INVESTING IN EMERGING MARKET DEBT: WHAT SOLUTIONS?

- In a backdrop that sees European investors faced with the low and sometimes negative yields offered by sovereign bonds, one segment is standing out particularly well within the bond universe: that of emerging market debt. The market is a fully-fledged asset class, offering attractive yield potential, in both relative and absolute terms, as well as good diversification capacity.
- Romain Bordenave and Jean-Jacques Durand, both Emerging Debt and Currencies Managers at Edmond de Rothschild Asset Management, provide us their view of emerging market debt and the approach they favour to take positions in it.

JEAN-JACQUES DURAND

ROMAIN BORDENAVE
Emerging debt and currencies managers

INTERVIEW

What arguments currently play in favour of emerging market debt?

Diversifying investments is a real challenge and there are only very few opportunities at present. We need to look for risk in order to benefit from more attractive yields than those offered by developed markets.

In a backdrop of monetary tightening, bonds with the lowest yields are likely to suffer the most. In the case of emerging debt, assets currently harbour healthy fundamentals and upside potential, backed by more attractive valuation levels. We have positive forecasts for this market: growth is robust and the level of debt remains stable at around 50%. The impact of high 10-year US yields and the strong dollar, both of which tend to weaken the emerging bond class, should stabilise over the year.

The emerging sovereign bond market has witnessed clear growth thanks especially to the improvement in ratings of several economies in the zone. Increased interest and trust from international investors for this market has helped transform this niche category into a fully-fledged asset class. The market offers opportunities to diversify from traditional bond investments and opens up new prospects for investors only owning sovereign bonds from developed countries. Despite a difficult year in 2018, we are confident in the potential of the asset class in 2019. Note also that since 1991, hard currency emerging debt has not performed negatively two years in a row.

What expertise does Edmond de Rothschild Asset Management have in emerging market debt?

Edmond de Rothschild Asset Management has almost 20 years of expertise in the emerging markets segment. This expertise represents almost €2 billion in total assets under management, with a comprehensive range covering a wide market spectrum. The largest is the EdR Fund Emerging Bonds (around €445 million[1]), managed by our team since 2011. This is a conviction based fund that is able to stand out considerably from its benchmark index, while using the investment grade to high-yield rating spectrum and looking for high-potential shares in particular. The latest fund in the range is also specialised in emerging markets debt, EdR Fund Emerging Sovereign, the objective of which is to maintain a similar investment philosophy, but with a less aggressive profile, thereby aiming to limit risks.

SINCE 1991, HARD CURRENCY EMERGING DEBT HAS NOT PERFORMED NEGATIVELY TWO YEARS IN A ROW

Your expertise in emerging markets debt is focused on two funds: EdR Fund Emerging Bonds and EdR Fund Emerging Sovereign. What are the specific features of each fund?

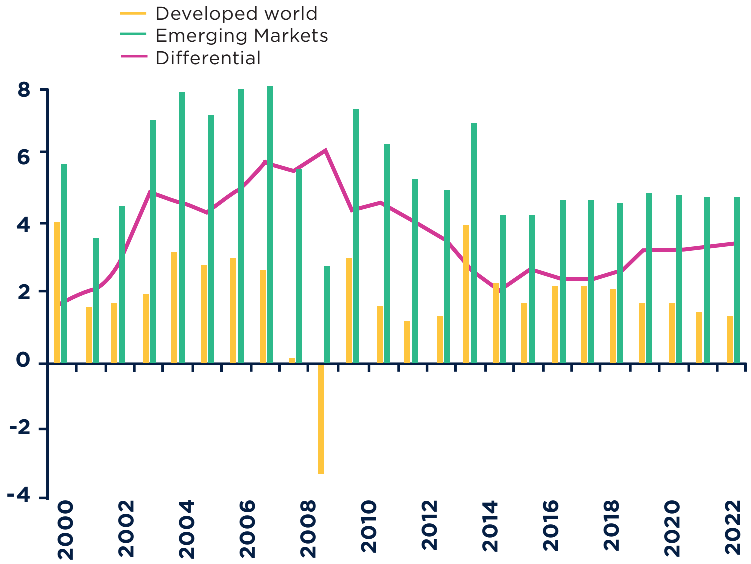
For both funds, EdR Fund Emerging Bonds and EdR Fund Emerging Sovereign, we have a flexible and opportunist approach. Emerging market debt offers a huge investment universe helping to diversify sources of performance. As such, we can invest in debt in hard currencies, in local currencies, in currencies and in sovereign, quasi sovereign and private issuers. Both funds are nevertheless primarily invested in sovereign and quasi-sovereign debt in hard currencies, given the very wide diversity of instruments in this category.

One of the strengths of the EdR Fund Emerging Bonds is its ability to distance itself significantly from the make-up of major emerging market debt

KEY POINTS

- **Two bond funds from the emerging markets universe, with the objective of making the most of the diversity and potential of these markets.**
- **A constantly increasing variety of issuers offering new diversification opportunities.**
- **Opportunist management, for which the guiding principle is conviction.**
- **Emerging markets can prove volatile and less liquid than developed markets.**
- **Investing in these funds presents the risk of capital loss.**

GROWTH IN EMERGING MARKETS VS. THE DEVELOPED WORLD



Source: Edmond de Rothschild Asset Management - Bloomberg - Morgan Stanley. Data as at 31/10/2018.

indices and to make clear choices on investment cases, sometimes contrarian to the market consensus. A benchmarked management approach is not suited to this asset class due to the biases noted in the indices. We believe it is important to affirm clear and long-term convictions. In this market, outperformance plays every year in certain specific cases that we need to be able to identify.

TURKEY, ARGENTINA AND UKRAINE ARE CURRENTLY AMONG OUR STRONGEST CONVICTIONS

The objective of the EDF Fund Emerging Sovereign is to maintain a similar management philosophy, but with a less aggressive approach, aiming to limit market shocks. As such, we are ruling out the CCC category of the high-yield credit spectrum, which provides better amortisation of specific shocks, while maintaining a sufficiently vast investment universe. Associated with a precise risk-control process, this stance provides the fund a risk-return profile that is half way between emerging debt indices and the EdR Fund Emerging Bonds fund.

The EdR Fund Emerging Sovereign is your latest creation: what are your main current convictions for the fund?

The EdR Fund Emerging Sovereign portfolio is currently based on three major convictions, each representing around 10% of the allocation.

Our main position is Turkey. Macro-economic factors are favourable, especially inflation, which is set to fall in 2019 and a banking system that remains robust. The Turkish economy is well diversified, with a net debt/GDP ratio that remains low and relatively well controlled budgetary spending. Political risks seem to have calmed with Turkey pursuing its discussions with the US and the European Union. Finally, the valuation of its sovereign debt is generally attractive.

Our second conviction is located in South-America and is Argentina. Since the local government is extremely market friendly and is backed by the IMF, the country is a significant contributor to GDP in the region, such that our local exposure is currently at 10%. We are also 4% exposed to the Argentine pesos.

Finally, Ukraine is also a strong conviction. The country has substantial support from western countries and from the IMF. The reforms initiated under this framework are contributing to the gradual recovery of this economy and should resist coming elections.

Our convictions do not only concern investment in sovereign bonds, but also investment in local currencies, currently for around 10% of the portfolio and primarily in Argentine pesos, Mexican pesos and the Turkish lira, with the rest invested in hard currencies.

Aware of a number of risks in these markets, especially concerning the Chinese-US trade war, we maintain a liquidities segment, currently at around 20%, and have implemented hedging. We are maintaining this defensive approach, which does not nevertheless undermine our vision of the asset class and our convictions. This offers us an ability to seize opportunities in the event of significant market move.

1. Data at 28/02/2019

GLOSSARY

- **High-yield: bonds issued by companies that have a higher default risk than investment grade bonds and offer a higher coupon in exchange.**
- **Investment grade: bonds issued by companies for which the default risk varies from very low (almost certain redemption) to moderate. They correspond to a rating of AAA to BBB- (Standard & Poor's scale).**
- **Hard currency debt refers to bonds denominated in benchmark currencies, globally exchanged on forex markets. These are mostly the US dollar and the euro.**
- **Local currency debt refers to bonds denominated in the national currency of the issuing company.**

FUND INFORMATION*

Inception date: 21/12/2018

ISIN Codes:
A Share: LU1897613763
I Share: LU1897614902

Maximum management charges:
A Share: 1% TTC
I Share: 0,40 % TTC

Variable management fees: 15% of performance in excess of the benchmark.

Minimum initial subscription:
A share: 1 share
I share: 500 000 €

Front load charge:
A Share: 1% max
B Share: 3% max
I Share: None

Redemption charge: None

Benchmark: JP Morgan EMBI Global Diversified ex CCC Index (EUR hedged)

Recommended investment horizon:
> 3 years

* Shares described herein are the main euro-denominated Shares. Please ask your sales contact or refer to the prospectus to have details concerning all the fund shares available.

PRINCIPAL INVESTMENT RISKS

The fund is classified in category 5 in line with the nature of securities and geographical zones in the "objectives and investment policy" section of the key investor information document (KIID).

The risks described below are not exhaustive: it is the responsibility of investors to analyse each investment's risk and to come to their own opinion.

Risk of capital loss: The Fund does not guarantee or protect the capital invested, and there is a risk that the capital invested will not be returned in full. Unitholders are advised that the performance objective is provided for information only and does not in any way constitut an obligation for the management company to provide results.

Credit risk: If a credit event occurs (for example, a significant widening of the remuneration margin of an issuer compared to a State bond with the same maturity), or a default or downgrading of the quality of bond issuers (for example, a downgrading of their rating), the value of the debt securities in which the Fund is invested may drop, and cause the Fund's net asset value to fall. The use of high-yield securities up to a 100% limit of the Fund's net assets may result in sharper falls in net asset value, and such securities can present a greater risk of default. This Fund must therefore be considered as speculative, and is specifically intended for investors who are conscious of the risks inherent in investing in securities whose rating is low or non-existent.

Credit risk from investing in high yield bonds: the fund may invest in government and corporate rated as non-investment grade by a rating agency (i.e. rated below BBB- by Standards and Poor's or an equivalent rating from another independent agency) or considered as equivalent by our investment company. These issues are so-called speculative debt securities with a higher risk of issuer default. The fund must be viewed as partly speculative and concerns in particular investors who are aware of the risks inherent in these securitiesConsequently, investing in high yield securities (speculative securities which have a higher default risk) may entail a bigger fall in the fund's net asset value.

Interest-rate risk: Interest-rate risk is the risk that bond-market rates may increase, thereby causing bond prices to fall and reducing the Fund's net asset value. A rise in interest rates may negatively affect performance for an indefinite period; similarly, if the portfolio's sensitivity is negative, a drop in interest rates may have a negative impact on performance for an unspecified period. This phenomenon may cause the net asset value to fall. Such interest-rate risk may cause the net asset value to fall.

Exchange rate risk: Assets may be exposed to exchange rate risk when currency exposure of certain assets of the relevant Sub-Fund into another currency.

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