Blended mandates, the importance of local investors & the growth of China

Just before the summer, **Tell Media Group**, in co-operation with **Blackrock**, **First State Investments** and **Erste Asset Management**, invited three Danish institutional investors and manager selectors to discuss emerging market debt. Tell Media Group founder **Niklas Tell** and Nordic Fund Selection Journal editor **Caroline Liinanki** moderated the roundtable.

By: Niklas Tell Photo: Christer Salling

ANDERS ELLEGAARD – INDUSTRIENS PENSION, LAURENT DEVELAY – BLACKROCK, LENE BOSERUP – NYKREDIT ASSET MANAGEMENT, NIKLAS TELL – TELL MEDIA GROUP, CAROLINE LIINANKI – TELL MEDIA GROUP, JAMIE GRANT – FIRST STATE INVESTMENTS, MICHAEL BØDKER – DANICA PENSION, PÉTER VARGA – ERSTE ASSET MANAGEMENT.

The discussion, which was held at Hotel d'Angleterre in central Copenhagen, started with Caroline Liinanki commenting that Danish investors have been some of the earliest movers into emerging market debt and also one of the first to have the asset class as a strategic allocation. She then asked the investors at the table how their emerging market debt portfolios have changed over the years and about their current exposures.

MICHAEL BØDKER: "We have, as you say, been involved for a long time. It's a decent size of the portfolio now and it will likely increase over time. Our exposure to emerging markets on the fixed income side is split between hard currency and local currency and we don't have any exposure to corporate debt right now. That's, however, something we're looking into. In terms of allocation, some 5 to 6 per cent of a medium risk portfolio is in emerging market debt. About 25 per cent is in local currency and 75 per cent in hard currency."

ANDERS ELLEGAARD: "We started early and did our first opportunistic mandate in 1999. A couple of years later, we made a 2.5 per cent strategic allocation to the asset class, which has increased to 9 per cent today. Originally, we had separate allocations to hard currency and local currency with the idea to opportunistically move between the two. We realised, however, that it made more sense to outsource the opportunistic allocation to external managers and therefore allocated a part of the emerging market debt portfolio to blend managers. We don't have a dedicated corporate mandate."

NIKLAS TELL: "AND WHERE ARE YOU TODAY IN TERMS OF YOUR ALLOCATION – CAUTIOUS OR MORE OPTIMISTIC?"

ANDERS ELLEGAARD: "I would say we're very close to our strategic allocation. We've been following the corporate debt market and we might add a pure corporate mandate going forward."

NIKLAS TELL: "LENE, I KNOW YOU'RE NOT DIRECTLY INVOLVED IN ASSET ALLOCATION BUT HOW HAS YOUR STRATEGY FOR EMERGING MARKET DEBT CHANGED?"

LENE BOSERUP: "We changed our strategy for emerging market debt in 2015 from a pure local currency exposure to a blend mandate with 50 per cent in local currency, 25 per cent in hard currency sovereign as well as 25 per cent in corporate debt. Our clients in this strategy are primarily high net worth individuals and the original emerging market debt strategy was too volatile for a fixed income investment."

JAMIE GRANT: "We actually spoke over lunch about this topic of pure exposure to local currency. Over the last three years, we incubated a local currency-only strategy that came out in the middle of last year and despite good performance, we realised that we would have a hard time gathering assets for that. A blended strategy is a more appropriate way forward and that's the way we're moving as well."

NIKLAS TELL: WE'VE BEEN HEARING ABOUT CHALLENGES IN DIFFERENT AREAS OF EMERGING MARKETS. WHERE ARE WE RIGHT NOW FOR THIS ASSET CLASS?

LAURENT DEVELAY: "We've had a significant repricing of the dollar, which is impacting emerging economies and we've seen monetary responses from many of the central banks in these countries. Now, we have a much more stable environment."

PÉTER VARGA: "What we have had is a tsunami of top-down events but if I look across the different corporate names, they look fine to me and in particular compared to corporate bonds in developed markets. Hence, we're fairly optimistic. That said, it's been key to manage the country allocation given the developments we've seen over the last couple of months. Should those top-down events last for longer, we're going to start to see first signs of worsening corporate fundamentals. In that case, all bets would be off."

NIKLAS TELL: WE HEARD EARLIER ABOUT THE PREFERENCE OF HAVING BLENDED MANDATES. IS THIS A GOOD ENVIRONMENT FOR THAT?

JAMIE GRANT: "Definitely. For the past five years, it has been very much a top-down environment. Now, we move into an environment where you must have your research right and you must know how to be an active manager. Also, people in the industry are much younger and many haven't been around in different environments, which can play into the hands of experienced teams. I'm happy for there to be volatility. That gives us opportunities."

NIKLAS TELL: HOW DO YOU ENSURE YOU GET THE RIGHT ACTIVE MANAGER FOR THE NEW ENVIRONMENT WE MAY HAVE IN FRONT OF US?

LENE BOSERUP: "It's of course difficult to find an active manager because as soon as you put a benchmark in there, they will align to the benchmark – even if we give them wide room to manoeuvre. What I think is very important is that managers look at the global risks and not only on bottom-up factors."

JAMIE GRANT: "We seek to set up strategies that we can distribute globally and some regulators are not comfortable with fully unconstrained strategies. In the past, we could have a total return strategy against a cash benchmark. Now, regulators force us to have a performance-based benchmark, which opens up to what you described, Lene. It changes the manager's behaviour. I understand why the regulator is doing it but I don't think it's good for the product."

ANDERS ELLEGAARD: "Coming back to the question on manager selection, it's of course difficult given the strong environment we've had over the last five years. Has your manager performed because he or she selected the right credit and been in the right place or have they performed thanks to taking on risk? It will be very interesting to see how managers perform going forward."

JAMIE GRANT: "I certainly see that where I live in Asia. For me, active management is risk first and yield second. What I see among a lot of managers in Asia is the opposite – it's yield first."

NIKLAS TELL: WHAT HAVE BEEN THE BIGGEST CHANGES TO EMERGING MARKET DEBT AS AN ASSET CLASS?

MICHAEL BØDKER
Danica Pension
Portfolio manager and part of the team responsible for credit investments at the Danish pension company Danica Pension. He joined the pension company in June 2015 from Nykredit, where he had worked as a credit portfolio manager since 2007. He has previously also worked as a portfolio manager at PFA Pension.

LENE BOSERUP
Nykredit Asset Management
Senior portfolio manager at Nykredit Asset Management, responsible for the selection and monitoring of external managers within fixed income and illiquid credit. She joined the company in August 2013 from Nordea, where she was a senior fixed income specialist. She has just resigned from Nykredit to start a new job at the Danish pension fund Industriens Pension.

ANDERS ELLEGAARD: "It has, of course, developed from only hard currency to becoming a much broader universe with better liquidity. Our main problem, which was discussed earlier, is that it becomes very much benchmark-driven. And the benchmarks are also very broad."

LAURENT DEVELAY: "It's even more so if you look at the local currency space where we today only have 18 countries. That's one of the big challenges for these products - the investment universe is not very big. It's a balance between an investable universe and liquidity. It's, however, changing with new countries being added, such as China."

PÉTER VARGA: "But will it not be dangerous if we have new markets added without developed local markets? That will mean a lot of money chasing these new markets."

LAURENT DEVELAY: "You're absolutely right. It's very important that the local market develops as this is what provides liquidity and we see that happening. Local banks, insurance companies and pension funds are becoming much more active in their local markets, which allows for better pricing. The opening up of new markets must go hand in hand with the development of local investors."

PÉTER VARGA: "Coming back to your question of changes to the asset class, I must say that the rise of the local investor has been very important. We've seen this in corporate debt as well."

NIKLAS TELL: WOULD YOU SAY THAT LIQUIDITY IS NOT SUCH A BIG RISK IN EMERGING MARKET DEBT TODAY?

MICHAEL BØDKER: "Liquidity is a risk everywhere."

JAMIE GRANT: "We've seen liquidity events in US treasuries. When we assess investments, liquidity is always high on the list. We must assume that something could happen that we hadn't foreseen and that we must get out. You don't want to get stuck with a holding that you can't sell and it destroys your performance."

NIKLAS TELL: DOES THAT MEAN THAT YOU BUY WITH THE ASSUMPTION THAT YOU MIGHT NEED TO HOLD TO MATURITY?

JAMIE GRANT: "It depends on the asset class. If it's credit, then yes. If we talk about a tactical allocation to local currency, I would be putting much more weight on liquidity."

NIKLAS TELL: WHAT ABOUT ETFS IN THIS ASSET CLASS?

MICHAEL BØDKER: "We use ETFs but more for liquidity reasons and ease of execution. There are both pros and cons with ETFs. I think it's an ok tactical tool to have in place and it's also good when you need to re-allocate in your portfolio. Instead of going to your manager, you can use the ETF for liquidity. The problem is that ETFs are not a good representation of the market. They tend to underperform active managers and the market because they're more concentrated. You don't get the tails of the market."

PÉTER VARGA: "I totally agree. We also see ETFs as a good way to express an opinion on liquid asset classes. However, we struggle to see how they can play a more prominent role in asset classes like emerging market corporates.

CAROLINE LIINANKI: WHAT ROLE DOES THE EMERGING MARKET ALLOCATION PLAY IN THE PORTFOLIO AND WHY SHOULD YOU HAVE AN ALLOCATION IN THE FIRST PLACE?

MICHAEL BØDKER: "I think the question should be "why shouldn't you". If you look at the GDP share of emerging markets, it's around 60 per cent today. It's only some 20 per cent of the fixed income universe. You could argue that we're underinvested in emerging markets."

LAURENT DEVELAY: "There's also an argument from a pure yield perspective and from a diversification point of view. That's for the hard currency allocation, both sovereigns and corporates. If you look at the currency side of things, it's both about yield but also currency diversification."

NIKLAS TELL: SO WHEN INVESTING IN LOCAL CURRENCY DEBT, IS IT MORE OF A CURRENCY INVESTMENT THAN A FIXED INCOME INVESTMENT?

LAURENT DEVELAY: "When investing in local currency debt, some 75 per cent of the risk is currency and 25 per cent of the risk is local debt. We see this as two different asset classes that are fairly different from each other and with two different investment horizons. This is why we have two managers responsible for this asset class."

JAMIE GRANT: "You can be right in your analysis of local rates but lose everything on the currency."

NIKLAS TELL: DO YOU PUT EMERGING MARKET DEBT INTO YOUR FIXED INCOME BUCKET?

ANDERS ELLEGAARD: "For us it's in fixed income but I agree that a lot of the volatility in local currency emerging market debt comes from the currency. That said, you still get a yield return when investing in hard currency or even a hedged local currency product given the sovereign credit risk."

MICHAEL BØDKER: "Fixed income and currency are part of the same group for us."

CAROLINE LIINANKI: WHEN INVESTING IN EMERGING MARKET DEBT, IS IT MAINLY FOR THE YIELD OR IS IT MORE ABOUT DIVERSIFICATION?

MICHAEL BØDKER: "It's both. When you do your portfolio construction, you go through all of those factors. It's obviously about return versus risk but also diversification."

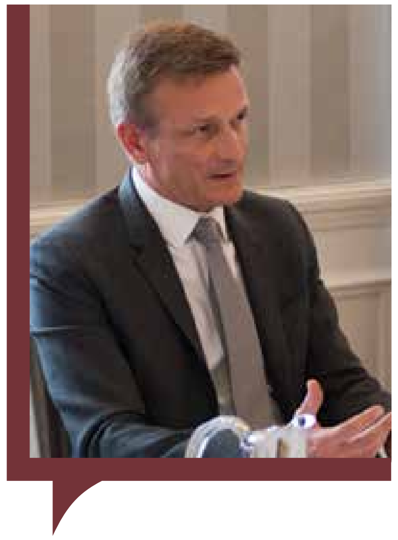
NIKLAS TELL: MICHAEL AND ANDERS, YOU BOTH MENTIONED THE POSSIBILITY OF ADDING DEDICATED CORPORATE DEBT MANAGERS GOING FORWARD. WHAT'S THE REASONING BEHIND THAT?

MICHAEL BØDKER: "I think it's simply the next step. It's part of the emerging market universe and it's a growing asset class. We have different strategies for hard currency and local currency and we can tilt the allocation between them. We would then probably add a dedicated corporate debt mandate to that overall allocation."

JAMIE GRANT: "What we've seen in Asia and specifically in Taiwan is that they are adding emerging market corporate and specifically Asia-focused corporate debt as a way to increase their exposure to Asia in general, where many have been underweight. We haven't seen it in many other places so it would be interesting to hear your thoughts."

PÉTER VARGA: "We had similar client conversations earlier this year where our clients explained that they would like to build up exposure to emerging markets but were slightly hesitant to add corporate debt because they perceived it to be more risky compared to sovereigns. This led us to do

ANDERS ELLEGAARD
Industriens Pension
Portfolio manager at Industriens Pension, which he joined in March 2017. Prior to that, he worked as a senior credit manager and head of credit investments at Nordea Life & Pension in Denmark. He started his career as a risk specialist at Standard and Poor's in London.



LAURENT DEVELAY
BlackRock
Managing director and head of emerging markets local debt investments within BlackRock's global fixed income group. Prior to joining BlackRock in 2012, he was a senior portfolio manager in the emerging market debt team at Fischer Francis Trees & Watts.

some internal research on the topic. The conclusion was the opposite of what people usually would expect: the headline spread and yield is higher for the emerging market bond index because of Venezuela, Argentina, Ecuador and Lebanon. Also, the interest rate sensitivity is higher. Stripping out the defaulted Venezuela, the corporates allocation provides you with more spread and with less rate sensitivity. That goes to show that the perceived safe allocation to emerging market sovereigns might not be that safe after all."

CAROLINE LIINANKI: LENE, HAVE YOU CONSIDERED ADDING A SEPARATE CORPORATE DEBT MANDATE?

LENE BOSERUP: "No. The reason is that the allocation we have to emerging market debt in a mid-risk portfolio is some 5 per cent so it wouldn't make sense to have a separate allocation. But I do think that there will be more interest, which is why we took an allocation of 25 per cent to corporate debt in our strategy and I'm happy to have a 50 per cent allocation if our manager sees opportunities."

CAROLINE LIINANKI: SO SHOULD YOU HAVE THE SAME MANAGER FOR THAT CONSIDERING THE DIFFERENCE BETWEEN INVESTING IN COUNTRIES COMPARED TO COMPANIES?

LENE BOSERUP: "I think you need to select a bigger manager because you need them to have a big team. We mentioned earlier that even when investing in local currency debt, you need someone to look at the currency component. Then on hard currency, you need someone to look at rates and someone at credits."

ANDERS ELLEGAARD: "Yes, I agree, you might need a dedicated corporate manager but it makes sense to have a sovereign team as well because you also need to have a view on the county when investing in corporates - even if it's not the same team."

LAURENT DEVELAY: "But there needs to be good co-operation between the different teams. You need a corporate team, a sovereign team and a local currency team and there needs to be good communication between these teams. I need to talk to the corporate team and the sovereign team on a daily basis and they sit two meters from me."

NIKLAS TELL: WHAT ABOUT ESG IN THIS SPACE? HOW DO YOU APPROACH ESG IN EMERGING MARKET DEBT?

JAMIE GRANT: "In corporate debt, it's no problem. What we look for is non-financial risks that could become financial risks. Sovereigns are different. We've had a methodology in place for some time and we're currently reassessing it to see how effective it is."

LAURENT DEVELAY: "It's something that's very important to us and we've been working hard together with JPMorgan to develop the ESG suite of indices. We believe that what's relevant for companies is also applicable to countries."

CAROLINE LIINANKI: WHAT'S THE BIGGEST DIFFERENCE BETWEEN THE STANDARD BENCHMARK AND THE ESG BENCHMARK?

LAURENT DEVELAY: "The benchmark is re-weighted according to the ESG score so if you have a bad ESG score, your weighting will be less. There are exclusions in the hard currency benchmark but not for the local currency benchmark because the universe is too small to begin with. That said, the average score for the countries in the local currency benchmark was higher than for the hard currency benchmark."

CAROLINE LIINANKI: DO YOU SEE INCREASED INTEREST AND DEMANDS FROM CLIENTS IN THIS AREA?

PÉTER VARGA: "Absolutely. However, what ESG is to one client will probably differ from the views of another client so in many cases it needs to be tailor-made."

JAMIE GRANT: "We see this very much in Europe and also in Australia with the super funds. However, in Asia, they didn't know what ESG stood for some five years ago. Things are happening even if it's small steps, such as the fact that Mercer is hosting an ESG conference in Beijing in June and it's sold out. In the US, it's still very small."

CAROLINE LIINANKI: RESPONSIBLE INVESTING IN THIS SPACE IS ALSO VERY RELEVANT HERE IN DENMARK AS THERE WAS A BIG DISCUSSION SOME SIX YEARS AGO WHEN DANISH PENSION FUNDS WERE CRITICISED FOR INVESTING IN COUNTRIES IN AFRICA BREACHING HUMAN RIGHTS IN WHAT WAS REFERRED TO AS 'BLOOD BONDS'.

MICHAEL BØDKER: "A lot has happened since then and the attention to ESG is very high. Danica has been very active for a long time and we're working to make it an integrated part of what we do. It has, of course, been an implicit part of the fundamental, bottom-up analysis for a long time so it's very much making it explicit. It's, however, not only about the absolute ESG score but also the changes. How we can improve it going forward."

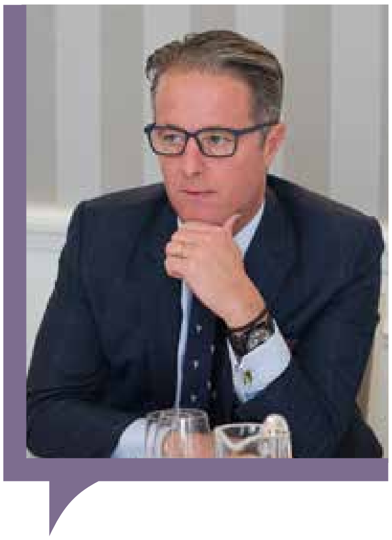
LAURENT DEVELAY: "This is exactly why we must not reduce ESG to exclusion. Re-weighting is a much better way forward because you want to push people to become better."

ANDERS ELLEGAARD: "There are very few companies that we have outright excluded. We do want to engage and will stay invested as long as we see improvements, especially with regards to the E and the S. The G in ESG has always been a focus area in credit analysis."

LENE BOSERUP: "We have a lot of focus on ESG and it's something we look at for all mandates and for us it's important that the manager integrates ESG factors into their investment process. Then we do have exclusions but we prefer to engage to make companies and countries improve.

NIKLAS TELL: COMING BACK TO THE QUESTION ON ENGAGEMENT AND GOVERNMENTS, HOW DO YOU DO THAT PRACTICALLY? CAN YOU WORK TOGETHER TO HAVE A BIGGER IMPACT?

LAURENT DEVELAY: "There's actually no need to coordinate or discuss in order to agree among investors. As more and more investors are integrating ESG factors into their analysis, it will have an impact on countries. Every country



JAMIE GRANT
First State Investments
Head of emerging markets and Asian fixed income at First State Investments. He joined the company in 2013 from QBE Insurance in Sydney. Prior to that, he worked at AXA Investment Managers in London as a senior investment manager and in Singapore as head of fixed income Asia.

PÉTER VARGA
Erste Asset Management
Responsible for emerging market corporate bonds at Erste Asset Management, which he joined in 2005. Before that, he was a manager for global convertible and US and European corporate bond funds as well as two total return funds at Union Investment in Frankfurt.

that's doing a roadshow for a new issue today will have this in their presentation. It's already happening."

PÉTER VARGA: "You also have to be vocal about it. We are fairly segmented but you can put together an article or a white paper to highlight your views."

MICHAEL BØDKER: "It's happening, just give it time. We are also seeing banks implementing ESG for their loan books, which will have an impact."

NIKLAS TELL: WHAT ABOUT THE GROWING IMPORTANCE OF CHINA?

JAMIE GRANT: "I wrote a paper the other day for a client and said that the biggest events in my career in fixed income have been the introduction of the euro and the start of QE. And, I think that the opening up of China is just as big for the global fixed income markets. Currently, your options are bond connect, which is not fully functional yet but they will resolve that. It's currently not allowing for outbound investments but when that happens you will have a lot of money looking for investments via Hong Kong and I think that's very exciting for emerging markets. I'm very happy to live in Hong Kong to see how this evolves. It's very interesting times."

MICHAEL BØDKER: "It's going to be massive. I guess in some 20 to 30 years, the Chinese fixed income market will be bigger than the US and we will all trade that. Of course, market infrastructure needs to improve a lot for that to happen.

JAMIE GRANT: "We've been thinking a lot about whether we're being true to our beliefs if we buy negative yielding assets in Europe or Japan. Japan represents 20 per cent of some of these indices and even if it will not go away in a hurry, I think we could have an environment where investors will start arguing for excluding negatively yielding assets from the index. Where will positive yield come from? China. I think European and Japanese bonds are at a real risk in terms of importance in benchmarks over the next five years."

MICHAEL BØDKER: "I think if we look ahead, China will be included in global benchmarks, so you will have the US, Europe, Japan and China. The first step will be emerging market benchmarks but it will come into the global benchmarks eventually."

PÉTER VARGA: "For emerging market countries, the next leg of development should be less reliance on external flows. That will make them less volatile. When we see higher saving rates in these countries that can finance the local growth, then they will become less vulnerable to external flows. That will make the whole asset class less volatile and that in turn will make investors more willing to increase their allocations. Together with the further development of the middle class in these countries this will provide the foundation for EMD 2.0."

JAMIE GRANT: "My favourite quote on that subject is from the Asian development bank that estimates that over the next 15 years some 500 million people in emerging markets will start their first pension savings plan. That's an extraordinary number."

NIKLAS TELL: BEFORE WE CLOSE, WHAT WOULD YOU CONSIDER TO BE THE BIGGEST RISKS RIGHT NOW?

MICHAEL BØDKER: "Geopolitics and trade wars are high on the agenda for most people and it should be."

ANDERS ELLEGAARD: "I agree. On top of that I think emerging market debt suffers from many of the same risks that most other asset classes face, such as high valuations, even though emerging markets probably is one of the least stretched."