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# THE WHYS AND HOWS OF INVESTING IN EMERGING-MARKET CORPORATE BONDS

Once a backwater of the bond world, emerging-market (EM) corporate debt has grown into a full-fledged asset class that investors can tap to diversify their EM allocation and boost their return potential.

For years, when institutional investors talked about the composition of their EM bond portfolios, they were talking about currency. Some bonds would be denominated in US dollars or another “hard” currency, others in the local currency of the issuing country—Mexican pesos, Turkish lire, Chinese renminbi. But nearly all of them were government-issued sovereign bonds.

EM corporate bonds have historically been relegated to the periphery of fixed-income portfolios—if they’re represented at all. There was US\$113 billion benchmarked to J.P. Morgan’s EM corporate indices as of June 30, about one-sixth of the amount tied to its hard- and local-currency sovereign indices.

This underallocation may have been understandable a decade ago, when the outstanding debt stock was lower and less diversified. It isn’t anymore. The total EM corporate debt stock doubled between 2012 and 2018 to US\$2.3 trillion, which is about twice the amount of outstanding hard-currency EM sovereign debt. And the standard EM corporate benchmark, the J.P. Morgan Corporate Emerging Markets Bond Index (CEMBI), encompasses bonds from more than 600 corporate issuers in 52 different countries (*Display 1, page 2*).

For investors willing to go beyond the index, the opportunity set is even bigger.



**Shamaila Khan**  
Director—Emerging Market Debt



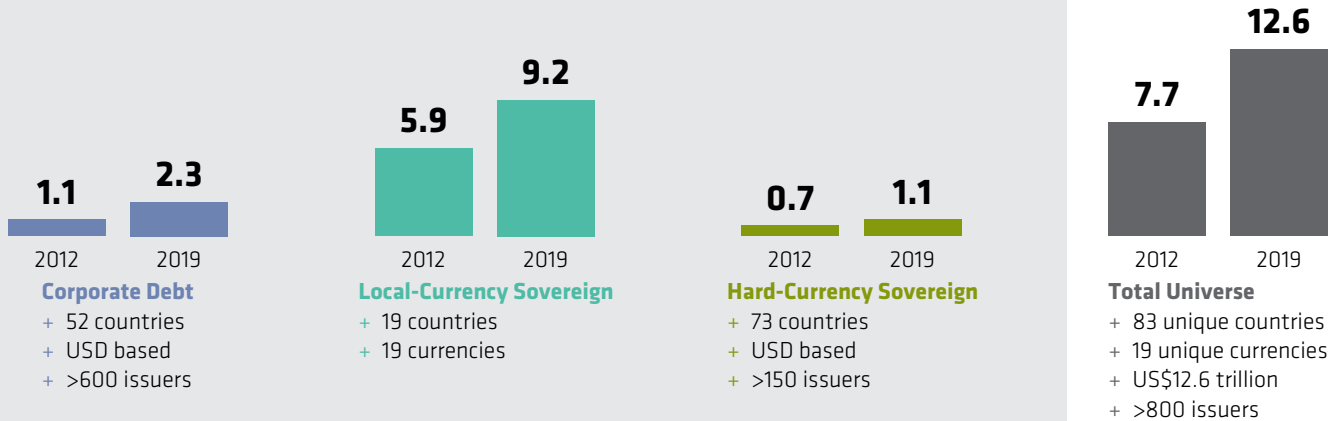
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Portfolio Manager—Emerging Credit



**CORPORATE DEBT PROVIDES DIVERSIFICATION THROUGH EXPOSURE TO MORE COUNTRIES AND TO DIFFERENT PARTS OF THE CREDIT CYCLE.**

## DISPLAY 1: A BIGGER POND TO FISH IN—EM DEBT'S GROWING OPPORTUNITY SET

Total Debt Stock (USD Trillions)



For informational purposes only. There can be no assurance that any investment objectives will be achieved.

Corporate Debt: J.P. Morgan CEMBI Broad Diversified; Local-Currency Sovereign: J.P. Morgan GBI-EM Global Diversified; Hard-Currency Sovereign: J.P. Morgan EMBI Global Diversified  
As of June 30, 2019  
Source: J.P. Morgan Markets and AB

## WIDENING THE OPPORTUNITY SET

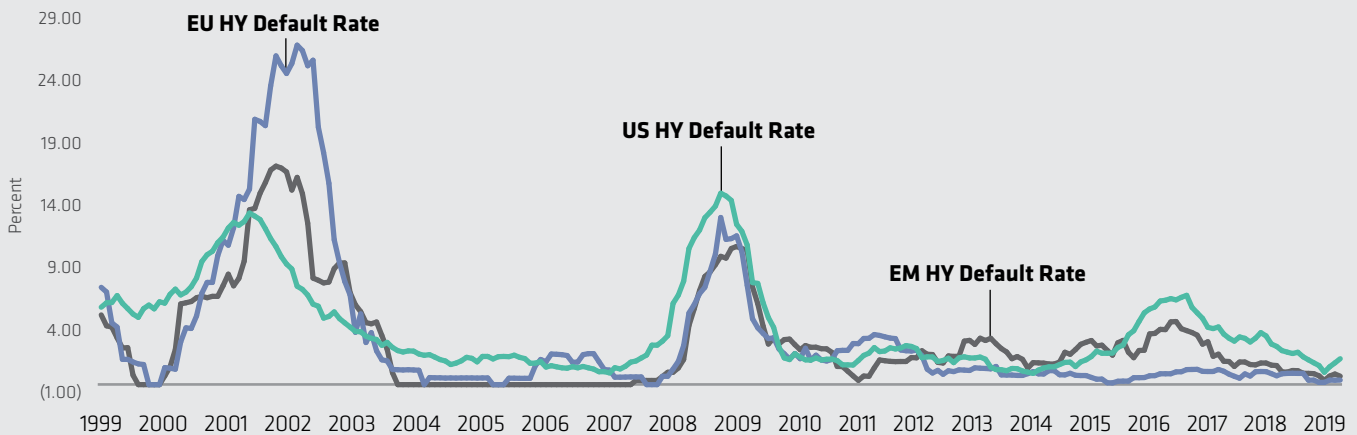
How investors add EM corporates to an existing fixed-income allocation will depend to some extent on their individual needs and comfort level. For **institutional investors with dedicated EM mandates to hard- and local-currency sovereign bonds**, it can be as easy as adding a stand-alone allocation to EM corporates.

An allocation to corporate debt provides diversification through exposure to more countries and to different parts of the credit cycle.

It also gives investors access to a wider range of issuers in different sectors, often with a spread pickup over EM sovereign debt.

Investors might also be surprised to learn that default rates for EM high-yield issuers have been in line with—and often lower than—those in developed markets since the mid-2000s (*Display 2*). EM recovery rates are also broadly comparable with those seen for high-yield debt in developed markets.

## DISPLAY 2: EM DEFAULT RATES IN LINE WITH DEVELOPED ECONOMIES



Historical analysis is for illustrative purposes only.

EM HY: ICE BofAML High Yield Emerging Markets Corporate Plus Index; EU HY: ICE BofAML Global High Yield Index—DM EMEA; US HY: ICE BofAML Global High Yield Index—US and ICE BofAML 0-1 Year US High Yield Index  
Through June 30, 2019  
Source: ICE Data Indices and AB

### DISPLAY 3: NO SECTOR WINS ALL THE TIME—BUT EMD IS OFTEN NEAR THE TOP

Returns for EM Debt Sectors and Global Investment-Grade and High-Yield Corporates (Percent)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Best	DM IG Corporate Debt (5.1)	DM HY Corporate Debt 57.7	DM HY Corporate Debt 15.1	EM Sovereign Debt 8.5	EM Local-Currency Debt 19.9	DM HY Corporate Debt 6.5	DM IG Corporate Debt 7.6	EM Corporate Debt 1.3	DM HY Corporate Debt 15.6	EM Local-Currency Debt 15.4	EM Corporate Debt (1.7)
	EM Local-Currency Debt (6.9)	EM Corporate Debt 34.9	EM Corporate Debt 13.1	DM IG Corporate Debt 4.8	DM HY Corporate Debt 19.2	DM IG Corporate Debt 0.1	EM Sovereign Debt 5.5	EM Sovereign Debt 1.2	EM Local-Currency Debt 11.4	EM Sovereign Debt 9.3	DM IG Corporate Debt (3.6)
	EM Sovereign Debt (10.9)	EM Sovereign Debt 28.2	EM Local-Currency Debt 13.1	DM HY Corporate Debt 3.6	EM Sovereign Debt 18.5	EM Corporate Debt (0.6)	EM Corporate Debt 5.0	DM IG Corporate Debt (0.2)	EM Sovereign Debt 10.2	DM HY Corporate Debt 8.4	DM HY Corporate Debt (4.1)
	EM Corporate Debt (15.9)	EM Local-Currency Debt 16.6	EM Sovereign Debt 12.0	EM Corporate Debt 2.3	EM Corporate Debt 15.0	EM Local-Currency Debt (5.5)	DM HY Corporate Debt 2.6	DM HY Corporate Debt (0.7)	EM Corporate Debt 9.7	EM Corporate Debt 7.9	EM Sovereign Debt (4.3)
Worst	DM HY Corporate Debt (25.2)	DM IG Corporate Debt (16.2)	DM IG Corporate Debt (7.2)	EM Local-Currency Debt (6.3)	DM IG Corporate Debt (10.9)	EM Sovereign Debt (6.6)	EM Local-Currency Debt (6.1)	EM Local-Currency Debt (18.0)	DM IG Corporate Debt 6.2	DM IG Corporate Debt 5.7	EM Local-Currency Debt (6.2)
Gap between best and worst returns	20.1	73.9	22.3	14.8	30.8	13.1	13.7	19.3	9.4	9.7	4.6

Past performance does not guarantee future results. These returns are for illustrative purposes only and do not reflect the performance of any fund.

**Diversification does not eliminate the risk of loss.** An investor cannot invest directly in an index or average, and they do not include the sales charges or operating expenses associated with an investment in a mutual fund, which would reduce total returns. DM HY Corporate Debt: Bloomberg Barclays Global High Yield Index; DM IG Corporate Debt: Bloomberg Barclays Global Aggregate Corporate Index; EM Corporate Debt: J.P. Morgan CEMBI; EM Local-Currency Debt: J.P. Morgan GBI-EM; EM Sovereign Debt: J.P. Morgan EMBIG. As of December 31, 2018  
Source: Bloomberg Barclays, J.P. Morgan and AB

### THE LIMITS OF A SOVEREIGN-ONLY ALLOCATION

Investors with discretionary mandates who entrust their allocation to a manager might benefit from a blended approach that adds corporates to the 50/50 mix of hard- and local-currency sovereign debt that most investors use today.

Again, diversification and downside protection are key selling points. For example, a sharp rise in the US dollar—and a corresponding slide in EM currencies—hit local-currency sovereigns hard between 2013 and 2016 and wreaked havoc on traditional 50/50 blended strategies.

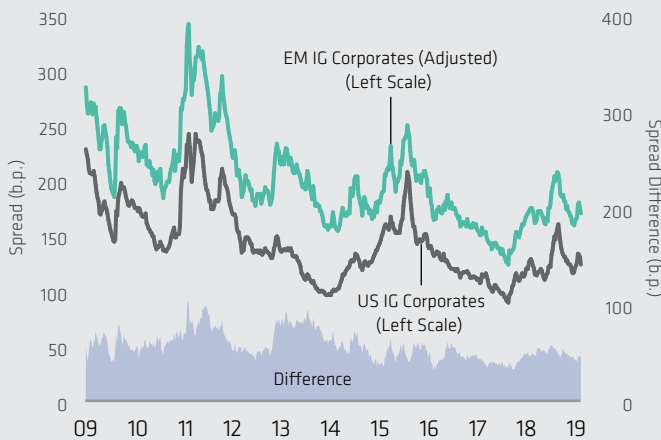
An allocation to hard-currency corporates would have diversified the currency risk in the 50/50 blend by giving investors exposure to companies with dollar-denominated export revenues. For these types of issuers, a rising dollar was good news because it boosted margins and cash flow.

In 2015, there was a 16.7% difference in annual returns for hard-currency corporates and local-currency sovereigns. Such disparities aren't unusual. As *Display 3* illustrates, EM debt (EMD) sub-asset classes rarely move in unison.

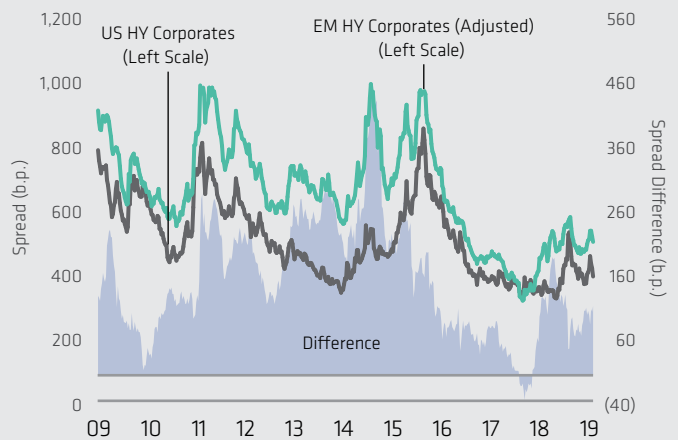
Professional asset managers have recently started managing EM portfolios for interested investors against a customized blended benchmark that includes corporates. J.P. Morgan's decision to launch a suite of blended EM indices, most of which include corporates, offers a more standardized strategy and is likely to increase interest in EM corporate debt. We expect an equally weighted blend of hard-currency sovereigns, hard-currency corporates and local-currency sovereigns—the "one-third, one-third, one-third approach"—to become the preferred benchmark for measuring performance.

#### DISPLAY 4: EM CORPORATES ATTRACTIVE VS. COMPARABLE US CREDIT

EM IG Corporates vs. US IG Corporates



EM HY Corporates vs. US HY Corporates



Reflects government option-adjusted spread over US Treasuries. EM IG Corporates: ICE BofAML Emerging Markets Corporate Plus Index; US IG Corporates: ICE BofAML US Corporate Master Index; EM HY Corporates: ICE BofAML Emerging Markets Corporate Plus Index (High Yield Sub-Index); US HY Corporates: ICE BofAML US High Yield Master II. Spreads are adjusted prior to June 30, 2017. Through June 21, 2019  
Source: ICE Data Indices and AB

#### HIGH QUALITY—AND LOWER VOLATILITY

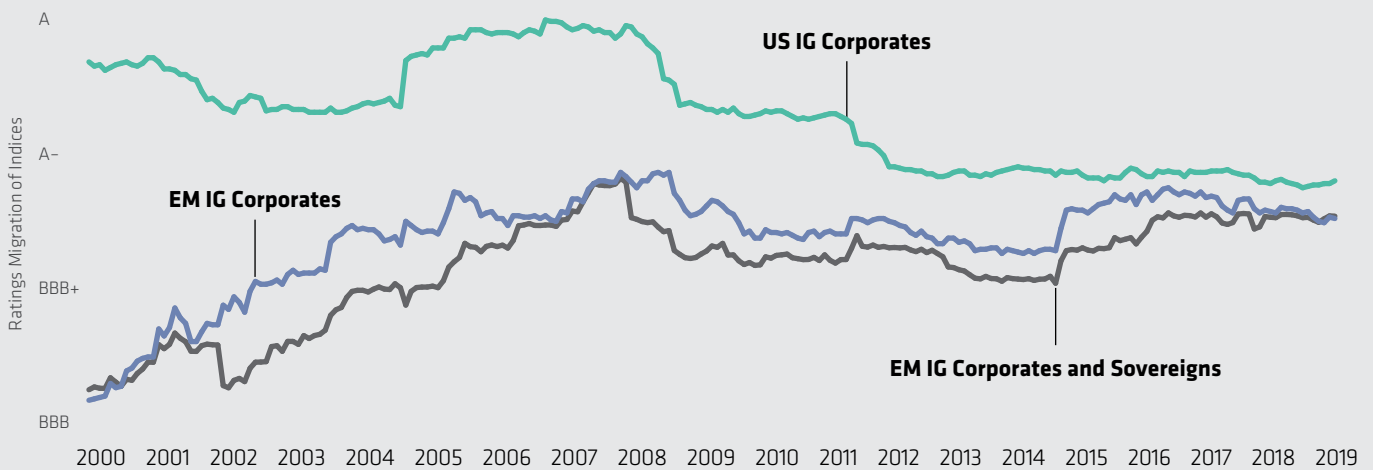
Institutional investors with a lower risk tolerance might consider getting exposure to EMD through an investment-grade-only approach, split between sovereign and corporate debt. This is an increasingly popular strategy among **insurance companies, pension funds and others** who have traditionally focused on developed-market (DM) credit exposure.

Adding investment-grade EM corporates can give investors high quality with attractive yields. That's because yields are higher than

those on comparably rated debt from US companies (*Display 4*)—an important consideration at a time when low interest rates globally are making it harder than ever for investors to generate income.

And in recent years, the average credit quality of investment-grade EM corporate debt has converged with that of US investment-grade bonds. In fact, there's never been such a small gap between the average ratings of the two sectors (*Display 5*).

#### DISPLAY 5: NOT MUCH DIFFERENCE BETWEEN EM AND US CORPORATE CREDIT QUALITY

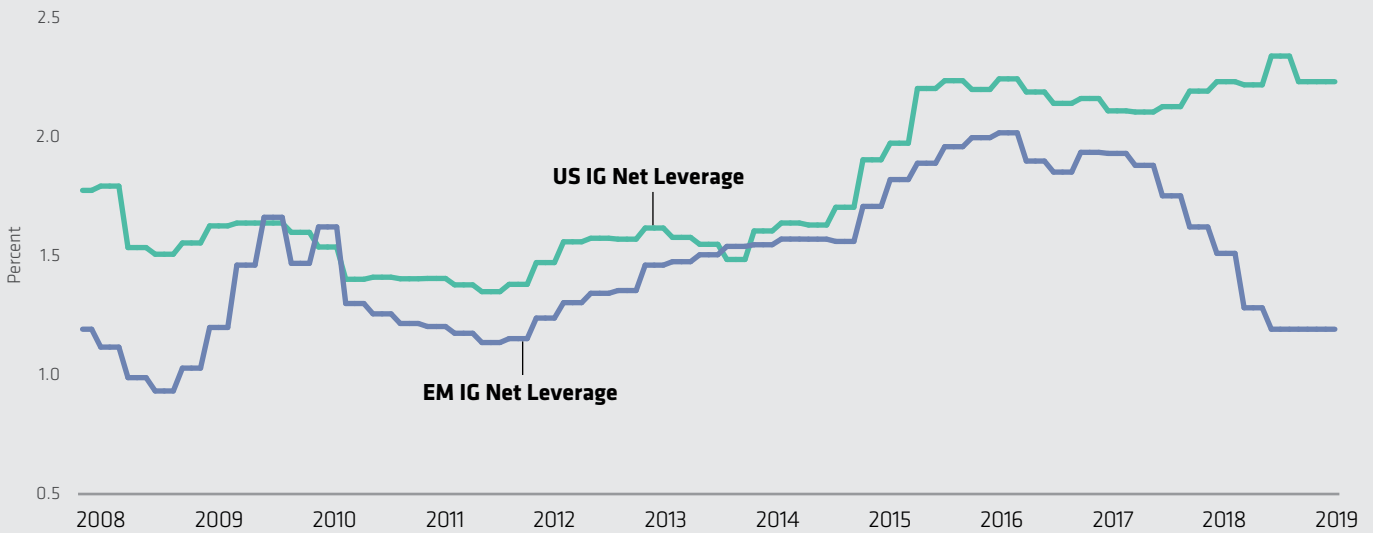


+ Credit quality has never converged to this extent historically, which makes it challenging to look at historical valuation comparisons

EM IG Corporates: ICE BofAML Emerging Markets Corporate Plus Index; US IG Corporates: ICE BofAML US Corporate Master Index; EM IG Corporates and Sovereigns: ICE BofAML Emerging Markets Corporate Plus Index and ICE BofAML Emerging Markets External Sovereign Index. Through May 31, 2019  
Source: ICE Data Indices and AB

**DISPLAY 6: EM CORPORATES ARE LESS LEVERAGED THAN THEIR US COUNTERPARTS**

EM vs. US Investment-Grade Net Leverage

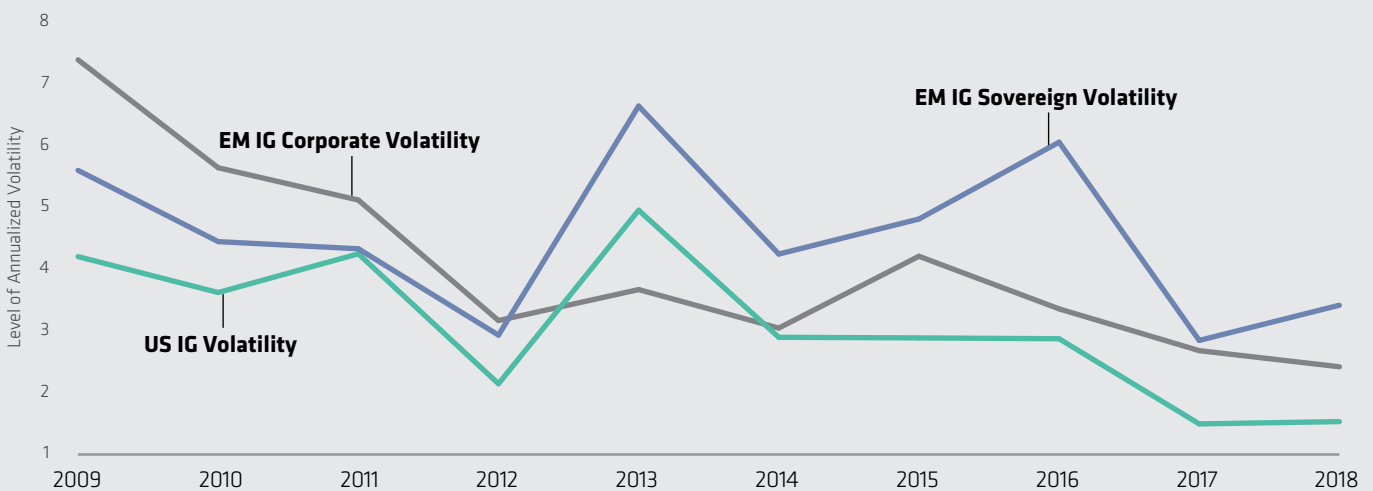


Historical analysis is for illustrative purposes only.  
Through June 30, 2019  
Source: Bloomberg and AB

EM investment-grade issuers also boast lower net leverage than their US counterparts (*Display 6*). According to J.P. Morgan, the spread per turn of leverage—the ratio of additional return an investor might receive per unit of risk (in this case, leverage)—from investment-grade EM corporates was more than twice as high as that for comparable US bonds through June 21.

Volatility for the asset class has also declined sharply in recent years (*Display 7*). That’s partly because the sector has become more popular among large institutional and local investors, who tend to eschew frequent trading in favor of a buy-and-hold strategy. What’s more, the average duration for EM corporates is lower than that for sovereign bonds, making the former less vulnerable to interest-rate changes.

**DISPLAY 7: A SMOOTHER RIDE—HIGH-QUALITY EMD HAS BECOME LESS VOLATILE**



Historical and current analyses do not guarantee future results.  
Annualized volatility is shown for the J.P. Morgan EMBI Global Investment Grade, J.P. Morgan CEMBI Broad Investment Grade and J.P. Morgan US Liquid Index (JULI).  
Through December 31, 2018  
Source: Bloomberg Barclays and J.P. Morgan Markets

## WHAT TO LOOK FOR IN AN ASSET MANAGER

EM corporate bonds aren't entirely without risk, of course. While corporate governance, transparency and protections for creditors and shareholders have improved over the last decade, they still lag standards in developed economies. This is why it's so important to choose the right manager for your EMD allocation.

First, let's tackle the issue of expertise. Investors or their advisors should make sure that prospective managers have a long track record of investing in all types of EMD assets and a thorough understanding of the risks associated with EM corporates—economic-, political-, credit- and industry-related.

## A 360-DEGREE APPROACH TO RISK MANAGEMENT

The way we see it, this requires a holistic, 360-degree approach to credit research and analysis. It starts with economists who can conduct extensive research into the macroeconomic and political risks associated with every EM country in which the portfolio management team invests.

Equally important is having a team of dedicated EM credit analysts. Some asset managers task their analysts with covering both DM and EM credits within a given industry or sector. A better approach, in our view, would be to have dedicated EM analysts who focus exclusively on EM issuers collaborate with industry specialists. Look for managers who can boast a diverse, global group of experienced, multilingual EM analysts with regional and country expertise, and industry specialists who can add important perspective when determining the relative value of a credit.

Prospective managers that cut corners in the research process probably aren't seeing the whole picture of the credits they're investing in.

## ANALYZING CREDITS: BOTTOM UP OR TOP DOWN?

There's another reason investors should insist on dedicated EM credit analysts: EM companies come with unique risks. Some are family businesses, where information about operations and finances can be difficult for investors to obtain. In these situations, having experts who can conduct comprehensive top-down analysis is crucial.

It's not uncommon for some EM firms to be wholly or partly owned by the government. Government involvement can also muddy the waters when it comes to classifying debt. For instance, the bond of a company that is 100% government owned is considered sovereign debt, and resides in sovereign indices. A 99% government-owned company's bonds are considered corporate debt. In practice, though, there's very little difference between the two. Both should be treated as corporate credits, and both call for comprehensive, bottom-up credit analysis.

## THINK GLOBALLY...

Even well-run companies in some EM countries may be subject to risks that a firm in the developed world is less likely to face, such as political turmoil, corruption or nationalization. That's why it's important that managers look at emerging markets through a global lens and understand the varying political and economic dynamics at play throughout the world.

To this end, investors should insist that their managers routinely score EM issuers on environmental, social and governance (ESG) issues and make ESG considerations a key part of their investment process. Here, too, it helps to have a global footprint and a team of portfolio managers, analysts and economists who can address ESG issues directly with government officials, central bankers and corporate executives.

## ...BUT INVEST IN COMPANIES, NOT COUNTRIES

Of course, EM risk can lurk in a wide variety of individual bonds, and often gets mispriced. Sometimes, it doesn't matter whether the borrower hails from Shanghai, São Paulo or Seattle. That's because there are plenty of DM companies with exposure to emerging markets and the risk that comes with that. At the same time, many EM companies have become more global by investing in and importing to developed markets.

Imagine a Mexican food company that does a large share of its business in the United States and a Canadian mining firm with a big footprint in sub-Saharan Africa. Which one has more EM risk? It may turn out to be the second, particularly if it is subject to frequent arbitrary tax increases or nationalization risks.

## SUMMING IT UP

Most investors today recognize that EM countries and companies are at the core of the global economy and should be a component of any fixed-income allocation. But many are still broadly underexposed to EM corporate bonds. We think that's a mistake.

As wealth continues to shift from developed to emerging economies, growth across the emerging world is likely to accelerate, boosting the bottom lines of an increasingly dynamic set of EM companies. There are complexities associated with analyzing EM corporate credit. But we think the size and diversification benefits that EM corporates offer make them a valuable addition to any bond portfolio. In time, we expect these assets to become a standard feature of investors' EM allocation, irrespective of their original mandate.

EM RISK CAN LURK  
IN A WIDE VARIETY  
OF INDIVIDUAL BONDS, AND  
OFTEN GETS MISPRICED.



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