October 1, 2013

In Search of Income: Emerging Market Bonds

Historically, a balanced account has consisted of stocks and bonds. Having a typical 60/40 allocation to equities/fixed income has been a way to achieve moderate returns with lower risk, as measured by volatility of returns. This has worked well in the past because the correlations of the returns between stock and bond performance have been very low or even negative.

In the current investment environment, interest paid on cash and fixed income securities is not even keeping pace with inflation, producing a negative real return. With treasury rates (**Figure 1**) at such low levels, perhaps for some time into the future, it is prudent to take a hard look at other income-generating securities.

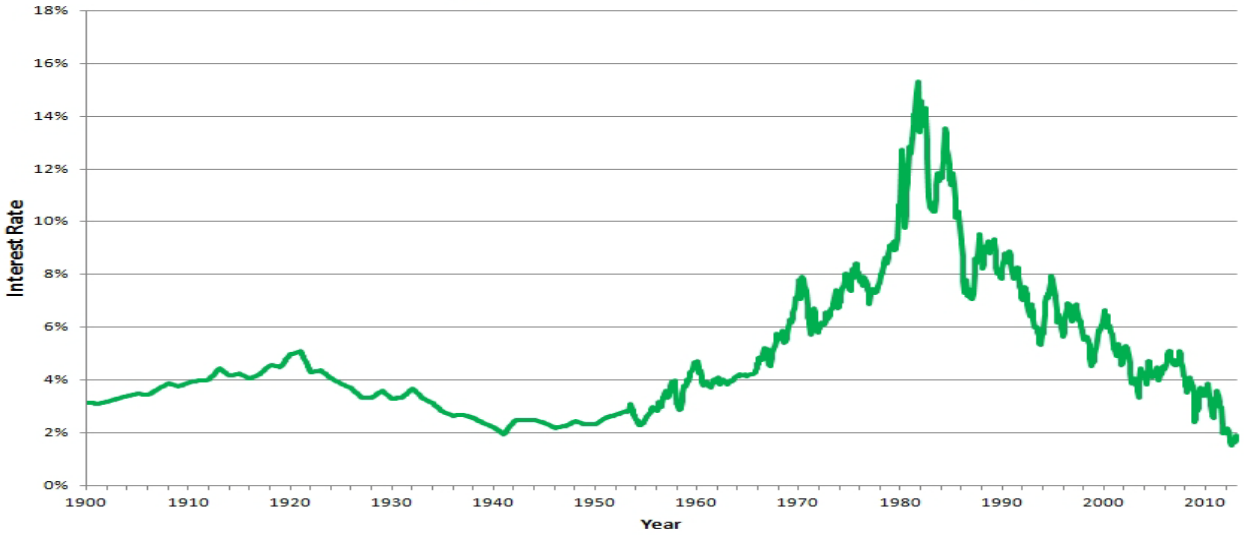

Figure 1. US Treasury Bond Interest Rate
Source: Observations

As always, our focus must be primarily on the total return characteristics of each investment and secondarily on its income-producing capabilities. Stated another way, we do not want to focus too heavily on current income that we place our principal at risk. This balance is especially important as we take a look at emerging market bonds.

What is attractive about emerging market bonds?

- ✓ Yields are higher than domestic bonds
- ✓ Country balance sheets are less levered than developed markets
- ✓ Credit quality is improving in most emerging markets
- ✓ Emerging countries have higher GDP growth (**Figure 2**)

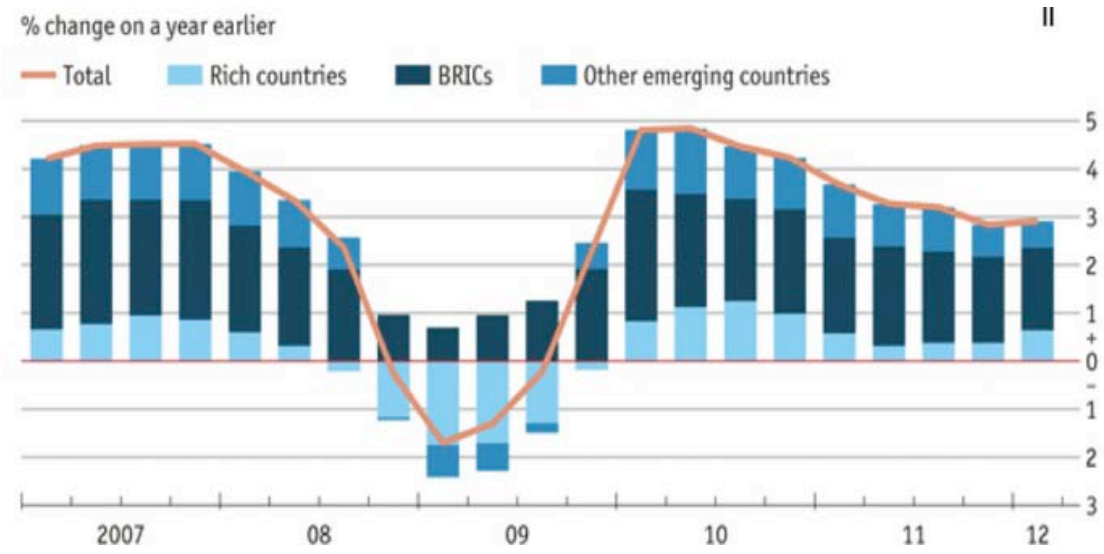

Figure 2. World GDP *Estimates based on 52 countries representing 90% of world GDP. Weighted by GDP at purchasing power parity.
Source: The Economist

What risks are inherent in these bonds?

One of the largest risks in emerging market bonds is currency risk. As the country's currency rises and falls against the US dollar, the interest earned and the market values on their bonds fluctuate as well. The inflation rates in most emerging markets are very volatile and often higher than the developed markets (**Figure 3**). The two primary drivers of inflation in the emerging economies are food and energy prices. This is an especially tenuous situation since both of these goods are very important structural pieces to the continued growth of these economies. Investors can alleviate a portion of this risk by purchasing bonds that are dollar-denominated, i.e. issued in the US dollar. The interest paid on the bonds will be a consistent dollar amount; however, the market value of the bond would continue to be susceptible to local currency strength or weakness versus the dollar.

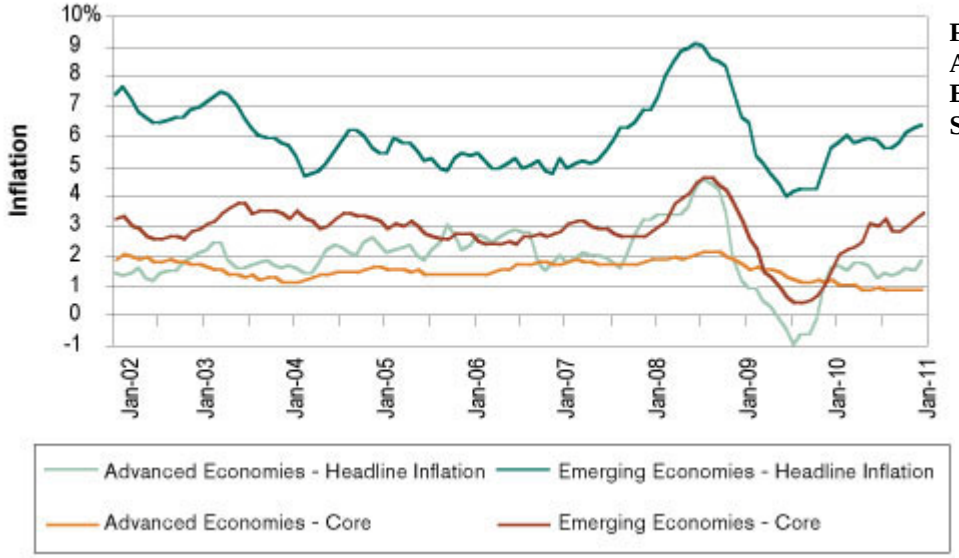

Figure 3. Inflation: Advanced vs. Emerging Economies.
Source: IMF

Another significant risk is each country's political environment, which includes the following:

- Changes in elected governmental officials and their policies
- Central bank policy changes
- Fiscal policy errors
- Price fixing, quotas, and tariffs
- Taxation and foreign investment restrictions

In spite of unknown and known risks, emerging market bonds are an asset class that does not correlate closely with other asset classes. Do not simply assume that they are a secure or conservative investment, just because of their fixed income characteristics. In many cases, it could be said that emerging market bonds are even more aggressive than equities.

With this in mind, an allocation to these securities should be considered as a diversification tool, not as a conservative income play. Summa Global's investment strategy in emerging market bonds focuses on high quality, valuation-driven allocations to portfolios as opportunities arise. Please do not hesitate to call us to discuss this topic in more depth.

- Rachel Wakefield, CFA