



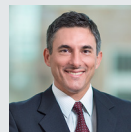
# BARINGS

PUBLIC FIXED INCOME

## EM Debt: The Benefits of a Blended Approach

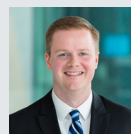
INSIGHTS

The EM debt universe—larger, more diverse, and of higher-quality than generally perceived—offers compelling opportunities today. But given the uncertainties ahead, there are potential benefits to taking a blended approach.



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Emerging markets (EM) debt is often referred to as one single homogenous asset class, but in reality, it is a large investment landscape offering a diverse range of opportunities. EM and developing economies (ex-China and Russia) represent a significant 23% of the world’s GDP, or around \$24 trillion<sup>1</sup>, with EM issuers spanning over 90 countries and 1,000 corporates.<sup>2</sup> Within this broad universe, there are four distinct opportunity sets: **sovereign hard currency, corporate credit, local interest rates and local currencies.**

While EM debt often receives negative headline attention, it would be a mistake to paint the asset class with one broad brush. In fact, for those willing and able to dig deeper, there is significant value to be uncovered across the investment landscape. In this piece, we debunk some of the common misconceptions of this expansive asset class and discuss why a blended approach to investing in EM debt may be beneficial now, more than ever.

## Unique Performance Drivers

### SOVEREIGN HARD CURRENCY & CORPORATE DEBT

Each sub-asset class within EM debt has its own unique characteristics and drivers of potential returns. For investors in EM sovereign hard currency and corporate debt, **credit risk is the underlying source of return.** As follows, deep fundamental analysis on countries and companies is crucial, not only in forming strong conviction in the creditworthiness of issuers, but also in uncovering value. And there is plenty of potential value on offer, particularly considering that this universe is higher-rated—and less prone to defaults—than is commonly perceived.

Indeed, one common misconception about sovereign and corporate debt is that it consists of primarily high yield issuers—leading some investors to assume they are taking on more risk than is often the case. Rather, the **majority of both the EM sovereign hard currency and corporate debt markets are investment grade rated.** Of the debt that is rated below investment grade, much of it is BB, or on the higher-quality end of the high yield spectrum (**Figure 1**).

**Figure 1: Not All EM Debt is High Yield**

	Sovereigns	Corporates
Investment Grade	50.2%	59.9%
High Yield	49.8%	40.1%
BB	22.3%	20.3%
B	19.7%	11.7%
< B	7.8%	8.1%

Source: JP Morgan. As of December 31, 2023. Sovereign and corporate figures shown are from the representative indices JP Morgan EMBI Global Diversified and JP Morgan CEMBI Broad Diversified, respectively.

1. Source: IMF WEO. As of October 2023.  
 2. Source: Barings.

Another misconception is that defaults across the asset class are common. In reality, **only 1.3% of the EM corporate debt universe defaulted, on average, over the last decade (Figure 2)**. For comparison, this figure is significantly lower than the 2.8% default figure in the U.S. high yield market. In the EM sovereign debt space, defaults also are typically few and far between. From 2001 to March 2020, only seven countries defaulted on their debt.<sup>3</sup> A slight increase in defaults did occur in the wake of the pandemic due to the more fragile EM economies being unable to fully adjust to the shocks and stay current on their debt. Since Covid, nine countries have defaulted, including Ukraine following Russia’s invasion. Despite these post-pandemic difficulties, an average of only 2.1% of the EM sovereign index’s components have defaulted over the last 10 years.

**Figure 2: EM Corporate Debt has Experienced Fewer Defaults, on Average, Than U.S. High Yield**

	2023	2022	2021	2020	2019	2018	2017	2016	2015	2014	10-year Average
EM Corp Defaults	2.5%	2.5%	1.7%	1.1%	0.3%	0.5%	0.7%	1.7%	1.0%	1.2%	<b>1.3%</b>
EM Sov Defaults	0.1%	3.1%	0.0%	7.6%	0.0%	6.1%	0.1%	0.0%	1.8%	2.1%	<b>2.1%</b>
U.S. HY Defaults	2.8%	1.7%	0.4%	6.8%	2.9%	1.9%	1.5%	4.3%	2.9%	3.2%	<b>2.8%</b>

Source: JP Morgan. As of December 31, 2023. Within the EM corporate high yield segment, the default rate was 3.5% over the last 10 years—but this has been mostly elevated in recent years by defaults in Russia and China.

## LOCAL RATES & CURRENCIES

For investors in local debt, or sovereign debt denominated in a country’s local currency, there are **two distinct sources of returns and risks: 1) the level and direction of interest rates, and 2) currencies**. Interest rate returns are driven primarily by a country’s local economic cycle. Slowing economies tend to be positive from an interest-rate performance perspective as they generally lead to a compression in yields. Currency returns are driven by a nation’s economic competitiveness and the demand for its currency. Unlike sovereign hard currency and corporate debt, credit (or default) risk is not the primary concern for investors in local debt, as most of the countries that comprise the EM local space have deep, sophisticated local markets. To that end, the economies that constitute the local debt universe, which includes countries like Brazil, Indonesia and Mexico, are fundamentally stronger than many other EMs. Perhaps unsurprisingly, roughly **80% of the EM local space is investment grade rated**.<sup>4</sup>

## Value Creation, Diversification

The size of these markets and varying performance drivers, alone, underscore how misleading sweeping generalizations can be when it comes to EM debt. Even within each of the above-mentioned drivers, there are nuances and idiosyncrasies that further influence the individual performances of the issuers. But the complex and diverse nature of this asset class is also what makes it **rife for value creation**.

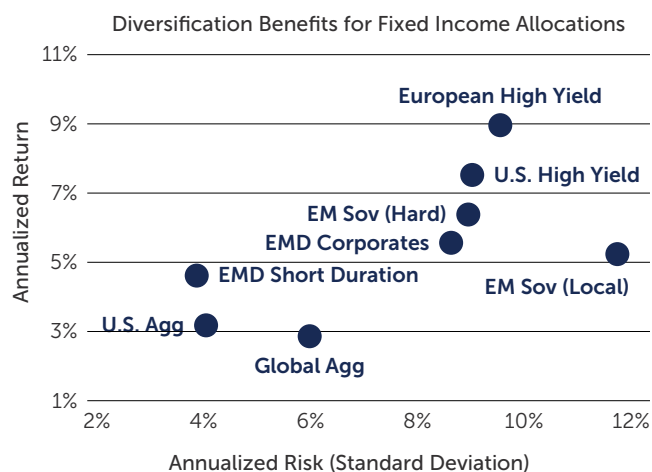
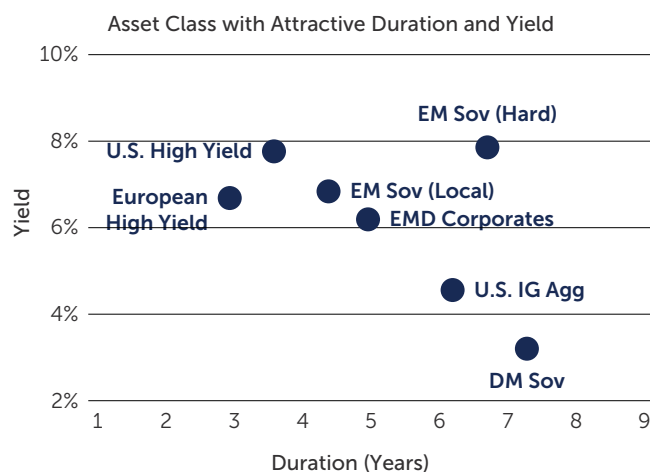
3. Source: JP Morgan. As of December 31, 2023.

4. Source: JP Morgan. As of December 31, 2023.

While global or regional economic trends can certainly impact overall performance, it is country-by-country and credit-by-credit analysis that can bring to light the most attractive investment opportunities. This level of scrutiny, in addition to affording detailed insight into a country or company’s current state, can also—and perhaps more importantly—help determine an issuer’s future direction of travel. And it ultimately helps distinguish between issuers that are on a positive trajectory—fundamentally improving their creditworthiness and poised for potentially strong performance—and those that may be headed for greater challenges and underperformance.

The opportunity for value creation, coupled with the expansive market and unique drivers of each sub-asset class, is also what makes EM debt an effective portfolio diversifier. In particular, each sub-asset class provides **the potential for attractive long-term returns with varying yield, duration, and risk profiles (Figure 3)**. EM debt has also demonstrated **low correlations with developed market asset classes** like equities, U.S. fixed income, and global fixed income **(Figure 4)**. Over time, we see these diversification benefits continuing to increase as emerging market countries with independent central banks and monetary policies become even less correlated with developed markets.

Figure 3: Effective Portfolio Diversifier



Sources: JP Morgan; Barclays; BofA; Bloomberg; FTSE. As of December 31, 2023.

Figure 4: Low Correlations with DM Asset Classes

5 years	EM Corporate	EM Sovereign (HC)	EM Sovereign (LC)	EM Equity	U.S. Equity	U.S. IG Corp	U.S. HY Corp	U.S. TBill	DM Sovereign	EU HY Corp
EM Corporate	100%									
EM Sovereign (HC)	86%	100%								
EM Sovereign (LC)	64%	75%	100%							
EM Equity	48%	56%	62%	100%						
U.S. Equity	30%	44%	41%	43%	100%					
U.S. IG Corp	63%	58%	36%	14%	16%	100%				
U.S. HY Corp	72%	77%	63%	54%	59%	53%	100%			
U.S. TBill	8%	6%	2%	-6%	-5%	15%	0%	100%		
DM Sovereign	47%	47%	46%	11%	3%	73%	33%	22%	100%	
EU HY Corp	73%	72%	56%	57%	44%	38%	79%	-3%	21%	100%

Sources: JP Morgan; Barclays; MSCI; S&P; FTSE. As of December 31, 2023.

## The Benefits of a Blended Approach

As markets have digested the shocks of the last several years—from the pandemic to significant monetary policy tightening across the globe—the outlook for EM debt in the year ahead looks cautiously optimistic. More specifically, given the improving macro backdrop supported by normalizing inflation, expectations for rate cuts from the U.S. Federal Reserve (Fed), still supportive growth in the U.S., and the resilience of many EM sovereigns and corporates, **2024 has brought with it the potential for attractive returns across the asset class**. However, while all EM debt sub-asset classes are poised for potentially strong performance in 2024 and beyond, the environment is not without its challenges. For instance, politics will play an important role as much of the world heads to the polls for national elections this year, while geopolitical tensions are an ever-present concern.

*“This variation in performance creates opportunities for active managers to invest where their conviction is greatest and where relative value appears most promising.”*

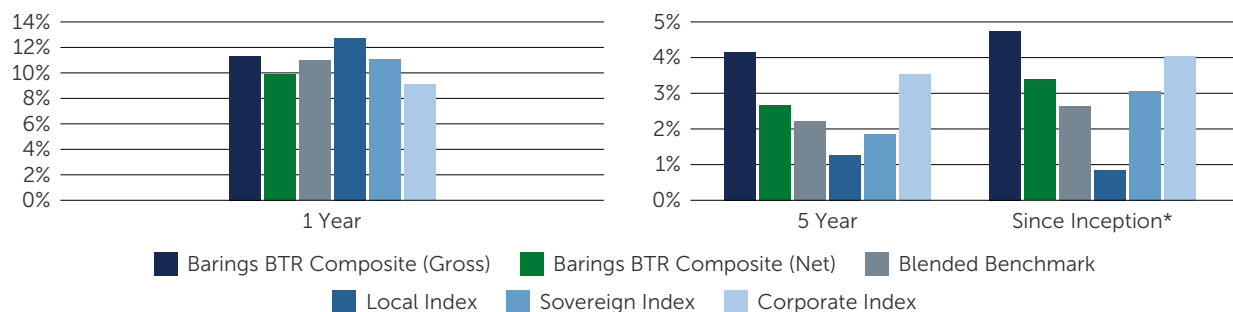
Against this backdrop, a blended total return strategy that allows managers to timely and efficiently allocate capital between EM sovereign, corporate and local debt can be particularly beneficial. One key benefit of a blended strategy is that it **enables investors to put tactical investment decisions into the hands of a manager with expertise across the EM debt spectrum**. As mentioned, each sub-asset class within the vast EM debt space has its own unique attributes, with performance often driven by idiosyncratic or differing factors. As a result, EM economies and issuers often outperform or underperform at different times and across a range of market conditions. This variation in performance creates opportunities for active managers to invest where their conviction is greatest and where relative value appears most promising.

## Barings' Blended Total Return Strategy

Barings' EM debt blended total return strategy seeks to achieve attractive risk-adjusted returns by investing in a combination of EM sovereign (hard and local currency) issuers, corporate issuers and currencies. The strategy relies on rigorous, bottom-up analysis—rather than top-down asset allocation—to identify the best ideas within the space. While the strategy operates across every sub-segment of the market, it is **highly selective within each segment**—the typical portfolio only includes around 120 positions, out of an opportunity set of over 1000. Moreover, the strategy is managed against cash, meaning it is not handicapped by allocations or inherent risks within benchmarks.

In uncertain markets in particular, the combination of high conviction and selectivity, coupled with agile benchmark agnostic asset allocation, are key components in delivering strong performance—and have resulted in the strategy delivering **strong returns on a historical basis**.<sup>5</sup> While the strategy is not managed to a benchmark, the value of the strategy can be best observed by comparing performance against the broader market. As shown below, our blended strategy has outperformed an equal blend of the standard EM debt indices over the long run, as well as the return of each individual index (**Figure 5**).

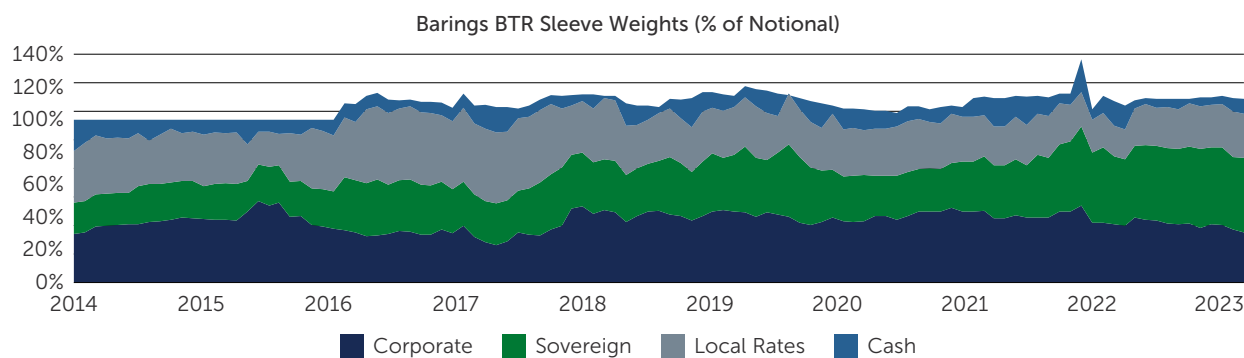
**Figure 5: Strong Performance Over Time**



Sources: Barings; JP Morgan. As of December 31, 2023. Barings BTR Composite = Emerging Markets Debt Blended Total Return. Blended Benchmark = Equal weights JP Morgan EMBIGD, JP Morgan CEMBIBD and JP Morgan GBIEMGD. Local Index = JP Morgan GBIEMGD Index. Sovereign Index = JP Morgan EMBIGD Index. Corporate Index = JP Morgan CEMBIBD Index. PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS. Please refer to the prospectus for further information. \*Since inception performance starts from January 1, 2015.

The design of the strategy is flexible, and there are no strict guidelines on the portion allocated to each of the sub-asset classes (although the portfolio is managed to soft internal guidelines to limit downside risk). Portfolio management decisions are made in a fluid manner, with **portfolio managers for each of the sub-asset classes communicating their respective “best ideas”** to the rest of the portfolio management team. Following these discussions, the portfolio management team makes the case to increase or decrease exposure to certain sub-asset classes. At the same time, we focus on our **high-conviction country-by-country and credit-by-credit views**, and avoid making top-down calls on sub-asset class relative views. While asset allocations do change, the changes occur over time and in response to changes in the underlying credit by credit and country by country convictions (**Figure 6**).

**Figure 6: An Unconstrained Strategy Based on “Best Ideas”**



Source: Barings. As of December 31, 2023. PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS. Please refer to the prospectus for further information.

5. PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS.

## Key Takeaway

Emerging markets debt is a vast and diverse asset class that provides access to a large opportunity set. Given the unique characteristics and performance drivers that influence the key sub-segments of the market—government and corporate issuers, hard and local currencies, and investment grade and high yield credits—certain credits and issuers tend to outperform or underperform at different times. For this reason, we see particular benefits to a blended approach. At Barings, our blended total return strategy relies on country by country, credit by credit, and currency by currency analysis. Because it is unconstrained by a benchmark, it gives us the flexibility to capitalize on our team’s “best ideas” and execute timely allocations across geographies and asset classes in pursuit of strong risk-adjusted returns for our clients.

**Barings Emerging Markets Debt Team**

BARINGS HAS ONE OF THE LARGEST DEDICATED EM DEBT TEAMS

<p><b>10</b> Dedicated Investment Professionals Covering</p> <p><b>85+</b> Emerging Market Sovereigns</p>	<p><b>10</b> Dedicated Investment Professionals Covering</p> <p><b>1,100+</b> Emerging Market Corporate Issuers</p>	<p>Our Dedicated EM Analysts Collaborate with</p> <p><b>59+</b> Global Credit Analysts from Across the Barings Platform to Identify the Best Opportunities in the Asset Class</p>
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**BARINGS BTR STRATEGY**

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Source: Barings. As of December 31, 2023.

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