of advice is that if you get advice by multiple people generally means it's right. So the one thing to take into consideration is you can hear opinions and advice, but when you hear it multiple times from multiple people, you need to respect that.

The other one, too, and this one gets back a little bit to EM, is the concept that you own your portfolio every day. I was taught that very early in my career, which is, "Don't look backwards into where you got in." There are people who get in at a certain price or a certain yield and they think if they want to change their mind, they need to get back to that price or back to that entry level. That was one of the biggest pieces of advice that I think has worked for me, in general, but also for emerging market investing. If the facts change, if the information changes, you need to change with it. So just because you bought it doesn't mean you shouldn't get out. And so I've saved myself, fortunately, a number of times and, hopefully, as I get older and more experienced and continue to get more experience in this, you learn from those lessons. And so if you have a decision to get out or to get in, get in or get out. You own your portfolio every day.

Stewart: I love that. Do you want to tackle a lunch question? Who do you want to most have lunch with alive or dead? Or you can pass.

Jeff: I'm a big Beatles fan. I would love to have lunch with John Lennon. I think that'd be really cool.

Stewart: That's so cool. You're the second person who named John Lennon. That's really interesting. I agree with you. That's a great call.

Jeff: Maybe it's partly watching the movie yesterday where he gets to go visit the John Lennon who survived in his tangential reality, if you've ever saw that movie. They were amazing at what they could do in a very short period of time.

Stewart: So true.

Jeff: I figure he's one of the more recent geniuses we've had, similar to some of the other music geniuses in the history.

Stewart: That's fantastic. I really appreciate you being on. We've been joined today by Jeff Grill, CFA, head of us cross markets and emerging markets debt at Aegon Asset Management. Jeff, thanks for being on. Thanks for taking the time and thanks for a great education.

Jeff: Great. Thank you very much.

Stewart: My pleasure and thanks for listening. Please rate us, like us, and review us on Apple Podcast, Spotify, or wherever you listen to your favorite shows. My name's Stewart Foley and this is the InsuranceAUM.com podcast.

[1] Please see disclosures for additional important information.
[2] Based on the Bloomberg US High Yield Corporate Index, JPMorgan EMBI Global Diversified, and the ABS component of the Bloomberg US Aggregate Index as of December 2023. Data is provided for illustrative purposes only. Indices do not reflect the performance of an actual investment. It is not possible to invest directly in an index, which also does not take into account trading commissions and costs.

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