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Opportunities in Emerging Markets Debt

Peter Marber, July 2019

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Why Emerging Markets Debt?

Peter Marber

Executive Summary

We believe that emerging markets (EM) offer an enormous range of investment opportunities. This burgeoning marketplace includes more than 75 countries, with sovereign ratings from AAA to default. This country mix includes extremely wealthy countries, to some of the world's poorest. With growing markets for foreign exchange, local bonds, hard currency bonds, stock indices, and single-name stocks, EM has become a complex asset class mix that may confuse investors. Debt or equity? Investment grade or high yield? Local currency or hard currency? Long or short? Benchmark or absolute return philosophy?

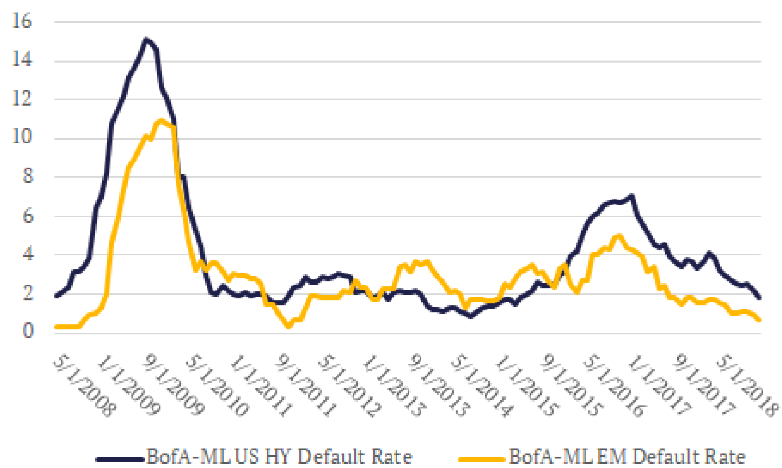
When creating our EM strategy, we had several goals: capital preservation, compelling risk-adjusted returns, and an ability to profit in both positive and negative environments. In total, our strategy aims to produce equity-like returns with bond-like volatility over a market cycle. Part of this conviction originates from the distinct properties of EM coupled with my long-term experience running similar strategies at firms including HSBC, Loomis Sayles, and UBS. The Aperture New World Opportunities Fund attempts to identify attractive risk-adjusted returns and exploit inefficiencies across more than 75 countries in an effort to produce returns in excess of a relatively low-volatility index, the Bloomberg Barclays EM USD Aggregate 1-5 Year Total Return Index (BEM5TRUU). We believe that this benchmark provides an attractive base level of risk and return for investors enhanced by long, short, and relative value opportunities from the entire emerging markets country spectrum.

The Counterintuitive Risk Profile of EM Debt

While emerging markets' long-term growth story often attracts investors, what is interesting and less understood are opportunities of cheap risk-adjusted premia, particularly in hard currency (large US dollar) credit instruments. For example, most investors would be surprised to learn that default rates of EM hard currency high yield bonds have actually been *lower* than those in the US High Yield arena:

Avg. monthly default rates: May, 2008 to December, 2018:[1]

- US HY Default Rate: 4.06
- EM HY Default Rate: 3.03

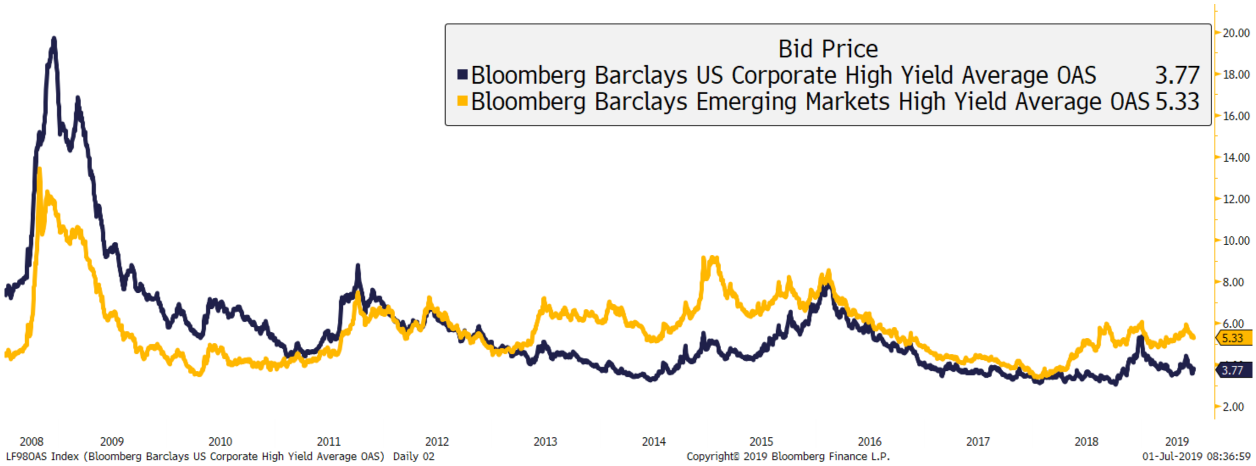


Despite this, EM spreads tend to be competitive with those in US HY.

Average OAS spreads as of June 28, 2019:

- US HY Spread: 3.77[2]
- EM High Yield Spread: 5.33[3]

[1] Bank of America Research - Merrill Lynch High Yield Default Rates
[2] Bloomberg Barclays US Corporate High Yield Average OAS, as of June 28, 2019
[3] Bloomberg Barclays Emerging Markets High Yield Average OAS as of June 28, 2019



In the investment grade universe, EM corporate bonds have generated about 1% more return per year than US corporates have (6.56% vs. 5.58%) since 2002, as measured by the US IG and EM IG bond indices.[4]

Emerging markets are traditionally associated with elevated volatility. However, again, by analyzing the broad EM credit universe, there have been attractive returns to extract with extraordinarily low volatility. Our strategy's benchmark, for example, as of June 28, 2019, experienced lower two-year volatility than the major EM and developed market credit indices shown below:[5]

Index	2Y Volatility
Bloomberg Barclays EM USD Aggregate 1-5 Year Total Return Index (BEM5TRUU)	2.08
Bloomberg Barclays US Agg	2.92
JP Morgan CEMBI Broad	3.20
Bloomberg Barclays Barclays Global Agg	3.70
Bloomberg Barclays US Corporate HY	4.54
JP Morgan EMBI Composite	5.35

[4] Bloomberg Barclays US Corporate Total Return Index, JP Morgan EMBI Global Investment Grade Index as of June 28, 2019. Indices are unmanaged and do not include the effect of fees.
[5] Volatility is measured as the annualized standard deviation of monthly index returns. Index returns provided by Bloomberg Finance, L.P., JP Morgan, as of June 28, 2019. Indices are unmanaged and do not include the effect of fees.

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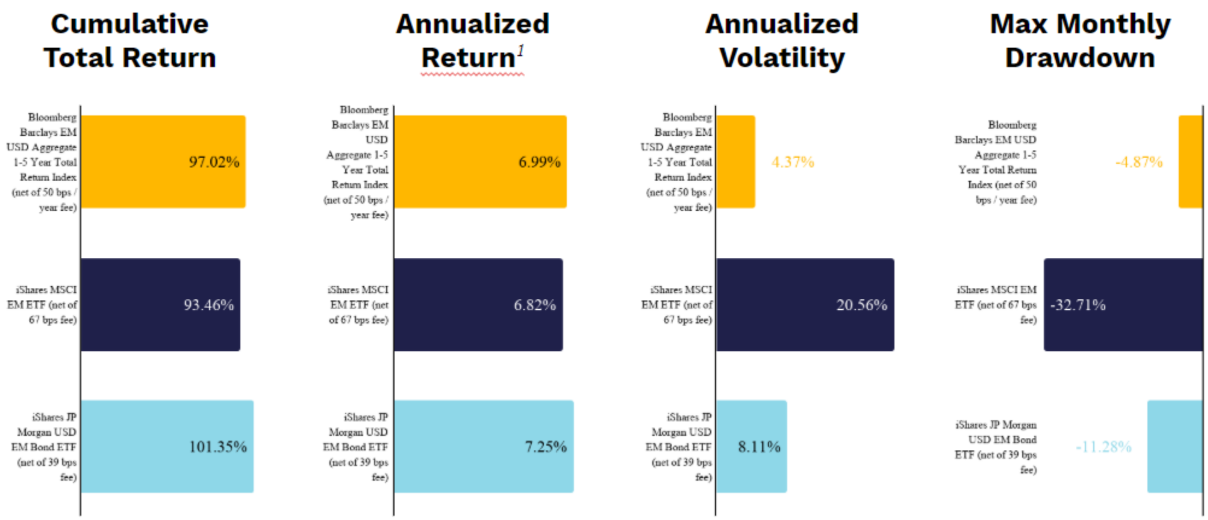
Our Benchmark

Taken together, we believe that these characteristics make the BEM5TRUU an attractive benchmark for an EM debt strategy. As noted above, it has had relatively low volatility as compared to the major EM and developed credit indices, it combines investment and non-investment grade debt (weighted average credit rating of BBB-), and it combines corporate, quasi-sovereign and sovereign instruments (73.96% corporate and quasi-sovereign and 26.04% sovereign).[6]

Despite its lower volatility, the BEM5TRUU has successfully produced annualized returns competitive with those of the largest EM bond ETF *and* the corresponding equity ETF. The below chart shows data for all three - the yellow bar represents the BEM5TRUU, the navy blue represents the main EM equity ETF and the light blue represents the EM bond ETF. Over the last 10 years, our benchmark (net of our minimum 0.50% fee) has generated a greater cumulative return than the EM equity ETF (outperformed by 3.56%) and trailed the EM bond ETF's cumulative return by only 4.33%, with significantly lower volatility and maximum drawdown.[7]

[6] Source: Bloomberg Finance, L.P. as of June 28, 2019

[7] Sources: iShares product website, all else: Bloomberg, all for Dec. 31, 2008 - Dec. 31, 2018. Past performance is not indicative of future results.
Indices are unmanaged and do not include the effect of fees. One cannot invest directly in an index. References to indices, benchmarks or other measures of relative market performance over a specified period of time are provided for your information only and do not imply that the Fund will achieve similar results.
50 bps is the base TER charged for the Aperture New World Opportunities Strategy when returns are at or below its benchmark (40bps management fee plus 10bps expenses). The Aperture New World Opportunities Fund (UCITS) has an inception date of Jan. 2 2019, and the Aperture New World Opportunities Fund (US mutual fund) has an inception date of March 18, 2019.



We believe that this benchmark not only offers an accurate representation of the beta to which our strategy is exposed, but that it represents many of the best credit instruments EM has to offer. At Aperture, clients only pay more than the fund's base fee when it outperforms its benchmark, so we believe that a relatively low-volatility benchmark like the BEM5TRUU is especially attractive to our clients.

Investment Strategies

We segment our portfolio into four distinct strategies:

1. Fundamental category reflects core longer-term credit and other positions
2. Relative Value segment contains strategic pair trades (long/short positions) across different asset classes
3. Technical Strategy is where we express short-term trades to take advantage of current market conditions
4. Special Situations includes positions which attempt to capitalize on idiosyncratic opportunities.

We layer 2, 3 and 4 over our Fundamental strategy in order to attempt to produce outperformance outside of our core benchmark replication process.

Why Now?

As the EM marketplace continues to evolve and grow, current valuations are creating compelling investment opportunities in many asset classes.

We believe EM hard currency bonds - the basis of our benchmark - are structurally cheap. In credit, persistent excess risk premium exists relative to credit and defaults. Between 2017 and 2018 A, BBB, BB and B corporate spreads have widened + 42bps, +78bps, +109bps, and +327bps respectively.[8]

As of the end of 2018, A, BBB, BB and B rated bonds within the EM corporate universe had excess spreads to US equivalents of 43bps, 56bps, 91bps, 328bps and 253bps respectively, shown below as the difference between the last two columns in the table.

Higher Risk Premiums versus DM equivalents [9]

Rating Segment	Duration US	Duration EM Corp	YTM US (%)	YTM EM Corp (%)	Spread US (bps)	Spread EM Corp (bps)
A	7.02	5.54	3.84	4.21	117.27	160.44
BBB	7.18	5.59	4.61	5.11	192.56	248.32
BB	6.61	4.61	5.47	6.36	279.00	370.08
B	3.67	3.57	7.08	9.17	331.41	659.94
CCC	3.42	3.71	9.81	11.59	649.38	903.10

In foreign exchange, we perceive a number of undervalued EM currencies on PPP and other theoretical bases. In EM equities, we perceive a combination of factors leading to undervaluation including currencies, multiples and earnings discounts.[10]

[8] Source: Bloomberg Barclays US Aggregate Index, Bloomberg Barclays US Corporate High Yield Index(B, CCC), iShares JPM EM Corporate Bond ETF, as of January 1, 2019
[9] Source: Bloomberg Barclays US Aggregate Index, Bloomberg Barclays US Corporate High Yield Index(B, CCC), iShares JPM EM Corporate Bond ETF, as of January 1, 2019
[10] Source: Bloomberg Finance, L.P.. Data as of December 31, 2018.
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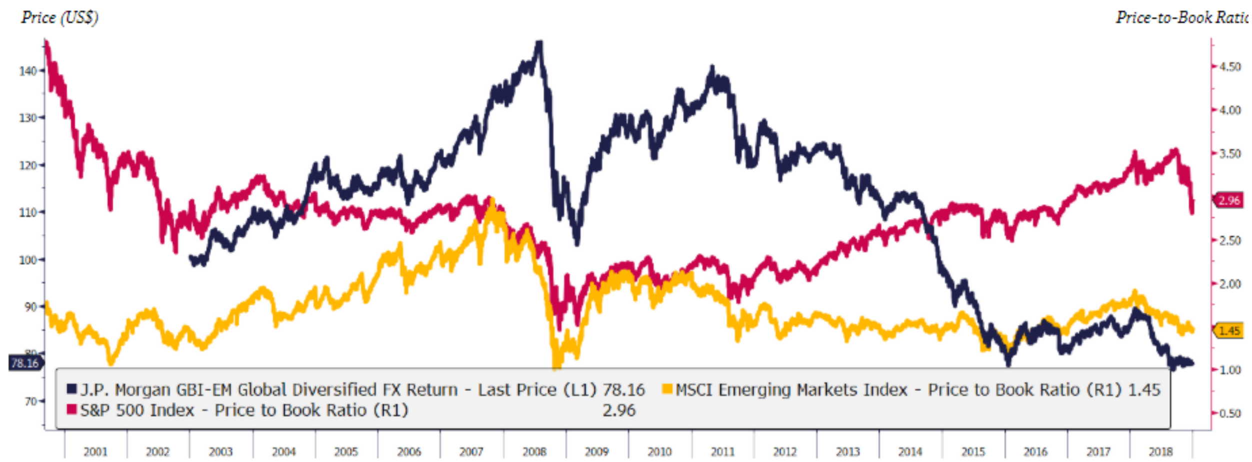
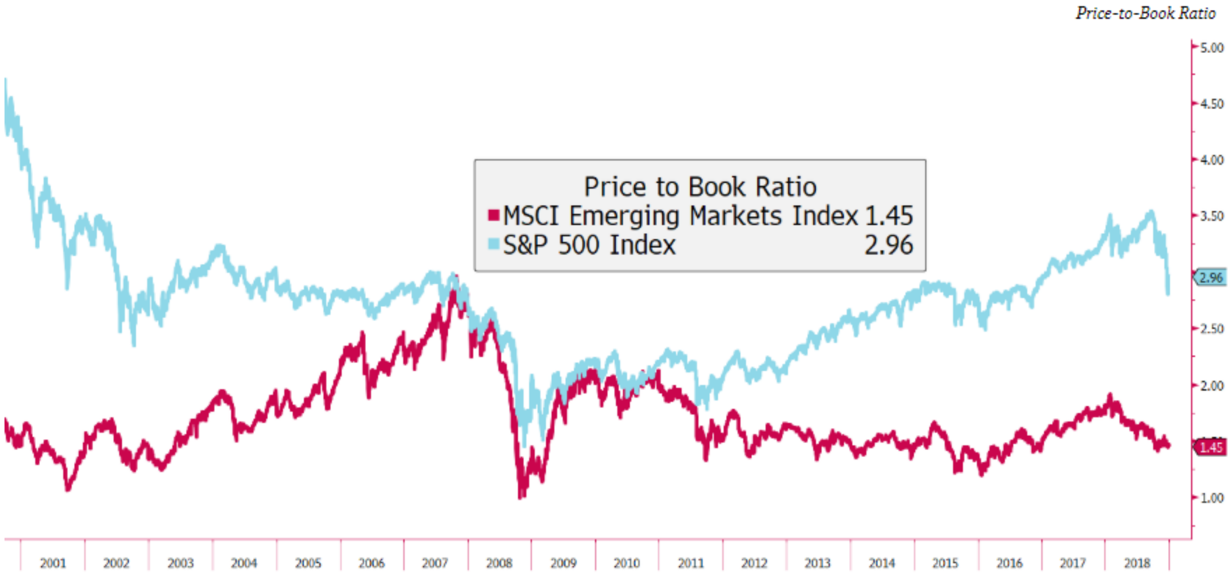


Relative to the S&P 500, the EM Price/Book ratio is back at 2004 levels:[11]

And on an absolute basis, the EM Price/Book ratio is back to 2003 levels while the S&P 500 is at post-crisis highs:[12]

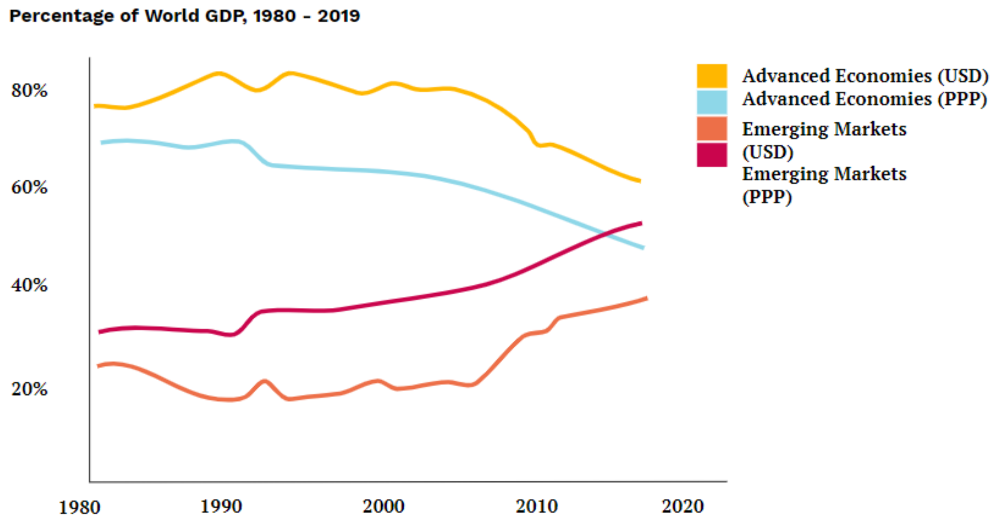
[11] Source: Bloomberg Finance, L.P. as of Dec 31, 2018.
[12] Source: Bloomberg Finance, L.P. as of Dec 31, 2018.



In the context of longer term historical trends, we believe that EM countries are now important engines of the global economy. For example, since 1980, EM's share of world GDP has gone from over 20% to almost 40% (or on a PPP basis, from over 30% to over 50%),[13] and the EM's financial assets have grown from less than 5% of the world's total in the 1980's to an estimated 30% through 2020.[14] Yet most investors remain significantly underweight these countries.[15]

[13] Source: World Economic Outlook, IMF as of December 31, 2018.
[14] Source: McKinsey Global Institute as of January 2012.
[15] Source: Vanguard Research as of September 2017

The Shifting World Economy



[16]

Conclusion

Interestingly, when I started investing in the late 1980s, many former Communist and Socialist countries were almost inconsequential to the world's economy. They were closed-off, and comprised less than a quarter of global GDP.[17]

A lot has changed. As capitalism spread, emerging market economies grew rapidly and their financial markets mushroomed. Emerging markets now represent more than half of the world's economic activity (see above). In my opinion, investment opportunities in these countries are now simply too big to ignore.

Emerging financial markets are still broadening and deepening, and I believe that today they remain less efficient than developed markets. Starting a portfolio based on low-volatility EM hard currency bonds, coupled with opportunistic positions in foreign exchange instruments, interest rates, and equities has the potential to generate equity-like returns with bond-like volatility.

We used to think that investing in emerging market countries was very risky. In my opinion, the biggest risk in emerging markets today is NOT investing in them.

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[16] Source: World Economic Outlook, IMF as of December 31, 2018.
[17] Source: World Economic Outlook, IMF as of December 31, 2018.