

## **SHINING A LIGHT ON..... BAILLIE GIFFORD EMERGING MARKET DEBT FUND**

### **At a glance**

Fixed interest (bond) investments are seen as low risk, however many accept that the returns in a rising interest rate environment will be challenged. A small upward rise in interest rates could deliver negative returns, and as an asset class perceived as low risk this starts to make it less attractive for investors.

One area of the market investors are turning to is Emerging Market Debt. The argument is that away from seeing economies as a homogenous group there are some strong economies. These economies show signs of greater growth when compared to developed economies. They have solid fundamentals (lower debt), better demographics and higher yields.

Accessing the debt is via two routes – hard currency which tends to favour less developed economies and local currency. Local currency is shown to outperform hard currency over the long term and countries using local currency tend to be stronger. The worry is that with the dollar strengthening, countries using hard currency will struggle to meet the repayments and defaults may be greater.

For many investors this means there is greater risk of volatility and this is true, there is also the question around whether investors should opt for local or hard currency.

Our approach has been to blend both currencies because they will perform differently and at different points of the economic cycle. One fund we have followed and use is the Baillie Gifford Emerging Market Debt Fund. This invests a minimum of 75% in local currency. Performance over hard currency has been poor in the last two years and we have recently had an update with the manager to understand more about what potential investors should consider before opting for this fund or any emerging market debt fund.

### **Who are the team behind the fund?**

The lead manager is Steven Hay who joined Baillie Gifford in 2004 and had previously worked at Scottish Widows. Previous to that he had spent seven years undertaking analysis and research for the Bank of England monetary policy committee and was involved in managing the UKs foreign exchange reserves.

He is well respected and although the team is small it is clear that the approach is about the team. His co-manager is John Barry who joined the team in 2009 and previously spent a number of years in the charity sector.

## Fund highlights?

The fund invests 75% of the assets in emerging market borrowers or bonds dominated in emerging market currencies but it may also invest in one or more of the following; sovereign, supranational, public sector and corporate issues in the developed world (currently it has around 8% in US dollar dominated debt).

Steven explained that much of the skill in managing the fund is focused on choosing the right country. He argues that many consider emerging markets as a homogeneous group but the reality is that different countries are at different stages of the economic cycle. What the team are looking for are those economies which have low debt, improving current account deficits etc. The belief is that those economies which have the ability to issue local currency debt are stronger and less aligned to the international markets.

The argument for local currency especially in a rising interest rate environment is complex but Steven explained that if the US dollar strengthens then those economies paying for the debt in the US dollars are likely to have a depreciating currency which means the cost of the debt increases and chances for default increases. Local currency removes that risk.

There are of course other factors but this is an example of what individuals need to consider. Country risk is another factor and this is something the team spend a lot of time considering. Steven used the example of India where they are overweight and Indonesia where they are underweight as to the importance of understanding country risk.

Indonesia has a lot of potential – it has an abundance of natural resources and a young population however it has poor infrastructure, it currently subsidises petrol and oil and importantly it has a coalition government. Coalition governments are often not reformist and therefore it is unlikely to get the investment it needs. It doesn't make it a bad country it just means the headwind is against it and therefore the team prefer an underweight position.

As an opposite India offers considerable potential; just from a basic overview one third of the population are in poverty which means they are working from a much lower base and therefore the potential to grow is greater. One of key differences is the reformist government which they believe will deliver long term potential for India and one of the positions of the fund is long the Indian Rupee.

Other areas they don't like are South Africa where they feel there is too greater reliance on foreign investment to fund their deficit and Hungary with rising inflation. They have also moved to an underweight in Turkey as there is a fear that bond yields and inflation will rise. They have moved to overweight currency positions in the US, Mexico and Colombia with a view that the currencies of Thailand and Australia are at risk.

Other areas they have investment in include Brazil, Russia, Poland and Peru.

Investing in emerging market debt does carry more risk than developed market bonds, however the dynamics are different. There is also an argument that developed market debt will suffer with rising interest rates. As Steven explained one of the key things about this fund is choosing the right countries as well the right investments. It won't avoid the contagion effect but the strong economies will recover whereas the weaker ones won't.

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Choosing hard or local currency is a consideration and we have seen with the strength of the dollar that local currency has struggled and underperformed US dominated debt. The comparison we have used is the Threadneedle Fund. Steven believes long term this will reverse and investors will need to consider what they believe is right. Investors can buy blended funds or they can blend this with a hard currency fund. As Steven mentioned there is a risk with hard currency and that is that as the dollar strengthens the payments are higher and therefore the risk of default is greater. Again a good fund manager would be careful on what investments he makes which reduces that risk.

Credit is at a tricky crossroad. Investors like credit because it is perceived as safe, it is likely this perception will be challenged. Emerging markets may offer an alternative option but the risks are greater and this may not appeal to all investors.

In conclusion this is a well-managed fund but there are many considerations for investors and what they are looking for. This shouldn't be seen as a short term investment and investors will need to accept greater volatility when compared to other fixed interest investments. It has struggled against dollar denominated bond funds but the belief is that long term this will reverse.

### Fund performance

Performance since launch on 22 September 2008

	2008	2009	2010	2011	2012	2013	2014	Since Launch
<b>Baillie Gifford Emerging Market Debt Fund</b>	13.85%	7.32%	19.40%	-1.85%	13.08%	-13.77%	0.37%	40.14%

The table below compares the performance against the Threadneedle Emerging Market Debt Fund which was launched on 29 September 2009 and runs from that date to the 30 September 2014.

	2009	2010	2011	2012	2013	2014	Since Launch
<b>Baillie Gifford Emerging Market Debt Fund</b>	2.58%	19.40%	-1.85%	13.08%	-13.77%	0.37%	17.66%
<b>Threadneedle Emerging Market Debt Fund</b>	0.07%	12.76%	8.97%	12.80%	-9.68%	8.92%	36.44%

*You should note that past performance is not a reliable indicator of future returns and the value of your investments can fall as well as rise. The total return reflects performance without sales charges or the effects of taxation, but is adjusted to reflect all on-going fund expenses and assumes reinvestment of dividends and capital gains. If adjusted for sales charges and the effects of taxation, the performance quoted would be reduced. Returns are based on the US share class.*

## **Conclusion**

This is an actively managed bond fund with a good long-term track record. It has suffered against hard currency in the last couple of years and investors need to consider whether this will reverse.

*The source of information in this note has been provided by Baillie Gifford and is correct as at October 2014. These are notes from meeting the fund manager or representative and should not be seen as a recommendation to purchase any fund mentioned. Any reference to shares is not a recommendation to buy or sell. Should you wish to make a decision based on these notes we cannot take responsibility for this and you should carry out your own research before making a decision. You should note that past performance is not a reliable indicator of future returns and the value of your investments can fall as well rise.*