Insight

Investing in Emerging Markets – It's a Marathon not a Sprint

October 2018

The 30-year anniversary of the firm coincides with the 5-year anniversary of the company's emerging market debt business.

Portfolio Manager Warren Hyland discusses how he has sought to forge a leading path in emerging market short duration corporate debt, what trends and challenges he has seen and the opportunities he believes lay ahead in emerging market fixed income.

What was your objective in starting an emerging markets (EM) business at Muzinich?

I wanted to make Muzinich the go-to place for EM hard currency corporate credit, underpinned by the firm's deep, fundamental approach to credit investing. I believe this gives us an added advantage in selecting the best credits for our EM portfolios and seeking to provide attractive returns for our clients.

How has the EM business evolved over the last five years?

Five years ago, the firm had virtually no EM exposure. Today we have nearly US$5bn in EM assets across dedicated funds, segregated accounts and allocations within other pooled vehicles.

Our team has grown from 3 in 2013 to 13 today. Many of them are from EM countries, which gives us the benefit of understanding the language and cultures of the regions in which we invest. We have expanded into Asia, opening an office in Singapore in 2017, expanding the base of our investment team which offers us wider access to Asian credit markets.

We have also widened our product offerings; our initial EM short duration strategy, launched five years ago, has been joined by a regular duration EM strategy. We have also launched two dedicated Asia credit strategies.

With China a growing presence on the world's stage, I think it's fantastic that we have sought to be early adopters in what we believe is likely to become a fast-growing investment opportunity in the years to come.

Warren Hyland
Portfolio Manager

Warren joined Muzinich in 2013. Prior to that he was the Senior Portfolio Manager for Global Emerging Markets at Schroders where he managed $2 billion and helped develop the firm's EM corporate capabilities. Warren has a B.Sc. in Mathematics for Business from Middlesex University London and an M.Sc. in Shipping Trade and Finance from CASS Business School. He holds the Chartered Financial Analyst designation

What is the significance of reaching a five-year milestone in EM debt?

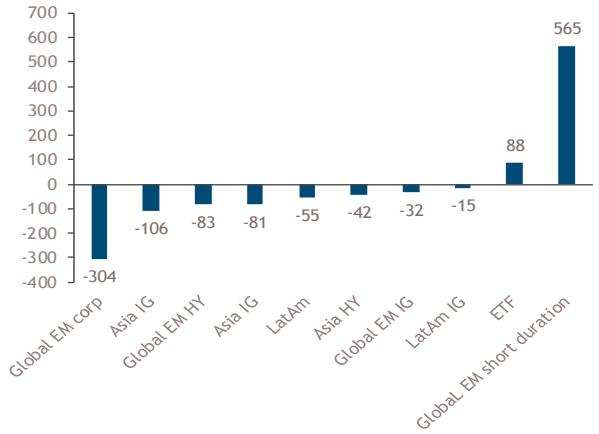
First, I think it's important to have longevity in the asset class – it's a marathon not a sprint. As a team we can also show that we have gone through a full market cycle and experienced all the ups and downs that it can bring.

We have developed a thorough understanding of the nature of the investment universe, how it works, its technicals and subtleties.

EM short duration is now recognised as a standalone asset class in the broader market and is seeing increasing interest from investors (Fig.1).

Over time we have also improved our risk management tools and other models, such as those focused on liquidity. As the team has grown, so too has our coverage.

Fig. 1 – EM EXD Corporate Fund Flows ($US mn) Over Last 3-Months



Source: : ICE BofA Merrill Lynch. Data as of April 18th, 2018. EM Corporate Credit Strategy Dispersion is Here To Stay.

Why did you choose to launch a short duration strategy first?

Muzinich has had a long tenure in managing short duration developed market strategies. Opening an EM strategy seemed like a natural extension of that business and was in-line with the firm's ethos of offering clients risk averse credit solutions with a capital preservation mindset.

What are the benefits of a short duration approach to EM?

We believe a short duration strategy can be considered a more risk averse way of accessing EM, while avoiding the volatility of the higher beta parts of the universe.

Approaching EM via a credit portfolio can lower the risk as investors are usually at the top of the capital structure and are therefore less likely to lose money in the event of a default. In addition, we believe it is an efficient way to access EM, which in our view is the best asset class for coupon clipping and capital gains.

Short duration portfolios tend to have less credit spread risk and, as we move into an environment of rising rates, it's a strategy that is becoming increasingly relevant.

Credit curves are relatively flat and, in our view, investors are not being amply compensated for moving further out along the curve – i.e. they are being paid the same yield but for longer duration bonds which have more duration risk. Therefore, in our view, taking a position at the shorter end of the curve appears to be a more efficient investment choice.

The market has also grown considerably over the last five years, providing investors with a widening opportunity set (Fig. 2).

Fig. 2 – Short Duration Share of EM Market (0-3yrs % of Total DTW) – EMCL Index

Source: ICE BofA Merrill Lynch & Muzinich data. ICE BofA Merrill Lynch Emerging Market Corporate Liquid Index (EMCL), ICE BofA Merrill Lynch Emerging Markets External Sovereign Index (EMGB). DTW – Duration to Worst. Data as of June 30th, 2018

Who should consider an allocation into EM short duration?

We believe it's a good starting point for people who want to invest in EM for the first time, to understand how the mechanics of EM work and the effects of different variables – both global and micro.

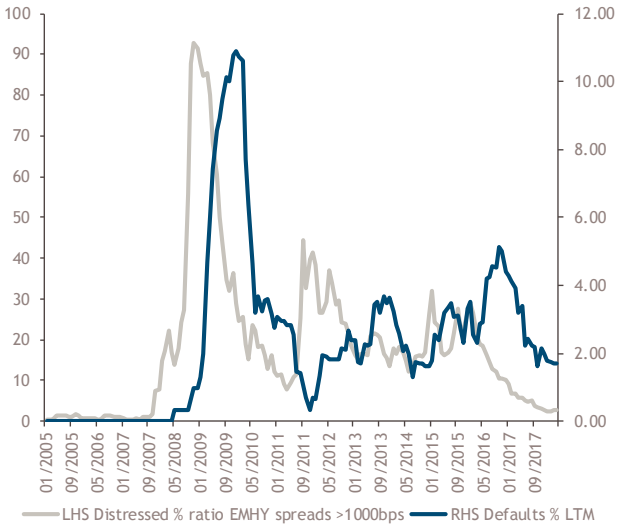
I think it would also suit those who are looking to dial down risk in EM, those looking for an efficient cash plus strategy or investors worried about duration in general.

Are there any key moments over the last five years you have found particularly challenging?

We have certainly seen a number of notable political and geopolitical events across EM countries over the last 5 years, ranging from the Taper Tantrum through to a number of currency crises at the sovereign level, while within the corporate landscape we have seen downgrades, tightening liquidity conditions and outflows.

However, despite all these factors, we believe EM debt has shown resilient performance, even in poor market conditions. In the last five years ending December 31, 2017, it has only produced one year of negative returns.[1] Defaults have also come down (Fig. 3).

Fig. 3 – EM Distress Ratio and Defaults



Source: : ICE BofA Merrill Lynch. Data as of April, 30th, 2018. EM Corporate Credit Strategy Dispersion is Here To Stay.

We believe emerging markets have learned from the lessons of crises past. After the Taper Tantrum, EM countries reduced their dependency on US dollar funding; after the geopolitical unrest in Russia and Turkey there has been significantly less issuance; post the commodity crisis energy companies delevered their balance sheets.

In our view, political crises and scandals have resulted in the removal of corrupt governments while currency crises have improved terms of trade and balance of payments.

Overall, corporate balance sheets have improved and, as EM companies become stronger, we expect to see further upgrades.

Therefore, I believe these challenges have actually resulted in new opportunities for EM investors in an asset class that is continuing to develop and strengthen over time.

How do you produce good performance, even during periods of elevated risk?

I believe one of the keys to successful performance over the longer term is diversification. We seek for our portfolios to be well diversified by sector and region.

This does not stop us from taking bets on areas where we are very bullish, but it means we can change positioning more easily if needed.

The ability to adapt to the changing environment is important. Things can move fast in EM, and we need to move equally quickly in response.

Having a strategy that is nimble enough to reposition accordingly helps us here, and has done so during periods such as the commodity and Russia crises.

Strong security selection is also very important; our primary focus is on the fundamental analysis of each individual credit prior to its inclusion in portfolios.

The asset class has grown and evolved notably. Where do you see it developing from here?

Today, investors ask why global portfolios are not given a greater weighting in EM alongside US and Europe. Therefore, I think we will continue to see a rebalancing of portfolios to reflect the growth and development of the EM universe.

We could also see the increase in demand for other hard currency debt, such as euro denominated debt, versus a decline in demand for US dollar denominated debt.

The incumbent US administration continues to cause wide-ranging ramifications on issues from global trade to limiting countries' external borrowing for political purposes, which is reducing demand.

I also believe we are likely to see the separation of EM debt into distinct asset classes; investment grade and high yield – in line with what we have in developed markets.

We have gone through several periods of heightened volatility this year and the investment grade segment of the EM market has held up remarkably well under pressure. As the universe continues to grow therefore, I think we are likely to see the separation of the two ratings bands.

1. Source: ICE BofA Merrill Lynch. Data as of June 30th, 2018. ICE BofA Emerging Markets Corporate Liquid Index (EMCL). Past performance is not an indication of future performance.

Important Information

This document has been produced for information purposes only and is not intended to constitute an offering, advice or recommendation to purchase any securities or other financial instruments. The investment strategies and themes discussed herein may not be suitable for investors depending on their specific investment objectives and financial situation. Investors should conduct their own analysis and consult with their own legal, accounting, tax and other advisers in order to independently assess the merits of an investment.

The views and opinions expressed should not be construed as an offer to buy or sell or invitation to engage in any investment activity, they are for information purposes only, are as of the date of publication and are subject to change without reference or notification. Certain information contained in this document constitutes "forward-looking statements," which can be identified by the use of forward-looking terminology such as "may," "will," "should," "expect," "anticipate," "project," "estimate," "intend," "continue," or "believe," or the negatives thereof or other variations thereon or comparable terminology. Due to various risks and uncertainties, actual events, results or the actual performance of the securities, investments or strategies discussed may differ materially from those reflected or contemplated in such forward-looking statements. Nothing contained in this document may be relied upon as a guarantee, promise, assurance or a representation as to the future.

Past results do not guarantee future performance. The value of investments and the income from them may fall as well as rise and is not guaranteed and investors may not get back the full amount invested. Diversification does not assure a profit or protect against loss. Changes in the rate of exchange of a currency may affect the value, price or income of an investment adversely. Emerging Markets may be more risky than more developed markets for a variety of reasons, including but not limited to, increased political, social and economic instability; heightened pricing volatility and reduced market liquidity.

All information contained herein is only as current as of the date indicated, and may be superseded by subsequent market events or for other reasons. Nothing contained herein is intended to constitute investment, legal, tax or other advice nor is it to be relied on in making an investment or other decision. Historic market trends are not reliable indicators of actual future market behavior.

Certain information contained herein is based on data obtained from third parties and, although believed to be reliable, has not been independently verified by anyone at or affiliated with Muzinich & Co.; its accuracy or completeness cannot be guaranteed.

Issued in Europe by Muzinich & Co. Limited, which is authorised and regulated by the Financial Conduct Authority FRN: 192261. Registered in England and Wales No. 3852444. Registered address: 8 Hanover Street, London W1S 1YQ.

Market Index Descriptions:

EMCL - The ICE BofA ML US Emerging Markets Liquid Corporate Plus Index tracks the performance of the U.S. dollar denominated emerging markets non-sovereign debt publicly issued in the major domestic and eurobond markets. Qualifying issuers must have risk exposure to countries other than members of the FX G10, all Western European countries, and territories of the U.S. and Western European countries.

EMGB - The ICE BofA ML Emerging Markets External Sovereign Index tracks the performance of US dollar and euro denominated emerging markets sovereign debt publicly issued in the major domestic and eurobond markets. Qualifying securities must have risk exposure to countries other than members of the FX-G10, all Western European countries and territories of the US and Western European countries.

You cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance.