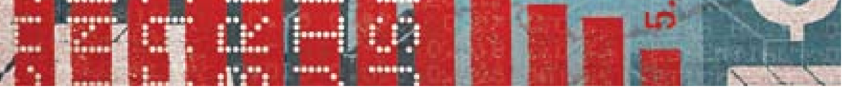
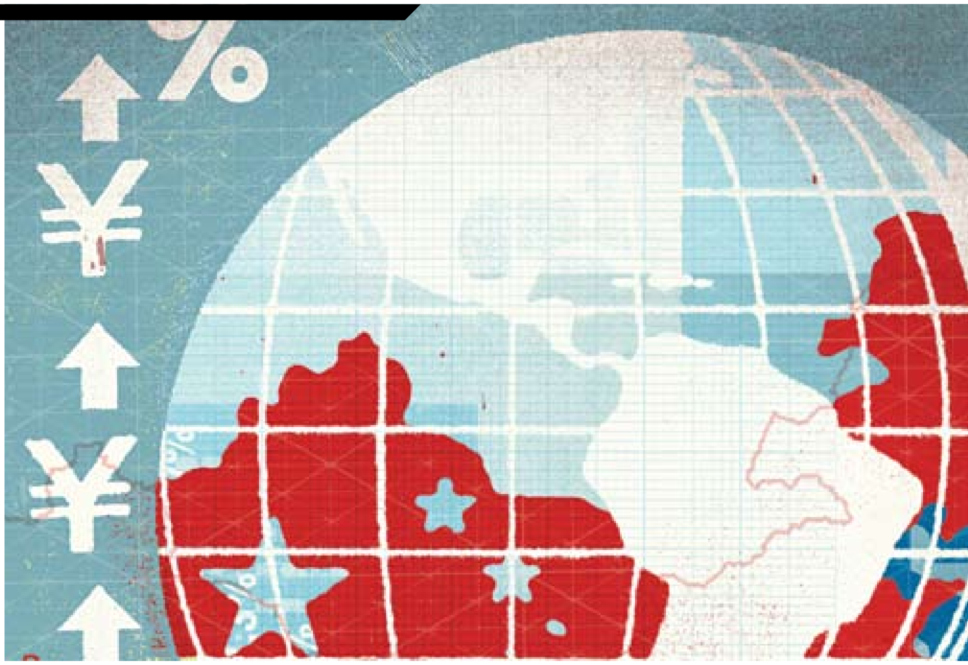


Diversification potential of emerging market debt

By Jean Charbonneau



According to an April 2010 report by Goldman Sachs Asset Management, emerging market (EM) economies have grown dramatically and now account for 43% of global GDP. By far the biggest driver is demographics, such as massive population growth and the rise of a robust and savings-oriented middle class.

EM Debt as a Core Asset

EM debt has been largely overlooked as an asset class. However, according to Pyramis Global Advisors' 2010 *Global Defined Benefit Survey*, many institutional investors are increasing their exposure to EM equities. As a result, investing in EM debt may soon become a core strategy for diversifying a portfolio with EM equities and Canadian bonds.

Following are five reasons why plan sponsors should consider EM debt in their asset allocation decisions.

1 | Attractive correlations

Emerging markets represent a unique opportunity to diversify, manage risk and achieve excess relative returns throughout various market conditions. Correlations between emerging markets and their developed market peers are still low, providing a key benefit for investors seeking diversification in an increasingly correlated global marketplace.

2 | EM bonds do not equal junk bonds

Investors often compare EM bonds with high-yield bonds (those with a rating below BBB-), but the comparison can be misleading. According to June 2010 data from the International Monetary Fund—and to the surprise of many investors—56.4% of EM bonds are now rated investment grade, compared with only 16.5% in 1998.

3 | More sustainable debt levels

There has been increased concern over sovereign debt default (the risk that a country will default on its debt obligations) in a number of developed countries. Excessive consumption levels have created significant fiscal imbalances and unsustainable debt levels within these countries. In comparison, EM countries have more sustainable debt levels and are expected to decrease debt as a percentage of GDP over the next five years (see Debt-to-GDP Ratio: Country Comparison).

4 | Strong yields favour emerging markets

EM government bond yields are typically higher than those offered by other sovereign bonds, and the fundamentals that have led to growth and stability in emerging markets (i.e., high savings rates, better regulation and a growing middle class) have significantly decreased the risk premium. The risk premium is expected to continue to narrow as EM and developed market yields converge.

DEBT-TO-GDP RATIO: COUNTRY COMPARISON

World Rank	Country	Debt-to-GDP Ratio
2	Japan	189.3
6	Italy	115.2
7	Greece	113.4
18	Canada	75.4
30	**Brazil**	**60.0**
34	**India**	**58.0**
47	U.S.	52.9
55	**Thailand**	**45.9**
87	**South Africa**	**29.5**
109	**China**	**16.9**

Source: *The World Fact Book 2011*, Central Intelligence Agency, 2009 estimates

IMAGE: GETTY IMAGES

5 | Rise of local currency debt

Historically, EM debt was issued only in hard currencies, such as the U.S. dollar (i.e., external debt). Since liquidity and transparency have improved dramatically—and, more importantly, because these countries have fewer financing needs in external currencies—more and more EM countries have issued debt in local currencies. Demand for local currency-denominated debt has also grown rapidly from rising investor demand, both externally and within the countries themselves.

External and local currency EM debt, both issued by the same country, are different asset classes differentiated by their underlying risks. External debt is measured by the spread over U.S. treasuries and tied to U.S. monetary policy. Local currency debt (currently the largest and fastest-growing part of the EM debt market) has two different sources of return—currency and duration risk—and is tied to the monetary policy of the country of issue.

EM bonds have produced consistently strong total returns over the last several years, and the market today is larger and less risky than it was 10 years ago

Risks and Opportunities

Investing in EM debt does not come without risk. Risks associated with investing in emerging markets include political, credit, interest rate, currency and inflationary risks, to name a few.

Interest rate differentials between developed and EM countries generally remain attractive. However, inflation and currency risks are still a threat. With regard to currency risk, a significant portion of return for an unhedged portfolio will come from currency. Diversified currency exposure—including diversification away from the U.S. dollar and the euro—can enhance returns.

Rising inflationary pressure is the inevitable consequence of rapid expansion. Recent EM performance reflects mounting concerns of a slowdown in growth rates from tightening policies. Inflation, while still a concern, is showing signs of stabilizing in many countries.

EM governments have learned valuable lessons from the sovereign debt crises and currency devaluations of the mid- to late-1980s and have since transformed their fiscal situations. Most have introduced flexible currency exchange rates, accumulated vast reserves of foreign currencies and reduced their debt levels, resulting in a structural improvement in creditworthiness of their markets, and have considerably reduced volatility.

EM bonds have produced consistently strong total returns over the last several years, and the market today is larger and less risky than it was 10 years ago. With its increasing share of global bond markets, the expected reduction in risk premium and attractive growth prospects, EM debt may warrant an increased allocation within investors' portfolios. BC

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