Emerging Markets:

Three Reasons Why We Believe Active Makes Sense

Our experts outline some key considerations for investors weighing the use of actively managed strategies in the emerging-market sovereign debt space.

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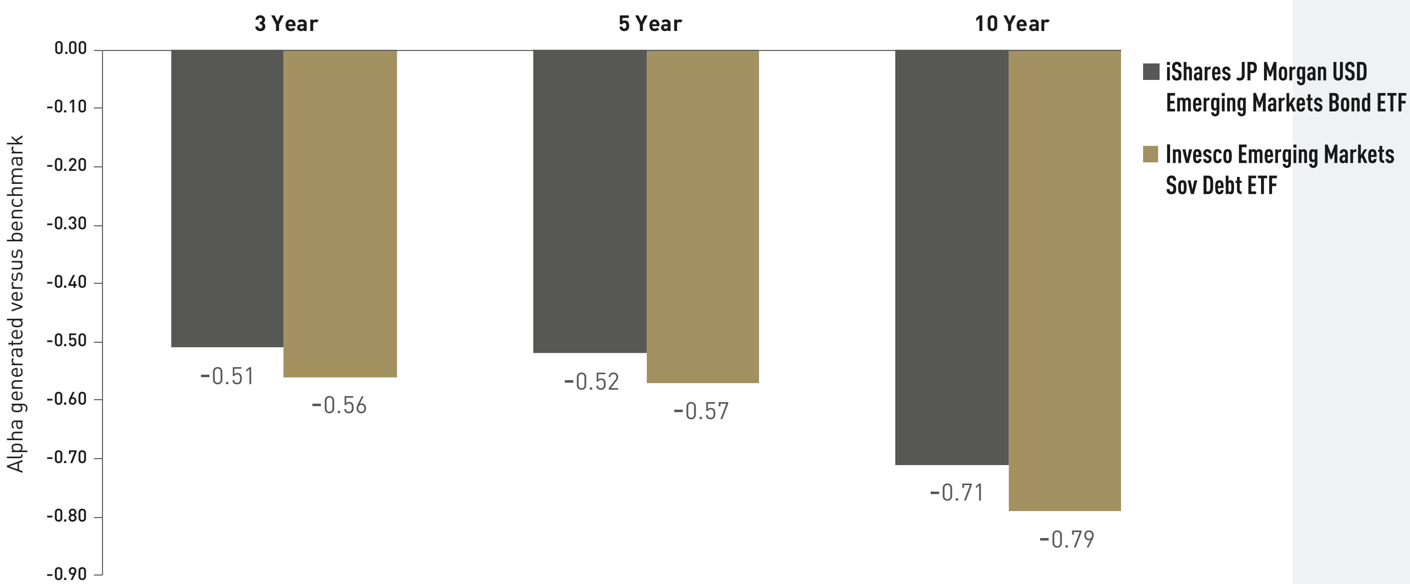
Chart 1. Major Passive Emerging Market Bond ETFs Underperform Benchmarks

Comparison of alpha generated by select ETFs versus their prospectus benchmarks for three-, five-, and 10-year periods



Source: Morningstar. Annualized data is of 03/31/2019. The alpha generated by the iShares J.P. Morgan USD Emerging Markets Bond ETF (EMB) is being compared to its prospectus benchmark, the J.P. Morgan Emerging Markets Bond Index (EMBI) Global Core Total Return USD. The alpha generated by the Invesco Emerging Markets Sovereign Debt ETF (PCY) is being compared to its prospectus benchmark, the DB Emerging Market U.S. Balanced Liquid Total Return USD. Exchange-traded funds shown are net of fees. For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment.
Past performance is not a reliable indicator or guarantee of future results.

In Brief

- Country selection is vitally important in an emerging market portfolio, in our opinion, particularly when considering how much exposure to allocate to one country or another.
- While fundamental research is a foundational tenet of emerging markets investing, connectivity with various country officials and multi-lateral institutions also may be a key factor.
- Passive emerging markets strategies can be significantly less efficient than most investors would prefer.

Investing in emerging markets (EM) is still a relatively new phenomenon, considering that institutional investing in such countries began just over three decades ago, when the World Bank encouraged more investment in the capital markets of underdeveloped nations. The category got a big lift when J.P. Morgan developed the J.P. Morgan Emerging Markets Bond Index in 1998, which created a crucial benchmark for active and passive strategies focused on EM sovereign (i.e., government-issued) debt. Since that time, international markets have seen the creation of mutual funds and exchange-traded funds (ETFs), among other investment vehicles that enabled a variety of investors to add this exposure to their portfolios. The options may be plenty, but we believe there are three important considerations for investors when deciding between passive and active strategies.

1. The importance of country selection in an EM portfolios

While large emerging countries like China, India, and Brazil garner the most attention in the media, the EM investable universe is much broader; the J.P. Morgan Emerging Markets Bond Index includes over 70 countries. The efficiency of research across all of those sovereign issuers (especially smaller ones like Angola or the Dominican Republic) is limited, thus presenting opportunities to exploit market inefficiencies. Table 1 illustrates the critical importance of correct country selection and vast potential for active alpha generation.

Table 1. Country Selection Has Been Crucial for EM Sovereign Bond Returns

Dispersion of returns by country grouping (as defined), 2014–2018

J.P. Morgan EMBI Global Diversification	2014	2015	2016	2017	2018
Top Country	22.08%	41.75%	53.19%	57.13%	14.02%
Bottom Country	-29.77%	-19.50%	-36.30%	-34.43%	-24.79%
Difference	**51.85%**	**61.25%**	**89.49%**	**91.56%**	**38.81%**

Source: Bloomberg. Data as of December 31, 2018. "Top country" and "bottom country" refers to best and worst performing country, respectively, within J.P. Morgan Emerging Markets Bond Index Global Diversified Index for the referenced time period. For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment.

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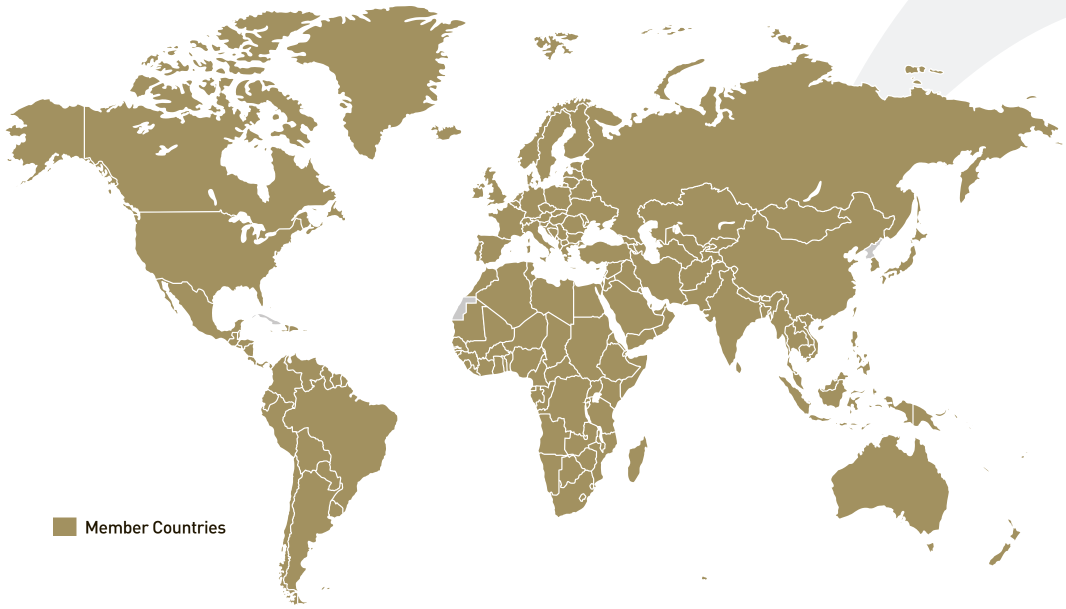
2. Human connectivity is key to investment strategy in a technology-focused world.

Fundamental research plays an extremely important role in emerging market country selection, and active managers devote significant resources toward that end. To effectively assess the investment merits of EM issuers, we believe an investing team's ability to travel to EM countries in order to establish deep relationships with local banks, policy makers and country experts is essential to research capabilities and the generation of active investment concepts. In addition, investment professionals' relationships with far-reaching, multi-lateral institutions such as the International Monetary Fund or the World Bank can leverage the knowledge, and connectivity, and access to financial and technical data these bodies can provide.

Chart 2. With 189 Member Countries, the IMF Is a Critical Resource for EM Managers
International Monetary Fund member countries as of December 31, 2018



Source: International Monetary Fund

3. Index-mirroring passive EM strategies are not well positioned to avoid risk.

The political and economic complexities of emerging markets can make the investment strategy of simply following an index less effective than investors would prefer. Chart 1 compares the alpha generation of two ETFs versus each fund's prospectus benchmark, illustrating underperformance over three-, five- and 10-year periods. As active managers, we seek to utilize our robust global investment process in the pursuit of outperformance. From a macro view, we seek to evaluate global risk appetite and global capital flows to calibrate the overall risk of the portfolio. We also use quantitative models and comprehensive risk modeling.

In addition, as active managers we seek to avoid bonds of sovereign issuers where our estimates of probability of default are rising. In contrast, a passive rules-based ETF will seek to mimic the index even if default is imminent. Venezuela's recent experience provides a good example. As its finances began to weaken in mid-2014 on the back of significant declines in oil prices, the country continued to issue more and more debt at higher coupon rates. At the peak, Venezuela made up 13% of the J.P. Morgan Emerging Market Bond Index Global (EMBIG), and now only about 1% remains in the benchmark. An investor following a passive strategy that included those bonds would be accepting 70% loss of value on those securities. We illustrate this in Chart 3, which shows Venezuela's Global 2027 Bonds trading at par and now trading at 30 cents.

Chart 3. The Plunge in Venezuelan Sovereign Debt Weighed on Many Passive EM Portfolios

Prices for Venezuela 9.25% USD 2027 Global Bonds, January 1, 2009– April 16, 2019

Source: Bloomberg. Data as of April 19, 2019.

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Therefore, careful selection and close monitoring of country exposure in geopolitically complex environments are both a core part of an active investment strategy within emerging markets. Avoiding these asymmetric movements could be instrumental in enhancing returns on emerging market debt.

Summing Up: How AM Can Work in EM

As active managers in emerging markets fixed income, we highlight country selection, in-depth research, and having the ability to actively make adjustments to risk exposure. Given the sensitivity of emerging markets to worldwide economic trends (such as global growth and rates), it is important as a starting point to develop a view on broader risk appetite and credit cycles for EM sovereigns. In addition, the ability to interface with international banks and government officials provides a deeper understanding of risks; in that regard, local visits by the research team and relationships with local experts are critical. It is our belief that an optimal investment strategy in emerging markets should always encompass an active management consideration. ■

Glossary

The **DB Emerging Market U.S. Balanced Liquid Total Return USD Dollar Index** tracks the potential returns of a theoretical portfolio of liquid emerging market U.S. dollar-denominated government bonds issued by approximately 22 emerging-market countries. The countries in the Index are selected annually pursuant to a proprietary index methodology and the membership list is rebalanced quarterly.

J.P. Morgan Emerging Markets Bond Index (EMBI) is a benchmark index that measures the total return performance of emerging market government bonds, not issued in local currency. To be part of the index, the government bonds must meet specific liquidity and structural conditions.

International Monetary Fund (IMF) is an organization that "promotes international financial stability and monetary cooperation. It also facilitates international trade, promotes employment and sustainable economic growth, and helps to reduce global poverty. The IMF is governed by and accountable to its 189 member countries." (via IMF.org)

J.P. Morgan Emerging Market Bond Index Global (EMBI Global) is a benchmark index that measures the total return performance of international government bonds that are issued by emerging market countries, not issued in local currency, and meet specific liquidity and structural conditions. EMBI Global includes USD Brady bonds, loans and Eurobonds with a face value of $500 million or more.

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