5 Differentiators in Emerging Markets Debt

July 6, 2021

While we believe overall market conditions should remain favorable for emerging markets (EM) debt, the pandemic created idiosyncratic risks and diverging prospects across EMs. This makes it critical to have a clear understanding of the opportunities and risks these markets represent—and our hard currency strategy's combination of top-down macro views with rigorous bottom-up credit analysis helps us navigate these opportunities and risks. Here are five key differentiators to our approach.

1. **Obsession With Diversification Limits Drawdown Potential**

Some investors associate EM debt with high risk, but the annualized default rate in sovereign EM debt over the past 20 years is 1%, much lower than other credit asset classes. Still, because EM debt is a high-yield asset class, defaults are a consideration, and to minimize our exposure to them, we use several risk-management strategies.

Risk management is a critical, continuous element of our investment process. We take concentration risk seriously and believe a diversified portfolio will limit drawdown risk and provide for better long-term risk adjusted returns. We typically hold a large number of relatively small positions (typically 1% active cash exposure to a single country), rather than concentrating too much risk in a small number of countries. We also analyze risks in the portfolio from different perspectives: active cash allocations, active spread duration, duration, liquidity, and sensitivity to relevant global risk factors.

Our research process is integrated into William Blair's proprietary research tool, Summit, which allows us to analyze sovereign fundamentals and identify country and security selection opportunities with greater efficiency.

Summit systematically categorizes fundamental and market data in an easy-to-use platform, allowing us to share information and collaborate with other William Blair investment teams. Having input from many perspectives, as well as insight into the interaction of market and economic dynamics between EMs and developed markets, reinforces and complements what we do.

2. **Alpha Strategically Optimized Across the EM Debt Market**

Our process is structured to strategically combine several sovereign and corporate debt options to optimize our risk-adjusted return potential.

The EM debt universe consists of three main types of debt: 1) sovereign debt, which is issued directly by EM countries; 2) quasi-sovereign debt, which is issued by companies that are owned by governments or have explicit government guarantees; and 3) corporate credit, which is issued by companies based in EM countries.

The core of our portfolio consists of hard currency sovereign and quasi-sovereign bonds, which is the biggest component of EM debt. The J.P. Morgan Emerging Markets Bond Index Global Diversified (EMBI-GD), which represents the sub-asset-class, has 74 issuing countries. Historical default rates are low at approximately 1% annualized with restructuring rates typically higher than corporate bonds.

We tend to overweight frontier markets (up to 25% of assets) because we believe the risk premium there is structurally mispriced. Of the 74 countries in the J.P. Morgan EMBI-GD, 36 are also in the frontier-focused J.P. Morgan Next Generation Markets Index. This index has a slightly higher historical default rate of approximately 1.5% annualized but compensates investors with a higher carry.

We also typically hold up to 15% in hard currency corporate debt because we believe a combination of hard currency options will optimize our risk-adjusted returns. This sub-asset-class is usually represented by the J.P. Morgan Corporate EMBI Diversified Composite Index, which represents 42 countries and has a low historical default rate of 1.5% annualized.

3. **Beta-Bucket Approach Optimizes Allocation of Risk Budget**

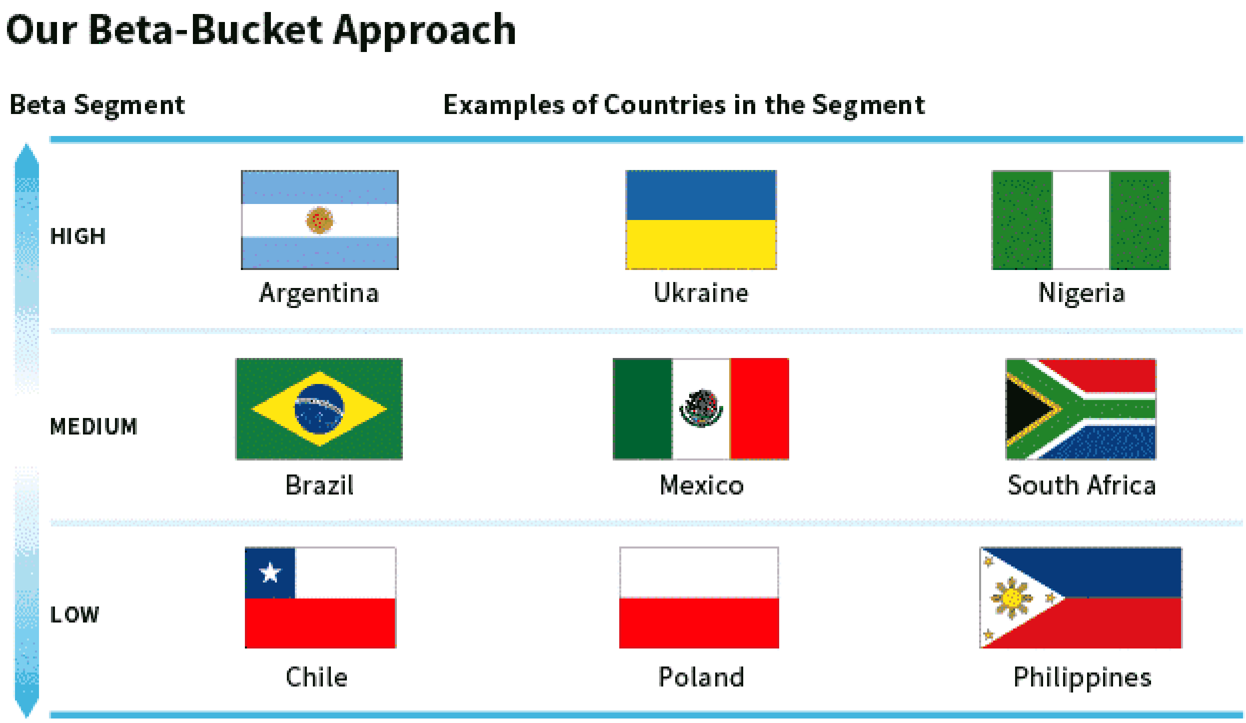
We assess global market dynamics monthly using our top-down analytical framework. The framework consists of two pillars: 1) global macro conditions and 2) the fundamental backdrop, technical conditions, and valuations for EM debt.

The output of the process is a top-down score that reflects our views of the asset class and informs the allocation of the risk budget throughout the portfolios.

To achieve a more efficient deployment of the risk budget, we divide the investable universe into three risk buckets—high-beta countries, medium-beta countries, and low-beta countries—and allocate the risk budget to risk buckets according to our top-down score.

Segmenting the investable universe into different risk buckets also provides for more efficient relative value assessment among countries. For example, Argentina neighbors Chile, but these countries offer totally different credit risks. Argentina is better compared to Ukraine than Chile, and Chile is better compared to Poland than Argentina.

Segmentation also provides for more accurate risk management. When investing in high-beta countries, we look at how much active cash we have allocated, because ultimately the biggest risk is that investors are not repaid in full. When investing in low-beta countries, on the other hand, the risk of default is very low. The debt of these countries tends to be highly correlated with U.S. Treasury yields, and the most relevant risk metric there is spread duration, so we look more closely at active spread duration contributions in that space.



Source: William Blair, as of May 2021. Beta segments are based on the team's quantitative and qualitative analysis and are provided for illustrative purposes only.

4. **Sovereign Risk Model Identifies Mispriced Opportunities**

The next step in the process is country selection within each risk bucket. The starting point for our country selection process is our proprietary Sovereign Risk Model (SRM), a framework that we have developed over more than 25 years of quantitative research in EM debt.

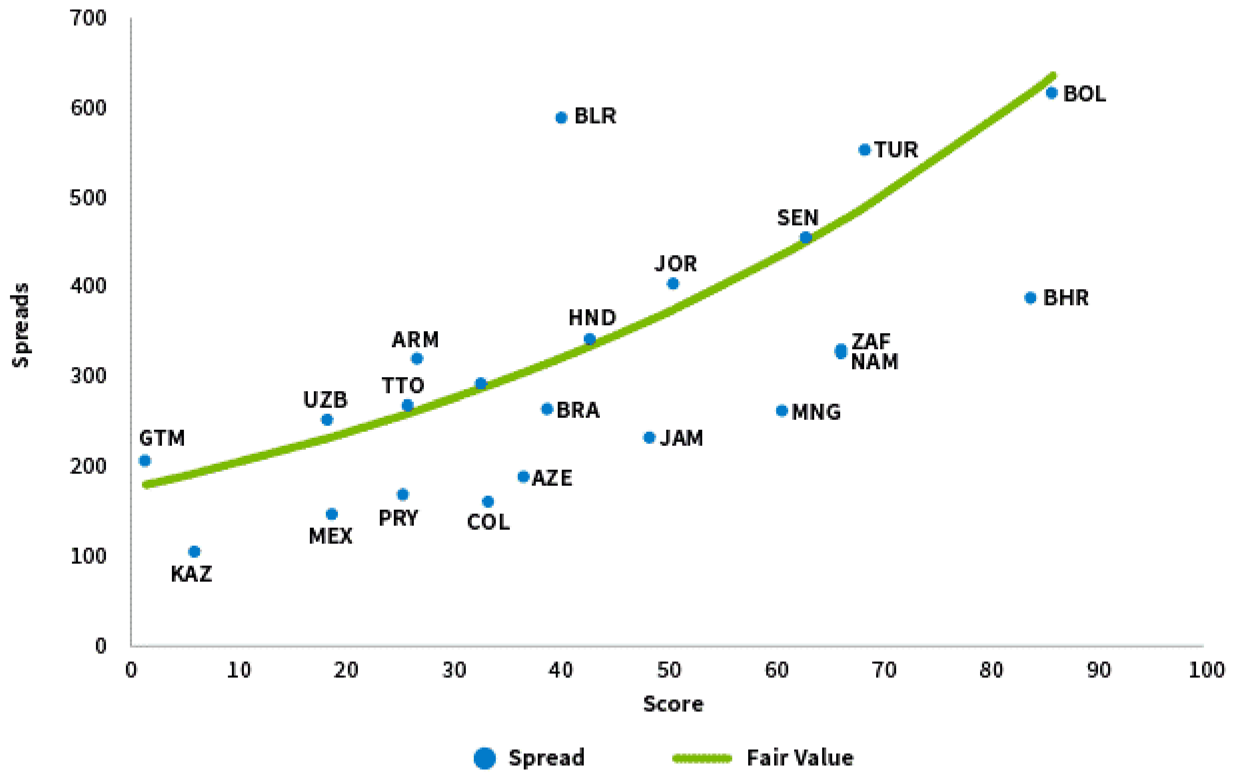
The model uses a combination of factors to score each country in our investable universe along two dimensions: fundamentals and environmental, social, and governance (ESG) factors.

The fundamentals score is constructed by looking at 14 macroeconomic variables, which can be grouped into three major categories that we believe are critical components of credit analysis: economic growth and resilience, public finance health, external balances and buffers.

The output of the model provides a common starting point—an unbiased data set encompassing the entire EM debt universe. Portfolio managers use SRM scores as the basis for country selection, complementing the scores with qualitative analysis of additional factors—such as technical conditions, sustainability trends, and vulnerability to climate risks (using our ESG dashboard), and geopolitical and political dynamics—to add nuance to the sizing of positions.

We then use the risk scores that come from our model to help assess fair value for sovereign spread levels, as the chart below shows.

EMD Hard Currency Sovereign Risk Model Current Opportunity Set



Source: William Blair, as of March 31, 2021. For illustrative purposes only. Not intended as investment advice. The score stems from the William Blair proprietary sovereign risk model. In this model, countries are ranked according to their performance against various macro-economic and ESG factors. A country's overall score — between 0 (best) and 100 (worst) — follows from its average performance across factors in these two pillars.

Once we define the countries we want to overweight or underweight, the next step is to define the most efficient instrument selection: sovereign debt, quasi-sovereign debt, or corporate credit debt—all of which we look at in conjunction with the attractiveness of the different points of the yield and spread curve.

5. **Spread Over Sovereign Model Captures Corporate Opportunities**

To select corporate credit issuers, we use a proprietary framework called Spread Over Sovereign (SOS) model.

This bottom-up approach combines a valuation screen, fundamental analysis, and a risk-management framework to help capture the excess spread corporates offer over their countries of risk, while avoiding exposure to excess idiosyncratic corporate credit risk.

Corporate credit analysis is carried out by the team's dedicated analysts using a multi-risk-factor framework that includes financial risk, business profile risk, management and strategy risk, debt structure, ESG factors, and sovereign risk. By adding spread while avoiding issuers on a deteriorating credit trend, the team believes it can improve the risk/return profile of portfolios.

Potential Benefits

Despite an improvement in bond liquidity, EM debt remains under-researched and not properly understood. As a result, it is under-owned, with global fixed-income indices and institutional investors under-allocated. But this creates inefficiencies, which translate into opportunities to unlock alpha through rigorous research and risk management. We believe the differentiators of our process—described above—help us capture and exploit opportunities on behalf of our investors.

Marcelo Assalin, CFA, is a portfolio manager on and head of William Blair's Emerging Markets Debt team.

Marco Ruijer, CFA, is a portfolio manager on William Blair's Emerging Markets Debt team.

Disclosure:

This content is for informational and educational purposes only and not intended as investment advice or a recommendation to buy or sell any security. Investment advice and recommendations can be provided only after careful consideration of an investor's objectives, guidelines, and restrictions.

Information and opinions expressed are those of the authors and may not reflect the opinions of other investment teams within William Blair Investment Management, LLC, or affiliates. Factual information has been taken from sources we believe to be reliable, but its accuracy, completeness or interpretation cannot be guaranteed. Information is current as of the date appearing in this material only and subject to change without notice. Statements concerning financial market trends are based on current market conditions, which will fluctuate. This material may include estimates, outlooks, projections, and other forward-looking statements. Due to a variety of factors, actual events may differ significantly from those presented.

Investing involves risks, including the possible loss of principal. Equity securities may decline in value due to both real and perceived general market, economic, and industry conditions. The securities of smaller companies may be more volatile and less liquid than securities of larger companies. Investing in foreign denominated and/or domiciled securities may involve heightened risk due to currency fluctuations, and economic and political risks. These risks may be enhanced in emerging markets. Different investment styles may shift in and out of favor depending on market conditions. Individual securities may not perform as expected or a strategy used by the Adviser may fail to produce its intended result.

Investing in the bond market is subject to certain risks including market, interest rate, issuer, credit, and inflation risk. Rising interest rates generally cause bond prices to fall. High-yield, lower-rated, securities involve greater risk than higher-rated securities. Sovereign debt securities are subject to the risk that an entity may delay or refuse to pay interest or principal on its sovereign debt because of cash flow problems, insufficient foreign reserves, or political or other considerations. Derivatives may involve certain risks such as counterparty, liquidity, interest rate, market, credit, management, and the risk that a position could not be closed when most advantageous. Currency transactions are affected by fluctuations in exchange rates; currency exchange rates may fluctuate significantly over short periods of time. Diversification does not ensure against loss.

There can be no assurance that investment objectives will be met. Any investment or strategy mentioned herein may not be appropriate for every investor. References to specific companies are for illustrative purposes only and should not be construed as investment advice or a recommendation to buy or sell any security. Past performance is not indicative of future returns.