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WHITEPAPER

Take a closer look: Why your EMD manager may be set to underperform

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For today's investor

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Barney is an Investment Director focused on Emerging Market Debt strategies . He works closely with our portfolio managers to articulate their investment process, portfolio positioning and investment performance to clients and consultants around the world.

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Structural biases, poor risk management and a failure to separate beta and alpha drivers are common in underperforming active emerging-market debt strategies over the long term, as our research reveals.

Summary

Emerging-market debt (EMD) is often characterised as an opaque and inefficient asset class that should provide a fertile alpha-hunting ground for active managers, especially in volatile markets. If that's true, why do so many active managers significantly underperform during periods of market stress?

To find an answer, we analysed ten years of historical returns for the EMD hard-currency manager universe. Our research has identified three sources of long-term underperformance that we believe are likely to persist:

1. Structural biases that leave investors overexposed to the riskiest segments of the market;
2. An overreliance on traditional metrics to evaluate portfolio risk;
3. A failure to separate beta and alpha drivers in portfolio construction.

While these issues have persisted for many years, the need to understand and react to them is particularly acute in the current environment.

The fallout from the COVID-19 crisis has left many countries poorer, with more debt and larger budget deficits. This has created a more challenging investment environment for active managers, with index return dispersion at levels not seen since the global financial crisis. We believe attractive investment opportunities are still available, but harnessing them is now likely to require a very different approach than has been practiced by much of the peer group historically.

Our research identified three sources of underperformance we believe are likely to persist.

The problem

EMD offers the potential for attractive returns while also being susceptible to periods of increased volatility and rapid spread widening. It is known to be a relatively opaque, inefficient asset class. Together, these characteristics should create a fertile alpha-hunting ground for active managers.

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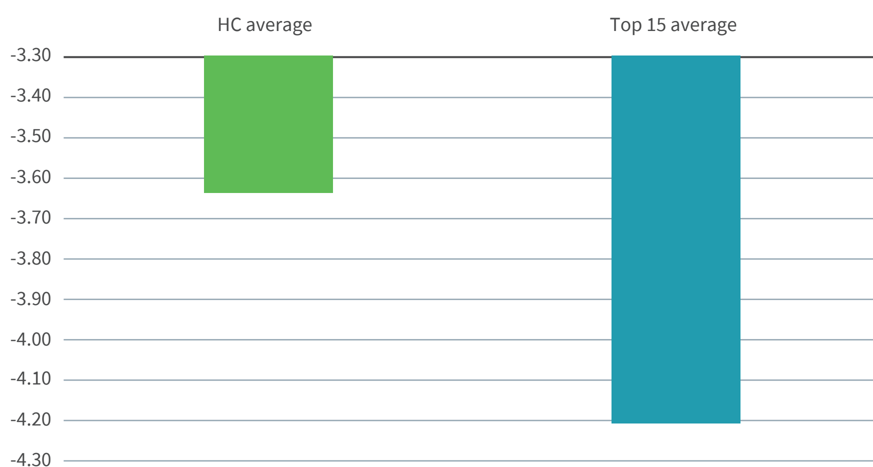
Active managers, however, typically struggle to outperform their benchmarks when the market's risk-return characteristics change rapidly—precisely those periods when investors are banking on their alpha-generation abilities to shine.

When we examine the ten worst quarters of returns over the last decade, we see the average hard-currency EMD manager underperformed by 3.64 per cent. The underperformance is even more stark when we focus on the top 15 active managers, as measured by AUM. This begs two questions: Why are active managers failing so significantly, and why do the largest managers appear to be the riskiest of the bunch?

Figure 1. **Active manager performance (Cumulative excess return from 10 worst quarters)**



Past performance is not a guide for future performance

Source: Aviva Investors, eVestment as of June 30, 2020. Peers are those strategies in the Global Emerging Markets Fixed Income Hard Currency universe with 10 years of monthly returns and preferred benchmarks listed as either the JPM EMBI Global or JPM EMBI Global Diversified index. Calculations based on the spread of the JP Morgan EMBI Global Index.

In this paper, we explore the three drivers we believe explain this underperformance and discuss how understanding these drivers is even more important in the current market environment.

1. Structural biases that leave investors overexposed to the riskiest segments of the market;
2. An overreliance on traditional metrics to evaluate portfolio risk;
3. A failure to separate beta and alpha drivers in portfolio construction.

Three reasons why active EMD managers underperform

1. Structural biases lead to higher drawdowns and increased volatility of returns

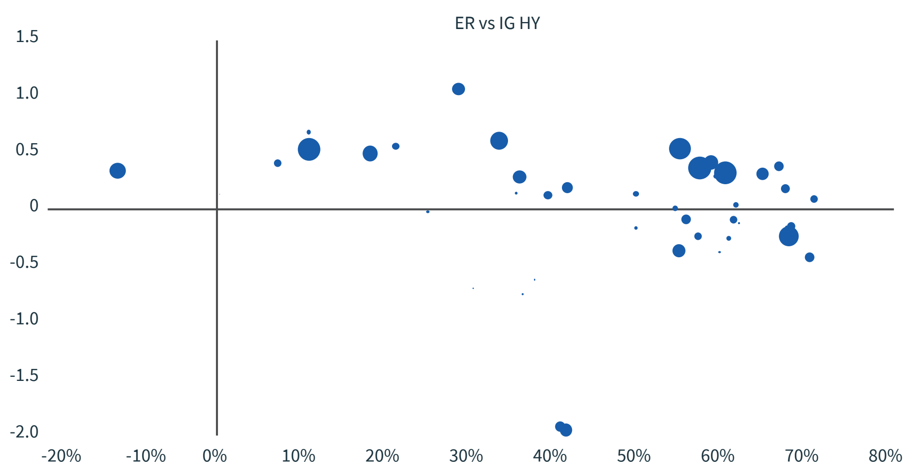
The fallout from the COVID-19 crisis has created a more challenging investment environment, especially for EMD. This is likely to drive higher levels of dispersion and volatility, particularly for lower-rated issuers. It is therefore critical to avoid overexposure to this riskier part of the market, which represents approximately 40 per cent of issuers within the EMD hard-currency universe.

However, avoidance of riskier issuers is more difficult to achieve than many investors realise. Our analysis shows most active managers have a structural bias towards the higher-risk part of the market.

The chart below illustrates the average excess return and correlation to high yield for the universe of active EMD hard-currency managers over the last ten years. The dot for each manager is sized relative to their AUM. We see that the average correlation to high yield is 0.42, but when weighted by AUM, the correlation increases to 0.48, indicating many of the largest funds are skewed towards the high-yield portion of the market.

Our analysis shows most active managers have a structural bias towards the higher-risk part of the market.

Figure 2. **Correlation to high yield/investment grade spreads, 10 years ending June 20, 2020**



The size of the bubble is determined by the strategy AUM.

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Source: Aviva Investors, eVestment as of June 30, 2020. Peers are those strategies in the Global Emerging Markets Fixed Income Hard Currency universe with 10 years of monthly returns and preferred benchmarks listed as either the JPM EMBI Global or JPM EMBI Global Diversified index. Calculations based on the spread of the JP Morgan EMBI Global Index, Investment Grade and High Yield indices. Please note the chart does not depict any Aviva Investors product or strategy.

A bias toward high yield is likely to lead to bigger drawdowns and increased volatility of returns. As shown below, of the ten worst quarters of performance over the last ten years, the first quarter of 2020 was a particularly stark example of when a "high beta" approach to the asset class turned out to be costly.

Figure 3. **The costs of a high beta bias in downturns (per cent)**

	Benchmark return	Average active "high beta" manager excess return	Average active manager excess return	High beta vs. average
Q3 2015	-2.04	-1.04	-1.49	0.45
Q4 2016	-4.21	0.81	0.73	0.08
Q1 2018	-1.78	0.46	0.51	-0.05
Q3 2014	-1.65	-0.65	-0.45	-0.2
Q1 2013	-2.3	0.49	0.7	-0.21
Q4 2010	-1.85	0.88	1.1	-0.22
Q2 2018	-3.51	-1.24	-0.77	-0.47
Q2 2013	-6.06	-0.49	0	-0.49
Q3 2011	-1.82	-1.82	-1.14	-0.68
Q1 2020	-11.76	-4.45	-2.1	-2.35

Past performance is no guarantee of future returns.

"high beta" managers defined as those with historical correlation of excess returns to high yield spreads of over 60% .

Source: Aviva Investors, eVestment as of June 30, 2020. Peers are those strategies in the Global Emerging Markets Fixed Income Hard Currency universe with 10 years of monthly returns and preferred benchmarks listed as either the JPM EMBI Global or JPM EMBI Global Diversified index. Calculations based on the spread of the JP Morgan EMBI Global Index. Please note the chart does not depict any Aviva Investors product or strategy.

2. Overreliance on traditional metrics to evaluate portfolio risk

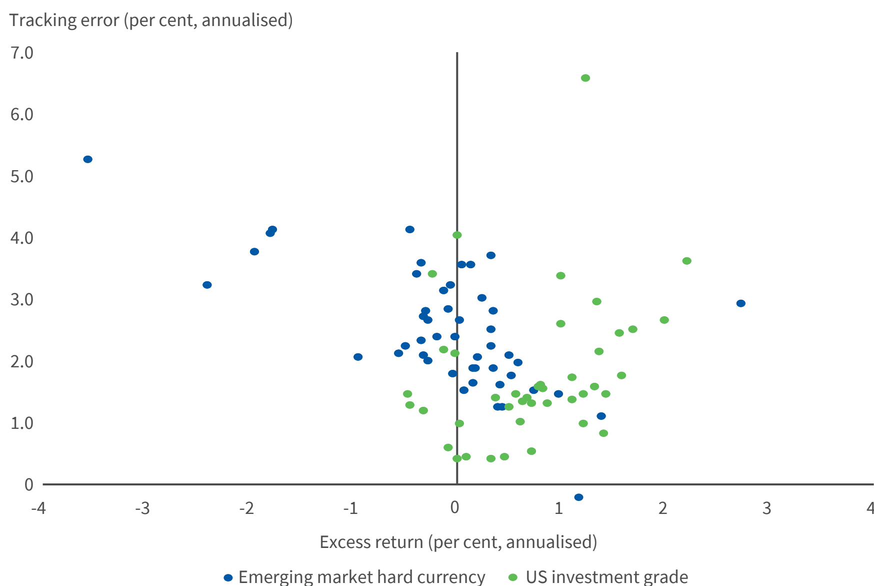
EMD markets can offer attractive returns; however, they also exhibit high levels of idiosyncratic financial and non-financial risks, including political instability. These are difficult to capture using traditional measures such as tracking error.

Tracking error is widely used by both portfolio managers and fund selectors to understand the levels of risk within a portfolio. However, we believe there are several serious limitations that make it a poor risk metric, especially with EM portfolios.

- **Fails to measure risk of loss:** Tracking error measures the deviation from a benchmark rather than the risk of loss. If a benchmark index is inefficient, deviations from the benchmark should be beneficial by reducing risk or improving portfolio returns. Too often, however, deviation from a benchmark is viewed as "taking risk" rather than reducing it or improving risk-adjusted returns.
- **Engenders forced ownership:** Fund selectors and consultants often focus on tracking error as a measure of the degree to which a portfolio is active. Strategies with low historical levels of tracking error are often labelled as "closet trackers" or "semi-passive". This forces managers to add risk or off-benchmark positions as a means to appear sufficiently active.
- **Incorrectly assumes more risk leads to excess returns:** In some asset classes, such as US investment-grade debt, there is a strong correlation between tracking error and excess returns, suggesting adding risk on average improves manager returns. To the contrary, our analysis indicates there is no correlation between tracking error and excess returns for EMD hard-currency managers, which is likely due to the higher downside risks.

We believe there are several serious limitations that make tracking error a poor risk metric, especially with EM portfolios.

Figure4. **More risk does not always lead to more return**



Past performance is no guarantee of future returns.

Source: Aviva Investors, eVestment as of June 30, 2020. Peers are those strategies in the eVestment Global Emerging Markets Fixed Income Hard Currency and US investment Grade universe with 10 years of monthly returns. Chart does not depict the performance of any Aviva product or strategy.

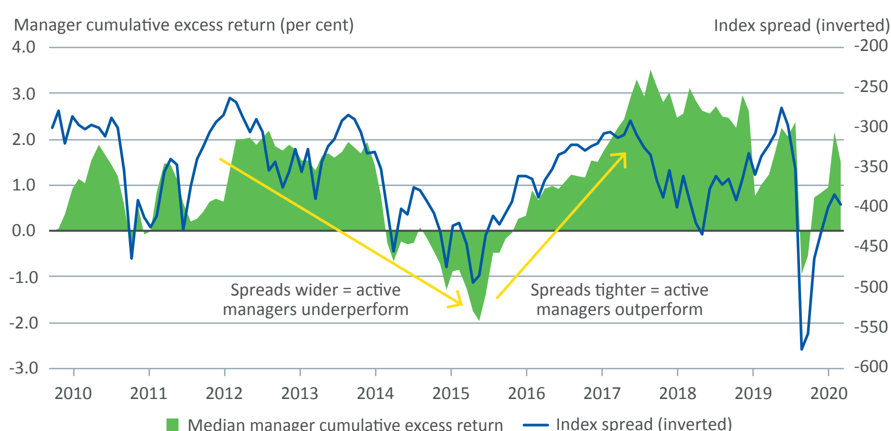
3. Single-dimension portfolio construction leads to inconsistent performance

To achieve consistent outperformance through market cycles, portfolio construction within EMD requires a multi-layered approach that separates credit beta decisions from alpha drivers.

Regardless of the asset class, robust portfolio construction is essential to transforming good ideas into good portfolios. Within the EMD universe, we believe the failure of managers to adequately separate portfolio beta from active alpha-generating ideas leads to portfolios that are only able to outperform during periods of spread tightening.

The chart below shows the median cumulative excess return for active hard-currency EMD managers plotted against the spread of the index (inverted). We can see the median manager tends to only outperform the index when spreads are tightening.

Figure 5. **Reliance on spread compression leads to inconsistent performance**



Past performance is not a guide for future performance

Source: Aviva Investors, eVestment as of 30 September 2020. Peers are those strategies in the Global Emerging Markets Fixed Income Hard Currency universe with 10 years of monthly returns and preferred benchmarks listed as either the JPM EMBI Global or JPM EMBI Global Diversified. Please note the chart does not depict any Aviva Investors product or strategy.

To achieve consistent outperformance through market cycles, portfolio construction within EMD requires a multi-layered approach that separates credit beta decisions from alpha drivers.

Portfolio construction must also balance the competing needs of maximising returns whilst protecting portfolios from periods of volatility. Such an approach enables managers to build balanced portfolios that combine shorter-lived positions with longer-term, fundamentally driven ideas that have the potential to deliver performance over the medium to long term.

In the moment: Why proper positioning in EMD matters right now

While the issues identified in this paper have been present for many years, the need to understand and react to them is particularly acute in the current environment.

The benchmark index has moved back into positive territory for the year, but the fallout from the COVID-19 crisis has left many countries poorer, with more debt and larger budget deficits. This has created a more challenging investment environment for active managers, with index return dispersion at levels not seen since the global financial crisis.

In this sense, the headline returns of the index are hiding what is happening beneath the surface: The range of performance between different countries hasn't been this wide since 2008. As illustrated by our analysis above, many managers will likely struggle to outperform as parts of the market encounter significant stress. Attractive investment opportunities are still abundant, but harnessing them may require managers to change the way they approach the asset class.

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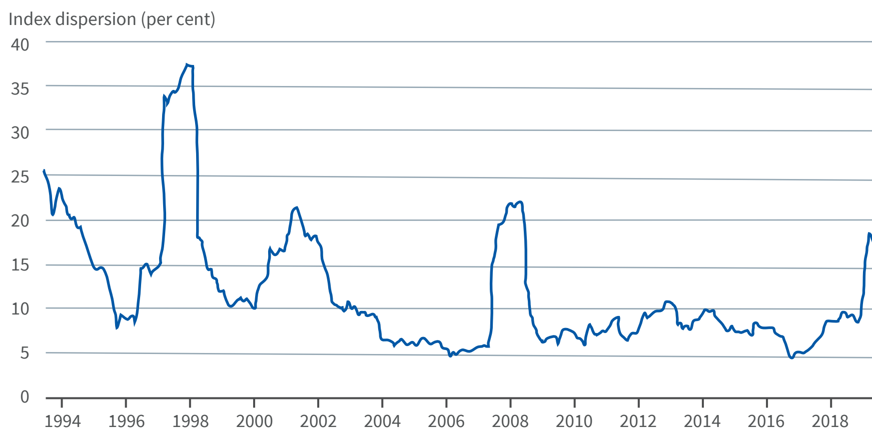
Figure 6. **Rising dispersion in EM debt markets creates risks and opportunities**



Past performance is not a guide for future performance

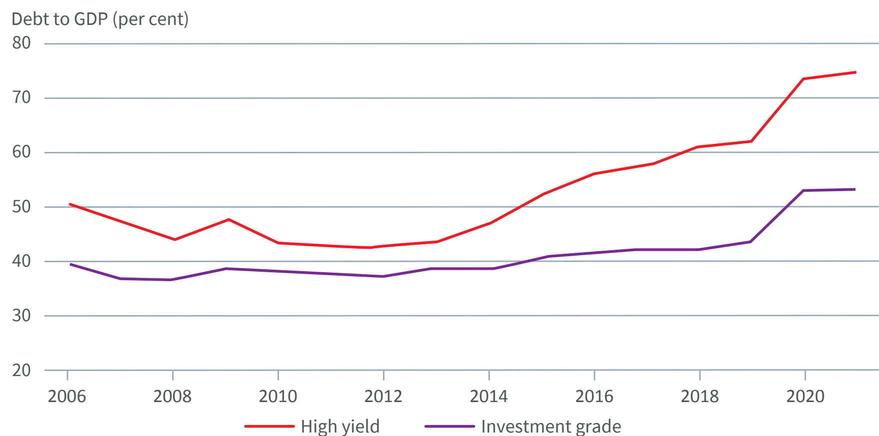
Source: Aviva Investors September 2020, JP Morgan EMBI Global Index. For illustrative purposes only.

Diverging fortunes within EMD

COVID-19 has accelerated several concerning pre-pandemic trends , including the widening dispersion between high-yield and investment-grade issuers.

The EMD universe was not created equal. COVID-19 has accelerated several concerning pre-pandemic trends , including the widening dispersion between high-yield and investment-grade issuers. Divergence is also widening between high-yield countries, which may be due to factors including how nations cope with the pandemic; the impact of oil prices; reliance on tourism; level of exports of non-essential goods; and their dependency on remittances.

Figure 7. **Divergence between high-yield and investment-grade emerging markets**



Past performance is not a guide for future performance

Source: Aviva Investors, November 2020. For illustrative purposes only.

This is particularly challenging for large parts of the EMD hard-currency manager universe, who have historically been heavily reliant on the higher-yielding part of the market to generate alpha.

In uncertain times, investors can benefit from an ability to closely examine real risks between and within countries and the flexibility to look beyond historical biases and make forward-looking assessments. While avoiding exposure to large parts of the market can actually reduce portfolio risk, reliance on measures such as tracking error can limit managers' success. Traditional risk metrics are also unable to quantify many of the largest EM risks, such as election-related volatility, a resurgence in COVID-19 cases or an increased risk of credit events.

Because the asset class is not homogenous, investors will need to assess the relative resilience of individual EMD issuers to capture meaningful, consistent performance in the months ahead. A multi-layered approach to portfolio construction is favorable in such an environment, shifting the focal point beyond beta to a more rigorous focus on credit selection.

How investors can position for success

Active managers face the challenge of preparing for a downturn without sacrificing their ability to generate returns as the market continues to rally. In EMD, history has shown most actively managed portfolios struggle to deal with periods of volatility, failing to deliver consistent outperformance. Ultimately, the most sustainable option may be to adopt a structural allocation to EMD, based on a dynamic investment process with proven resilience, to realise attractive returns while mitigating higher volatility.

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Why timing the market isn't the answer

Many investors take a tactical approach to EMD, relying on their ability to time the market to protect portfolios from potential volatility.

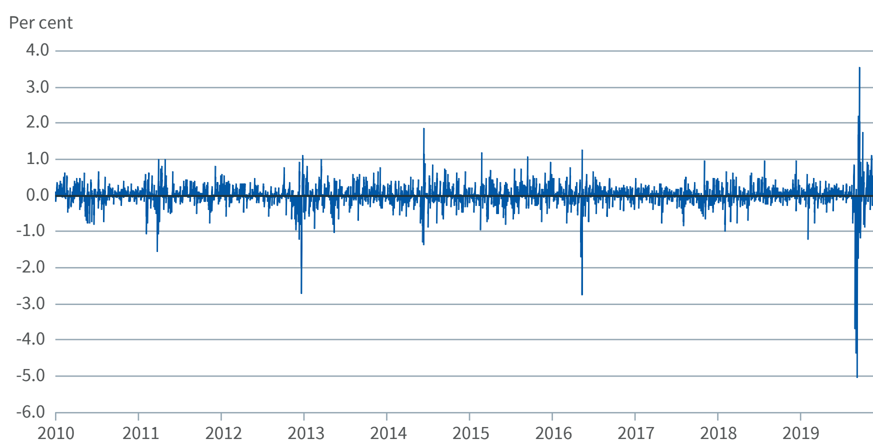
Portfolio protection that relies on market timing is extremely difficult to do repeatedly and can also leave investors underexposed when markets recover. Looking at historical returns, there have only been 40 days in the last ten years that saw index moves of greater than +/- one per cent. Timing each of these periods of volatility would require exceptional skill.

The first quarter of 2020 is a particularly good example. Although significant by historical standards, the drawdown experienced was most astonishing because of its speed, with the hard-currency sovereign index seeing a 20 per cent fall from the end of February to mid-March.

We believe investors will be better served by looking to embed resilience throughout the cycle rather than rolling the dice with their ability to consistently time the market.

At Aviva Investors, we embed resilience into EMD portfolios throughout the cycle, protecting performance during challenging environments — like today's — while still delivering consistent alpha.

Figure 8. **Daily index returns 2010-2020 (per cent)**



Past performance is no guarantee of future returns.

Source: Aviva Investors, JP Morgan as of June 30, 2020. Index defined as the JP Morgan EMBI Global Diversified index returns in USD.

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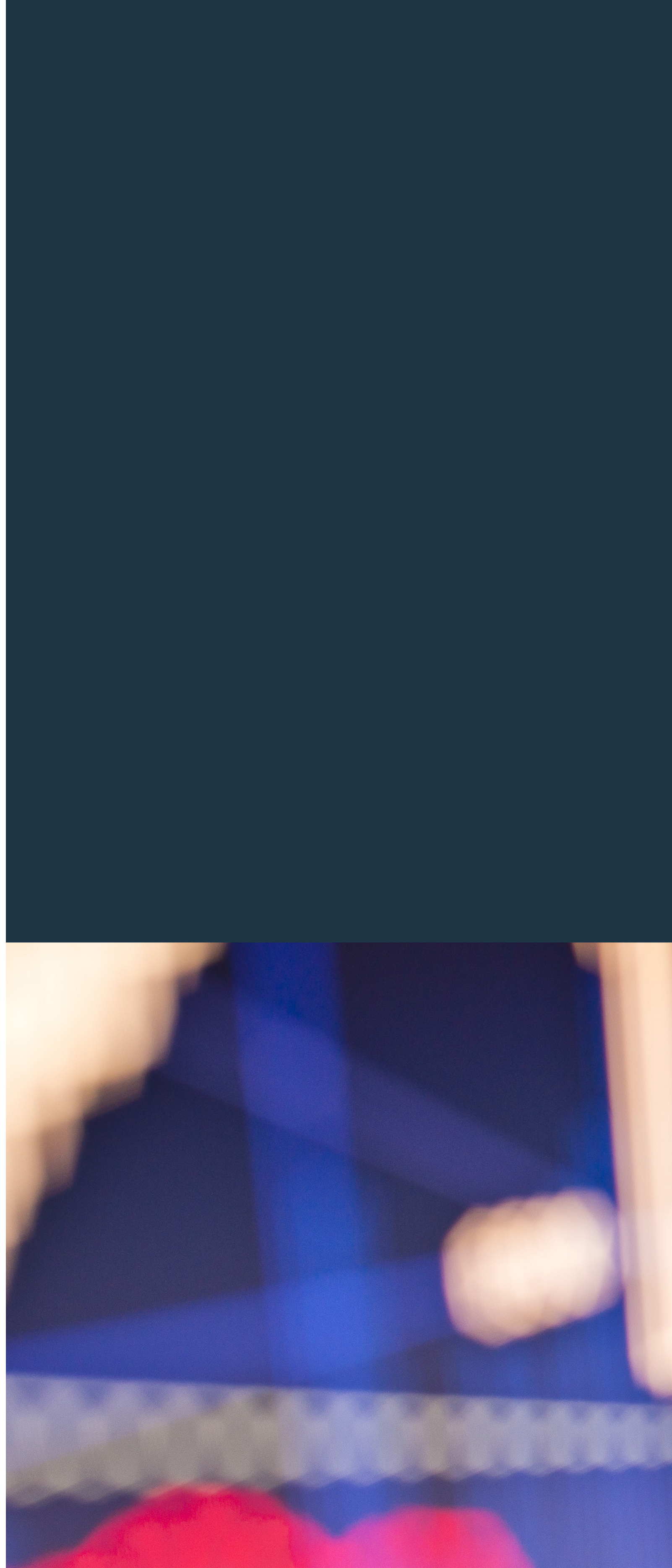

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