Custom Research Lab

Vontobel

Institutions Look to Emerging Market Fixed Income for Yield, Diversification, and ESG Alignment

The view from asset-owning institutions around the world

Asset Management

More information:
vontobel.com/fi2022

Foreword

We have all endured a tough ride over the past two years. First, with the global Covid-19 pandemic, followed by a humanitarian crisis caused by the war in Ukraine. In addition, inflation, submerged for decades, resurfaced as a key concern for all investors.

In these unprecedented times, institutional investors continue looking for yield whilst avoiding risks that could derail their portfolios. However, over the last few months I have been observing decreases in flows and the reluctance of many investors to make a substantial allocation to emerging market fixed income. As a lifelong emerging markets investor, I believe that emerging market bonds offer highly attractive yield and long-term capital appreciation opportunities for active investors. Emerging market bonds are a core allocation of my own investment portfolio, and I strongly believe they should play a more important role in investors' portfolios. But perhaps not everyone sees things the same way.

In February, we commissioned this survey of more than 300 institutional investors in Europe, the Americas, and Asia-Pacific to get to the bottom of this conundrum. We included in-depth interviews with investment decision makers at pension funds and insurers to try to understand their thinking and beliefs on a deeper level. By chance, we were also able to capture how investor sentiment changed as the Ukraine crisis emerged.

To me, two things stand out from this survey: Yield and ESG. The majority of investors surveyed stated as their top priority the need to increase the yield of their fixed income investments, hence a focus on emerging markets. The study also shows that nearly half of investors consider an issuer's ESG policies and performance when deciding whether to invest or not.

With geopolitical tensions rising and central banks poised to raise rates, it's not surprising that many investors have concerns about emerging market bonds. However, emerging market spreads and yields actually performed well during previous hiking cycles. As for volatility, it is a natural part of this asset class and one of its greatest opportunities, as the dispersion of returns makes emerging market bonds a perfect hunting ground for alpha.

So, even if it may appear that we are in the midst of chaos, fixed income assets, and particularly emerging markets, continue to offer investors a viable source of returns. This is why, and as this study confirms, astute institutional investors are allocating to this asset class in growing numbers, and not just as a tactical play, but as a core strategic allocation in their portfolios.

Simon Lue-Fong

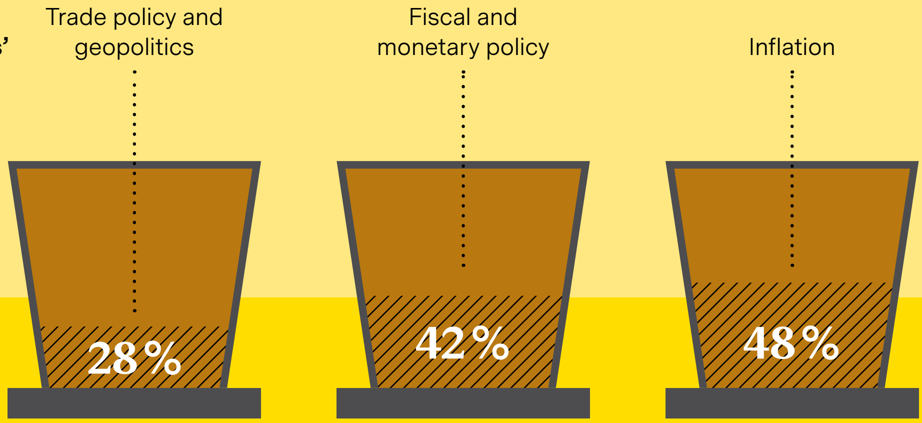
Head of Fixed Income
Vontobel Asset Management

Where to find FI investments aligned with ESG mandates that can deliver higher yields?

New research finds institutional investors reaching for emerging markets fixed income for yield, diversification, and ESG alignment.

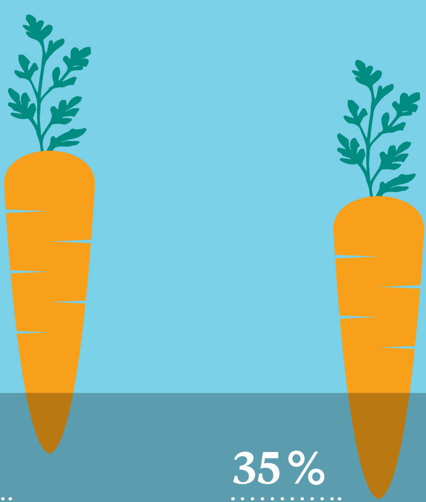
Inflation, growth, and public policy weigh heavily on asset-owning institutions worldwide …

Top macroeconomic factors affecting investors' fixed income portfolio over the next 24 months.



… as the war in Europe brings anxiety about trade policy, geopolitics, and outlook for emerging Europe.

Russia's invasion of Ukraine drives concern for trade policy and geopolitics up by 14 percentage points.



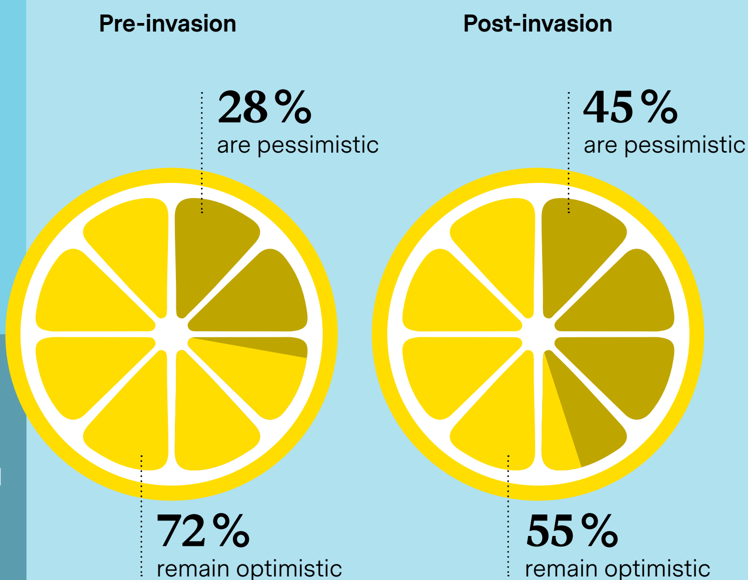
21 %

of investors are concerned about trade policy and geopolitics **pre-invasion**

35 %

of investors are concerned about trade policy and geopolitics **post-invasion**

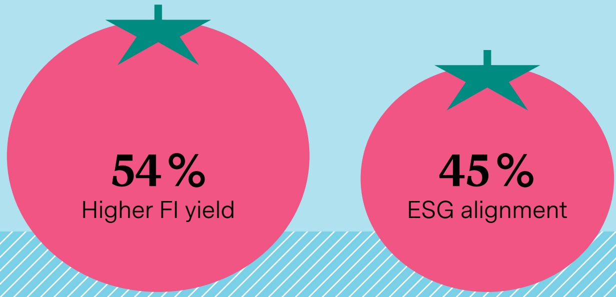
The invasion of Ukraine erodes optimism for investment in emerging Europe by 17 percentage points.



Source: Primary research from Vontobel and Institutional Investor Custom Research Lab. April 2022.

Investors seek yield amid anxiety about inflation, growth, and geopolitics

Asset-owning institutions seek the following top two portfolio objectives for the next two years.



As a solution, 64 % of respondents embrace fixed income assets in emerging markets for diversification, ESG performance, and yield.

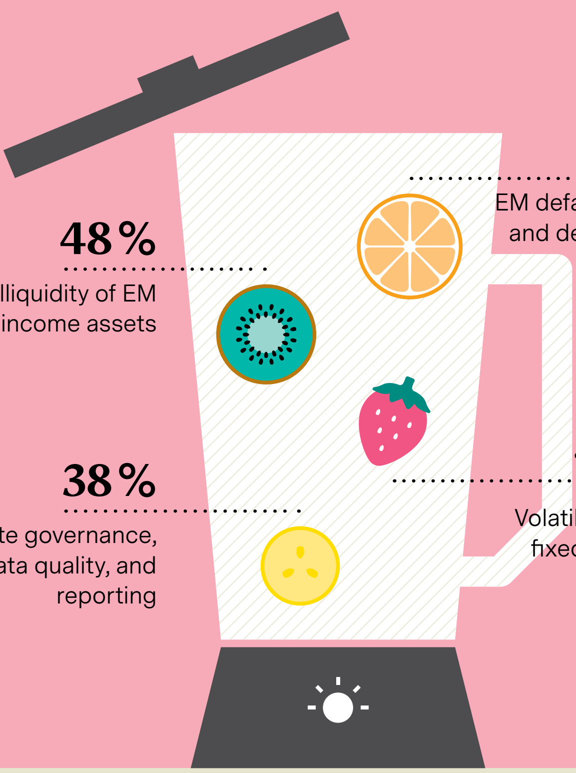
Top two reasons for investors around the globe to increase investments in emerging markets fixed income.

56 %
Diversification

48 %
Highly-liquid market

Market inefficiencies drive institutions to active fixed income strategies in emerging markets.

Top four challenges for investors when investing in EM fixed income assets.



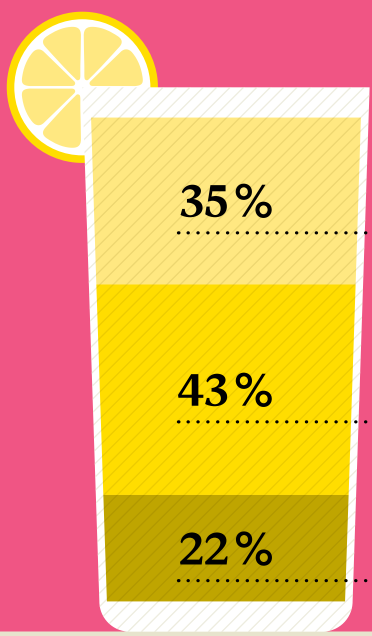
51 %
EM default rates and debt loads

48 %
Illiquidity of EM fixed income assets

45 %
Volatility in EM fixed income markets

38 %
Corporate governance, data quality, and reporting

More than three in four investors endorse active strategies for EM fixed income as they see opportunities for alpha in mispriced and inefficient emerging markets.



35 % High-conviction strategies

43 % Diversified active strategies

22 % Passive / index strategies

Bring your portfolio to prime health this year.

1:
Disruption on the path to normalcy leads investors beyond their usual fixed income universe

After nearly two years spent mired in the Covid-19 pandemic, economies across the world have endured devastating events that may well be unique in modern history. The drastic reduction in economic, commercial, and investment activities shook the global economy and spurred governments to respond with unprecedented and massive relief measures for companies and households. In the US and other developed economies, the combination of a sustained shutdown and powerful stimulus have disrupted equity markets, pushing them to new heights, followed by punishing corrections in early 2022. Amid this volatility, bond yields have remained low in recent years, and as of early April 2022, inflation has exceeded 7% in the US and much of Europe, the highest rates seen in 40 years[1]. These consequences have policymakers and financial leaders scrambling to enact initiatives that will rein in these negative forces, promote stability, and advance a national recovery that will—surely, if perhaps slowly—end the economic upheaval brought on by the pandemic.

As a prominent example, in early 2022, the US Federal Reserve began raising interest rates and signaled its intent to raise them as many as six more times before year's end, with the goal of taming the inflation that troubles investors, producers, and consumers. Other monetary authorities—notably, the Bank of England, along with those in the emerging markets of Mexico, Chile, Pakistan, and Hungary, among others—have begun tightening monetary policy and raising rates. The European Central Bank's dovish policy, which called for interest rate hikes in 2024, may well give way to a more hawkish stance against inflation in the months ahead. In due course, these shifts in monetary policy are likely to spur investors to revisit their allocations to fixed income in both developed and emerging markets. Indeed, they're likely to reveal opportunities for new bond investors to earn higher cash yields and encourage those who currently hold bonds to retain them in the hope of price recovery in the future.

This carefully managed reemergence from the pandemic has been complicated by the Russian Federation's invasion of Ukraine in late February. In response, the United States, most of Europe, and indeed the rest of the world's freer nation-states have invoked highly restrictive sanctions on Russia and its leadership, effectively cutting the nation off from the global banking system and international trade. The invasion has hit fixed income markets in emerging Europe and elsewhere hard, as investors retreat from the conflict and uncertainty in the region. Suspension of long-standing purchases of energy, grain, and other basic inputs from Russia has contributed to inflation and disrupted commodity markets amid an increasingly integrated supply chain and global economy.

These and other forces are likely to encourage risk-seeking investment in emerging market fixed income, where nominal yields are likely to rise. However, investors may hold back out of concern for sustained inflation and commodity market disruption brought on by the lingering pandemic and war in Europe.

How these crises will unfold in the months ahead—and how they will affect asset markets and their investors—is uncertain. However, institutional investors around the world seem confident in their approach to this uncertainty, according to this survey of more than 300 asset-owning institutions in Europe, the Americas, and Asia-Pacific, as well as interviews with ten investment decision makers at pensions and insurers in these regions. (Unless attributed otherwise, the data cited in this report is sourced from the survey of investment decision makers conducted by Vontobel and Institutional Investor. All the interviews cited in this study took place after Russia's invasion of Ukraine). See "About this research" for a more complete description of this survey.

[1] Source: https://tradingeconomics.com/euro-area/inflation-cpi

2:

Investors seek yield amid anxiety about inflation, growth, and geopolitics

Institutional investors around the world—notably, insurance companies, pensions, foundations, and endowments, among others—depend on fixed income assets to generate stable, predictable returns by investing in highly liquid bonds issued by governments and companies. In our recent survey of more than 300 asset-owning institutions, a majority of investment decision makers (54%) see increasing the yield on their fixed income investments as among their top objectives over the next several years (see Figure 1). Notably, they are likely to invest with a keen eye on issuers' environmental, social, and governance (ESG) policies and performance, say 45% of respondents, a clear indication that mandates to invest with a watchful eye on issuers' environmental, social, and governance policies are increasingly mature among policymakers at asset-owning institutions around the world. Nearly 40% of respondents say they'll strive to have ready access to cash to pay insurance claims, pension benefits, and other liabilities that grow from their institutional mission. Ensuring the diversification benefit of fixed income—that is, the lack of or inverse correlation between fixed income and other asset classes and markets—is top of mind to 38% of survey respondents.

This quest for stable, highly liquid fixed income yield is commonplace among institutional investors interviewed for this report. A fixed income analyst at a UK insurer says, "Our book of assets is primarily investment grade fixed income with short duration, primarily in developed markets. It doesn't pay very much, but it pays something; it's very liquid, and it's generally low risk—so when there's a catastrophe and we have to pay claims, having most of our money in very safe assets is very valuable to us."

His firm invests the bulk of its reserves in low-risk, highly liquid assets and devotes its surplus in higher-risk assets, especially fixed income in emerging markets. "With reserves, we match our assets against our liabilities, but if you're an insurance company that's doing well, you should have a surplus. There's a big question, however, of what to do with it. Do you act tactically and make it longer or shorter when doing so seems like a good idea? Do you invest the same as your reserves?" His response is to seek higher returns through emerging market fixed income: "Because EM debt is less liquid than US investment grade bonds, we see it as a surplus rather than reserve asset," says the UK fixed income analyst. "We don't want to have to sell them regularly to fund claims. We want to be able to hold them through volatile periods, collect the income, and ride out the mark-to-market volatility."

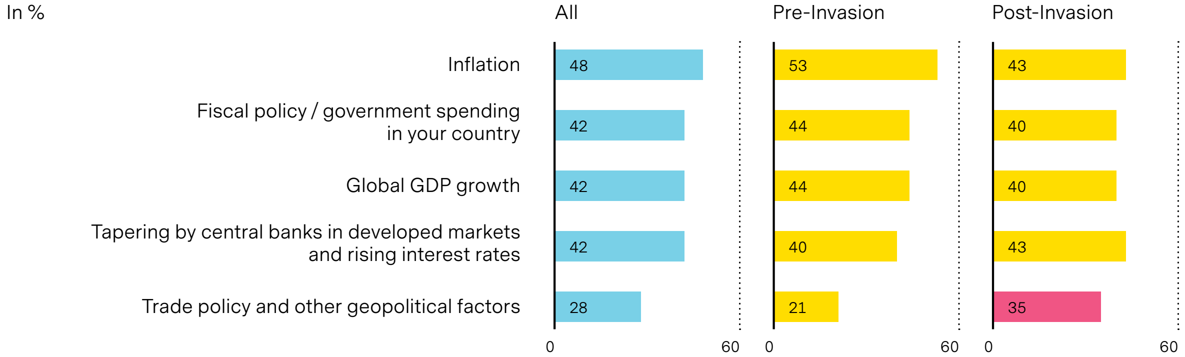
Figure 1: Investors worldwide seek higher yield amid concern for ESG

Which of the following fixed income portfolio objectives are most important to your institution over the next 24 months?

Source: Primary research from Vontobel and Institutional Investor Custom Research Lab. April 2022.

Figure 2: Inflation, government spending, GDP growth, and monetary policy weigh on fixed income

Which of the following macroeconomic factors are most likely to have a material impact on your fixed income portfolio over the next 24 months?



Investors' search for yield comes at a time when interest rates are likely to rise, after more than a decade of very low, even negative real rates from central banks. The financial crisis of 2008, followed by an extended period of strong economic growth with low inflation, and then the massive government stimulus tied to the global pandemic, have sustained the very low-rate environment for years. Now, because the world's economies are awash in low-cost cash and supply-chain disruptions make matching buyers and sellers more difficult, inflation has reached heights not seen since the early 1980s. In response, policy makers are taking affirmative steps to control price increases by tightening the money supply and raising interest rates. Such rate increases are likely, in turn, to increase the cash paid to bond investors through coupons or discounting.

Read more about
"Why central bank policy errors
should be top of your 2022 worry list"

Inflation and other macroeconomic factors weigh heavily on investors, according to survey data. Investors are most likely to see the specter of inflation (48 %) and uncertainty about GDP growth (42 %), government spending (42 %), and the monetary policy of central banks in developed markets (42 %) as the factors that will have the greatest impact on their fixed income holdings over the next two years (see Figure 2). These several factors are closely related: Inflation is the effect of too much money chasing after too few goods and services. Government spending increases both the supply of cash in commodity and labor markets, thus driving up prices, and limits the availability of such offerings for use elsewhere in the economy. Central banks in developed markets establish the interest rates used to price loans, bonds, and other credit instruments. And geopolitical matters—from trade agreements and tariffs to all-out warfare—affect the flow of capital, commodities, and labor throughout the global economy. Indeed, survey data collected for this study indicates that Russia's invasion of Ukraine in February 2022 has had a notable effect on investors' views of geopolitics and the outlook for fixed income markets. Prior to the invasion, 21 % of survey respondents identified trade policy and other geopolitical factors as likely to have a material impact on fixed income portfolios. In the wake of the invasion, 35 % of investors see a material impact from geopolitical matters, as shown in the highlighted bar in Figure 2.

Source: Primary research from Vontobel and Institutional Investor Custom Research Lab. April 2022.

"The biggest thing affecting fixed income right now is inflation worldwide," says the head of a Swiss pension, "especially in the US and Europe now, with energy prices as they are. Here in Switzerland, we are quite stable, and in some sense, it's less our problem than a problem for our asset manager."

Similarly, a portfolio manager at a large German insurer says, "Inflation will be the most important macroeconomic driver in fixed income over the next few years. We are in the camp that thinks inflation will be higher for longer, although not at current levels. Because of the super-cycle of high demand for commodities, this inflation may be here to stay for some years. Inflation will be higher now with the war in Ukraine, too, and it is the big issue hurting emerging market debt. We don't expect a global recession, but it's very hard to judge because there is some cyclical inflation pressure but also structural inflation pressure, as well."

Inflation has many facets, some of which may help rather than hinder the prospect for emerging markets. One source, for example, argues that the current inflationary environment counterbalances the rate increases expected from developed market central banks by supporting the prices of commodity producers in emerging markets. The fixed income manager at a large pension in Australia says, "One of the big things that affects emerging markets is the commodity cycle dynamic. We've held onto our EM fixed income because we saw this as a means of increasing commodity prices, which would be helpful to the emerging markets and would counter what we usually see when the US raises interest rates. The US now has quite an aggressive rate-hike cycle, which normally helps the US dollar and hurts emerging markets. In the past, when you'd see the US raise rates and strengthen the US dollar, emerging markets would get hit and hit hard. But what we've seen this time around is that inflation is coming through the supply side, from the commodity side of the equation, which would in general be helpful to producers in emerging markets."

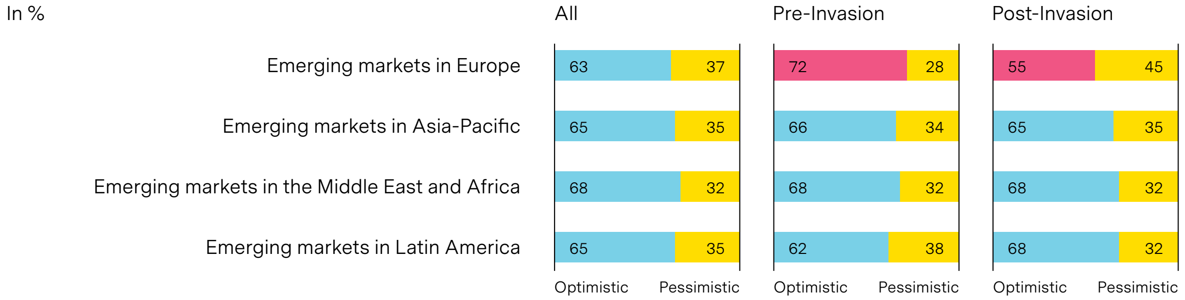
> **"I think there are three things that will define then what will happen in the coming years: inflation, Russia, and China."**
>
> **Portfolio manager at a Dutch pension**

War in Europe brings tragedy, risk, and opportunity
Russia's invasion of Ukraine occurred on February 24, the approximate midpoint in our fielding of the survey in this study. In an effort to gauge the impact of the invasion on investors' views, we compared the 160 survey responses received before the invasion to 180 received after the invasion. This analysis reveals a notable 14 percentage point increase—from 21% before the invasion to 35% after—in the proportion identifying trade policy and other geopolitical factors as among the top factors affecting their fixed income portfolios in the years ahead.

The war in Ukraine is undoubtedly disruptive to the economies of developed and emerging Europe, but, say sources, amid this disruption lies both risk and opportunity. "With what we see now from Russia and Ukraine—we don't really foresee a worldwide recession," says the Swiss pension head. "I'm quite optimistic because we've had this correction caused by Russia and Ukraine. And I think it's a good time now to start thinking about a greater allocation to emerging market bonds so we can profit from the recovery that we expect."

Figure 3: Widespread optimism for emerging markets, amid notable decline for emerging Europe in the wake of Russia's invasion of Ukraine

Are you optimistic or pessimistic about GDP growth, inflation, and bond yield premiums in the following emerging markets in 2022?



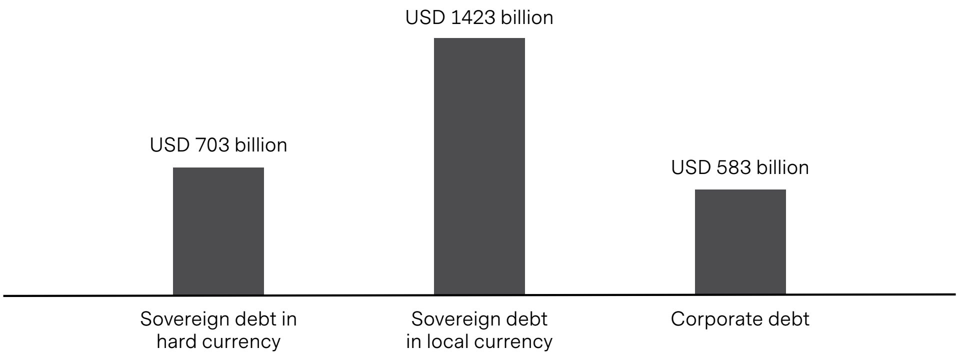
As high inflation, shifts in public policy, and geopolitical uncertainty bear down on asset markets, investors express cautious confidence about fixed income in the years ahead. They want higher yields from their fixed income investments, which should be aligned with increasingly expansive ESG mandates. And they value the diversification that grows from investing in fixed income and that provides insulation from the vagaries of other asset classes. The viable sources of such investments include the emerging markets of Central and South America, parts of eastern and southern Europe, and much of the Asia-Pacific region, Africa, and the Middle East. These emerging economies often have less developed financial systems, less accessible recourse for creditors in the case of default, and uneven regulatory and reporting regimes. Similarly, commercial and financial infrastructure lags behind that of developed markets, and language and cultural differences make outside investment more difficult. This risk premium in emerging markets, coupled with the diversification benefit from investing in markets that are adjacent to but insulated from developed markets, provides the motive force behind much of the enthusiasm shown by institutional investors for emerging market fixed income.

Despite the current turmoil of global economic and political affairs, respondents are broadly sanguine about the economic prospects of emerging markets (see Figure 3). Respondents are approximately twice as likely to say they're optimistic rather than pessimistic about GDP growth prospects, inflation, and bond yield premiums in Asia-Pacific, Latin America, and Africa / Middle East. By examining responses received before and after Russia's invasion of Ukraine, we see that the war in Europe has had little discernable effect on investors' near-term outlook for emerging markets—except those in Europe. As shown above, 72% of respondents worldwide viewed emerging Europe—which includes Poland, Ukraine, Bulgaria, Hungary, Turkey, and Romania—with optimism prior to the invasion. However, only 55% of the respondents whose surveys were received in the 11 days after the invasion have an optimistic outlook for GDP growth, bond yields, and inflation in emerging Europe, as shown in the highlighted bars in Figure 3. This decline in optimism is consistent regardless of respondents' location.

Source: Primary research from Vontobel and Institutional Investor Custom Research Lab. April 2022.

Figure 4: Sovereign debt dominates the emerging market fixed income universe

Emerging market fixed income universe



Amid the conflict in Europe, fixed income investors say that they and their managers are able to take a circumspect view of how geopolitics affects their strategies for generating returns. “We’ve identified emerging market fixed income as an asset class that is important to return,” says a fixed income portfolio manager for an Australian pension, “and we want a dedicated EM manager to manage it for us. It can be quite volatile at times, but over the long run the payoff from it is very good if you construct your portfolio correctly—that is, so that you’re getting the premium out of that market without so much of the volatility.” He and his peers around the world will have a total universe of more than USD 2.7 trillion in emerging market fixed income assets to choose from (see Figure 4).

Echoing the crisis-presents-opportunity views of his peers, he sees sound investment prospects in the wake of the war in Europe. “Obviously at the moment the whole sector of EM fixed income is getting hurt because of the contagion that’s coming via Russia and Ukraine.” This contagion spreads throughout the EM fixed income sector because, he says, some investors seek to sell the Russian or Ukrainian debt instruments in their EM portfolios but cannot. In response, some sell other EM bonds from their portfolios, thus increasing the supply on the market and driving down prices—in effect, the market becomes oversold. “When people just want to get their money out and exit,” says the fixed income manager in Australia, “they just exit with what they can sell, and this creates opportunities for an active manager to say, ‘company X or country Y has moved further than what the fundamentals say it should, and that’s a great opportunity.’”

Source: Vontobel Asset Management, March 31, 2022

3:

Fixed income investors look to emerging markets for diversification, ESG performance, and yield

As investors scan asset markets for sources of yield, they look to fixed income assets issued in emerging markets. Such investments, according to survey data, usually make up a modest proportion of investors' portfolios. World-wide, 43% of survey respondents invest 5% or more of their fixed income allocation in emerging markets (see Figure 5). Those from the Asia-Pacific region, which itself includes many emerging economies, are more likely to hold 5% or more of their fixed income in emerging markets (53%), compared with their peers in the Americas (49%) and Europe (36%). Respondents are most likely to hold EM fixed income through a diversified global allocation (64%) that spans across regions and sectors and through EM corporate bonds (56%).

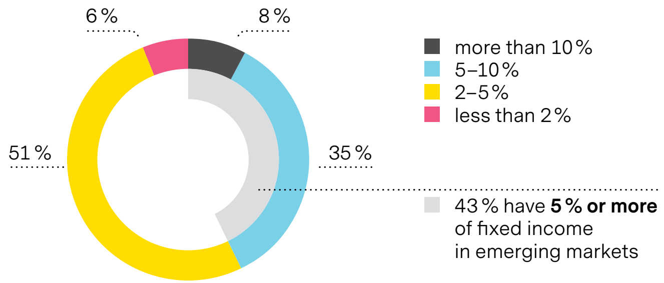
More than three-fourths of institutions with USD 5 billion or more under management say they hold EM fixed income through a diversified global allocation.

"We have recently implemented a strategic allocation to emerging market corporate credit in hard currency which is relatively large, and which our yield targets for it are about 4.5%."

Portfolio manager at a Dutch pension

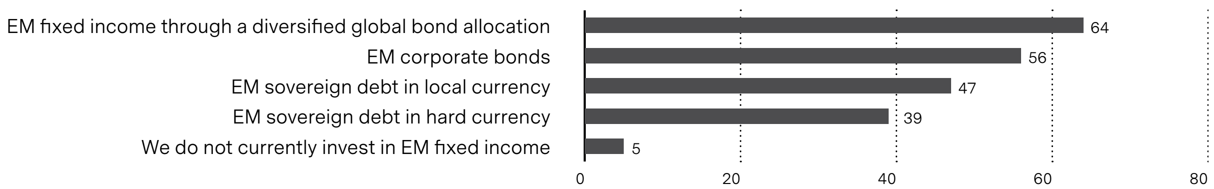
Figure 5: A solid majority of respondents holds EM debt through a diversified global allocation

Approximately what proportion of your fixed income portfolio is allocated to emerging market fixed income?



Does your institution currently allocate to emerging market fixed income in the following ways?

In %



Source: Primary research from Vontobel and Institutional Investor Custom Research Lab. April 2022.

Figure 6: Seeking diversification and yield, investors are likely to embrace fixed income in emerging markets

How do you anticipate your overall asset allocations are likely to change over the next 24 months?

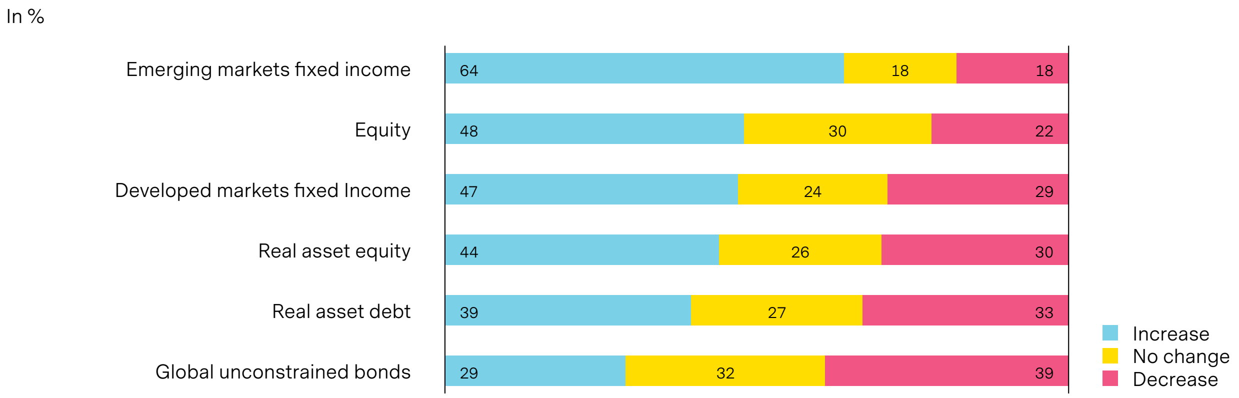
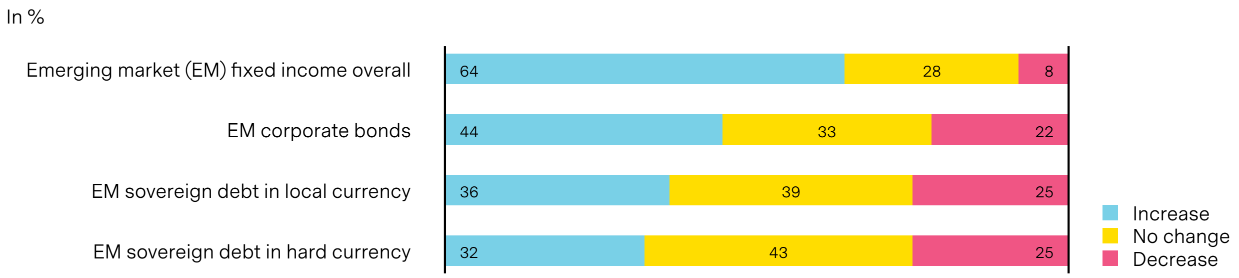


Figure 7: Consistent support for increasing EM fixed income holdings

How is your institution's allocation to emerging market fixed income likely to change in the next 24 months?



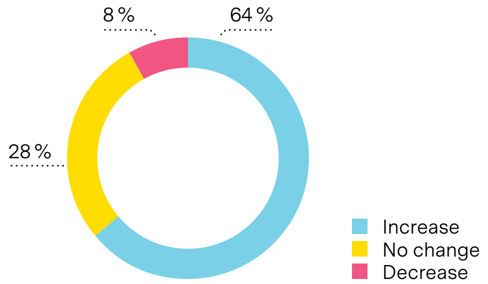
While these allocations may seem modest in comparison to the rest of institutional holdings, EM fixed income provides investors with the combination of diversification, yield, and liquidity required to meet their objectives. In the years ahead, investors say they'd like more of the same. In total, 64% of respondents are likely to increase their use of fixed income assets in emerging markets, more than for any other asset class (see Figure 6). This increase in EM fixed income may well come at the expense of broadly diversified, global bond allocations, as investors look toward fixed income strategies that focus more directly on emerging or developed markets.

In a series of separate questions, we asked investors how they're most likely to alter the EM fixed income allocations in the next two years and their principal reasons for doing so. Fully 64% say they're likely to increase EM fixed income assets, and 44% anticipate increasing their allocations to EM corporate bonds (see Figure 7). Sovereign debt has less appeal in the near term, say investors.

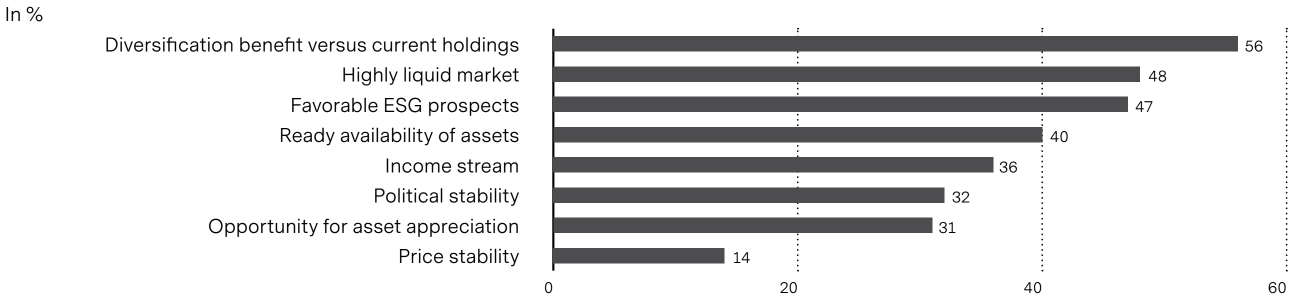
Source: Primary research from Vontobel and Institutional Investor Custom Research Lab. April 2022.

Figure 8: Those likely to increase EM fixed income overall do so in search of diversification, ESG alignment, and yield

Likely changes in holdings of emerging market fixed income overall



Most pressing reasons for increase in emerging market fixed income overall



Why do investors seek to boost their EM fixed income holdings in aggregate? Survey data from the subset likely to increase their EM fixed income holdings overall reveals that they value the diversification benefits of EM fixed income (56%) available through liquid markets (48%) in which assets are readily available (40% as shown in Figure 8). Consistent with their aspirations expressed earlier, they see EM fixed income as a viable source of ESG-policy-compliant assets (47%) that will, to a lesser extent, offer an attractive income stream (36%).

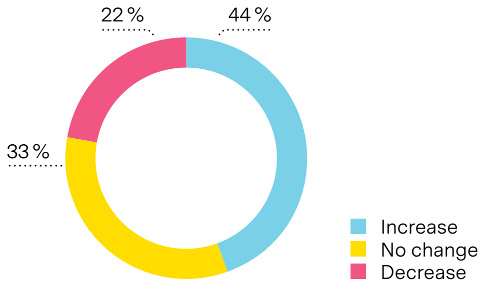
"We are 100% active because we think emerging markets are not really efficient, and we see that local specialists can really add value with their knowledge."

Head of pension investments at a Swiss pension

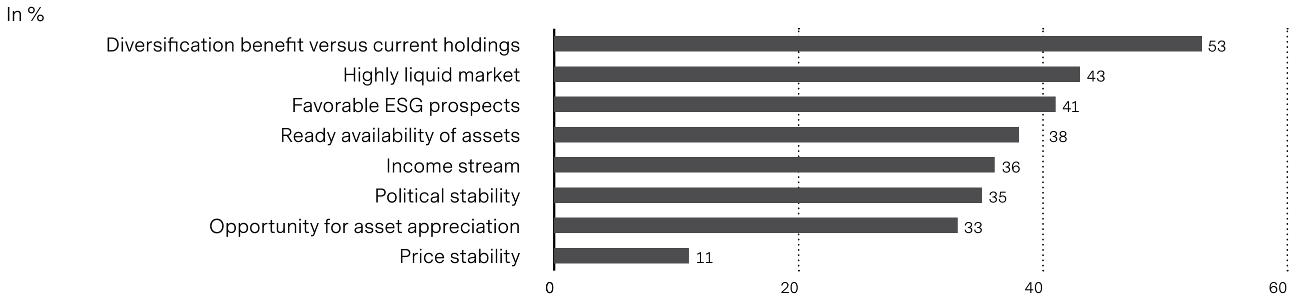
Source: Primary research from Vontobel and Institutional Investor Custom Research Lab. April 2022.

Figure 9: Diversification, income, and ESG alignment lead investors toward EM corporate bonds

Likely changes in EM corporate bonds



Most pressing reasons for increase in EM corporate bonds

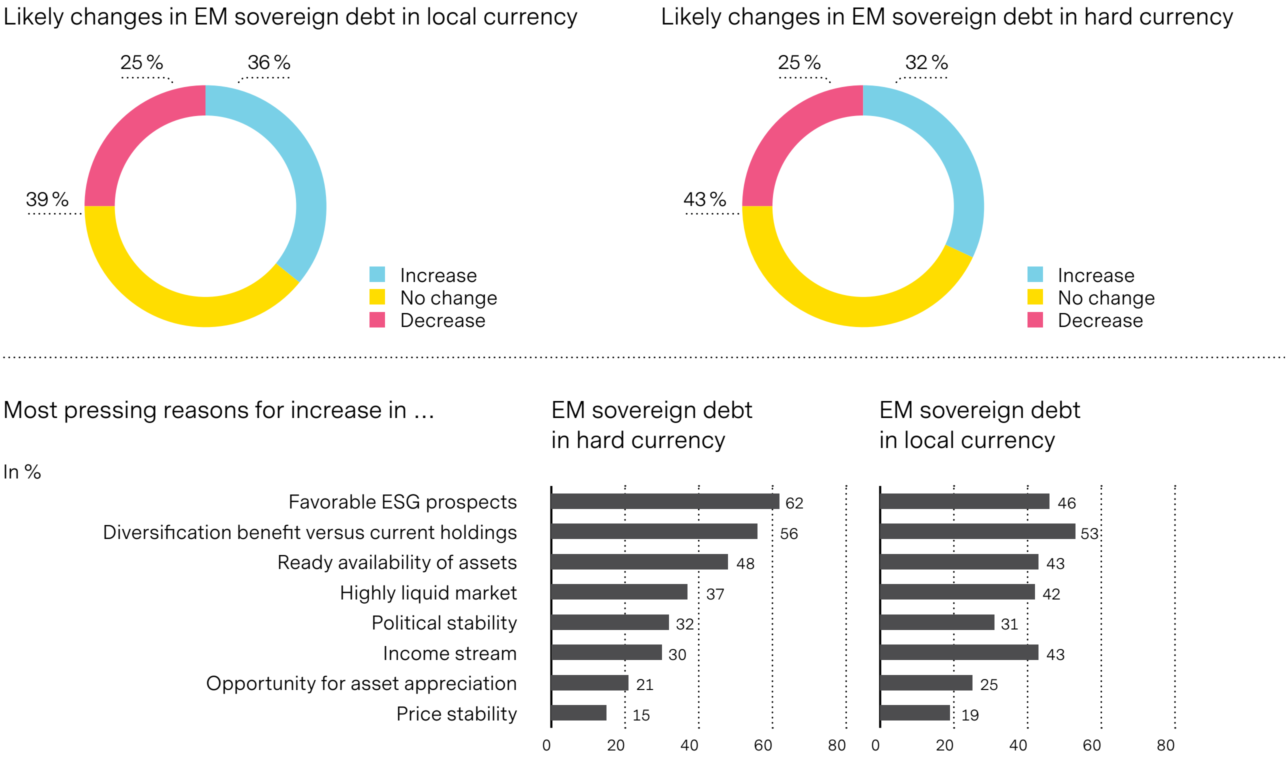


Investors are most likely to increase their holdings of EM corporate bonds rather than EM sovereign issues in the next two years, according to survey data. Those expecting an increase in EM corporate bonds value their potential to mitigate risk through diversification (53%), and they're more likely to see such bonds as a healthy source of income (43%) than sovereign debt denominated in hard currency (see Figure 9).

The appeal of EM corporate fixed income, say sources, is tied in large part to their focus on the measurable commercial activity of an enterprise, rather than on the broader performance of an entire emerging market economy. "If we're looking at a fund that's just municipal or government bonds, it's clear that, yes, this is one way to get exposure," say a fixed income manager at a US life insurer. "But if the mining industry is booming in this country, and it's rich in minerals or resources—or if the country is having a huge tech boom like India—we want to capitalize on it. We don't want something else dragging the investment down, since we're already taking a risk by investing in it."

Source: Primary research from Vontobel and Institutional Investor Custom Research Lab. April 2022.

Figure 10: Investors embrace EM sovereign debt issues in hard currency for their ESG prospects and diversification benefits



The head of pension investments at a Swiss pension says it holds several hundred million Swiss francs in emerging market debt, primarily through corporate bonds and "semi-sovereign" bonds issued by state-owned entities. "We look most closely at yield to maturity," he says. "Minus hedging costs from the US dollar to the Swiss franc—we hold only hard currency bonds—we see a positive yield to maturity." His institution holds its EM fixed income sleeve through an actively managed fund linked to its risk/return benchmark and depends on its EM fixed income manager to make buy and sell decisions.

Investors worldwide seem somewhat less eager to increase their holdings of emerging market sovereign debt, according to survey data. Approximately one-third of respondents anticipate increasing their EM sovereign holdings denominated in hard currency (36%) or local currency (32% as shown in Figure 10). Investors who will boost their holdings of EM sovereign debt in hard currency are drawn to this asset subclass for its positive ESG outlook, perhaps due to the availability of debt instruments linked directly to sustainability/ESG goals. And, as in other EM fixed income asset classes, a majority of investors sees EM sovereign debt as a source of diversification versus their DM holdings. (See Figure 11 for a breakdown of sovereign and corporate debt in emerging markets.)

Source: Primary research from Vontobel and Institutional Investor Custom Research Lab. April 2022.

> **“The rationale for the sovereigns in local currency is basically that we want that foreign exchange premium and FX exposure. So, do we trade in the FX markets? Or do we just do the local currency sovereign debt? We chose the latter.”**
>
> **Portfolio manager at a Dutch pension**

Hard currency EM debt offers substantial benefits to the UK insurer, says its fixed income analyst. “Generally, we use hard currency emerging market debt,” he says, “because according to the research we’ve seen, you don’t really get paid more, but there’s a lot more volatility” due to the risk of currency fluctuations. His firm has “reasonably global mandates, so we have a policy of ‘go anywhere, within some constraints,’” which include ESG considerations and requirements for average credit ratings for a mandate to be investment grade. This flexibility allows investment in fixed income around the world, and he cites the appeal of “the major markets like South Africa, Saudi Arabia, Brazil, India, and Mexico—so it’s globally diversified, but only hard currency.”

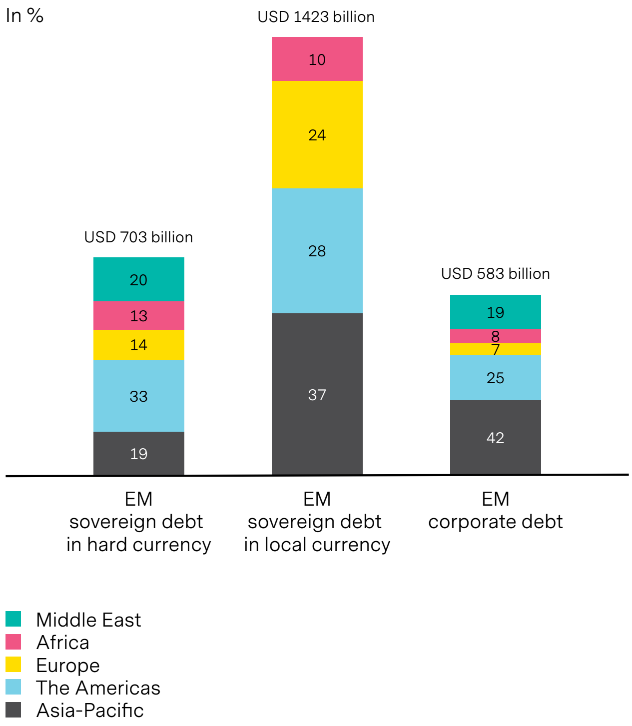
Indeed, EM sovereign debt is competitive with some US investment-grade issues, say the fixed income analyst. “BBB sovereigns from a government like Saudi Arabia in hard currency, senior secured (by the credit of the country), looks very attractive,” he says, “compared to BBB bonds in the US investment-grade market. It’s likely to yield more at the same capital charge, with similar risk. It may even have a lower capital charge if it’s senior, while the US IG bond is unsecured debt.”

Other investors see opportunity in EM sovereign debt denominated in local currency, largely as a return-seeking allocation with diversification benefits relative to DM investments. The fixed income portfolio manager at a large German insurer says, “We have some opportunities in emerging market debt which are tactically driven. We have, for example, added Asian high yield and also have some long-term exposure in the ‘shiny space’ of Chinese government bonds, which we like a lot because of their high yield and very good correlation properties. Given the low-rate environment in particular in Germany and elsewhere in Europe, we have moved a lot from developed markets to emerging market fixed income.” He sees these investments in the sovereign debt issued in the world’s second-largest economy as sources of yield, diversification, and stability relative to developed market holdings. “We’ve invested in Chinese government bonds in local currency since 2018 because we get a high yield of 3% or more and a very stable currency. Since the financial crisis, the Chinese yuan has been able to outperform the US dollar. Chinese bonds are stable. They profit from ETF flows and index inclusions, etc., and so we hold these bonds for the long term.”

These and other examples of analytically savvy investments illustrate both the opportunity for solid returns and diversification from investing in emerging market fixed income and the risk of doing so. Emerging markets are inherently riskier than developed markets. These markets are culturally and geographically distant from investors and their managers in developed markets. Their investment and legal infrastructure is less fully developed, or at least foreign. In some cases, corruption is widespread and is treated more as a cost of doing business than as a crime. Accordingly, as we’ll see in the next section, the rewards of EM fixed income investment are tempered by the manifold risks—some transparent, others opaque—of such markets and asset classes.

Figure 11: Asia-Pacific is the largest regional source of emerging market fixed income assets

Dollar amounts, with percentage breakdown of the worldwide values by region and asset class.



Source: Vontobel Asset Management, March 31, 2022

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Risk tempers enthusiasm for EM fixed income

Emerging market fixed income offers investors an opportunity to offset portfolio risk in their non-EM holdings, and to direct their capital toward income-generating assets that are aligned with their ESG objectives. They're held back, however, by asset-specific concerns such as debt loads and default risk (51 %) and the quality of data available for making investment decisions (see Figure 12). Market factors such as liquidity (48 %) and volatility (45 %) are top of mind among investors as well.

EM fixed income investors seem to have ready access to EM fixed income assets, as "a lack of suitable fixed income offerings from asset managers" ranks second to last among respondents' most significant challenges to investing in the asset class.

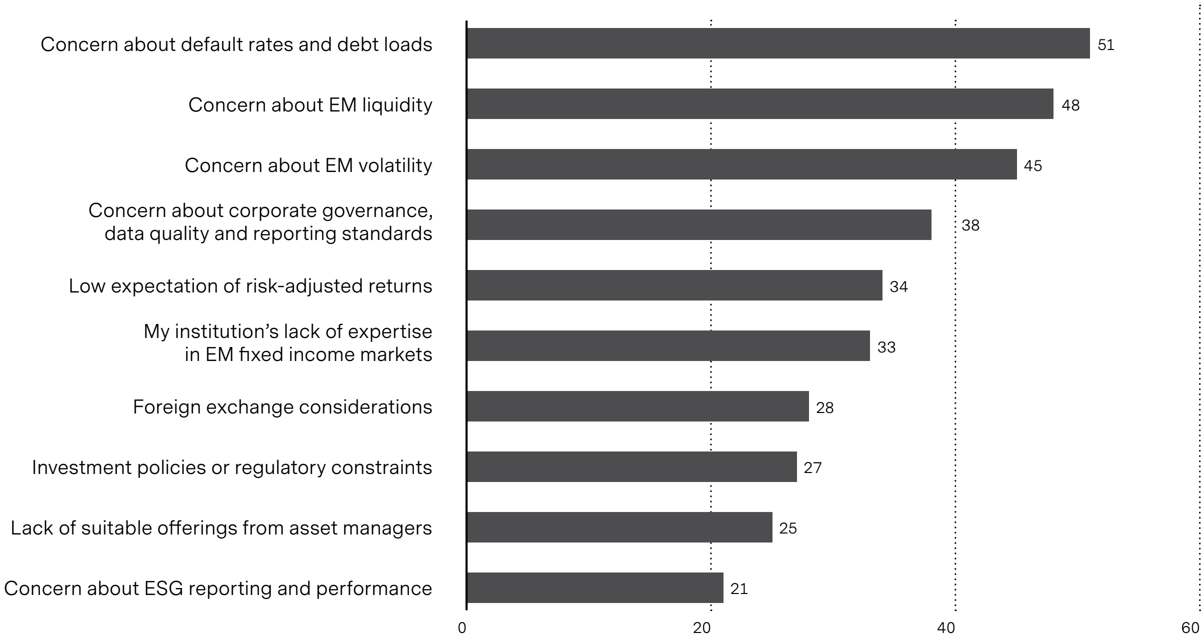
"Although emerging markets are a smaller part of our portfolio, for us it's to diversify the portfolio and even to get some premium comparing to the developed markets."

Fixed income manager at an Italian insurance company

Figure 12: EM fixed income investors are especially conscious of the risk of default, illiquidity, and market volatility

Most significant challenges to investing in emerging market fixed income assets

In %



Source: Primary research from Vontobel and Institutional Investor Custom Research Lab. April 2022.

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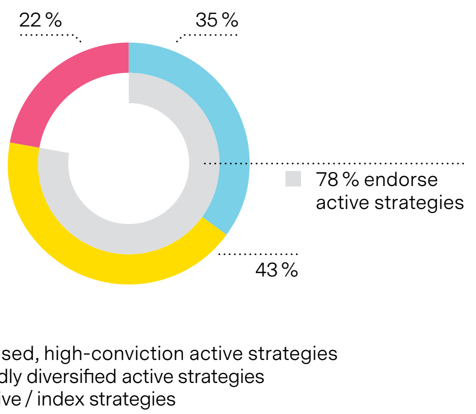
Active strategies prevail amid volatility, pricing errors, and uneven information

EM fixed income offers institutional investors access to the risk and return they seek for their often-modest EM allocations, and investors are eager to increase these allocations in the years ahead, most often by investing in corporate bonds and, to a lesser extent, sovereign debt. Survey data indicates that on the one hand, investors are optimistic about the economic prospects of emerging markets, and on the other hand, they are clear-eyed about the asset-specific and market risks of investing in EM fixed income. With this in mind, nearly 80% of investors in this study endorse active strategies over passive / index strategies (see Figure 13). Investors are most likely to select broadly diversified active strategies (43%) as their preferred method for EM fixed income investment over the next two years, which seems in line with their abiding concern for the diversification offered by EM fixed income. More than one-third of respondents see more focused, high-conviction strategies (35%) as their method of choice for investing in EM fixed income.

Figure 13: Investors prefer active to passive strategies for EM fixed income

Which of the following fund strategies do you see as especially suitable for investing in emerging market fixed income in the next 24 months?



"We are 100% active," says the Swiss pension head, "because we think emerging markets are not really efficient, and we see that local specialists can really add value with their knowledge. We see emerging market countries that are completely dominated by the energy industry, along with others that don't have any energy, and so why go passive when we see opportunities to do better with an active approach?" He endorses a high-conviction strategy composed of 30 – 40 positions, but since his allocation is shared across several managers, each with many positions, it is in effect broadly diversified.

He looks for managers that have the freedom to take advantage of opportunities and points out that "we trust more in the manager himself—the person—rather than the name of the firm." Such managers, he says, are typically "speedboats, not oil tankers. If the manager's volumes are too big, then the opportunities are gone. If you have a small boutique manager, it's likely to have greater ability to take advantage of market inefficiency, and because it's small, it doesn't have to buy every big bond issue just to get the volume."

Active strategies are the approach of choice for the fixed income analyst at the UK insurer, "but not really because active managers have especially amazing skills in this area. Rather, I think the level of customization and tailoring that we want in our mandates can't be achieved with passive funds. In terms of having a short duration, with specific credit rating limits, along with ESG considerations and exclusion of particular countries—suddenly we have a mess of additional constraints that can't be addressed with a passive strategy. Firm-wide, we generally use active managers in segregated mandates, because they can customize everything for our needs, which is a big requirement for us."

Source: Primary research from Vontobel and Institutional Investor Custom Research Lab. April 2022.

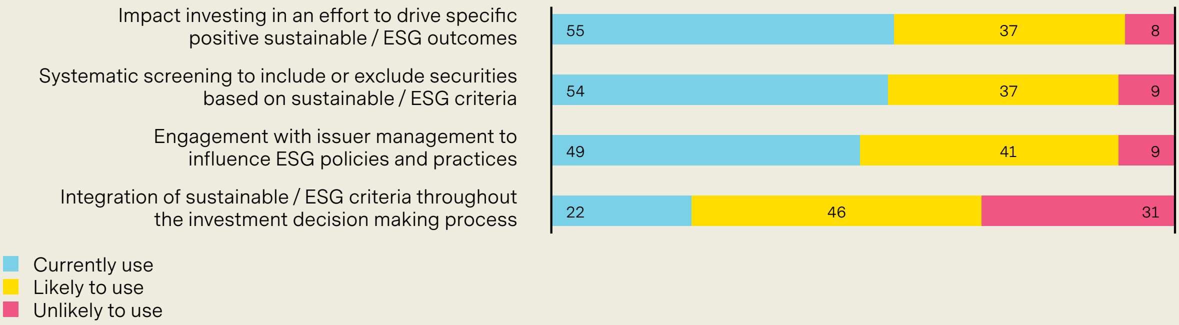
Investors' ESG strategies balance investment priorities with the externalities of production and consumption

Institutional investors look to emerging markets as a source of higher returns, stability, and diversification by investing in EM fixed income. Recall, however, that ensuring alignment with ESG principles is among investors' top priorities for their fixed income holdings. Survey respondents say they are most likely to use a combination of strategies to direct their capital toward investments that deliver positive social and environment outcomes and away from those that degrade the natural world, contribute to climate change, and harm employees, customers, and the public more broadly. A majority of respondents report that they use impact investing strategies, which direct investment toward positive ESG outcomes (55%), or screen their portfolios to include or exclude investments according to issuers' ESG policies and practices (54% as shown in Figure 14). Direct engagement with issuers in an effort to encourage transition to better and cleaner practices is also commonplace.

Figure 14: ESG strategies vary widely, as a majority target capital toward particular outcomes and screen investments against sustainability criteria

Which of the following ESG approaches does your institution's asset managers use when investing in emerging market fixed income assets?

In %



Source: Primary research from Vontobel and Institutional Investor Custom Research Lab. April 2022.

Systematic screening is well established among investors interviewed for this study. The German insurer says his company "works with MSCI and uses some NGO data along with data from 14 different suppliers worldwide. If they have a negative sustainability rating, we don't invest in the country or company." Similarly, the fixed income manager at the Australia pension requires its asset managers to explains its ESG investment policies and include ESG disclosures in its quarterly reporting of investment performance. "Each manager has to have ESG policies, and we review them annually, there are sanctioned countries and industries (such as tobacco) that cannot be invested in for obvious reasons, he says. "More than anything else, we want to make sure that when an investment decision is made by our managers, they've taken into account all the ESG criteria in making that decision."

Investor thinking on engagement with issuers rather than divestment has matured in recent years, according to investors interviewed for this study. Rather than starve a bad economic actor through divestment, investors increasingly nourish such companies through active engagement with management on its ESG policies and practices. "We generally have a policy of engagement rather than divestments. We prefer to transition companies to a lower carbon path (rather) than just sell. If a company is just simply divested, then there are a couple things that can happen. One thing is, the company can't afford to transition to better practices, which is not really positive. Or private equity comes in, buys the company, does whatever it wants with it, and all disclosure stops, and that doesn't really help. And if you just sell, then the company still does whatever it was doing and the effect on the world is still the same. Your portfolio statistics may look better, but the world hasn't changed a bit."

"We want to make sure that when an investment decision is made by our managers, they've taken into account all the ESG criteria in making that decision."

Fixed income manager at an Australian pension

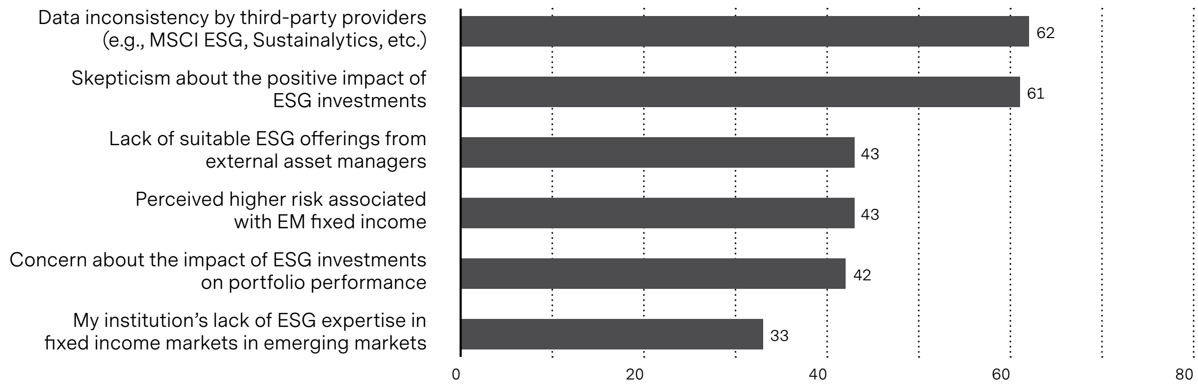
Among investors in developed markets, the mandate for demonstrable progress on ESG matters is well under way and indeed growing among public and private stakeholders. In the words of the fixed income analyst at the British insurer, "Here in the UK, there's a lot of discussion: shareholders are talking about it; management is getting a great many questions about ESG and sustainability; we're getting questions about it from other stakeholders or even employees. Asset managers are talking to us about it as well."

This growth in private concern and persuasion is amplified by government mandates and reviews. "The Bank of England did a stress test for insurance companies last year, which looked at our climate exposure and what would happen under different scenarios if some of these sectors really went to the wall—that is, if everyone had to transition away from fossil fuels very quickly?" The stress test called on the company to answer questions such as, "What would you do as a company if it looked like this was going to happen, what are you doing to mitigate this? How are you thinking about this and what data are you collecting?"

Figure 15: Investors voice concern about low-quality information and the efficacy of ESG investments in EM fixed income

Which of the following barriers hold your institution back from making ESG-focused investments in emerging market fixed income?

In %



Investing through an ESG lens may well be an especially daunting task for EM fixed income investors, according to sources interviewed for this study, largely, it seems, due to the nascent state of the transition away from fossil fuels, traditional but unsound management practices, and archaic treatment of the workforce. The fixed income analyst at a UK insurer asserts that ESG investing in emerging markets is notably more difficult than in developed markets. "Emerging markets are quite a lot more challenging for ESG than developed markets. You have to be a bit more realistic, because many things are in just the earliest stages of development. Some of the plans that, for example, India or South Africa put out last year about moving away from fossil fuels and toward wind and solar—they sound great, but they have not really started yet."

The eagerness to transition to new sources of energy can at times conflict with near-term ESG aspirations. A carbon neutral economy in which machinery is powered by sustainably generated electricity requires massive investments in generation and transmission infrastructure, along with the next generation of vehicles and other machinery powered by electricity. Such investments of course require many of the same materials and intermediate goods as the old hydrocarbon economy. These materials need to be mined, refined, and manufactured—all of which contribute to, rather than remedy, many of our current environmental problems. But, as the German insurance portfolio manager points out, "Without commodities there is no energy transition. If you look at European parties and the political landscape, they think commodities are a very bad thing. And because of the pollution, if you mine them, or if you produce them, there are very negative external effects. But in the end, if you want to have an energy transition, you need copper, nickel, and also oil."

Source: Primary research from Vontobel and Institutional Investor Custom Research Lab. April 2022.

Conclusion

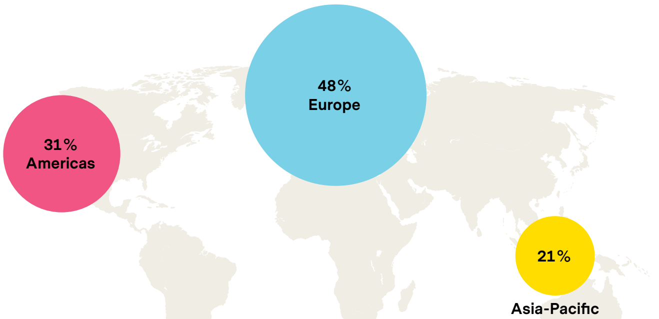
As one crisis—the global pandemic—recedes, others, such as sustained inflation and geopolitical conflict, rise and weigh heavily on asset markets and their investors. This research program has examined how institutional asset owners anticipate finding advantage through investment in fixed income from emerging markets. They seek stable EM fixed income investments aligned with their ESG mandates that will deliver higher yields. The diversification benefits of EM fixed income are seldom far from investors' minds, as they seek to distribute the risk underlying their equity, DM fixed income and other holdings. And, sadly, they're forced to do so amid an uncertain, often chaotic investment environment.

Investors' response to these challenges includes a commitment to active strategies in which they and their asset management partners find the most suitable assets in the expanded investment universe of EM fixed income. They wrestle with the risks of such investments—some of which are linked to broad market forces and the vagaries of unfamiliar markets, while others are tied to the fortunes of individual enterprises. Investors' success, say sources, hinges on decision makers' ability to find good opportunities amid chaos and to master the dynamics of national and regional fixed income markets and their issuers.

About this research

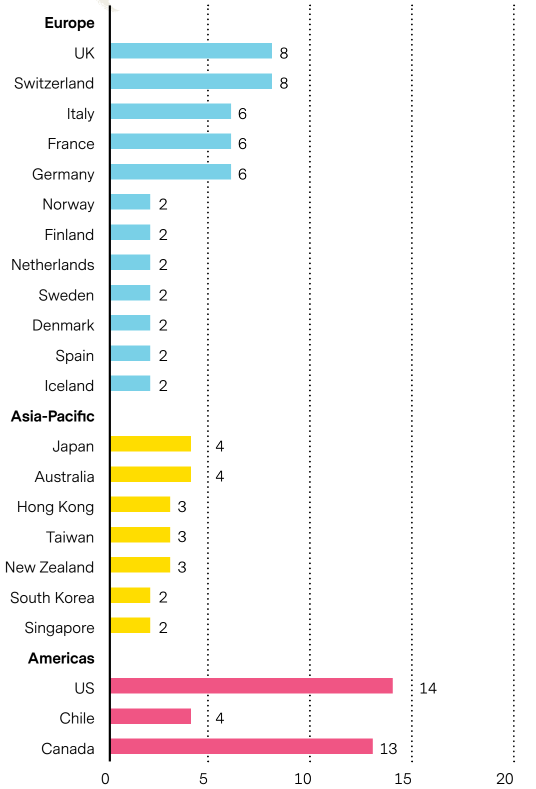
This study examines investors' interest in fixed income assets in emerging markets and their expectations for altering their allocations in the next two years. Institutional Investor's Custom Research Lab composed a questionnaire with Vontobel Asset Management to examine investors' views on emerging fixed income markets. The questionnaire was fielded in February-March 2022 and includes responses from 342 investment decision makers at insurance companies, public and private pensions, foundations, endowments, family offices, and sovereign wealth funds in Europe, Asia, and the Americas. In total, 47% of respondents were received before Russia's invasion of Ukraine, and 53% were received after the invasion.

To supplement the survey findings, we interviewed 10 investment decision makers at institutions in Asia, Europe, and North America. All the interviews took place after Russia's invasion of Ukraine. We're grateful to these investors at insurance companies and pensions for their time, attention, and candor in our conversations.



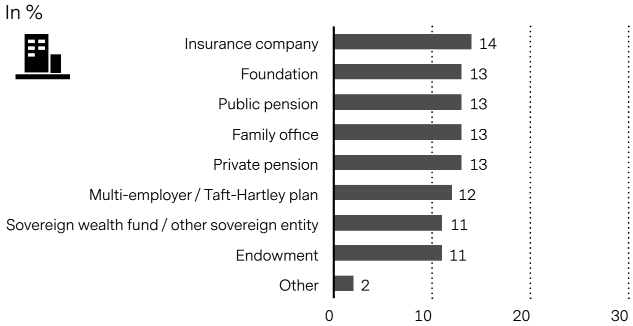
Respondents' location

In %



Institution type

In %

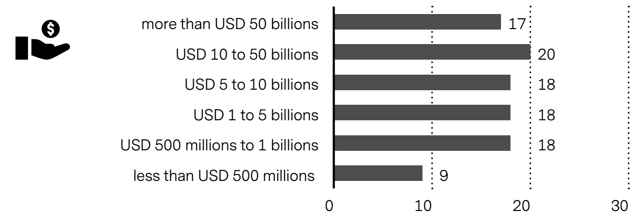


Titles and roles

In %

Assets under Management

In %



Sources: Primary research from Vontobel and Institutional Investor Custom Research Lab. April 2022.

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