**For professional clients only.
Not to be distributed to retail clients.**

Widening the field for yield

Why we believe buy and maintain investors may wish to consider allocating to emerging market debt.

Mark Vickery
Client Director

John Gray
Emerging Markets Portfolio Manager
Active Fixed Income

Ozkan Koyun
Portfolio Manager
Buy-and-Maintain

Business centre, Moscow, Russia

For defined benefit (DB) pension schemes, particularly those of greater maturity, buy and maintain allocations have been increasing in popularity and are now widely adopted.

Buy and maintain investment generally involves:

- an active selection of high quality global bonds to hold, ideally until maturity;
- reduced trading costs resulting from low turnover;
- duration targeting to help mitigate interest rate risks, affecting schemes' liabilities;
- yield generation above gilts to improve funding positions;
- and for those schemes whose ultimate target is buyout, corporate bonds can also provide a reduction in the cost of their transaction.

In order to achieve all this, schemes invest on a global basis in corporate bonds. However, UK DB pension schemes in fact remain significantly short of emerging market exposure. We believe that allocating to emerging market corporate bonds, alongside traditional developed market corporate bonds, is one of the key tools in creating high quality buy and maintain portfolios.

In this article, we present five reasons why we believe DB pension schemes may wish to consider including emerging market bonds in their portfolios as they progress along their journey to their chosen endgame.

The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.

Legal & General
INVESTMENT MANAGEMENT

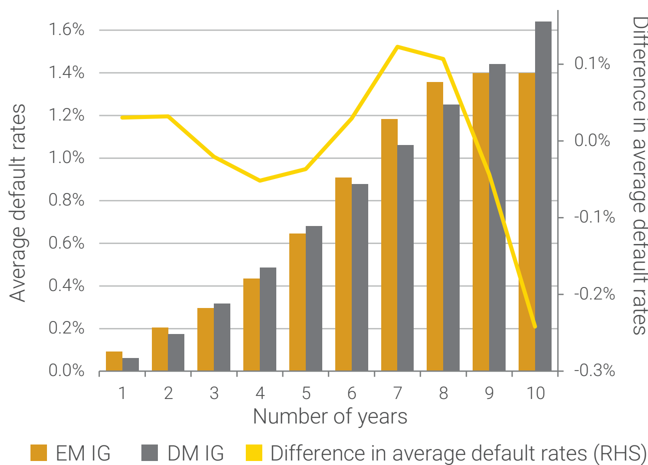
1

Emerging market bond default rates have been low and their ratings have been improving

We believe a fundamental pillar of buy and maintain investing is aiming to avoid rating downgrades and outright defaults – this helps to keep turnover low and yield constant. It is often assumed that emerging market corporate bond default rates are higher than developed market counterparts, but in Figure 1, which looks at investment grade corporate bonds, it is clear that average bond default rates occur at a similarly low level for both.

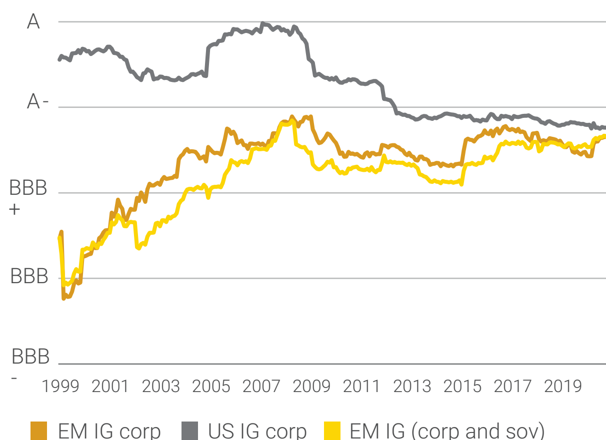
Figure 2 demonstrates that while the average rating of US investment grade bond indices has fallen, that of emerging market investment grade bond indices has actually improved.

Figure 1: Comparison of EM and DM default rates



Moody's as at 31 March 2020. The chart shows cumulative average default rates over 10 years (i.e. from 01 April 2010 to 31 March 2020).

Figure 2: Average rating of indices

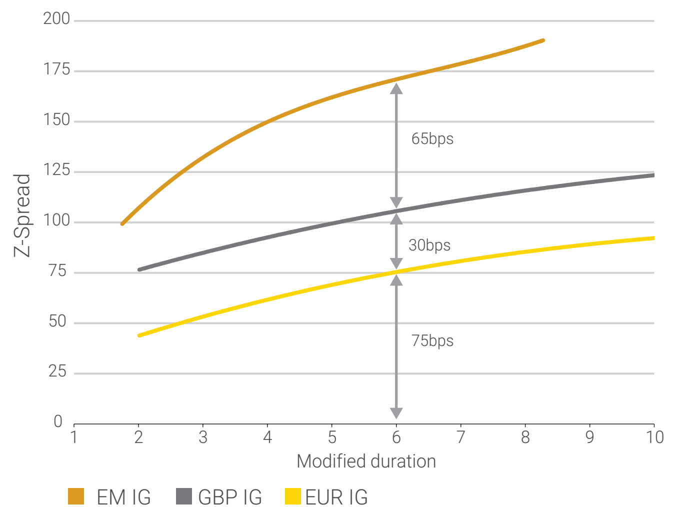


2

Yield, risk and reward

Yield is crucial in buy and maintain investing: in our view too low, and the reward for holding credit over gilts may be insufficient, but too high, and there may be concern over issuer risk or credit quality. Quantitative easing has driven developed market investment grade bond yields to extremely low levels. Worldwide, negatively yielding debt was worth roughly $18 trillion as at 31 December 2020. This has, in our view, significantly reduced the opportunity set available to clients to meet their risk and return objectives. However, for a given rating and duration, we observe that emerging market corporate bonds have the potential to offer an attractive spread to supplement developed market corporate bonds, as demonstrated by Figure 3 below, which shows a comparison of sterling, euro and emerging market (in US dollar or 'hard currency' terms) bonds typically held in buy and maintain portfolios.

Figure 3: Spread comparison



Source for Figure 3: LGIM as at 31 October 2020.
Past performance is not a guide to the future.

Source for Figure 2: Data: BofAML as at 31 December 2020. We show the US dollar holdings of the ICE BofA Global Corporate Index, and the investment grade portions of the ICE BofA Emerging Markets Corporate Plus Index and the ICE BofA Emerging Markets External Sovereigns Index. For full index performance over the past 5 years, please see Appendix A at the end of this document.

Past performance is not a guide to the future.

The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.

To place some further context around the risk-adjusted return benefits that we have observed in emerging market investment grade bonds, we highlight a few examples:

An A-rated, state-owned Middle Eastern bank's senior bond offers a c.60bps pick up to a BBB+-rated UK insurance company. (February 2021)

A BBB-rated Latin American utility provider's senior bond offers a c.100bps premium over that of a utility provider in the UK with the same rating and a similar duration. (February 2021)

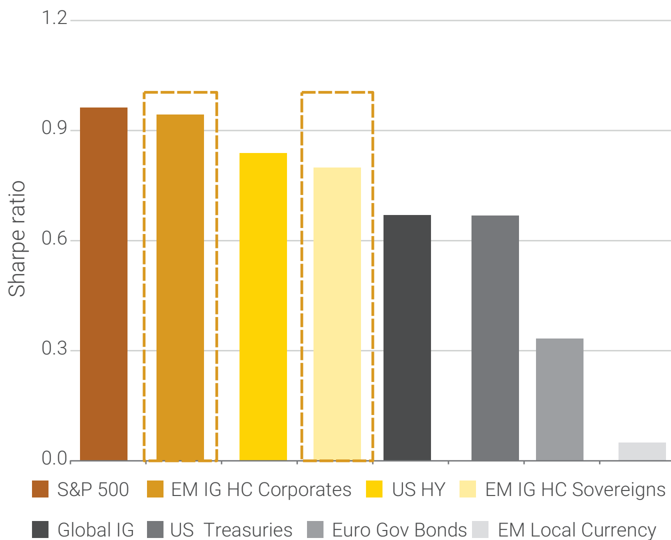
The senior bond of an A-rated, EM telecommunications company operating in the Middle East offers c.25bps premium to its A-rated counterpart in the US of similar duration. (February 2021)

For illustrative purposes only.

Given the higher spread, we believe that emerging market investment grade fixed income has the potential to improve the risk-adjusted return of an investor's portfolio compared to investing solely in developed market counterparts, particularly in the current low yield environment.

The Sharpe ratios[1] in Figure 4 show that the EM IG hard currency (or US dollar-denominated) indices rank favourably versus other asset classes in terms of returns experienced for the level of risk taken.

Figure 4: Sharpe ratio comparison



Source: BAML, JPM, Bloomberg 31 December 2020. Past performance is not a guide to the future. HC = hard currency (i.e. US dollars)
[1]Sharpe ratio: unit of excess return per unit of risk

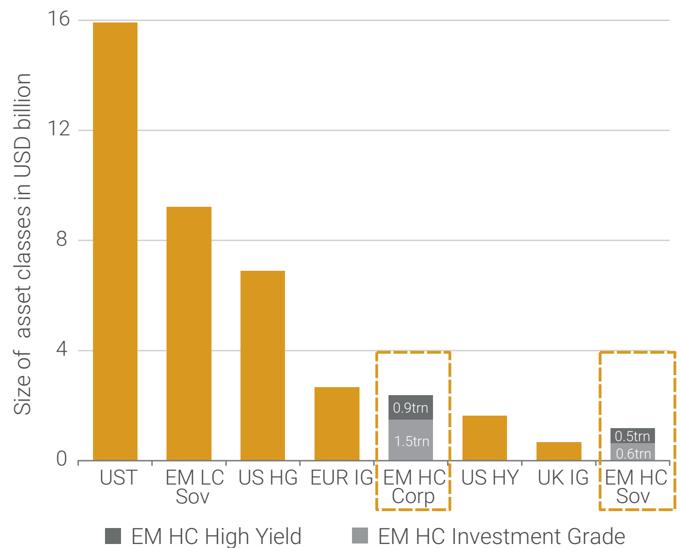
3

A broad opportunity set

Far from being a niche or specialised asset class, the $15.2 trillion emerging market debt investable universe comprises investment grade and high yield corporate, sovereign and quasi-sovereign bonds, with ratings ranging from AAA all the way down to D, in the same way as in traditional developed country bond markets.

In fact, more than half of the bonds in the most closely followed emerging market indices are investment grade rated. This highly liquid emerging market investment grade market is, at £2 trillion, over five times larger than the UK investment grade corporate bond market, 33% larger than the European investment grade corporate bond market and over half the size of the gigantic US investment grade corporate bond market. The emerging market debt market therefore enhances the ability of an active manager to seek appropriate, high quality and duration-targeted bonds at attractive spreads. In addition, broadening a portfolio's allocation may help to diversify exposure from traditional developed market investment grade buy and maintain strategies, thereby reducing concentration risk, both in terms of country and issuer. For pension schemes looking at their entire journey towards endgame, we also believe that emerging market debt may be appropriate for cashflow matching strategies.

Figure 5: $ value of fixed income markets



Source: JP Morgan, Bloomberg, December 2020. HC = hard currency (i.e. US dollars)

The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.

4

A favourable macroeconomic backdrop

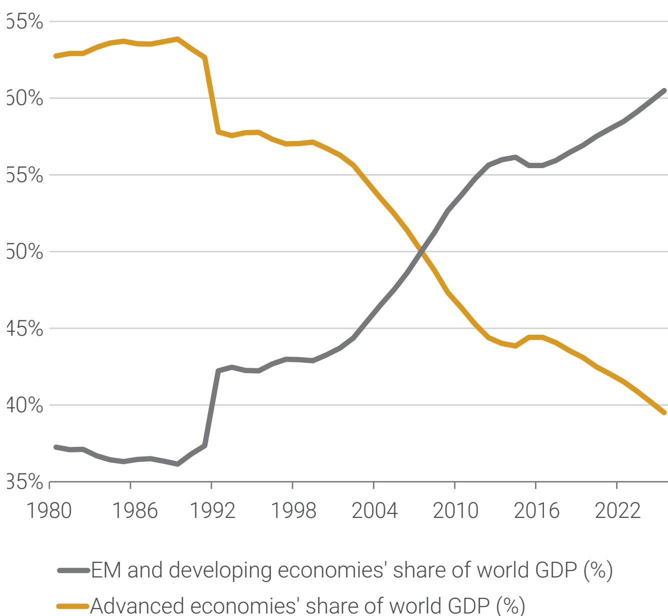
Emerging markets continue to be the driving force behind global growth, with these countries accounting for more than 50% of the world's GDP. This raises the question: can a portfolio really be described as efficient and suitably diverse if there is no allocation to emerging markets? Fiscal deficits and debt levels in emerging markets remain lower than in advanced economies and, crucially for investors, the financing costs of emerging market debt remain close to record lows.

Furthermore, emerging markets have historically proven more resilient than their developed market peers throughout economic cycles, with a real growth differential of between 2% and 3% over the last five years (Source: IMF World Economic Outlook October 2020).

According to PwC in its 'The World 2050' report, the GDP forecast for the top 10 economies showed that only 4 out of 10 were developed economies, with the USA in third place, trailing China and India; Japan, Germany and the UK took spots 8, 9 and 10, behind Indonesia, Brazil, Russia and Mexico.

In addition to these broad, favourable, global trends, we also believe that the outlook for 2021 holds a number of reasons to be positive about investing in emerging market debt.

Figure 6: Share of World GDP



Source: IMF World Economic Outlook, October 2020
The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.

5

Responsible investment and integration of ESG factors

Integrating responsible investment principles and upholding high ESG (environmental, social and governance) standards are becoming increasingly important to investors, and especially to DB pension schemes. At LGIM, we have long maintained that ESG factors are a key element of assessing credit quality and valuation, and that both pricing differentials and implied risk are not just a reflection of macroeconomic conditions and market technicals, but also of ESG. Evaluating a company's impact upon the environment, its use of natural resources, effect upon society, and the effectiveness of its governance is integral to a robust investment process in EM fixed income for a very simple reason: the protection of client capital and delivery of stable consistent returns. This implies that identification of downside risks should, in our view, be front and centre of any such strategy. And given emerging markets are likely to lag their developed country peers in areas such as governance, supply chain and environmental considerations, identification of ESG issues plays a central role in risk management, ascertaining credit quality, and assessing a country's and a company's trajectory. We employ a thorough, integrated approach to analysing ESG factors, incorporating both quantitative and qualitative elements and backed by the far-reaching work of our Investment Stewardship team – for more information, please read about ESG in LGIM's Active EMD investment process.

In summary, we believe that the case for incorporating an allocation to emerging markets within a buy and maintain portfolio is clear. For DB pension schemes seeking a better balance of risk and reward, broadening their geographic exposure beyond just developed corporate bond markets and also fitting in with their journey to endgame, this could be a valuable step.

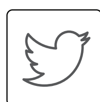
Appendix A

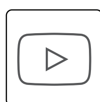
12-month periods to 28 February 2021 (%)	2016	2017	2018	2019	2020
ICE BofA Global Corporate Index	5.04	6.16	0.07	10.92	5.41
ICE BofA Emerging Markets External Sovereign Index	9.12	6.10	1.47	7.99	2.92
ICE BofA Emerging Markets Corporate Plus Index	11.22	4.48	2.35	10.28	5.16

Source: Bloomberg, as at 28 February 2021. Past performance is not a guide to the future. The value of an investment and any income taken from it is not guaranteed and can go down as well as up; you may not get back the amount you originally invested.

Contact us

For further information about LGIM, please visit lgim.com or contact your usual LGIM representative





Important information

Capital at risk. The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.

This document is designed for the use of professional investors and their advisers. No responsibility can be accepted by Legal & General Investment Management Limited or contributors as a result of information contained in this publication.

Specific advice should be taken when dealing with specific situations. Past performance is not a guide to future performance. This document may not be used for the purposes of an offer or solicitation to anyone in any jurisdiction in which such offer or solicitation is not authorised or to any person to whom it is unlawful to make such offer or solicitation.

© 2021 Legal & General Investment Management Limited. All rights reserved. No part of this publication may be reproduced or transmitted in any form or by any means, including photocopying and recording, without the written permission of the publishers. Legal & General Investment Management Ltd, One Coleman Street, London, EC2R 5AA Authorised and regulated by the Financial Conduct Authority.

DB136132021