



Corporate Bonds – Ideal for Emerging Markets diversification

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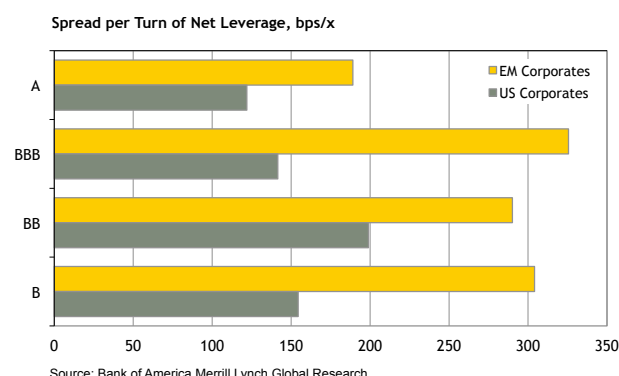
With sovereign ceilings rising, corporate governance and overall transparency improving, demand and liquidity high and returns attractive relative to risk, what's not to like about Emerging Markets corporate bonds?

Background of the asset class

Corporate bonds have an attractive long-term risk/return profile. Historically the asset class generates returns somewhere between equities and sovereigns but, in the past five (albeit exceptional) years and in a favourable environment of global deleveraging, it has far outperformed equities. Corporates are a long-established asset class in the US where they are the mainstay of many pension funds and the asset class is expanding rapidly. Post credit crunch, many companies have turned to the credit markets rather than the banks for funding. Thus it is that Emerging Markets corporates has grown into an asset class of its own.

In the Emerging Markets, credit markets are maturing just as rapidly as stock markets. Not only do EM corporates offer attractive diversification away from EM sovereigns and equities, they also currently offer very attractive return potential, compared with their US counterparts. As the chart below shows, EM corporates are paying more per unit of risk than US corporates across much of the credit spectrum. With the High Yield credit premium at 800 basis points and Investment Grade at 250

basis points, the willingness of investors to settle for historically low or negative interest rates from US and European 'safe' sovereign bonds is all the more surprising.



What makes these risk premia all the more attractive is the fact that default risk is lower on average in Emerging Market nations because of the corporate tradition of keeping debt levels low and cash levels high. The higher cash buffers in EM companies will also help them to withstand recession better and invest for growth as the recession ends.

Investment opportunities in EM bonds

As markets begin to mature and companies are able to demonstrate a history of debt repayment and creditor-friendly behaviour, so a value approach to corporate bond investment becomes possible. As with value equity investment, value bond investment means looking for pricing inefficiencies in the markets and investing with



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a 'margin of safety' which hinges on a low net-debt-to-equity ratio. Experience has shown that value and small-cap bonds in companies with low debts generate excess returns and therefore represent an identifiable alpha factor in the credit universe. This effect can be amplified in Emerging Markets. For example, we frequently find examples of smaller companies and value companies that are penalised by rating agencies for reasons totally unrelated to their ability to repay their debts. Also, the 'sovereign ceiling' effect has, in the past, meant that for some emerging market corporates, ratings are marked lower simply on grounds of the company's head-office location. However, given that Developed Countries' sovereign ratings seem to be on a negative trend - whereas we still expect positive rating actions among EM sovereigns - we would expect future convergence between the average ratings of the more mature Emerging Market countries with Developed Market countries.

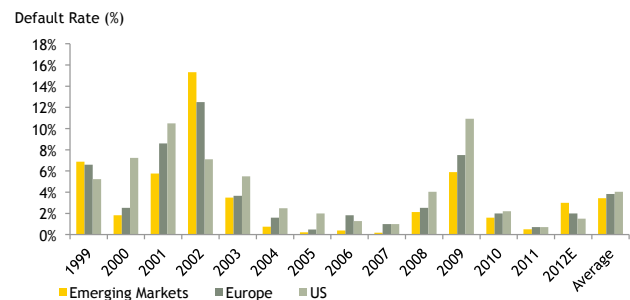
A value approach to corporate bonds seeks to identify 'overlooked' and under-rated companies that are forced to pay high yields while offering solid business models or assets or cash backing as a margin of safety for debt repayments.

Integrating SRI/corporate governance information

SRI and corporate governance insight is as important to fixed income investors as it is to long-term equity investors because any risk that might erode a company's future profitability is also a threat to its capacity to repay debts. Corporate governance is known to be weaker in Emerging Market companies - although it is improving - and this is one of the reasons that EM corporates need to pay higher yields. Thus a thorough analysis of corporate governance should be included as an essential step in the corporate bonds investment process. Failure to consider environmental, social and governance risks can expose investors to large 'tail risk' like litigation risk or the risk of large lawsuits arising from - for example - environmental disasters. Rule of law and property rights are also an important consideration. For example the Mongolian Government has made a 'National List' of resources and sectors of strategic importance. This type of action could end up in assets being expropriated from companies - which may involve a significant headline risk for their debt holders.

What is the outlook for EM corporate bonds?

The pace of economic growth has been slowing in the emerging market economies. But this is potentially good news for credit investors. For a start, the extreme pace of economic growth was starting to cause problems for companies - such as increasing salary costs, increasing inflation affecting raw material prices and decreasing global competitiveness. But in general, lower growth scenarios favour corporate bond investors because they force companies to focus on profitability and careful, organic growth rather than on leveraging up their balance sheets and taking risks. For these reasons and because of the strong cash levels in EM corporates, we expect the default rate, which is already lower on average than in developed markets over the past decade to retain that advantage over the coming years.



Source: Standard & Poors and JP Morgan

Sparinvest Emerging Markets Corporate Value Bonds

Sparinvest Emerging Markets Corporate Value Bonds was launched on 15 September 2010 and, despite large global macroeconomic fluctuations, it has delivered a return that places it as one of the best best-performing funds, investing solely in emerging market corporate bonds

The fund follows a bottom-up 'Value Bonds' investment strategy, meaning that it seeks to exploit identifiable alpha factors within the corporate bond credit premium. The Value Bonds team has adhered to the investment process since 2005 with a focus on companies' financial statements, the assets and strong loan documentation. Restrictive clauses in bond documentation is given high priority in the Value Bonds investment process and helps to ensure that the company acts in a way that



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– to a sufficient degree - places limits on the its future operational risk and thus reduces the credit risk in our investments.

Value companies issuing debt are typically punished for being less visible than other companies. These companies are forced to pay a higher interest rate compared to the credit risk investors assume. The use of value factors for investment in corporate bonds has been shown to generate a higher return to investors and to keep the number of bankruptcies lower than the average credit market.

Sparinvest Emerging Markets Corporate Value Bonds continually seeks to achieve attractive long-term returns for our investors. We carefully analyze any risk element before the final investment decision is made. Thus the portfolio managers actively optimize the risk-return profile through a Value Bonds bottom-up investment process, which is reflected in the over- and under-weights across countries, regions, sectors and rating classes.

Seizing the opportunity of market mispricing

For example, during the third quarter of 2011 when the bonds of Chinese industrial companies were unpopular and trading at favourable prices, the fund's managers increased the weighting of China from 4% to 10%. Through the first half of 2012, profit was taken on a few positions, and the exposure to investment-grade bonds was increased from 6% to 15%, particularly through a range of attractive new issues. The fund's underweight relative to benchmark of investment grade bonds is a natural consequence of the investment strategy in Value Bonds, which avoids bank capital in emerging markets because of the strong lending growth relative to deposits inflow. This and the combination of a red-hot housing market including Brazil and China, and the lack of transparency in banks' loan books, are factors that are weighted negatively in Value Bonds process. However, the fund remains overweight in energy and raw materials, where investors among other things benefit of pledges in assets such as oil rigs and mines.

Country risk is a natural part of the Value Bonds team's risk-return analysis of new and existing investments. They seek to enhance investor protection by investing in

bonds issued with New York Law loan documentation. This, among other things, requires companies to report in accordance with international accounting practices. Finally, they achieve international settlement rules - ie no local settlement risk- At the same time, the risk of local currency is limited, with minimum 90% of the currency exposure is hedged against euro.

The fund currently offers an attractive yield-to-maturity relative to its benchmark. The focus on companies with a conservative investment strategy, focus on profitability and strong balance sheets makes Sparinvest Emerging Markets Corporate Value Bonds attractive to investors.

More information about the fund is available at sparinvest.eu.