Investment Insight

EMERGING MARKET DEBT: PERCEIVED RISKS GREATER THAN ACTUAL RISKS

The Stern family has been an active investor in emerging markets for generations. In the nineteenth century, the family and its banks help to found important banks, many of which have prevailed until today, like Garanti Bank in Turkey or Banamex in Mexico. Meanwhile, Stern family banks in Paris, London and Frankfurt issued bonds in Europe for companies from many countries. In more recent times, J. Stern & Co. has developed its Emerging Market Debt strategy which seeks to preserve and create wealth by investing in hard currency bonds issued by quality emerging market businesses. It is an asset class that has traditionally been overlooked because investors' perception of the risks it carries is greater than the actual risks.

This year is a case in point, where geopolitics, rising inflation, monetary tightening and recession concerns have impacted all risk assets. However, some have suffered more than others. Global equities are down 17.5% in US Dollar terms, US investment grade bonds are down 13.8%, whilst 'hard currency' emerging market corporate debt has fared better than most, down 9.6%.

Risk asset class	2022 YTD*
J Stern & Co	
J Stern Emerging Market Hard Currency Corporate debt	-9.6%
Global Equities	
US equities (S&P)	-16.1%
Developed Market Equities (MSCI World)	-17.5%
Emerging Market Equities (MSCI Emerging Markets)	-17.3%
Developed Market Fixed income	
US Treasuries	-10.0%
US Investment Grade	-13.8%
US High Yield	-11.0%
Emerging Market Fixed income	
EM Hard Currency Sovereign	-18.8%
EM Hard Currency Corporate	-12.9%
Other	
Commodities	25.9%
Infrastructure	1.9%

** 31st August 2022*
Source: J Stern & Co., Bank of America, Bloomberg

ATTRACTIVE ENTRY POINT AND UNIQUE SOURCE OF INCOME YIELD

The market repricing this year has led to higher yields in fixed-income assets. We believe this presents an attractive entry point for long-term investors to buy and hold bonds from

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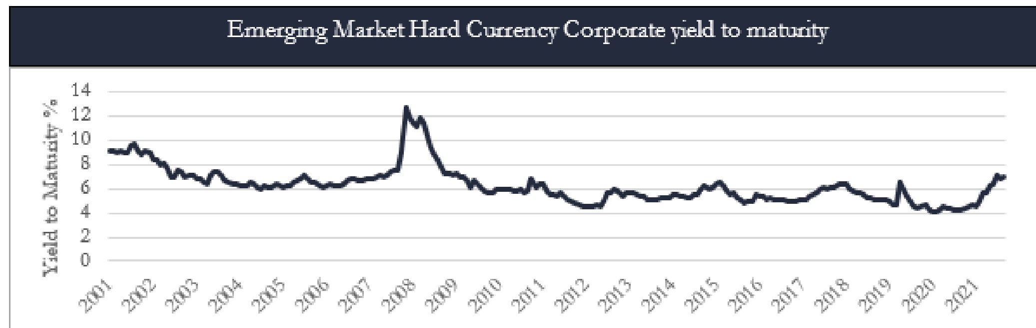
companies with solid underlying fundamentals that deliver generous income and total returns at a time when the global outlook is uncertain.



Source: JP Morgan

Moreover, this level of yield fares favourably when compared to other asset classes: including equity dividend yield (average 2.0% over the last 10 years), US Treasury current yield (average 2.5%), and US corporate investment grade current yield (average 4.5%).

The overall emerging market debt asset class is worth around USD 26.3 trillion and spans multiple countries, thousands of issuers, and sectors. It has matured over the past two decades and is no longer a play on commodities but a broader and more diversified asset class. The asset class has two distinct categories – sovereign debt and corporate debt. We believe the latter, in hard currency (mainly US dollars), has a key role to play as a standalone asset class within a diversified portfolio or as part of investors' wider strategy to generate an income from their portfolios.

The emerging market sovereign debt issued by governments accounts for the majority of the emerging debt universe (USD 13.6 trillion; of which USD 12.6 trillion equivalent is in local currency) and as such tends to attract the most attention from market observers. Erratic economic developments, political risks and foreign exchange volatility, which are more difficult to analyse, quantify and control, have all contributed to the high-risk image of the asset class.

However, 'hard currency' emerging market corporate debt whose risk profile is mostly driven by the companies' fundamentals, suffers from its association with the emerging market sovereign debt asset class. As a result, emerging market corporate debt's perceived risks are, in our view, greater than the actual risks associated with the underlying corporates as their financial and business strength more than offset the local risks.

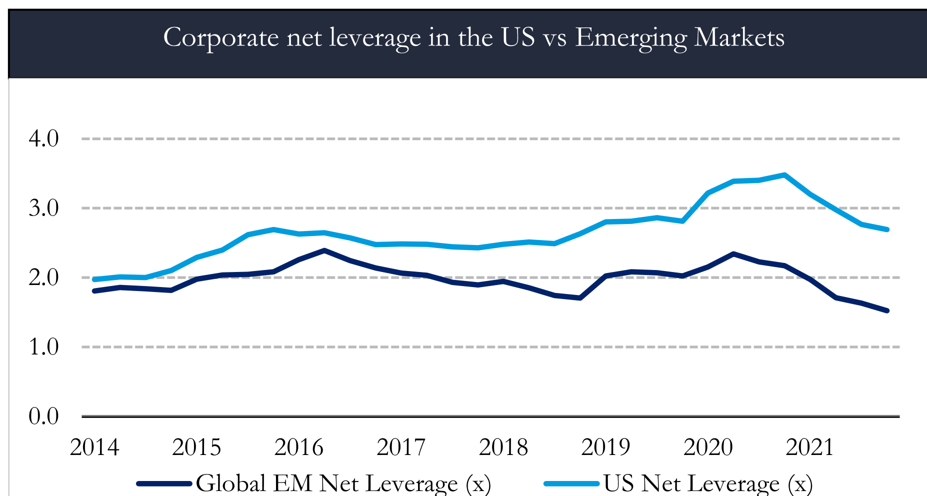
A quality company with a strong and sustainable competitive position, generating predictable cash flow, is in a solid position to repay its debt, regardless of where it is located. However, a quality company based in a developed market would pay a yield considerably lower than if it were based in an emerging market because it is perceived as a lower risk. Investors in hard currency emerging market corporate debt are paid a premium for investing in companies based on the rating of the country they are based in, even if they are global companies with diversified sources of revenue and solid fundamentals

Hard currency emerging market corporate debt currently provides investors with a current yield of 5% and a yield to maturity of 7%. This is a higher yield than in March 2020 when the global pandemic was breaking out. Although there have been times when yields

touched higher levels there is no doubt in our view that we are now in attractive value territory.

PERCEIVED RISKS ARE GREATER THAN ACTUAL RISKS

Furthermore, the perception of underlying corporate fundamentals is part of the issue itself. One would expect emerging market companies to compare poorly against their developed market peers. The reality is quite different. Based on two metrics which are core to all credit investments, leverage and default rates, emerging market corporate debt compares favourably. Firstly, emerging market corporates have healthier balance sheets than developed market peers with net leverage at their lowest levels in a decade.



Source: Bank of America

Secondly, default rates of emerging market corporate are very similar to the default rates of developed markets except for 2021 and 2022 year-to-date. The headline default rates look high in these years due to two well-known special situations – the highly levered Chinese property sector and Russian corporates post-sanctions related to the invasion of Ukraine. We were not involved in either based on fundamentals and corporate governance risk in the Chinese property sector and geopolitical risk in Russia.

If we exclude China and Russia, then the default rates are far lower. Such dynamics reiterate the need for investors to be highly selective and look for quality, which emphasises the need for an active manager focused on the asset class.

Default rates	2014	2015	2016	2017	2018	2019	2020	2021	2022 YTD	2022 YTD (ex-Russia and China property)
EM Corporate HY	3.7%	2.5%	4.0%	1.4%	1.2%	0.8%	2.5%	4.5%	2.2%	0.2%
US Corporate HY	3.0%	2.6%	4.3%	1.5%	1.9%	2.9%	6.8%	0.4%	0.5%	-

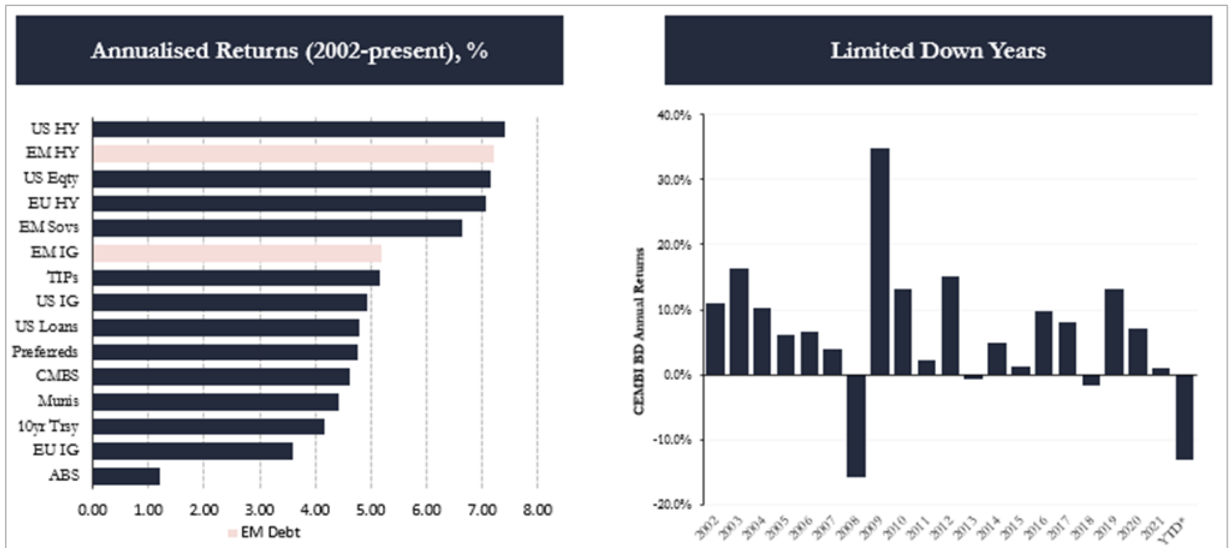
Source: JP Morgan

A SUPERIOR LONG-TERM RETURN PROFILE

Such strong overall fundamentals have been supportive of the return profile of hard currency emerging market corporate debt which has fared strongly against other asset classes and may

come as a surprise. It has demonstrated resilience over the past two decades, generating competitive absolute returns with limited negative years.

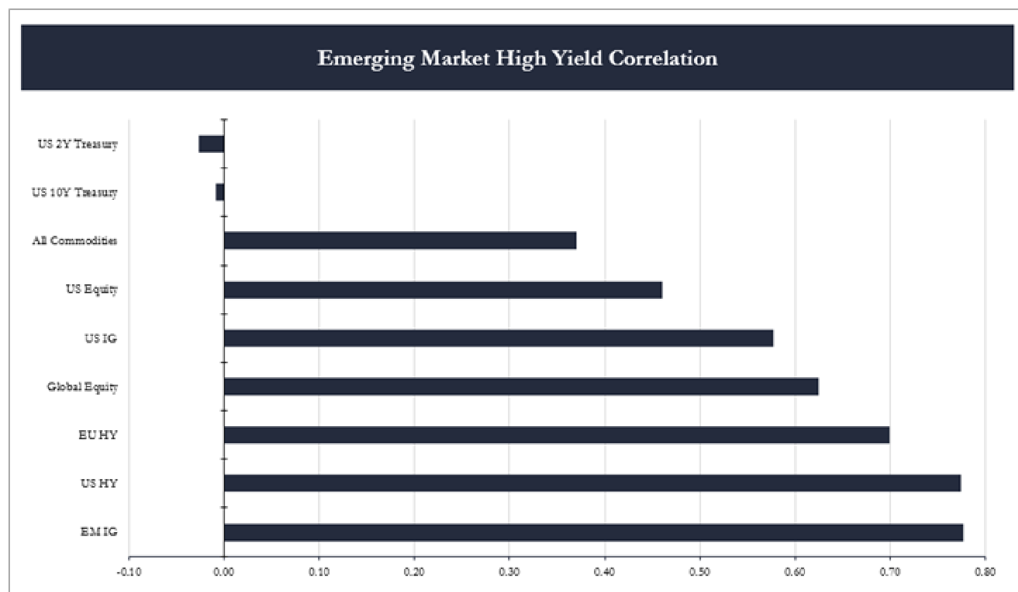
The emerging market high-yield component of the asset class has generated over 7% annualised returns (in US dollar terms). Directly related is the fact there have been very few down years for the asset class, albeit we note that when it does occur, it is often followed by a very sharp recovery and investors who have held for the long term, have been rewarded.



Source: Bank of America, JP Morgan

LOW CORRELATION TO OTHER MAJOR ASSET CLASSES

Alongside the higher yields, the asset class provides diversification benefits (particularly developed market equities and fixed income) to typical asset allocation. By way of example, emerging markets have a correlation of only 57% to US investment-grade bonds, and 45% to US equities.



Source: Bank of America

J. STERN & CO.'S EXPERIENCE AND DIFFERENTIATED STRATEGY

J. Stern & Co. Emerging Market Debt strategy has a specific investment objective to (i) generate a total return of 5-6%pa, net of fees, from income and capital growth over the medium term; (ii) maintain low overall volatility with a standard deviation of 4-6% (at least 50% lower than that of global equities) and (iii) provide diversification from other major asset classes (particularly developed market equities and fixed income). We believe the market repricing of risk assets this year, provides a particularly attractive entry point for investors as the strategy offers a current yield of 8% per annum (income via coupon) and a yield to maturity of 11% per annum (includes income and capital uplift with bonds trading at a discount to par).

The strategy which under the leadership of the current portfolio management team, and from the date of a change of management on 1 July 2020, has delivered returns of 7.1%pa (USD) to 31 December 2021 (net of fees of 1% per annum) – outperforming its benchmark by 1.7%pa. Up until 31 August 2022, it has increased its outperformance to 2.7%pa. The strategy follows an unconstrained approach, with a focused portfolio of 30-50 corporates based in emerging markets. We do not invest in sovereign debt. The strategy minimizes currency exchange risk and local liquidity risks by investing only in publicly traded hard currency bonds, and mostly in US dollars.

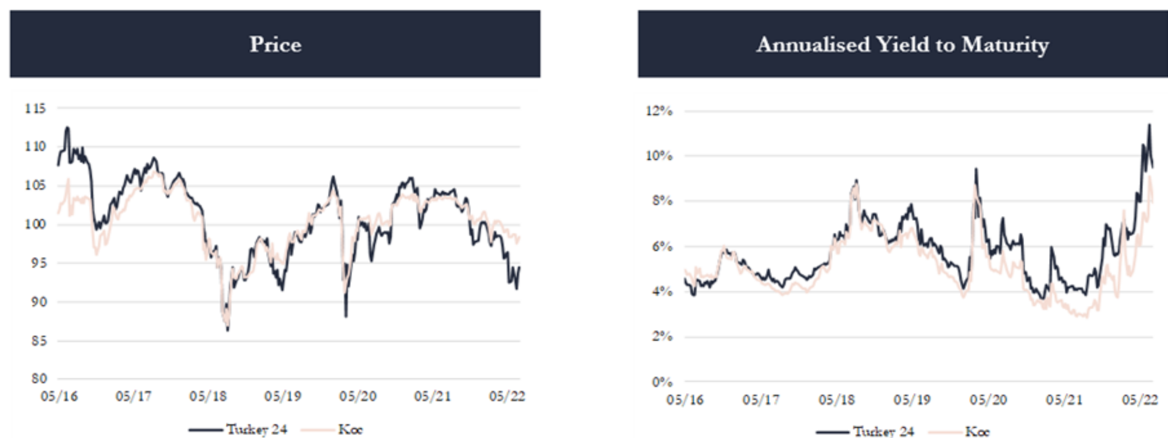
The underlying investment philosophy behind this strategy is no different from that deployed by J. Stern & Co across its established equity and multi-asset strategies. We invest in quality companies that have strong and sustainable competitive positions, operating in good and

growing industries, with predictable cash flows, the financial strength to weather adversity, access to multiple sources of capital, and strong management teams. The firm's investment approach is solely based on in-depth fundamental research, including ESG analysis which focuses on risks and opportunities within those businesses.

ILLUSTRATIVE HOLDINGS

By way of example, J. Stern & Co. invests in debt issued by the leading Turkish conglomerate Koc Holdings. Negative sentiment has weighed on all Turkish corporates given current geopolitical tensions and an unorthodox monetary policy to tackle soaring inflation (80% as of August 2022), which has resulted in substantial depreciation of the Turkish Lira (-53% over the past 12 months and -81% over the past five years) and a significant sell-off in sovereign debt. Yet, Koc is Turkey's largest conglomerate, with operations in more than 30 countries. It exports 10% of the country's exports and contributes 7% to Turkey's GDP, with most of its revenues denominated in hard currency across multiple business divisions.

From a company view, it has stable dividends, and a strong liquidity position, with enough cash on the balance sheet to fully repay its issued debt. Koc's debt currently trades at a 9%pa yield to maturity. Importantly, if we took a similar business based in a developed economy the yield would be significantly lower. The difference is the sovereign spread, and that is what investors are getting paid more for; that is a key component of the current opportunity.



Source: Bloomberg

It is important to reiterate that we only invest in corporate debt, not sovereign debt. The ultimate performance of emerging market corporate debt relies, for the most part, on the credit and the fundamental strength of the underlying companies. Emerging market sovereign debt, on the other hand, has the added complexity of political risks (i.e. the willingness of government to meet its debt obligations which are linked to political stability, security issues and succession) on top of the economic risks (i.e. ability to meet those debt obligations). By definition, the "willingness" is far more difficult to analyse, quantify and control and therefore the risk/return profile of sovereign debt is very different to that of corporate debt.

Moreover, whilst these businesses are based in emerging countries, they are far from emerging businesses with an average revenue and EBITDA (earnings before interest, taxes,

depreciation, and amortisation) of USD 8.9 billion and USD 2.4 billion respectively on current investment holdings. They are also often global companies with diversified sources of revenue as illustrated by Koc Holdings. Furthermore, investing directly in corporate debt provides a targeted means to gain exposure to themes we have identified as key drivers of economies going forward. These are infrastructure investment, communication and digitisation, globalisation, increasing purchasing power, energy transition, and strategic state importance. Such a diversified opportunity set is possible given the size of the asset class which encompasses around 1,000 corporate issuers which represent a market value of USD 1.5 trillion.

Taking the latter theme of strategic state importance as an example, J. Stern & Co. invests in debt issued by YPF, the largest integrated oil & gas company in Argentina and controlled by the state. The country has defaulted on its sovereign debt nine times in its history, suffering a recurring political and economic crisis. Today the country is struggling with economic contraction, runaway inflation and a hard currency squeeze exacerbated by the coronavirus pandemic and Russia's war in Ukraine, which has put renewed focus on the USD 40 billion still owed to the International Monetary Fund as part of the 2018 bailout.

Despite such macro dynamics weighing on asset prices, YPF, which was founded in 1922, has successfully navigated through the various crisis without ever taking a haircut to bond prices. There is implied support for the business given its strategic importance for the government and future economic recovery. Near term, foreign direct investment is key to funding capex and therefore it is critical that government fosters an attractive investment landscape for international oil companies. Longer term, the company is critical to the country reaching energy self-sufficiency and its ambitions of becoming a net exporter which would improve the economic position and provide an important source of US dollars. YPF's debt currently trades at a 20% pa yield to maturity. It is the only company in Argentina that we are invested in.

Source: Bloomberg

Jean-Yves Chereau and Charles Gélinet
September 2022

J. Stern & Co.

The Value of Long-Term Investing

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