Emerging Markets:
All of the Above

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As an investor in emerging markets for nearly twenty years, our team of professionals has talked to many people about the market segment. Interestingly, we find there are two common questions about investing in emerging markets:

What provides the best exposure to emerging markets, debt or equity?

What is the better option within the debt market, hard or local currency bonds?

Our answer to both of these questions has always been: *all of the above*.

Emerging Markets: Debt or Equity?

Since 1999, emerging markets equity (EME) and emerging markets debt (EMD) have posted annualized returns of 7.4% and 9.3% respectively[1], outpacing the S&P 500, Bloomberg Barclays High Yield Index, and Bloomberg Barclays Aggregate Index over the same time period. Given the higher growth rates and risk premia associated with emerging markets, an allocation could significantly benefit a portfolio. Even so, we find some investors are willing to consider EME, but shy away from EMD. Often, they underestimate the performance potential of EM debt given the lower returns generally found within fixed income. Investors are often surprised to learn that since 1999, EMD has generated higher returns than EME with less volatility. However, both returns and volatility are dependent on prevailing market conditions, and have varied over the last twenty years.

Part of EMD's performance can be attributed to a robust and growing universe of investable assets across diverse geographies. While the market cap of both the EME ($1.6 trillion) and EMD ($1.8 trillion)[1] universes are similar, the EME index is much more geographically concentrated. The JP Morgan EMBI Global Diversified Index ("EMD US Dollar Sovereign Index") contains the bonds of 67 different countries while the MSCI Emerging Markets Equity Index ("EME Index") includes only 25 countries and is heavily concentrated in Asia. In aggregate, the Asian region represents 73% of the EME index versus 20% of EMD. To compound the issue, several of the largest countries in the EME index by market cap, including Taiwan and Korea, have strong economic ties to China. As a result, China and China-related countries are having an outsized influence on the overall index.

FIGURE 1

	EMD US Dollar Sovereign Index [1]		EME Index [2]	
Countries	**67**		**25**	
Largest Countries	Mexico	5.2%	China	29.7%
	Indonesia	4.3%	South Korea	15.4%
	China	4.2%	Taiwan	11.3%
	Turkey	3.8%	India	8.8%
	Russia	3.6%	Brazil	7.6%
Top 5 Countries	**21.2%**		**72.8%**	

1 As measured by the MSCI Emerging Markets Index (EME) and the JP Morgan EMBI Global Diversified Index (EMD) at 12/31/17.

2 As of 12/31/17. The local currency and corporate indexes are as measured by the JP Morgan GBI-EM Global Diversified Index and JP Morgan CEMBI Broad Diversified Index respectively. Due to index construction requirements, the "diversified" indexes shown limit the concentrations of larger countries. The actual market capitalization of the EMD universe exceeds $3 trillion.

Despite the less geographically diverse make-up of the EME index, we strongly believe there is a place in the portfolio for both a debt and equity allocation. EME is an investment in the individual companies of emerging countries. EMD offers a direct investment into the growth of these countries through sovereign and quasi-sovereign bonds. Both offer exposure to developing markets, but have different sources of risk and drivers of return. As such, we recommend taking a diversified approach to benefit from both while being mindful of aggregate geographic exposures within the total portfolio.

Emerging Markets Debt: Hard or Local?

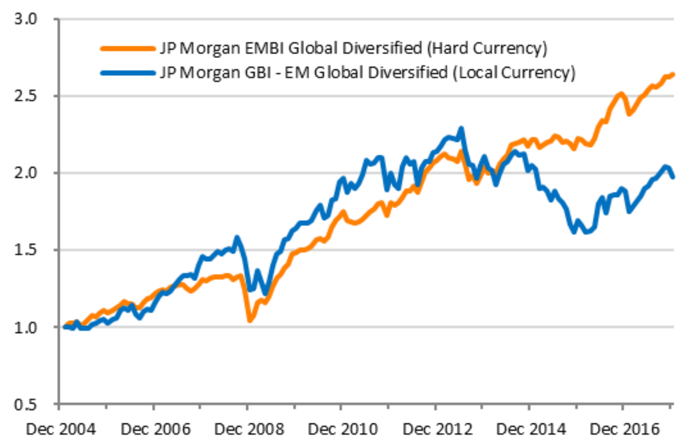
Investors have been drawn to local currency EMD over the past year due to the segment's strong returns. The JP Morgan GBI-EM Global Diversified Index ("Local Currency Index") certainly had a stellar year, outperforming the USD Sovereign Index by nearly 500 basis points. However, as with debt versus equity, we believe an opportunistic or blended approach to EMD investing is a better option due to the limited country options of the local universe and the additional risks associated with emerging currencies.

[1] As of June 30, 2017, as reported on September 30, 2017 by eVestment, Morningstar and Bloomberg

FIGURE 2	EMD US Dollar Sovereign Index [1]		EMD Local Currency Index [2]	
Market Cap	$541 billion		$893 billion	
Countries	67		18	
Yield	5.27%		6.14%	
Average Rating	Ba1/BB+		Baa2/BBB	
Largest Countries	Mexico	5.2%	Brazil	10.0%
	Indonesia	4.3%	Mexico	9.6%
	China	4.2%	Indonesia	9.6%
	Turkey	3.8%	Poland	9.0%
	Russia	3.6%	South Africa	8.4%
Top 5 Countries	**21.2%**		**46.6%**	

[1] JP Morgan EMBI Global Diversified Index as of 12/31/2017.
[2] JP Morgan GBI-EM Global Diversified Index as of 12/31/2017.

FIGURE 3: CUMULATIVE RETURNS (INDEXED TO 1)



Source: JP Morgan
Chart data is from 12/31/2004 through 12/31/2017. All returns are in US Dollars.

The market cap of the Local Currency Index is significantly larger than the USD Sovereign Index, $893 billion vs. $541 billion. However, much like EME, it is considerably more concentrated. The Local Currency Index included just 18 countries at year-end, as compared to 67 in the USD Sovereign Index. The top five countries in the Local Currency Index had a combined weight of 47% versus 21% for the US Dollar Sovereign Index.

Another very important consideration is the currency exposure inherent to local currency EMD. US Dollar sovereigns and local currency are highly correlated, but fluctuations in exchange rates can cause significant deviations in performance between the two indexes. Currency cycles tend to be long, causing extended periods of underperformance for local currency, as was the case in 2014 and 2015. The strength of the US Dollar against EM local currencies caused the annual returns of the two indexes to differ by as much as 16% during the time period.

Over time, the more diverse composition of the US Dollar Sovereign Index combined with its lack of non-dollar currency exposure has proven advantageous. Over the last ten years, its annual performance has dipped into negative territory just twice while the Local Currency Index posted negative returns in five of the past ten years. On a cumulative basis, the US Dollar Sovereign Index outperformed the local index with less volatility.

Despite the strong performance of US Dollar Sovereigns, we do see value in local currency. The segment has delivered periods of outperformance due to favorable movements in exchange rates. Timing the markets may be tempting and, when executed to perfection, would certainly yield the best results. However, it can be difficult to determine whether fundamentals and investor sentiment will continue to favor one category over another for a sustained period of time. For this reason, we maintain that an opportunistic or blended approach is most appropriate over a long-term investment horizon.

Mark Foust, Senior Portfolio Specialist, is responsible for serving as primary point of contact for the Fixed Income investment team to provide our clients with ongoing communication and in-depth portfolio insight regarding our fixed income strategies. Mr. Foust is responsible for understanding and communicating portfolio positioning and buy/sell rationale, attribution analysis, and serving as a representative for senior investment professionals such that they are primarily engaged in investment-related activities. Mr. Foust joined DuPont Capital in 2009 and has been in the financial services industry since 1985. Mr. Foust holds a B.S. in Administration and Management Science from Carnegie-Mellon University and he earned an M.B.A. in Finance from the Pennsylvania State University.