TRACKING DOWN INCOME IN EMERGING MARKETS

Sally Greig, Investment Manager. Fourth Quarter 2017

BAILLIE GIFFORD

RISK FACTORS

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Sally graduated MA in Economics and Statistics from the University of Edinburgh in 1998 and also gained an MSc in Finance and Econometrics from the University of York in 2003. Prior to joining Baillie Gifford, she worked at the Bank of England from 2001 as an economist in the Foreign Exchange Division, and provided regular analysis to the Monetary Policy Committee. She joined Baillie Gifford in October 2005 and is the lead manager of our Emerging Markets Bond strategy.

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TRACKING DOWN INCOME IN EMERGING MARKETS

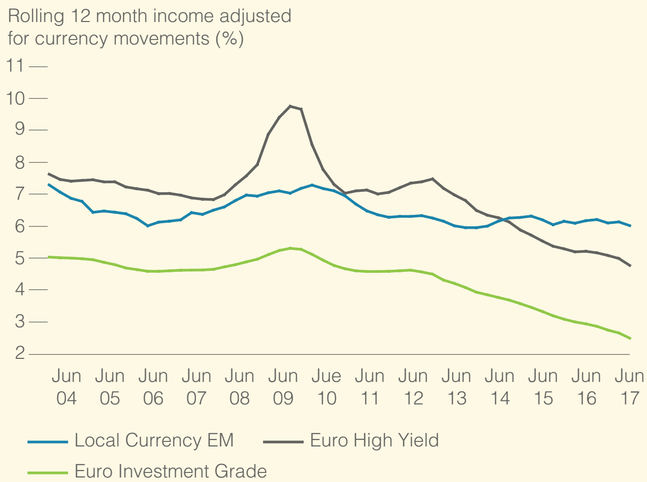
Humans use mental maps to make complex problems easier to solve. At the most literal level, we navigate a familiar city using our stored memory of its features. We can reach our objective safely and efficiently because we know the streets and districts, and the hazards and opportunities we may encounter en route. Cities change, of course, but too slowly for our mental maps to let us down.

We apply an analogous process to negotiating the financial world to reach our investment goals. However, markets are not cities: what was once a prosperous quarter can become impoverished quite quickly; the safe street may have become perilous. We anticipate a short walk to our destination but actually face a long, uphill trek.

Think of income. Our end clients are getting older, retiring, needing investment income to replace salaries. This is why our pension plans exist. Our mental map matches up 'income' to 'bond'; it also signals that safety lies in our home market's sovereign bonds. In today's market, the opposite actually applies. Government bonds render no income and they risk our clients' capital should interest rates rise. Despite this, Willis Towers Watson tell us that 77% of global fixed income pension assets were invested in domestic bonds in 2016.

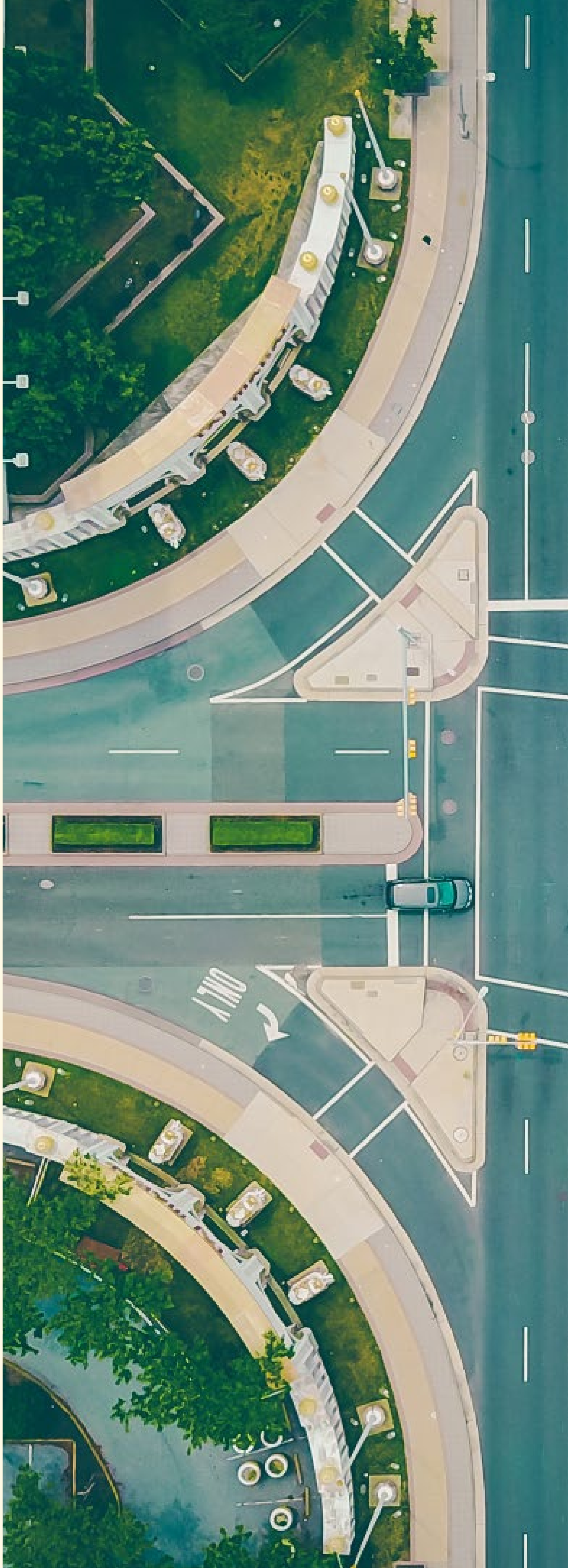
In the search for income, local currency emerging market (EM) bonds is the most obviously overlooked asset class. As the chart below shows, they have defied the fall in income from European domestic bonds, delivering steady payments in euros with little volatility.

Currency adjusted running income*



Source: Bank of America Merrill Lynch, Baillie Gifford.
*Previous 12 month's income as a percentage of principal adjusted quarterly for currency movements.

What is more, this income sits on an increasingly firm foundation. Emerging markets have become wealthier, generating half the world's economic output in PPP terms. Government revenues are an early beneficiary of development as commercial activity becomes more formalised – and taxable. It is little surprise then that the local currency EM benchmark is now solidly investment grade, suggesting that the risk of permanent loss of capital is much diminished.



ACTIVE MANAGEMENT MATTERS

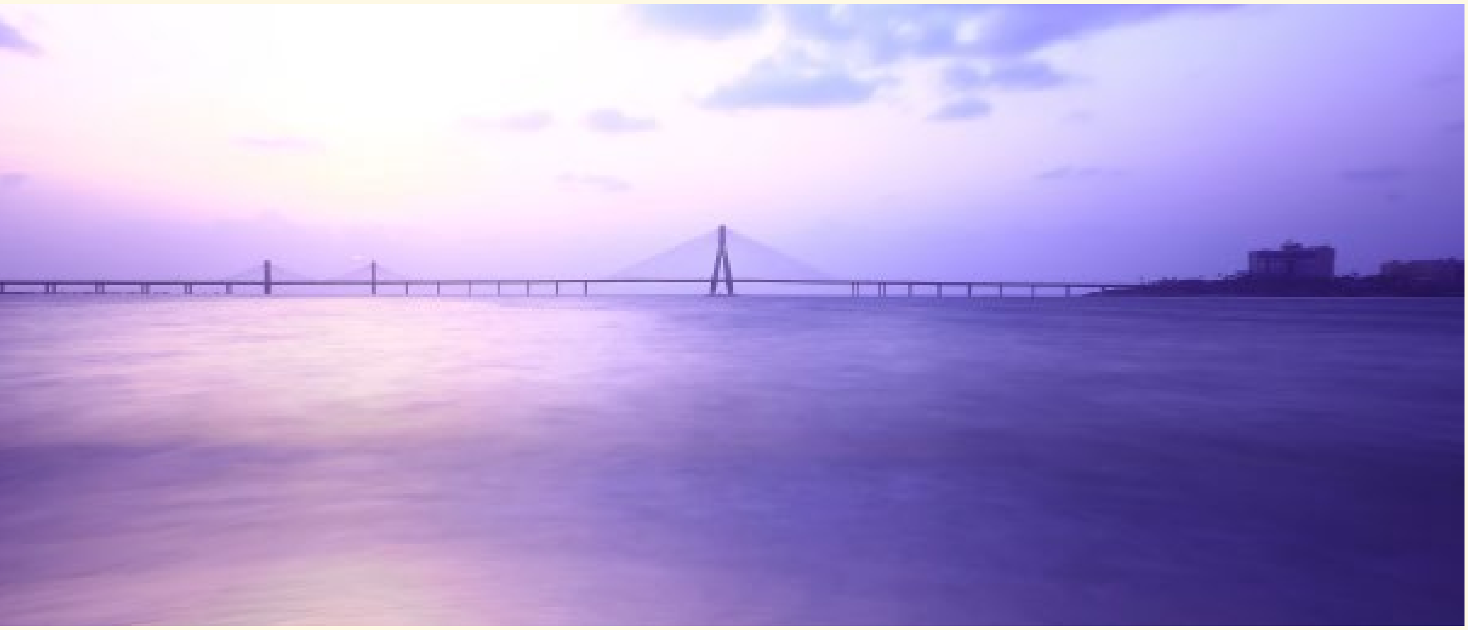
However, EM bonds are not a homogenous market and risks remain. The economic development process is exciting and is creating diverse, resilient sources of income, but we are not blind to the investment challenges a changing world presents. Economies develop at different speeds. Some succeed where others repeatedly fail. We therefore believe that active management, searching for those countries which will be a sustainable source of income, is essential for this asset class.

The growth of local currency issuance is one measure of the progress many countries have made – local currency bonds supersede dollar bonds as a country grows in wealth and credibility. Their growth has made economies which have developed this funding channel far less vulnerable to capital outflows.

A local currency EM bond portfolio offers exposure not only to the bonds, but also to the currencies of these economies, enhancing the diversification benefits for global investors. For example, commodity importers such as Turkey can sit alongside exporters, such as Chile.

It also adds a new investment dimension, and active managers must understand the factors which lead to healthy currency appreciation and ensure this is reflected in their EM bond funds.

Making this assessment, as with other sources of return, has been profoundly affected by the dawn of the information era. EM investment was once a case of 'who you know', now it is 'what you know' or, to be precise, how you piece together the plethora of data now readily available to all. Even corruption, the perennial enemy of economic development, is wilting under the onslaught of accessible information as Brazilian and Pakistani politicians have recently discovered. There has been more reform in EM countries than is recognised. The information era can hasten this progress.



MAKING CONNECTIONS

As investment managers, we seek to gain an edge by understanding connections, building an accurate mental map. We make comparisons – will Thailand be more resilient than Malaysia? We can also see connections by analogy. Could India develop if it follows the examples of China and Korea? In this respect, the organisational simplicity of Baillie Gifford's single investment location in Edinburgh gives us a structural advantage over competitors with several investment offices or implicit home country biases. We analyse emerging markets holistically, connecting the dots between the different countries we invest in to select the best opportunities across the EM bond universe.

The market's outdated mental map keeps EM yields attractively high, but it also makes a short-term investment approach useless. We know there will always be new market worries and unsettling political events. Each of these affect market sentiment and the traditionally risky markets, such as EM debt, take the brunt. Sentiment dominates shorter-term market movements, making them intrinsically unpredictable.

So to add value for clients we look for sustained returns, driven by economic and market cycles or – better still – by unrecognised structural advantages. This is not easy, and these factors take time to be reflected in bonds' values. We look for the connections we discuss earlier, analyse where the world is going, not where it has been, and – above all – take a patient approach. In doing so, we are aided by Baillie Gifford's partnership structure and its commitment to maintaining a focus on investment and shunning mergers and acquisitions.

Local currency EM bonds offer better income than almost any other major asset class. They are under-represented in most European institutional portfolios, despite the dearth of income generating alternatives. Much of the risk associated with them is overstated, and manifests itself in short-term volatility rather than permanent capital loss. However, this is a heterogeneous asset class and economic development between countries will take different forms and will not always flourish. Active management focused on sustainable returns is essential.

IMPORTANT INFORMATION

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