

## *“An investment in knowledge always pays the best interest”*

### **Fund Manager Meeting Notes – SLI Emerging Market Debt Strategies**



In 2012 we added emerging market debt to the portfolios. We definitely feel that this asset class is like marmite. Whatever we feel or say that is good about this sector others will say the opposite. Interestingly often those who are so opposed to emerging market debt have no emerging debt specialists within their firm. They cannot do anything but promote what they have to promote even if in their heart of hearts they know it is going one way!

There are risks with emerging market debt as there are with any asset class. The one thing that many of the doubters forget is that we are talking about 60 global economies in Asia, Europe and Latin America. We are not looking at one or two countries.

When we considered the options in 2012 we selected funds where we felt the managers adopted a conservative approach to investing in emerging market debt. This doesn't mean we were looking to compromise on performance but more that we didn't want to select those with a high risk strategy.

One of the funds we choose was the Threadneedle Emerging Market Debt Fund. The manager of this fund was Richard House. Richard left Threadneedle shortly after we added the fund and moved to Standard Life. At Standard Life he has been involved in formulating some of the themes underlying the GARS Fund and he manages the two emerging market debt funds they have recently launched.

We remain happy with the management of the two funds we have, but we respect Richard as a manager

and his views. This update provides some background to the funds but also the potential opportunities within emerging market debt.

### **Overview of the fund**

There are two strategies a hard currency and more recently an offshore local currency strategy has been added.

Richard talked about some of the negative headlines like – ‘will the fed push EM over the edge’, ‘echoes from 1997 – 98 Asian crisis’, ‘EM rout is merely the final tweet of the canary in the coal mine’ and there are more.....

There are some things to consider, there are over sixty economies across the global market. It is not just one economy. Many of these economies have seen large current account deficits move to surpluses, inflation fall and credit ratings move to sovereign debt.

Of course there are economies which face structural challenges the likes of South Africa, Indonesia, Brazil, Turkey and Ukraine but this again highlights the need for active management. If you consider spread this year, economies like Pakistan, Argentina, Jordan, Egypt and Jamaica have seen the yield spread narrow. Whereas countries like India, Belarus, Indonesia, Ukraine and South Africa have seen this widen. Put simply choosing the right countries can deliver returns.

If you consider currencies then Hungarian, Czech, South Korean, Polish and Chinese currencies have all remained strong whereas others like the Brazilian and Indian Currencies have suffered depreciation.

One of the arguments is that reserves are being stretched; emerging markets have \$6 trillion of currency reserves. If their currencies weaken the reserves increase.

And so the argument can go on. Many doubters of emerging markets pick the facts they want you to see, of course the reverse is true but again there are economies you can avoid to reduce the risk. Some of the countries Richard likes are Mexico, Peru, Romania and Columbia. Other countries where he has limited or no exposure include Turkey, South Africa, Malaysia, Brazil, Ukraine and Russia.

Interestingly Richard will look for opportunities so for example in Brazil the currency has reduced by 25% and they have started to raise rates. He has started to buy Brazilian bonds because he can see opportunities. India has seen its currency fall significantly and they have been buying exposure to the Rupee.

So they might like a country but it doesn't exclude them from short term opportunities.

In terms of returns we covered this and there are so many factors to consider with emerging market debt. But for hard currency the yield spread with the dollar is important. Currently this is around 3.10%. If treasury yields went to 2.50% (currently on 2.40%) and the yield spread went to 2.75% then the annual return would be around 7%. If treasury yields went to 3% and the yield spread was 2.75% then the returns would be 3.90%.

With local currency if yields went up to 6.50% and currencies strengthened by 5% then the return would be 9.80%. An increase in yields to 7.50% would still see returns of 5.1%. (Source Standard Life, these returns are not guaranteed and depend on a variety of figures. The actual returns could be lower or higher than the estimated figures.)

On the flipside, depreciation in currency and a spike in yields could see significant losses but again this is the importance of active management.

In summary it is unlikely we would move to using this fund however the feedback on the economies is crucial to testing our thinking. A lot of the negatives we hear use the negative side of the figures and it is easy to get lost in them. Similarly we use the negatives on

developed market debt but we know some managers are admitting that over the next five years if they can get flat returns they will be happy and Barclays have indicated that negative returns should be expected. These are facts and it makes you nervous about this asset class.

## **Conclusion**

We remain positive about emerging market debt, some economies do have challenges and this should not be ignored. These challenges sometimes deliver opportunities and in our view only active managers can deliver the right returns from this sector. Richard is a good manager and we saw that when he was at Threadneedle. It remains early days at Standard Life and it is certainly a fund to watch.

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