Elisabeth Colleran

Episode 213: Fact vs. Fiction? Tackling the Tough Questions about EM Corporates for Insurers

GUEST Q & A

Stewart: Welcome to another edition of the InsuranceAUM.com podcast.

Elisabeth: I think emerging markets, believe it or not, are somewhat in a sweet spot right now. Technology itself, it's alive and it changes and it changes to meet our needs. It's a great tool to demonstrate the value in the asset class. They see that there's enough opportunity to build the types of portfolios they want. The developed market at this point, when is the downturn coming?

Stewart: My name Stewart Foley. I'll be your host. Thanks for joining us. We've got a great podcast for you today. I want to give a huge shout-out to the insurance asset management community, the group that I always refer to as the world's smartest money. And I think you're going to hear more of that slogan here on our podcast as things go forward. So we are joined today by Elisabeth Colleran, portfolio manager for Emerging Market Debt Portfolios at Loomis Sayles. Elisabeth, you are a repeat guest. Thanks for being back on.

Elisabeth: Stewart, I'm so happy to be here. I had so much fun talking with you last summer. I think that was more about our technology and what we use for relative value, but it's great being here. I have to say you've had some great people in the EM space on that I've enjoyed listening to, also.

Stewart: Yeah, thank you. And I think it's a really interesting area. I was talking about you being a repeat guest. I don’t want to ask you the same rote questions. But I mean you and I share something in that we were both fixed income portfolio managers, and I guess my icebreaker question for you is what makes a good fixed income portfolio manager in your mind? Just kind of the high-level stuff and then we'll get straight into EM?

Elisabeth: That's a great question. In my view, it's really all about a real interest in what the big drivers are. So paying attention to what's going on, what may move markets, but you also have to have that combination, really what we call the bottom up, that then gets combined into the portfolio construction. Really, I love the portfolio construction piece because it's almost like a puzzle. How do you put it all together? So you have the bigger top-down views. You may be looking for a specific kind of risk-return. You have your bottom up, but then what are your sizes? What is your exposure to countries? A lot of this may be governed by your clients and their guidelines, but still you have that overall objective, to put it together in the right way.

Stewart: I think that's a great answer. I think there's a lot, a lot of fixed income people in the insurance space and we all speak a similar language and so forth. So I just thought it would be terrific given the depth of your experience to get your view on it. Just kind of an impromptu question. But the topic of the day is we're going to talk about emerging market debt. One of the things that happens when you're as old as I am is that you have outdated views of things, right?

Oftentimes I'm learning a lot about a particular asset class on these podcasts. And the goal of the podcast is to keep our audience so everybody knows. We're trying to educate here at the end of the day. I attend industry events and I hear questions, and I have my own questions. I want to suggest or make some observations that I think maybe they're dated, maybe they're not and you could help me through those.

The backdrop here is that when you look at US intermediate and long corporate spreads, they are essentially priced to perfection. So, I remember having a conversation the other day where long-term corporates are at their 5 percentile tights. Intermediates are at their 15 percentile tights and EM offers a significant incremental yield spread there. But I've always felt like there's a difference between 'cheap' and 'cheap for a reason' and I've always thought that EM was 'cheap for a reason'.

So that's the mindset of where I'm at. Can you talk a little bit about how you think about relative value in the intermediate and long corporate space versus EM just kind of generally?

Elisabeth: Yeah. I think in general to get into any particular part of the curve, we really need to step back and think about what we're talking about and what the opportunity set is. I mean it sounded like a very simple straightforward question, but I might have to answer it along several different prongs so I hope you don't mind if I sort of just go after that one.

Stewart: Not a bit.

Elisabeth: So first I would say, as you mentioned, you've been in this business a long time, I have too. I hate to admit how long, but my career has pretty much in the emerging market space has grown with the asset class. So I've had that luxury of when I first started out, it was a very small asset class. There was not a lot of diversification. I remember internal meetings we could almost go through every single credit that we held in 45 minutes because it was just so small.

But now, when you look at it and including 100% government-owned companies, you have this very large over $2.5 trillion universe. This is a big space. We have, I would say about 60 countries that we're looking at opportunity in. We use this 12 broadly defined industry segments. Although caveat there, the index provider that we use, JP Morgan is now because the index is more robust, offering us more sectors so we'll be transitioning there. And of course, the unique part of emerging market corporates that makes it a little bit even more challenging to compare to developed is that it's IG and high yield. So you have to remember that it does cover both.

But saying that, the asset class is on average investment grade and on top of that, this is something I think surprises people: 70% of issuers are in investment grade countries. So this is really not your old-fashioned 'EM should be comped to US high yield.' So I think that's important. In the space, as I've said it's grown a lot, we now have companies that we've watched a long time. They have developed significant track records. So this is something that when I was starting out, you didn't have. That was a lot of the work you had to do. And then the asset class, it's really evolved from these primary sectors that what we saw come out at the beginning, which is more like the financials, utilities, maybe some resource companies.

Now, we're getting some cool sectors like a few FinTech, we have some leisure, one or two healthcare companies, consumer discretionary has gotten a lot bigger. So there's a lot more opportunities to actually seek alpha, diversify, really look for these stories that we think represent the growth opportunity. I guess so to sum that up, we really look at the opportunity as offering high-quality carry and we think that's very important to insurance companies.

And when you back up even maybe one step before that, and you think that emerging markets now make up 40% of global output1. And that was only 20% at the turn of the century, when you think about it. And these countries are growing at two times the rate on an aggregate of developed markets. So that's really the backdrop of how we're thinking about looking at the relative value. This is really big.

As I said, I was going to be a little wordy because I think there's a couple of other things that are important to acknowledge. When you think of the comparative risks, I think it's important to step back and think about, is this the asset class that is always being bashed, I guess, I would say in the popular press? And the short answer to that is no. I mean generally, when you see a lot of Financial Times, Wall Street Journal, the articles that come out very frequently about EM, they're really talking about maybe the local currency, even the equity space in emerging markets, which can be quite volatile.

Oftentimes, they're also talking about the EM sovereigns, right? So that's a place that we know has really developed a large chunk of frontier countries in it, in addition to the core EMs. And that's something that has really maybe changed the flavor a little bit there. You have countries like Ghana, Sri Lanka and Pakistan that have all been somewhat distressed or actually are distressed.

And so a lot of the focus is really on that. When you look at the EM corporate space, the asset class holds up very well and really during periods of volatility you don't see the drawdown you have seen in these other asset classes. I guess we like to talk about... I mean a measure of a risk-return kind of, I guess measure, is really a Sharpe (ratio), right? So if you look at a Sharpe (ratio) and you see that EM corporates, they look good compared to both the EM sovereign and the developed market.

So if you split that IG and high yield - in the IG space, EM corporates have a Sharpe that is about 50% better than the sovereign IG space and 25% better than the US corp IG space. So you're really talking about this really nice risk-reward as a backdrop. And when you even look a little bit more specifically, what you find is that the corporates that are in emerging markets, they just have better metrics.

There's really a lower amount of net debt. And this is really from the DNA of these companies. They don't issue debt to pay dividends. They don't issue debt to buy back shares. Really, what we see in emerging markets is productive debt. It's to dig a mine, a port, put in telecom towers. So there's an investment that's going on. Once the investment is done, you often see these companies just paying back the debt.

It really is a mindset that we have seen in emerging markets. So when you add all those things together, the size, diversification, what we've seen from a risk-reward and then just the actual credit metrics that we see in the space, this is really a space that you can do the relative value and feel good about what you're getting the exposure to.

So when we look, you had asked a very specific question about relative value in the intermediate longer space. That is, of course, where we do get a lot of requests from our insurance clients and we have been looking at... It's not easy to give a direct answer because each client has a slightly different flavor of what they're looking for, but we are seeing an ability to pick up 30, 40, 50 basis points depending on what they're looking at for credit quality.

Stewart: That's really helpful. And so to get into the kind of fact versus fiction segment of the podcast, my kind of baseline view has always been that EM companies are riskier than their DM, otherwise known as developed markets, counterparts. Can you help me with just when you look at company to company risk?

Elisabeth: Yeah. So that's, I think, what I was pointing to when you look at the relative credit metrics. So what we really try to do is isolate to make sure that we're comparing like for like and we're not mixing up, as I mentioned before, the asset class can obscure what is going on just because it does mix high yield and investment grade. But when you do break it down by ratings category, you can see that there's just a much more conservative balance sheet for the most part with these corporates in the space.

So when you're looking at maybe a triple B in emerging markets versus a triple B in developed markets, you're really going to notice that there is just a different kind of set of metrics that you're looking at. And I think it's also interesting when you think about this view, and I just mentioned it a minute ago, but that emerging market corporates are sort of like the decision should be, is it US high yield or is it EM corporates? Even if you isolate it further down to the EM high yield corporate space, that's where you can compare defaults in the EM high yield corporate space to the developed market corporate space. And then you can see that over time, and it does vary. Some years you have higher EM defaults and some years you have higher developed market defaults. You'll see that in general, the difference is not that great.

For example, this year I think the expectation is for about a 4% default rate with EM high yield corporates and I think the US is around 3%. So this is not a huge difference from year to year, but in general, they are in line with each other.

Stewart: What would you say to the assertion that EM corporate credits are always held back by their country of origin? Could you help me with that?

Elisabeth: I think that's a really great question and it does sort of make sense when you think about it. So if you're in a country, you must be exposed to all the risks there. I think it's important to think about where we are in the sovereigns and how they have evolved over this period of time that we're talking about maybe these last 20 years.

I think investors, their view of the space, the sovereigns and then that leads into the corporates, really came about from maybe some very large crises that we saw in emerging markets in the 1990s, whether it was the Mexican peso crisis or the Russian financial crisis, the Asian crisis. And then, more recently I think we have the taper tantrum of 2013 memory.

So there were just these various crises where it seemed as though the emerging market policymakers, governments, they were caught off on the back foot and they were not able to get through some kind of liquidity issue that really set them into some kind of a spiral. But now when we look at it, it's really evolved, right? So I think this is even very evident in the most recent fed hiking cycle.

So when you look at, I don't know, a year ago when there was an expectation that, if you recall, that we were going to be having a developed market recession by the end of 2023 and then the fed was actually hiking rates until July, you would've thought that was going to be a perfect storm for EM, right? This has got to be a time when there will be capital flight and there will be a selloff in emerging markets. But what we saw was really a very good year. The asset classes did quite well. You saw the credit and even the local currency index did pretty well. So that was pretty surprising. So when you looked at it, you had to think, well, what was different? What has changed over this time that the standard playbook of a hiking cycle and weak developed market growth didn't send emerging markets into a panic?

I think it really comes down to the credibility that we have seen evolve in many of the EM, really the core emerging markets. What we saw relative to inflation, which was really quite impressive, was that the emerging market central banks, they have an institutional memory of high inflation and they moved fast. They didn't wait around to see if it was transitory, they just started hiking. I think Brazil might've been one of the first ones in the spring of 2021. And then we saw more hike that summer and then others into late that year. So really that led to attacking inflation, getting it under control. They hit inflation with a hammer. I mean, when you think Chile moved from a policy rate of 50 basis points to 11% in about 15 months, I mean that is quite impressive. So, that institutional memory really served them well. But I think also you can see more broadly in emerging markets, we've seen better policy frameworks, sizable increases in currency reserves, reduced reliance on I guess I'd say external funding and growing internal capital markets.

I think one thing that you're seeing now, there's some consternation right now that there's a strong dollar and emerging market currencies are selling off, but really it is this exchange rate flexibility that has done a lot to drive stability. So, we're looking at that as something that's been a positive relief mechanism in the space. So, I think the sovereigns are in much better shape than they were. But our job is really to then take the sovereigns and employ our research capabilities and we have a great team of credit and sovereign experts to really understand the sovereign opportunity, the areas of growth, the political backdrop, regulatory backdrop, and then the corporate experts that bring in the understanding of the sectors, the players in the space.

It's really a team that comes together to identify where we want to be. And the interesting thing is that oftentimes we see corporates that are stronger than the sovereigns. And so this idea of having a sovereign cap, which is very well known in the space that a company can't really be rated too much higher than the sovereign, especially if they're domestically focused. We're really able to look underneath that and look for well-run companies that even though they may be high yield, they're offering a premium when our work shows that this is a significantly stronger company than what the sovereign would imply.

So from a volatility angle, we see that in times of stress for a sovereign, companies that have put in place the right policies can actually show lower volatility. I think that is what has really evolved with this large opportunity set where the markets are looking to measure the correct spread for EM corporates is that it's not tied to the pickup, only this pickup to the sovereign.

So that's something that I think has changed. And if you recall, it was a while ago, last summer. We talked about this internal tool we have for valuation. And really the point of developing that tool was this fundamental belief that the team has that just the spread to the sovereign is not the only measure that you want to look at. Because of the complexity of this asset class and the growing diversification, it was more of a triangulation that we were looking at across countries, sectors, ratings, and these all became much more important. And really it was a reflection of how we think about it. So there is this disconnect to probably the volatility you see with the sovereign and what you can expect out of the corporate space.

Stewart: That's really helpful. So I've heard it said that insurance companies can't really capture the value in EM corporates because there's not enough incremental value for the headline risk. How do you respond to that?

Elisabeth: Yeah. I mean, I think that the value is there. I think we've been working with insurance companies for several years now and we find that each client comes to this work relationship with us with a set of constraints that fit the way they do business. We see guidelines on quality, duration, country limits. Some clients have ESG constraints. Oftentimes there is a reference benchmark, but also a view for relative pickup to developed market indices.

So they'll throw something in, but we also want to make sure we outperform this triple B index, so something else is added. And as you know, insurance companies are always making asset allocation decisions. So we need to be able to demonstrate that we are offering this pickup. It's what the client is looking for. So we frequently provide clients with updates on spread relationships between EM and DM at the index level. And we also are very careful to break it down by ratings band because we think sometimes that can also mask relative opportunity.

And to be honest, sometimes the pickup is more compelling than others. A good example was last year an interesting dynamic happened really in the EM corporate single A space relative to developed market single A space where you had the impact to the developed market single A's. They really widened out quite a bit, but it was all financials. And so that was really a developed market ball event that did not hit the EM financials at all. As a matter of fact, we saw the EM banks - they're very well capitalized, they're deposit funded, they were completely unscathed. So we didn't see that commensurate widening in the single A space. And that was something that we would demonstrate to our clients and then maybe that was something that instead the appropriate comparison was to take the financials out of the comparison.

And then when you did that, you were back to seeing much more of this 35, 45, 55 basis points of pickup depending on your ratings category, and the value was still there. So I think it's important to make sure that you're demonstrating what is driving the underlying relationship.

But that said, Stewart, the headline concern is valid. We understand that our clients need to be updated frequently with what is going on in the space. And obviously, we see a much different reaction than would be expected with different types of stories. So we communicate a lot, we have frequent meetings with our insurance clients that we think helps a lot. I think a good example was really what happened with Iran and Israel over the weekend, not this past weekend, but the prior weekend where it was a significant vol event. But really when we then broke it down, and of course we did all kinds of work internally with our experts, what we saw was there wasn't really an impact on the spreads from the other Middle East GCC countries. It was very concentrated on Israel.

So the correlation that people would've seen 20 years ago when you see an event that would then spread to other countries really wasn't there. So it was something that when talking with our clients and updating them on what was going on, that it was a way of helping them through the headline risk.

Stewart: That's super helpful and a great example that just happened. So the other thing, and I want to go back to something that you said earlier in the podcast, that this is a $2.5 trillion market. I want to make sure I got that number right, because I've heard people say that EM corporates is not a deep market and the trading liquidity is subject to headline risk.

When you talk about a $2.5 trillion market, could you maybe help us on a relative size basis to other markets that we might be more familiar with, in terms of their size?

Elisabeth: Yeah. So I think the conventional idea is that this is something bigger than the US high yield market. People have pointed to the Euro credit market. So it's a pretty big, valid asset class. The liquidity, I think, once again, is something that comes out of various crises that have happened. And so when we look at it, we like... And I'll say your line of thinking is very spot on because we often get this question from prospects and investors, which is, "How fast can we put this money to work once we give it to you?"

I think there's this idea that it's going to take us three or four weeks to invest the portfolio where that's really just not the reality anymore. I mean, we can generally fund something in two, three days at the longest. And then of course you get the flip side often from questions from risk officers at the clients, which is, “If we had to liquidate a portfolio, how many days would it take?” And so those are the types of questions that we get quite a bit.

Just to give a little color on that, I think back to March of 2020 when everyone was looking for cash, clients were trying to build cash reserves, requests for redemptions were pretty widespread at that point. There was a lot of panic in the market. Don't forget, we even saw liquidity problems in the US Treasury market during that month. Certainly, there was a lot of fear. And our traders were able to move our bonds. I mean, and this is something that I think really is a testimony to their skill; it's really understanding who the buyers are in this asset class. And in different regions it's different types of buyers. Some places it's more retail buying. Other places it's large pensions or the large money managers. For example, everyone knows... For the Asian names, Asia buys Asian names.

So if you're going to try to get out of something, you want to make sure you're selling where the buyers are. And I can say that was even something that we were hearing last week with the Middle East was going on when we didn't see the sell-off in Saudi and UAE names. A lot of that was because the buyers that were stepping in were in the Middle East. And so they were looking to put money to work, and especially as the US Treasury yield was higher, they were even moving out the curve.

So there was good support there. So our experience is that there are highly liquid markets with some of the really big names that have more robust curves. And for other ones, there's a little bit more patience required, especially when we're building a position, we want to make sure that we're very disciplined, that we're using our relative value tool to buy at the appropriate levels. And so we do rely on our traders to really know where to look for the sources of bonds to get us the position sizes that we're looking for.

Stewart: It has been another incredible education on EM Debt with you, Elisabeth. Thanks so much for coming on. We've got a couple of fun ones for you out the door.

Elisabeth: Uh-oh.

Stewart: Surely you know these are coming. So is there a piece of advice along the way in your career maybe that you would give to a younger... I shouldn't say that, because you and I have both been at this for a minute, people who are earlier in their careers. What would you tell somebody who's an investment professional coming in here that's two, three years out of school, where would you send them? And then the second one is, who would you most like to have lunch with, alive or dead? You don't have to take them both. You could take either one. Most of our guests take both, but no pressure.

Elisabeth: Wow. I don't have to do both. Okay.

Stewart: No, you don't have to.

Elisabeth: All right. So I think the piece of advice to an early career professional in this business... When I came into this business, was a little bit later. I had actually worked in the economics field and my work there was really driven by my father who was an accountant, used to say to me, "What are you going to do with an economics degree?"

Well, I had really not much idea what I was going to do with an economics degree at the time, but when I got out of college, I really needed a job fast to prove my father wrong. So I took a job in an economics company, a forecasting company, which was great. Don't get me wrong. I think I learned so much there about how to look at sectors and how to model. But I think what I would say to people starting out is to really keep your mind open and to talk to as many people as you can.

I mean, I know it's cliché about networking and everything, but there are different paths. And I think that I never would've found the asset management business if it hadn't been through people that I was talking to. I wish I had known about it earlier, but I eventually ended up in the right place where I feel is really where my passion is. So that's probably what I would say. Don't close yourself into one avenue too soon in your career.

Stewart: That's great advice.

Elisabeth: And the second question who would I have lunch with? Can it be a fictional character?

Stewart: A hundred percent.

Elisabeth: Okay. So this is maybe a little weird for an answer, but a while back, I guess maybe, I think it was maybe six years ago, I read the book, *A Gentleman in Moscow*, which I just thought was an amazing book, and now there is a television mini-series, whatever you call it, that's out. And I was thinking the main character is this Russian count, that having lunch with someone with him in this... Basically, he's under house arrest in a hotel. It really was about the seismic changes to the Russian economy and to really talk to this person about what the experience was, sort of the disconnect of when life changes that fast, would really be very fascinating with the caveat that in this fictional place, I was actually able to leave the hotel after we had lunch. So that would probably be my answer to that question.

Stewart: That's fantastic. Thanks so much for being on. I really enjoyed talking with you and I think you have a depth of experience, but you have a wonderful way of explaining it too. So thanks so much for taking the time and joining us again.

Elisabeth: Thanks, Stewart. It's great to be here.

Stewart: We have been joined by Elisabeth Colleran, portfolio manager for Emerging Market Debts Portfolios at Loomis Sayles. Thanks for listening. If you have ideas for podcasts, please shoot me a note at stewart@insuranceaum.com. My name is Stewart Foley and this is the InsuranceAUM.com podcast.

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