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EM Debt: Why Passive Strategies Often Miss the Mark

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When it comes to emerging markets, index tracking can result in both increased risks and missed opportunities.

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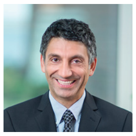

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The notion that the "average" active manager routinely underperforms the index has encouraged many investors to gravitate toward passive investing over the last decade. However, passive investment does not work equally well across all asset classes. When it comes to investing in less efficient markets, such as emerging markets sovereign and local debt, there are several reasons index tracking often results in both increased risks and missed opportunities.

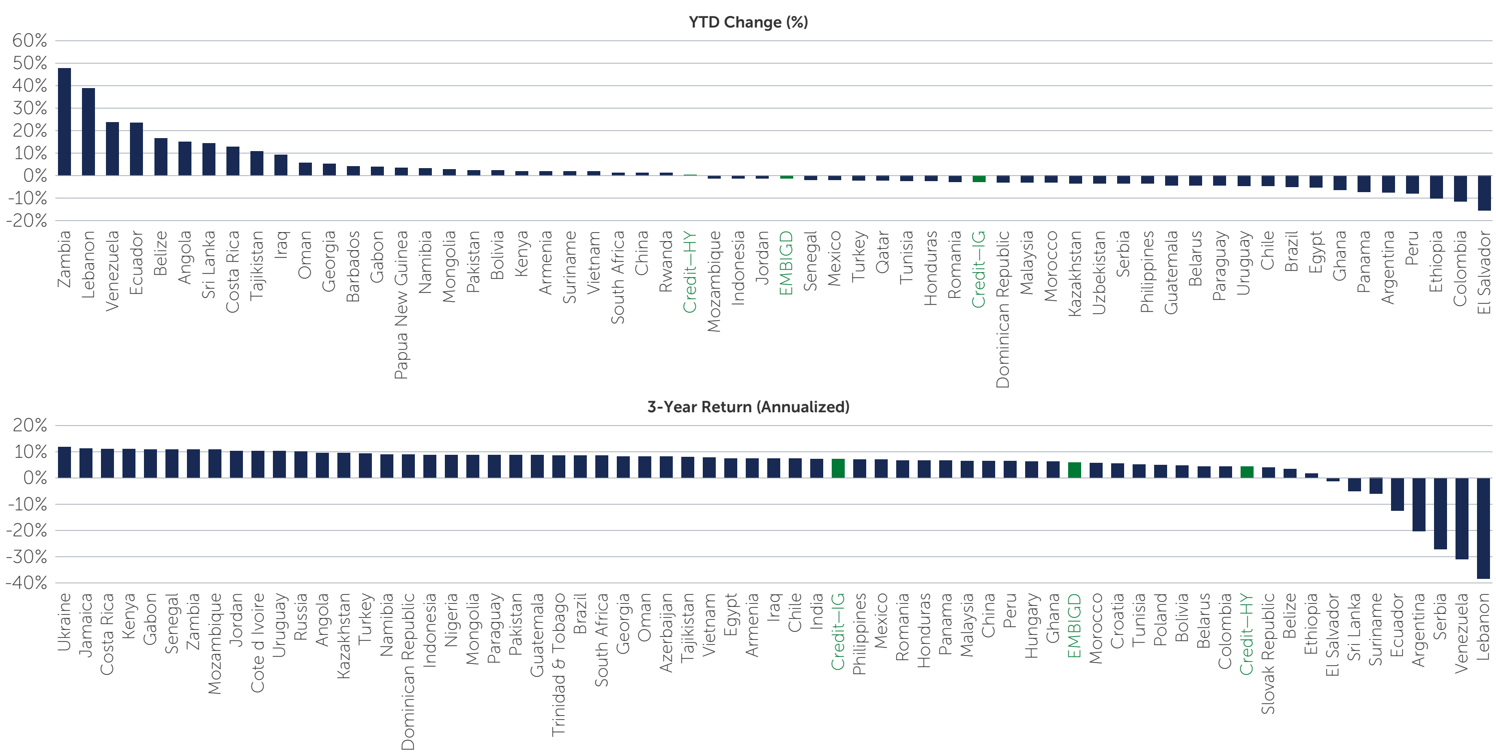
Performance Dispersion

EM debt seems to be facing a new wave of challenges after rallying strongly following the initial onset of COVID, which led to steep declines across nearly all asset classes in early 2020. These include not only COVID-related disruptions, which have contributed to higher current inflation, but also regulatory crackdowns in China and the prospect of rising developed market rates. Year-to-date performance across both local debt and sovereign hard currency debt reflects this mounting uncertainty, with both asset classes down for the year at the index level.

However, as is often the case, index-level returns mask the tremendous diversity, complexity and significant dispersion in performance from issuer to issuer. Indeed, while broad market conditions for EM debt often drive returns in the short term, idiosyncratic country fundamentals ultimately drive prices and performance over the long run. For instance, EM sovereign debt as a whole is in slightly negative territory this year, down -1.36% as of the end of September. However, some countries' returns have been much more positive (or negative) than others. In particular, nine sovereigns have outperformed the index by more than 10 percentage points in total return—with countries like Zambia returning 47.7%. Others, like Ethiopia, Colombia and El Salvador, are in decidedly negative territory, having returned -10%, -12% and -16%, respectively **(FIGURE 1)**.

Performance data for three years through September 30 paints a similar picture. In the past three years, the J.P. Morgan EMBIGD returned roughly 6%. While the vast majority of sovereign debt delivered positive returns, some countries were much more positive than others. Twelve sovereigns outperformed the index by more than 10 percentage points in total return. However, on an absolute basis, Serbia (-27%), Venezuela (-31%) and Lebanon (-39%) fell significantly **(FIGURE 1)**.

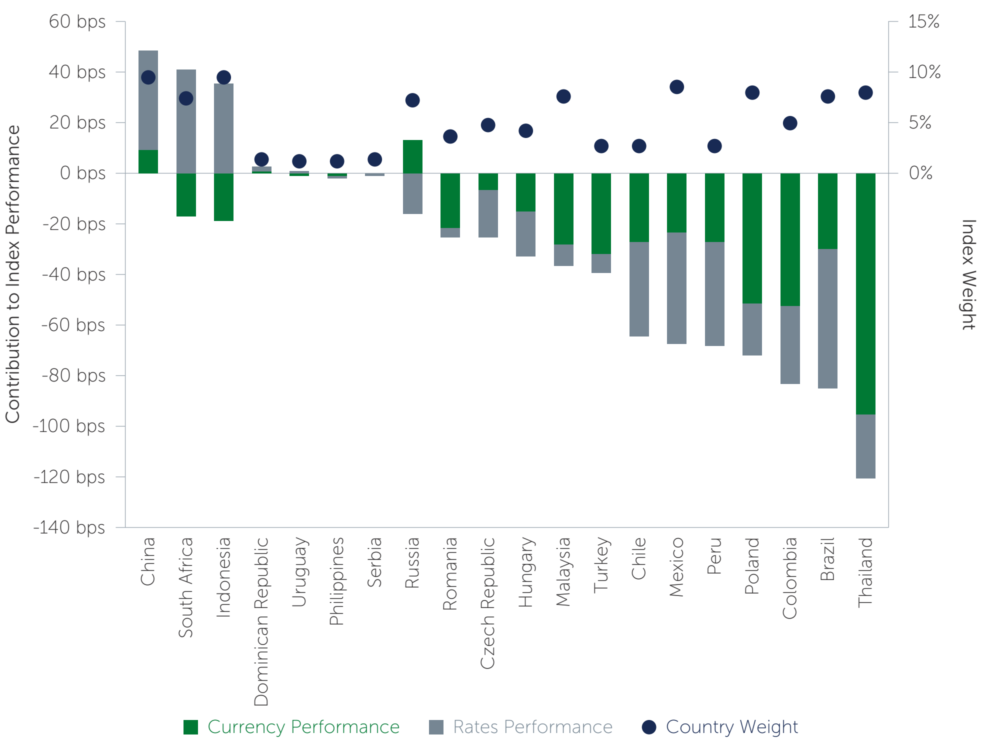
FIGURE 1: Country Excess Returns Relative to EM Sovereign Index*



SOURCES: J.P. Morgan. As of September 30, 2021.
*Excludes countries that have performance between -1% and 1%

We have seen similar dispersion in performance on the local debt side. In the first three quarters of the year, the index returned -6.38%—but there have been both positive and negative contributors. Countries like Indonesia, South Africa and China, for instance, contributed 30–40 bps each to index performance, while Colombia, Brazil and Thailand were significant detractors **(FIGURE 2)**. **FIGURE 2** also shows that within local debt, the rates component has been a slightly more stable source of return, whereas the currency component tends to be more volatile and the dispersion tends to be larger. This variation in performance underscores how important active management and picking the right countries and currencies is to investing in the asset class.

FIGURE 2: Local Debt Contribution to Performance (YTD)



SOURCES: J.P. Morgan GBI-EMGD; Barings. As of September 30, 2021.

CONTRIBUTION TO INDEX PERFORMANCE

One misconception in both the sovereign and local space is that the largest countries in the index are the biggest contributors to performance. That's not necessarily the case—regardless of a country's weight, it can make a big contribution to, or detract substantially from, total return. In the local debt space, for example, the index consists of fewer countries and bigger weightings per country, which vary from 0% to roughly 10%. But a closer look reveals that countries like Brazil and South Africa are weighted similarly, although the two countries have contributed very differently to performance this year. In fact, South Africa has contributed almost as much positive performance as China, which has a higher weight in the index. Chile and Peru are further examples. Even though the countries have weights below 2%, both have significantly detracted from performance **(FIGURE 2)**.

Replicating the Index can be Difficult (& Costly)

Successful passive management is based on the premise that a relevant asset class index can be replicated accurately and in a cost-efficient manner, which is not necessarily the case with EM debt—particularly local debt, where costs are incurred not only from replicating the index (trading costs), but also in the form of local taxes on government bonds. It is also important to note that EM debt exchange-traded funds (ETFs), like the index, tend to have smaller exposures to a large number of countries, meaning they are often invested in both the best (and worst) performers across the sovereign debt landscape, without the ability to discriminate on risky or deteriorating countries. At times, as noted above, even countries with small weights can contribute or detract significantly from total return—as we have seen in the sovereign space this year with Ecuador on the positive side (1.5%; 31 bps) and Colombia on the negative side (2.7%; -34 bps) **(FIGURE 3)**.

Active managers, on the other hand, are unconstrained by the index, and therefore have the ability not only to avoid the 'bad apples' that exist in the space at any given time, but also to take larger positions, relative to the index, in countries that are exhibiting positive trends.

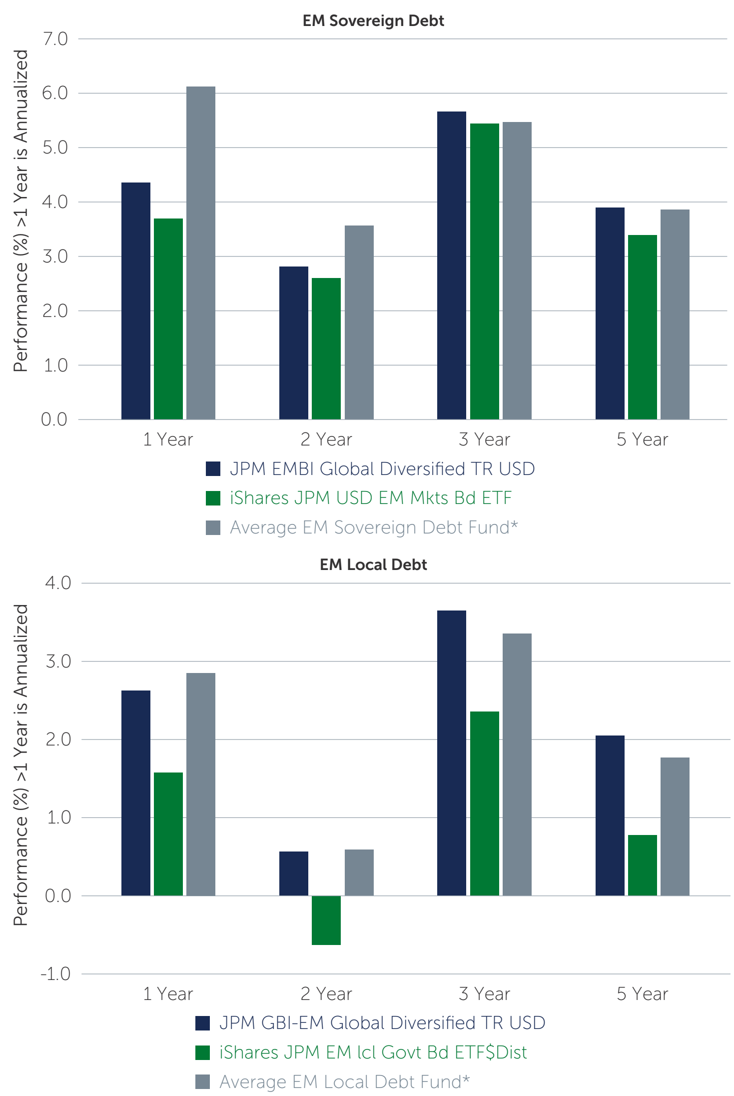
FIGURE 3: Sovereign Debt Contribution to Performance (YTD)

SOURCES: J.P. Morgan EMBIGD; Barings. As of September 30, 2021.

Passive Strategies Often Miss the Mark

Against this backdrop, it is perhaps unsurprising that passive strategies have tended to underperform the average active strategy over time **(FIGURE 4)**. In the sovereign space, for instance, actively managed strategies compared to the J.P. Morgan EMBIGD Index have outperformed passive strategies on a 1-year, 2-year, 3-year and 5-year basis, in some cases significantly. It's a similar story with EM local debt, with passive strategies meaningfully and consistently underperforming active strategies against the J.P. Morgan GBI-EMGD Index.

FIGURE 4: Active vs. Passive Investing in EM Sovereign and Local Debt



SOURCE: Morningstar. As of September 30, 2021.
*Average EM sovereign debt fund includes 37 actively managed funds. Average EM local debt fund includes 28 actively managed funds.

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Key Takeaway

While there are ongoing risks facing emerging markets, there are also reasons to believe that growth will be positive in the months ahead. For one, the recovery is well underway across both developed and emerging markets, and we believe the EM growth story remains well anchored. The fiscal firepower in developed markets continues to sustain demand for EM goods and services, and global trade has also started to re-engage, which should continue to support the asset class. Even the hardest hit economies—such as tourism-linked Thailand—are starting to see light at the end of the tunnel, with tourism expected to slowly resume over the next year.

As a result, many EM countries' current account balances are much stronger today than they were pre-COVID, which should remain supportive not only of EM sovereign hard currency, but also of FX and rates. Although there may be some economic lag for EMs relative to developed markets, we believe most countries are on solid financial footing, and better positioned to withstand outflows in the event that rising developed market rates impact EM countries' ability to access external financing.

However, given the wide dispersion in performance across the EM debt landscape, credit and country selection matters, and will continue to play a pivotal role in performance going forward. In our view, active managers that do their homework and closely assess risk on a country-by-country basis will likely be best positioned to identify the countries, rates and currencies that stand to benefit the most through the continued recovery, as well as in the face of any forthcoming uncertainty.

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**As of September 30, 2021*

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