Fixed Income

Managing for asymmetrical risk in emerging market local debt

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Wim Vandenhoeck
Portfolio Manager

We believe the unique character of locally denominated debt in emerging markets calls for a different look at risk management–and manager skill.

Executive summary

- When it comes to investing in emerging market local debt, we seek to maximise potential returns from market exposure to attractive yield and income opportunities that go hand in hand with the relatively higher risks of this asset class. Concurrently, we believe in harnessing manager skill to minimise downside potential, even at the opportunity cost of avoiding certain trades that could result in above-market returns.
- A portfolio's tracking error is an inadequate measure of volatility, because it gives equal treatment to the positive and negative differences between a portfolio and its benchmark. Given our aim to reduce volatility throughout the emerging market cycle, we propose the following loss-mitigation strategy:
  - Maintaining a low tracking error and high volatility in risk-on periods.
  - Maintaining a high tracking error and low volatility in risk-off periods.

Locally denominated debt securities in emerging markets expose investors to a variety of risks driven by foreign exchange, credit quality, interest rates, macroeconomic conditions, and regional politics.

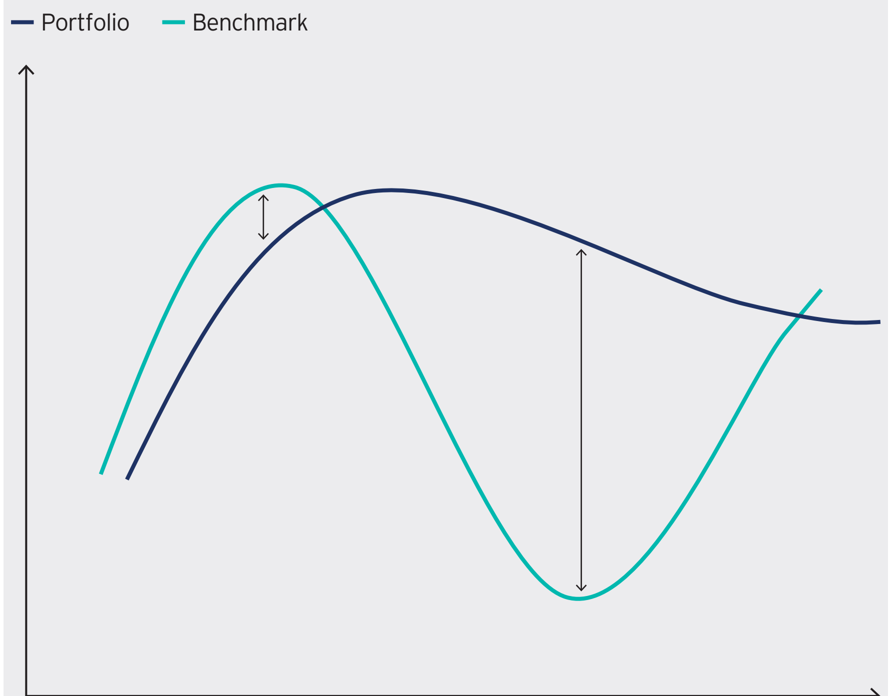
This unique combination of risks, in our view, warrants special emphasis on limiting the downside potential – one that requires manager skill – while wringing value from market exposure to attractive yields and income.

Limiting the downside—and the role of the tracking error

Toward establishing a discipline of measuring and attaining limited downside potential, we propose looking at one of the most common gauges of volatility – the tracking error – and putting it in perspective.

A portfolio's tracking error is not an adequate measure of volatility, because it gives equal treatment to the positive and negative differences between a portfolio and its benchmark – even though the former are obviously desirable, whereas the latter are not. For example, a theoretical portfolio that managed to stay roughly flat during a severe downturn would be characterised by a large tracking error on the upside, much to investors' benefit (Figure 1).

Figure 1
A higher tracking error doesn't necessarily equate to a "bumpier ride" (multiple negative fluctuations in a portfolio's value)



Source: Invesco. For illustrative purposes only.

A strategy for limiting downside potential
How do we propose limiting the downside?

When it comes to investing in debt of emerging markets, we seek to maximise potential returns from market exposure to attractive yield and income opportunities that go hand in hand with the relatively higher risks (chiefly economic and political) involved in these markets. Yet because of those higher risks, we also advocate harnessing manager skill to minimise downside potential, even at the opportunity cost of avoiding certain trades that could result in above-market returns (which come at the price of very high risk).

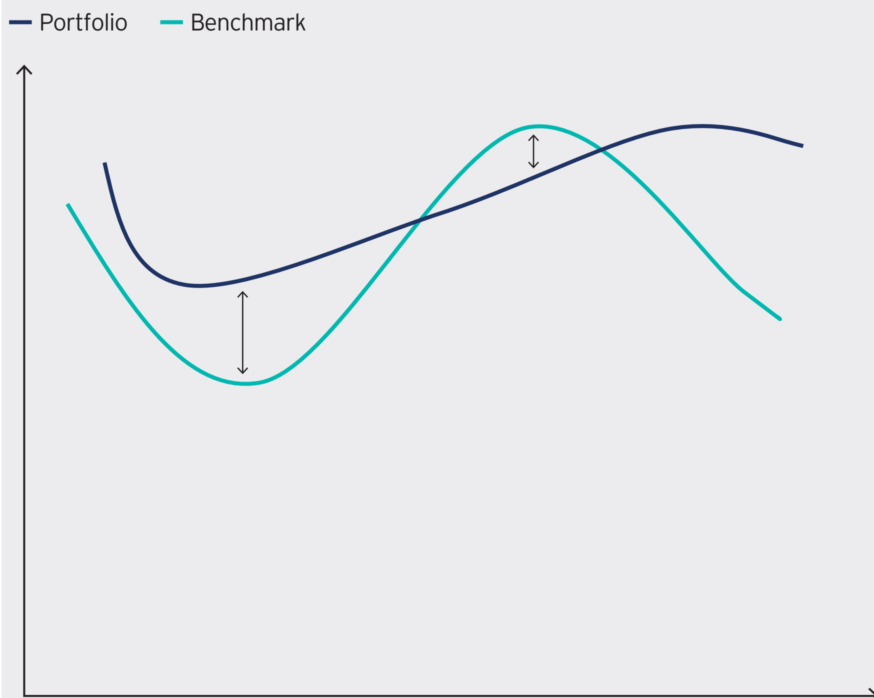
For example, investors may choose to avoid locally denominated bonds that offer highly attractive coupons if they believe that the socio-political risks (or other "soft" risk factors) in the country in which those bonds are issued are exceedingly high and could result in significant losses. The same could apply if investors foresaw potentially adverse trends in the movement of interest rates, inflation, currencies, government policies, bond defaults, or other factors.

Another way to look at this philosophy is as follows: Rather than trying to capture every potentially winning opportunity, investors may be better off in the long run trying to avoid as many loss situations as possible.

Our proposed strategy for affording investors a smoother ride throughout emerging market cycles is to incorporate an element of capital loss mitigation to allow for loss mitigation during downturns:

- Maintaining a low tracking error and high volatility in risk-on periods (i.e., remaining within close proximity to the benchmark's volatility when we deem market conditions to be favourable).
- Maintaining a high tracking error and low volatility in risk-off periods (i.e., managing the portfolio to much lower volatility than that of the benchmark when we believe market conditions deteriorate and become risky).

Figure 2
In seeking to achieve above-market annualised returns over the long haul, investors may consider giving up some upside potential in favour of significant limited downside



Source: Invesco. For illustrative purposes only.

Our proposed framework for limiting potential downside

We propose a multi-part framework for riding out emerging market gyrations and achieving above-market annualised returns over the long haul:

1. **Analysis:** The first part is to conduct a global macro analysis of emerging and developed markets – as well as the linkages between them – since we believe that no market or region can be viewed in complete isolation from exogenous factors that are affecting it (such as trade or international relations).

   This analysis enables us to aggregate individual views on the economic growth, inflation and risks of each country, and establish a global view as well. In the analysis, we also favour an assessment of qualitative factors such as political dynamics, monetary policy, fiscal policy, and opportunities to capitalise on trends.

2. **Risk budget:** The second part is determining a risk budget (the overall risk we wish to take, as well as the relative risk versus the benchmark).

3. **Country-level risk:** Once an overarching risk framework is established, we revert to the country level and determine (on the basis of macro analysis of each country) appropriate levels of risk to take for each country, as well as the levers (namely rates, foreign exchange and/or credit) through which to invest.

4. **Choosing securities:** We would then seek to identify country-specific opportunities, whereby we express our views on each country directionally via one or more of the three levers. Influencing our views are the risk/reward profiles they represent and security fundamentals.

   Once we identify specific opportunities, we conduct bottom-up security selection that matches our top-down risk budget. Note that, in our view, bottom-up considerations should be subservient to our overarching risk budget, and thus we make security-level adjustments until they conform to the top-down budget we determined.

Throughout the process, we recommend relying on local and regional knowledge and effort to conduct due diligence in critical spots of the world covering not just macro but also micro, social, institutional and business conditions. This effort can help investors identify idiosyncratic risk and calibrate their risk-reward views.

Conclusion

The risk/reward nature of locally denominated debt in emerging markets is idiosyncratic – the result of a complex interplay of multiple factors, including foreign exchange, credit quality, interest rates, macroeconomic conditions, and regional politics. We believe investing in them requires a more nuanced view of risk management and the ways in which manager skill can be harnessed to benefit investors.

First, we suggest that a portfolio's tracking error is an insufficient reflection of volatility, because it gives equal treatment to the positive and negative differences between a portfolio and its benchmark.

Second, we propose maximising returns from market exposure to attractive yield and income opportunities that go hand in hand with the relatively higher risks of emerging market debt. At the same time, we also believe in harnessing manager skill to minimise downside potential, even at the opportunity cost of avoiding certain trades that could result in above-market returns.

Lastly, to reduce volatility throughout the emerging market cycle, we propose a loss-mitigation strategy – one that entails maintaining a low tracking error and high volatility in risk-on periods; and maintaining a high tracking error and low volatility in risk-off periods. Our four-part framework for limiting downside potential includes global macro analysis, risk budgeting, country-level risk analysis, and security selection.

Wim Vandenhoeck
Portfolio Manager

Investment risks

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

As a large portion of the strategy is invested in less developed countries, you should be prepared to accept significantly large fluctuations in value.

The strategy will invest in derivatives (complex instruments) which will result in leverage and may result in large fluctuations in value.

Debt instruments are exposed to credit risk which is the ability of the borrower to repay the interest and capital on the redemption date.

Investments in debt instruments which are of lower credit quality may result in large fluctuations in value.

Changes in interest rates will result in fluctuations in value.

The strategy may invest in distressed securities which carry a significant risk of capital loss.

Investments in small and medium sized companies involve greater risks than those customarily associated with larger companies.

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