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# Local Currency Emerging Market Debt – right asset class, wrong way to invest

**E**merging market debt has seen significant inflows recently. However, we believe that a lot of investors are taking more risk in local emerging market debt (EMD) than is either optimal or fully appreciated. Investing in a local market index may expose you to some concentrated positions, with more currency risk than interest rate risk. Adding EMD exposure can have very positive portfolio effects, but doing this in the wrong way could significantly increase volatility.

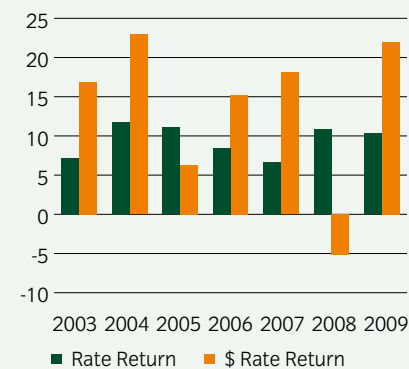
We believe that the market tremors of recent weeks could indicate problems ahead. With more of the same expected, those investing via an indexed fund might experience a lot more pain in 2011.

## Right asset class, wrong way to invest, reason 1

The nature of emerging market debt returns means that currency plays as important a role as the actual bonds themselves. Charts 1 and 2 show the annual returns and volatility for the JPM index shown in both local currency and dollar terms. As can be seen, there is a great deal of variability between the two. The implication of this for investors is that they cannot simply ignore currency in allocating to this asset class. As the charts show, doing this has created much higher volatility of returns. We expect 2011 to be a year of extreme variability in currency returns and investors need to position accordingly.

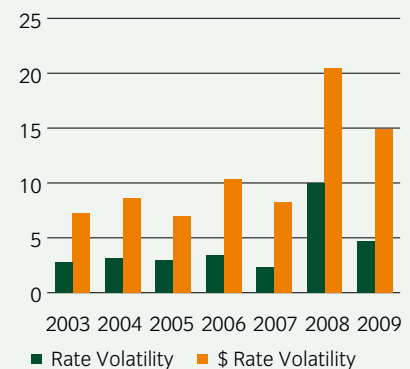
EM currencies have been less volatile than normal during 2010, partly due to widening growth differentials but also due to inflows to the asset class.

Chart 1: EMD returns in local currency and dollar terms



Source: JP Morgan.

Chart 2: EMD volatility in local currency and dollar terms



However, a combination of elections, differing government and central bank policy decisions, capital controls and issuance trends are likely to lead to greater differentiation (and hence volatility) in 2011. Active management of currency exposures – the ability to take outright short as well as long positions or to fully hedge out risk – will be key to generating returns and reducing volatility. Ignoring the currency risk inherent in long-only local market investing could lead to significant portfolio losses.

## Right asset class, wrong way to invest, reason 2

Traditionally, an investor moving into an asset class that is less familiar probably takes the 'less risky' option of investing through a well-known index – whether passively or through a long-only active strategy that uses the index as a benchmark. While this may be suitable for some investors, in EMD it may not provide the hoped-for benefits.

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The EMD indices are not necessarily representative of the universe as a whole. In fact, the JP Morgan local market Emerging Market Bond index (JPM GBI-EM) is dominated by nine countries which collectively account for just under 90% of the total index. While there are obviously different factors affecting different countries, this level of concentration is not helpful from a diversification perspective.

## Right asset class, wrong way to invest, reason 3

Currently, growth in many emerging markets, especially in Asia, is firm. In addition, rising commodity and food prices are starting to feed through to higher inflation. Already market levels look very expensive, with some 11 countries offering negative real policy rates. This suggests that rising interest rates and higher bond yields may soon be on the agenda. In order to make money in this environment, an ability to “pay” interest rate swaps to profit from rising rates is required. Clearly a long-only approach can seek only to minimise negative returns if yields start to rise.

## Right asset class, right approach

Strong fundamentals and positive technical factors make local market EMD an attractive asset class. It is also a wide and varied universe – indeed, this is part of its attraction as this breadth makes it a useful diversifier. However, as shown, investing on a simple long-only basis can lead to excessive volatility. We therefore firmly believe that the best way to gain the most from EMD is to invest on an absolute return basis, where the manager can position for both upward and downward yield moves, manage currency exposure proactively, and avoid the distortions that come with an indexed approach.

Arguably many of the same points can be made for externally denominated debt. The rise in US treasuries in recent weeks has led to increased volatility and higher yields across the board. Being able to hedge exposure with credit derivatives and to actively take positions to profit from spread widening makes the case for absolute return investing clear.

Over the long term, we remain highly positive on the attractions of EM as an

asset class. However, 2011 is set to be a year of considerable volatility. How you access the opportunities available will be key to the returns you achieve. Ignoring currency effects could be costly, while investing in a fund that can position for rising bond yields may be prudent.

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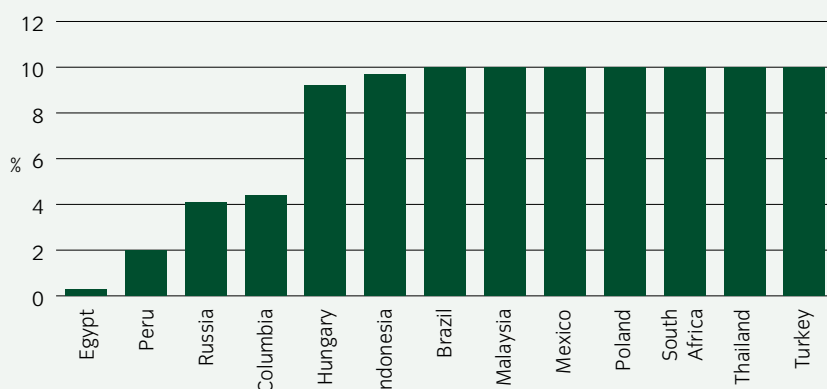
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Chart 2: Index is highly concentrated



Source: JP Morgan GBI-EM index constituents, 2010

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