In brief

Why make a strategic allocation to emerging markets debt? – There is a strong argument to be made for a strategic allocation to emerging markets debt (EMD) based on

- the increasing size and maturity of the asset class; at 8% of the global bond market, EMD has become too big to ignore
- improving fundamentals in many emerging markets (EM), which include credit metrics that in many instances are stronger than those of developed market sovereigns
- historically higher yield and a favorable risk-adjusted return profile — both important considerations in a low-yield, low-return world
- diversification potential to help manage portfolio risk

Some important considerations – Investors should consider several key points in making a strategic allocation to EMD:

- Volatility and recovery periods – EMD is subject to a generally higher level of volatility than many other fixed income assets. However, recovery periods following market declines have historically tended to be fairly rapid, and typically faster than those of certain other risk assets, including global equities.
- Yield, diversification and time horizon – A strategic approach to investing in EMD is best suited to investors who have a long-term focus and a tolerance for periods of weak performance, who seek to enhance yield and who value diversification as a tool to potentially enhance portfolio risk/reward.
- Strategic and tactical investing in EMD – The breadth of the EMD opportunity set means that a strategic allocation to the asset class allows investors to take advantage of tactical opportunities in it. Portfolio exposure to sovereign credit, corporate credit, local rates and the foreign exchange market (FX) can be tactically managed under the umbrella of a broad EMD mandate.

Current challenges, long-term virtues

2018 was a difficult year for EM as volatility returned to risk markets. EM assets were challenged by 1) tighter global monetary conditions early in the year resulting from policy normalization by the Fed (and, to a lesser extent, other G-10 central banks) and 2) end-cycle anxieties later in the year, particularly in the US, where fading fiscal stimulus, peak growth concerns and rising interest rates spooked markets. Slowing Chinese growth and the threat of escalating US–China trade tensions were additional and related risks. Chinese growth concerns weighed on EM sentiment due to the implications for EM commodity export prices.

Emerging economies with greater external vulnerabilities were particularly at risk. Some were forced to grapple with imbalances exposed by the deterioration in the global environment, resulting in policy tightening and lower or recessionary growth. Several EM central banks raised interest rates preemptively in efforts to stabilize financial conditions. Tighter financial conditions, along with heightened market volatility and increased geopolitical risks, dampened relatively strong growth trends in EM in 2018.
These challenges have led investors to become more discriminating in the EM credits they are willing to own, resulting in performance dispersion and creating fertile ground for managers looking to add excess returns (alpha) through selection decisions. In some cases, investors have also questioned whether they should continue to own the asset class. For these investors, the key question is whether EMD warrants a long-term strategic allocation as a core/foundational component of a well-diversified portfolio. Our view is that generally positive long-term fundamental trends in EM will ultimately be reflected in asset prices and that this, along with the maturity and size of the opportunity set, warrants a structural allocation to EMD. Below we make the case for a strategic allocation to the asset class.

Arguments in favor of a strategic allocation

**Evolution to a more stable investor base** – In its early days, EMD was seen as a satellite allocation versus a core/structural allocation, largely because it was a young, relatively small asset class subject to volatility arising from country fundamental shortcomings and a flighty investor base. The significant presence of a highly tactical, trading-oriented buyer-base was to a degree self-reinforcing: Episodes of indiscriminate contagion selling — during the Russia default and Long Term Capital Management (LTCM) debacle in 1998 for instance — led many to see participation in the asset class as a binary decision based on broader risk sentiment.

As the fundamentals of EM issuers improved, however, a virtuous cycle emerged: Better economic performance resulted in better returns, which attracted a broader and more stable investor base. Risk premiums declined and new funding sources opened up for emerging sovereigns and corporates. These developments supported higher growth and rising incomes in EM economies, bolstering political support for sound policies. Good policies, solid returns, expanding investor interest and a growing investment universe became self-reinforcing factors pushing the asset class forward.

With this favorable evolution of the asset class, institutional investor commitment has grown, contributing to reduced volatility. A number of structural reasons account for the moderating influence of institutional investors, including a longer investment horizon (e.g., pension plans engaged in asset–liability matching); the board-mandated/legislated strategic asset allocation of public and private plans; relatively infrequent asset allocation shifts; and disciplined plan rebalancing.

Most notably, the better credit metrics, contained volatility and broadening universe of EM asset opportunities have continued to increase investor confidence. Reduced volatility in EMD has led to the increased acceptance of a structural allocation to the asset class. As shown in Exhibit 1, for example, over the past five years, flows into institutional EMD strategies have more than offset flows out of retail vehicles.

**Exhibit 1: Cumulative strategic vs. retail flows into emerging markets debt**

![Cumulative strategic vs. retail flows into emerging markets debt](source: J.P. Morgan. Data from 31 December 2012 to 31 December 2018.)
Broad and growing issuer base – EMD has come to represent an ever-larger opportunity set in the global bond universe. There is now significant differentiation between EM issuers as well as types of issuance, offering geographic diversity across four distinct opportunity sets: sovereign credit, corporate credit, local rates and FX. The asset class also offers a range of alternatives across the credit spectrum and the yield curve.

Importantly, the asset class is marked by significant differentiation in underlying fundamentals, which often translates into performance dispersion. Through-cycle EMD investors may not be able to escape market beta, but they can potentially add alpha and manage downside risk through prudent security selection.

Improved EMD fundamentals – EMD has become a more robust asset class as broad EM credit metrics reflected in fiscal and external accounts have remained stable or have improved due to more prudent policies. For example, the move from pegged to floating currency regimes has left EM countries better able to weather market disruptions. More market-oriented policies, such as flexible exchange rate regimes, have resulted in more resilient economies. In certain respects, EM countries’ fundamentals are more attractive than those of developed countries (e.g., higher GDP growth rates, lower government debt/GDP ratios).

Better credit metrics in many cases have helped reduce the threat of contagion — the risk of broad-based indiscriminate selling — in response to idiosyncratic, country-specific events. This was the case in 2018: While there was some selling across the asset class in response to currency crises in Argentina and Turkey, the sell-off was largely targeted and rational. Spreads widened the most in the more vulnerable countries. Our own analysis, for example, showed a clear relationship between spread widening and the size of a country’s gross external financing requirements relative to reserves. In a true contagion event, indiscriminate, across-the-board selling occurs as correlations among assets converge. However, as noted earlier, the dispersion of returns among EM sovereigns increased during this period, suggesting that investors were differentiating between credits.

Long-term growth trends remain favorable for EM economies and EM asset prices. Superior and sustainable growth rates may result in better sovereign and corporate performance, which attracts capital flows and leads to asset appreciation.

Exhibit 2: Growth differential between emerging markets and developed markets

A substantial growth differential favoring EM over DM is secularly sustainable in our view. 

While Exhibit 2 indicates that there have been cyclical fluctuations in the differential, EM has consistently offered higher growth. A substantial growth differential favoring EM over DM is secularly sustainable in our view. GDP growth derives from both increases in the labor force and productivity. Exhibits 4 and 5 suggest a significant disparity between EM and DM with respect to these growth dynamics, with a better demographic profile providing a positive backdrop for EM. Gradually improving governance practices, along with progress on pro-business reforms, also support stronger productivity in EM.

Exhibit 4: Productivity and population growth estimates in EM

**Exhibit 5: Productivity and population growth estimates in DM**

- **Working-Age Population Growth**
- **Productivity Growth**

<table>
<thead>
<tr>
<th>Country</th>
<th>Working-Age Population Growth</th>
<th>Productivity Growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>3</td>
<td>2</td>
</tr>
<tr>
<td>Canada</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>New Zealand</td>
<td>1</td>
<td>0</td>
</tr>
<tr>
<td>Norway</td>
<td>0</td>
<td>-1</td>
</tr>
<tr>
<td>US</td>
<td>-1</td>
<td>-2</td>
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<tr>
<td>UK</td>
<td>-2</td>
<td>-3</td>
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<tr>
<td>Spain</td>
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<td>Sweden</td>
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<tr>
<td>France</td>
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</tr>
<tr>
<td>Switzerland</td>
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</tr>
<tr>
<td>Germany</td>
<td>-7</td>
<td>-8</td>
</tr>
<tr>
<td>Japan</td>
<td>-8</td>
<td>-9</td>
</tr>
<tr>
<td>Italy</td>
<td>-9</td>
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</tbody>
</table>


**Historically higher yield and favorable risk-adjusted performance** — EMD has consistently offered higher yield than many other fixed income asset classes and we believe could continue to do so. Given its credit risk, EMD has provided higher yields than DM debt irrespective of the interest rate environment, but the importance of incremental yield is magnified by the current backdrop. A lower secular interest rate environment — which we expect due to an array of forces depressing growth and inflation — poses critical funding risks for defined benefit pension plans targeting returns that are likely difficult to attain without moving further out the risk spectrum. EMD may be comparatively well-positioned to help institutional investors achieve this objective, as illustrated in Exhibit 6, where we show the yield advantage that dollar EM sovereign debt has historically held over DM sovereign debt.

**Exhibit 6: Emerging markets vs. developed markets sovereign debt yield**

- **EM Sovereign Debt (Hard Currency)**
- **DM Sovereign Debt**
- **Difference**

While EMD has historically been more volatile than many other fixed income asset classes, it has also offered attractive risk-adjusted performance over time and through market cycles, as illustrated below in Exhibit 7.

**Exhibit 7: Favorable risk-adjusted returns on a 5-year basis**

![Exhibit 7: Favorable risk-adjusted returns on a 5-year basis](image)


**Diversification potential** - EMD has historically offered diversification benefits, often enhancing the risk/reward characteristics of a portfolio over the long term and serving as a valuable diversifier to DM sovereign exposure. The efficient frontier shown in Exhibit 8 illustrates the potential diversification benefit: Over the past 10 years, adding 30% EMD sovereign exposure to a DM sovereign portfolio provided the optimal risk-adjusted return (i.e., a higher Sharpe ratio), by providing a 1.41% return premium with only 0.35% more risk.

**Exhibit 8: Emerging markets vs. developed markets sovereign debt efficient frontier**

![Exhibit 8: Emerging markets vs. developed markets sovereign debt efficient frontier](image)

Source: FactSet Research. Analysis from 31 December 2008 to 31 December 2018. The most efficient asset allocation mix is located at the point that corresponds to the highest Sharpe ratio. EMD represented by the JPMorgan EMBI Global Index (USD unhedged) and DM Sovereign Debt represented by JPMorgan GBI Global Index (USD unhedged).
Volatility a key risk

Adopting a strategic approach to EMD is not without risk. Commitment to through-cycle exposure to EMD means riding out the cyclical downside of the asset class. Historically, some drawdown periods have been sharp; however, recovery periods when investors have been made whole have tended to be fairly rapid (see Exhibit 9). As a result, despite shorter-term periods of volatility, the investor experience of positive performance over longer periods has been relatively consistent over time. Moreover, sound active management can help mitigate these periods of volatility.

Exhibit 9: Emerging markets drawdowns and recovery periods

- MSCI World Index
- JPMorgan EMBI Global Index

Source: Bloomberg. Data from 31 December 1993 to 31 December 2018. Figures are in USD and unhedged.

Strategic investor profile

In general, a strategic approach to investing in EMD may meet the needs of investors who:
- have a long term focus and a tolerance for periods of weak performance
- need to generate above-average yield to meet long-term liabilities
- value diversification and seek to use it as a tool to potentially enhance portfolio risk/reward opportunities

EMD strategies and opportunities

It should be noted that a strategic allocation can be made in a way that also allows investors to take advantage of tactical opportunities in the asset class. The evolution of distinct, liquid asset classes within EMD has given rise to a variant of the strategic approach that incorporates an element of tactical asset allocation.

Differentiated drivers of returns and the resulting performance dispersion between hard currency and local currency debt, as well as between sovereign and corporate debt, has given investors committed to a long-term structural allocation to EMD the opportunity to derive additional alpha and reduce volatility via timely exposures to sovereign credit, corporate credit, local rates and FX. This can be achieved by making an EMD allocation to a skilled active manager that embraces the full opportunity set in EMD.
Exhibit 10 below shows how differentiated performance among EM asset classes can create alpha opportunities. While these asset classes tend to be correlated, the disparity in performance in a given year can be significant—notably the returns of the hard currency sovereign and corporate bonds versus that of local currency denominated securities. EM currencies, in particular, tend to be higher beta to global financial conditions. As a result, the swings in performance are typically much larger. At MFS, we assess both top-down and bottom-up conditions and developments to make central security and asset allocation selections. By focusing on alpha-oriented decisions to drive outperformance, we seek to reduce the risk of global macro and financial variables in the portfolio.

Exhibit 10: EMD asset class annualized returns

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<tbody>
<tr>
<td>USD EM Sovereign Debt</td>
<td>22.21</td>
<td>11.62</td>
<td>10.25</td>
<td>9.86</td>
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<tr>
<td>USD EM Corporate Debt</td>
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<td>6.53</td>
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<tr>
<td>EM Local FX Sovereign Debt</td>
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<td>22.97</td>
<td>6.27</td>
<td>15.22</td>
<td>18.11</td>
<td>-5.22</td>
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<td>15.21</td>
<td>-6.21</td>
</tr>
</tbody>
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Conclusion

The maturation of the asset class, along with higher yield and favorable risk-adjusted performance in the context of improving fundamentals, makes a strong case in favor of a strategic asset allocation to EMD.

Our two decades of experience in managing EMD portfolios has taught us the value of staying invested in the asset class. In our view, the key to long-term success in an asset class with strong long-term performance potential, but where discrete adverse country and credit events are inevitable, comes from following a research-intensive, alpha-oriented investment approach focused on a global search for value, while looking to manage downside risks through a rigorous and disciplined process.

Investing for the long term does not mean simply riding out stormy periods of market turbulence while hoping for calmer seas ahead. For the successful investor, it means monitoring global macro risks, as well as country- and credit-specific risk factors, and adjusting his or her portfolio accordingly. By managing portfolio downside risk during periods of turmoil, we aim to position our portfolios to take advantage of buying opportunities which may arise. Our goal is to provide strong risk-adjusted returns through solid relative performance in both bull and bear markets.

Our two decades of experience in managing EMD portfolios has taught us the value of staying invested in the asset class.
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