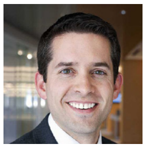
CEF INSIGHTS | Emerging Markets Debt: Diversification & Yield

CEFA was joined by Mark Hughes, Portfolio Manager & Research Analyst on The Emerging Markets Debt Team at Western Asset Management. The following Q&A recaps a discussion about emerging markets debt as a diversifier and yield enhancer within a fixed income portfolio. As part of CEFA's CEF Insights podcast series, the podcast audio can be heard here.


Mark Hughes

CEFA: **Welcome to CEF Insights, your source for closed-end fund information and education brought to you by the Closed-End Fund Association. My name is Diane Merritt. Today we are joined by Mark Hughes, Portfolio Manager & Research Analyst on The Emerging Markets Debt Team at Western Asset Management. We are happy to have you.**

Mark: Thanks, great to be here.

CEFA: **Now, investors sometimes refer to emerging market debt as a single sector, which might imply common characteristics across the space. However, this market is quite diverse. Can you give us an explanation of the breadth of the EM debt market and the benefits and risks that EM debt represents to investors?**

Mark: Sure Diane, emerging markets debt has increased in size and prominence in the market significantly over the past ten years. And obviously you could think of it as is as being one asset class but we try to break it down into three different sectors. Those sectors are hard currency sovereigns, hard currency corporates and local currency bonds. And between these three sort of sub-sectors we find that for different investors we can find different risk return profiles at different points of the cycle, some are more attractive than others. As a diversified estimator like ourselves we can actually rotate between these assets classes, depending on what's going on in the market.

CEFA: **Interesting. Western Assets is an active investment manager with a focus on fundamental credit research, in the emerging market debt sector, what advantages do you see for an active manager with respect to managing risk and adding to performance?**

Mark: So I'd say there's two parts to that question. One is that when you're looking for an active manager, you're looking for someone who has an emerging market advantage. You're looking for someone who has a global platform and a big research team that's out there able to go track down what's going on in all these diverse emerging markets around the world. So you need to have not just somebody who's operating out of one market necessarily, but with market investment professionals who are trading out of New York, trading out of London, perhaps Singapore, Tokyo, and even China now, and Asia. So we feel like having that diverse global platform is really important for emerging markets, and allows us to both select the great investments, but also avoid some of the pitfalls out there.

When it comes to active management--which active versus passive is obviously a big topic in investment research these days--I think emerging markets is an area where you really want to have an active manager. What we find is there are 70 something countries that fall into emerging markets debt space and if you go with a passive approach you often going to own every single one of them, and I think you know obviously we are going to have strong views on some, we're going to want to own or have over-weights in some and often in the emerging markets you're going to want to have zero weight to some countries. An example of some of the countries out there that are either risky, have elevated default profiles or are certainly in the news these days, certainly Venezuela comes to mind; countries like Lebanon, and even some really small issuers that don't really have a track record like Papua New Guinea, and Tajikistan. And so we think that having an active manager who's making that sort of overweight, underweight decision, and trying to keep you out of trouble is really important.

CEFA: Western Assets manages a closed-end emerging market debt fund with ticker symbol EMD. Do you find the closed-end fund structure to be advantageous in managing a portfolio of EM debt?

Mark: We do. I think both from the manager's side we like the close-end fund structure, and from the investor side the close-end structure offers some advantages. So from our standpoint the closed-end fund obviously provides the stable base of assets that we can manage. With certain other options such as an ETF you find that inflows and outflows out of the sector can cause volatility in pricing and they can even certainly longer term concern about what a larger market downtrend would do to technicals for ETF's. Whereas we know that when we're investing EMD we have a stable base of capital and we can put it to a more long-term use than having to worry about a position with excess cash for withdrawals, and we find that to be very attractive.

CEFA: I see. For much of 2018 the U.S. dollar strengthened and U.S. interest rates were rising creating some headwinds for emerging markets. 2019 has started with improved performance from EM debt. Given this, what are the key issues you see impacting the outlook for emerging markets.

Mark: Well I think your characterization of what's gone over the past year is really right on. What you saw in 2018 was a lot of market concern about the Fed hiking rates, and some evidence that the U.S. was growing faster than a lot of other regions in the world, both say the Euro zone as well as emerging markets. And those fundamental market expectations last year lead to some stress in emerging markets. Ultimately people wanted to have their investments in U.S. and in dollars and that was tough for EM. I think the EM team here at Western takes a lot of its ques from our global macro research team and portfolio managers. And I think we've been calling--even at tough times last year--we've been calling for U.S. growth to slow down. We've been calling for moderate inflation, both in the US and abroad. And if those conditions were going to take place we also thought that the Fed was going to have to take a more dovish stance over time and really starting with the end of 2018 you saw that dovish pivot, as we call it, occur.

So since then emerging markets have been less concerned about having to hike their own interest rates in response to the Fed. There's a feeling that, you know, that maybe U.S. growth isn't the best in the world after all, and that it's okay to sort of get back in the water in other asset classes, and that change has really contributed to nice performance in both hard currency emerging markets bonds as well as the affects in local currency debt.

CEFA: **Now your portfolio has the flexibility to allocate among countries as well as currencies. Where do you see the best opportunities in sovereign debt? Are you more comfortable with U.S. dollar denominated positions, or do you see benefits to local currency exposure?**

Mark: So as we talked about upfront a closed-end fund like EMD has the flexibility to sort of go wherever in an emerging market that we feel the best opportunities are. At the same time, the number one goal of this fund is current income, and so, when we think about our asset allocation within emerging markets we do try to think about what securities have the highest likelihood of paying those stable returns. As a result, our philosophy is to stick a little more to the hard currency emerging markets--bonds versus local currency debt. I think if you are looking for a different, either a different product, a different wrapper, or a different sort of total return profile you might consider increasing your allocation to local currency debt which we also do find attractive, but I think if our goal is to pair our stable high, but stable, coupon over time I think we're going to stick more to the hard currency debt.

What you saw last year is with the sell-off in treasuries, but also the sell-off in global spreads, whether it was emerging markets or places like the U.S. is that, sovereign debt became really attractive and had some nice yields in the five to eight percent range last year. And so that's really what we've been focusing on in EMD and we continue to find that segment attractive.

CEFA: **Shifting to the corporate debt market, do you find current valuations to be attractive? Where do you see opportunities in this space?**

Mark: Sure, so the EM corporates are an interesting, sort of, asset class because they share a lot of similarities to what you see in U.S. credit both in the investment grade market and the high yield market. But also at the same time you have to understand that emerging markets corporates have sovereign risk sort of embedded in them and obviously you know the riskier the country that the company operates in, the more sovereign risk and political risk that maybe taken there. So typically we like to see you're being paid for both the sovereign risk in addition to some sort of corporate premium.

What's different about EM corporates in the past couple years is that unlike the US credit market where you know money has been freely available and you've seen a lot of issuance particularity out of investment grade. The EM cooperates have been much more sort of responsible with their balance sheets. There hasn't been as much issuance, and we feel like that credit trends are actually more stable in emerging markets. So we feel like EM corporates are a nice sort of diversifier and sort of yield answer within the emerging markets universe, and actually we think that emerging markets corporates in some sense can be more attractive than developed market and US credit, as we're starting to become concerned about where we are in the economic cycle.

CEFA: **Considering that U.S. investors are typically underweight in non-U.S. investments. How do you believe an allocation to a emerging market debt is best positioned in an investor's diversified portfolio?**

Mark: Sure, so as I said from the beginning, I think you've seen asset allocations to emerging markets debt increase over time. I think institutional investors were sort of the first to the party in one sense with their allocations, and existing emerging markets do appear in some bond funds naturally. What we think of is a core-plus or sort of generic bond fund often has some the larger emerging markets issuers embedded in it, and that's because the for example the Barclay's Aggregate or the Barclay's Credit indices do have SEC registered EM bonds in it.

So I think that the typical investor with some allocation to fixed income is going to get a little bit of emerging markets sort of naturally in there. Sort of our recommendation is that you augment that with some standalone emerging markets debt exposure, and we're not talking about you know 20% of your asset allocation, but we feel like a single digit allocation out of your fixed income bucket can be both a yield enhancer and a diversifier.

CEFA: **Mark, we want to thank you so much for taking the time to join us today.**

Mark: Great. Thanks so much for your time.

CEFA: **And we want to thank you for tuning into another CEF Insights podcast. For more educational content please visit our website at www.CEFA.com.**