INVESTMENT EXECUTIVE
CANADA'S NEWSPAPER FOR FINANCIAL ADVISORS

Emerging-markets bonds an option

But high volatility, interest rate risk and default risk must be considered

October 2010 Print Edition

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With interest rates having plummeted to new lows, it's challenging for financial advisors to find investments that offer higher yields. Based on an analysis of emerging-markets bond performance (in Canadian dollars) conducted by my firm, **Tacita Capital Inc.** of Toronto, this is an asset class that deserves some consideration. But important caveats are in order.

EM bonds are primarily composed of the sovereign debt of EM countries located in Africa, Asia, eastern Europe, the Middle East, and South and Central America. Although bond issues denominated in local currencies now dominate this asset class, the majority of investment managers focus on the more liquid, U.S. dollar-denominated issues.

EM bonds — as measured by performance of the Barclay Capital EM index from Jan. 1, 1993, through July 31, 2010 — have been a winning asset class, with an annualized compound rate of return of 10.4%.

This return outperformed all the major indices, including the 9.7% and 7.6% returns of the S&P/TSX composite index and the DEX universe bond index, respectively.

Advisors attracted to these historical returns should understand that future returns are likely to be much lower. A unique combination of falling interest rates and improving economic fundamentals in developing countries had lifted returns to atypical highs. EM bond yields have plunged to recent near-record lows, in the 5.4% range, from double-digit levels.

It's important to note that EM bonds have had a moderate correlation of 0.41 to Canadian bonds. The Barclay Capital EM index also has had a correlation of only 0.32 with Canadian stocks and of

0.43 and 0.34 with the S&P 500 and MSCI EAFE indices, respectively. The Barclay Capital EM index's correlation with EM stocks, as measured by the MSCI emerging markets index, was only 0.50. These correlations have tended to increase, albeit modestly, over the past decade.

Unfortunately, this diversification effect comes at a price: high volatility. The annualized standard deviation of EM bonds 13.5% — almost three times more volatile than Canadian bonds. EM bonds have suffered eight drawdowns in excess of 5%, a much more painful experience than the three drawdowns experienced by Canadian bonds. In fact, the volatility of EM bonds has exceeded that of high-yield bonds.

You need to consider two other factors. There is considerable interest rate risk associated with EM bonds today. The duration of the Barclay Capital EM index is 6.7, so any meaningful rise in rates will be painful.

Also, you need to consider whether today's yields compensate clients enough for default risk.

The Barclay Capital EM index includes bonds issued by prior defaulters, including Russia, Argentina and Venezuela.

Overall, in a series of optimization runs performed by Tacita, EM bonds earned only a modest role within the fixed-income component of portfolios. Essentially, at today's lower yields, the higher volatility of EM bonds limits their allocation despite their moderate correlations to other bond and stock indices.

Until recently, you could access EM bonds only through exchange-traded funds in the U.S. However, Toronto-based **BMO Asset Management Inc.** has just launched BMO Emerging Markets Bond Hedged to CAD Index ETF, which replicates, to the extent possible, the performance of the Barclays Capital EM tradeable USD sovereign bond index CAD hedge.

Advisors who prefer active management can access another recent launch: RBC Emerging Markets Bond Fund, managed by Toronto-based **RBC Asset Management Inc. IE**

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