Emerging Markets Debt Can Potentially Enhance Income Portfolios

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Investors seeking to enhance their returns may want to consider adding emerging markets debt to their portfolios (and don't worry—we don't think we will see a repeat of the taper tantrum). In this discussion with Institutional Investor's Mike Corcoran, William Blair's Jared Lou explains why.

Watch the video or read the recap below.

Mike: So Jared, institutional investors are under tremendous pressure right now in this sort of low-for-a-long-time return rate. Wonder if you could talk to us a little bit about what I found really interesting. You were talking about how you went to a really interesting exercise to sort of look at how investors might improve their fixed-income performance.

Jared: Yeah, Mike, one of the things we did internally is we went back and we simulated millions of different fixed-income portfolios to see how they would have performed over the last 15 years.

We then constructed an efficient frontier and took a look at how many of these portfolios on the efficient frontier had more than a 5% allocation to emerging markets debt.

Unsurprisingly, many of them had much higher allocations to emerging markets debt than many core bond investors have currently in their portfolio.

We think that emerging markets debt is going to be a key pillar in this investment in order to help investors achieve these goals.

As you mentioned earlier, low core rates make it even harder to see outsized returns from fixed-income portfolios in the future. Therefore, we think emerging markets debt needs to be an important part of the solution.

Mike: So for investors who struggled for a long time with fixed income, this sounds like something that they should really be considering the merits of.

Jared: Yeah, with the Federal Reserve keeping core rates so low, they are encouraging you to take more risk and they are providing excess support for many economies in order to refinance their debt at lower rates, which we believe makes credit losses lower in the future. So, emerging markets debt has the potential to be a more attractive asset class in this low-rate environment.

Mike: So Jared, investors always love to hear about conversations you might be having with other investors, what you're hearing out there. You mentioned when we were talking before about how one of your investors was talking to you recently about what would happen if they were in emerging markets debt and then there was a sort of taper-tantrum-like event. How did that conversation go?

Jared: Well, first of all, Mike, our viewpoint is that we will not see a repeat of the taper tantrum that we saw in 2013. In our opinion, current account balances are healed and are much smaller relative to where they were in 2013, and many emerging markets debt economies have been proactive about rising policy rates ahead of expectations of taper from the Federal Reserve.

But let's say we go back in time and you look at what was the worst possible time to buy emerging markets debt—not the worst, one of the worst possible times to buy emerging markets debt—which was right before the taper tantrum caused a relatively sharp selloff in emerging markets debt assets.

One of the things that's attractive about emerging markets debt sovereigns in our opinion, is that they've got such high carry. So, we found that patient investors who bought at the worst time and waited a year only experienced a moderate loss. And over time, they're also able to create generous income for their investors.

So, we believe this asset class tends to snap back relatively quickly due to the high carry of emerging markets debt sovereigns.

Mike: That kind of resilience is something that investors are more interested in today than ever, it seems like.

Jared: Yeah, income and resilience are part of the reasons why we think investors should be long emerging markets debt.

Mike: All right, thanks. We've been talking about emerging markets debt with Jared Lou from William Blair. Jared, thank you for joining us today.

Jared: Thanks, Mike. It's great to speak with you.

Jared Lou, CFA is a portfolio manager on William Blair's emerging markets debt (EMD) team.

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