VIEWPOINT

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For Professional Clients and, in Switzerland, qualified investors

THE QUEST FOR HIDDEN VALUE

Three years from its launch, Insight's emerging market corporate debt strategy continues in its aim of unlocking value in some of the world's most exciting markets. Here, Colm McDonagh (head of Emerging Markets Fixed Income) and Rodica Glavan (Emerging Market Fixed Income portfolio manager) explain the investment process and why they believe the strategy is as relevant today as it has ever been.

"Whenever you find yourself on the side of the majority, it's time to pause and reflect." So said Mark Twain in a passage discussing the wisdom – or lack thereof – of crowds. For Insight's emerging market corporate debt team, Twain's comments serve to illustrate the proposition of investing in corporate debt issued by companies in often overlooked or unloved regions. By doing so, they argue, investors have a real chance of discovering opportunities unrecognised by the wider market.

In line with this philosophy, the BNY Mellon Emerging Markets Corporate Debt fund has established a track record of taking active and off-benchmark positions in some of the more interesting parts of the corporate debt universe. On a country basis, the fund's largest overweights (relative to the JP Morgan Corporate Emerging Bond Index) are to Indonesia (4.1% overweight versus the comparative index) and to Morocco (4.5% overweight). The Dominican Republic (2.3% overweight) and South Africa (3.8% overweight) are also large relative positions. In the same vein, the fund is currently more cautious about its exposure to the traditional big names in emerging markets. It retains an underweight to all the BRICs countries versus its comparative index, including Brazil (6.3% underweight), Russia (3.3% underweight), India (3.4% underweight) and China (6.9% underweight). [1]

The same active bias is evident in sector exposures too. Overweights include the consumer and industrial sectors, where, in each case, the fund is just shy of double the exposure of the benchmark. Likewise, in a wholly off-benchmark position, close to 10% of the fund is invested in Sovereign debt. Financial services holdings in the portfolio come in at less than a third of the equivalent weighting on the comparative index. [2]

As McDonagh says, and as these active positions indicate, this is not your run-of-the-mill index-tracking corporate debt fund.

THE INVESTMENT PROCESS

When looking to initiate new positions, the investment team starts with a top-down, macroeconomic assessment. This is important, says McDonagh, since "no matter how good a corporate is, if the macro environment is deteriorating, it's going to have a

In a nutshell:

A fund that scours emerging markets for opportunities to invest in attractively priced corporate debt. Head of Emerging Markets Fixed Income Colm McDonagh argues the recent sell-off in emerging markets has been indiscriminate, creating hidden pockets of value for those who know where to look. "In our view, the entire asset class has been tarred with the same brush," he says. "We believe it's important to take a more selective approach and drill below the surface."

[1] All fund data BNY Mellon, 31 January 2015.
[2] Ibid.

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negative impact on corporate bonds from that jurisdiction". Accordingly, the team has a shortlist of countries where governments are implementing reforms and where economic and political developments are creating the right environment for companies to thrive.

The next step is to consider which companies within those countries are well placed to be able to service fully their debts. This involves fundamental analysis of cash flows and balance sheets as well as consideration of industry sectors. As an example, Glavan points to the fund's recent investment in Colombian energy business Pacific Rubiales, whose credit was sold off as the oil price collapsed towards the end of 2014, despite the country's strengthening macroeconomic backdrop. Here, says Glavan, the investment team modelled how the company's revenues would be affected by a range of pricing bands for black gold. They concluded covenants were unlikely to be breached even at US$55 a barrel and decided investors were being adequately rewarded for any default risk.

Finally, the team has an established set of criteria for assessing companies on the point of entry into a trade. Companies need to be of a sufficient size (nothing less than US$300m market capitalisation) and they need to provide evidence of sufficient transparency and legal structures. Says Glavan: "We believe this rigorous approach provides an element of downside protection even in falling markets."

This is not to say the team only invests in countries where the macroeconomic backdrop is improving. One case in point is in Russia, where the conflict in the Ukraine, international sanctions, the faltering oil price and a weakening rouble have come together to create an ostensibly dismal investment climate. But here too, McDonagh believes there are hidden pockets of value.

One example he points to is Russian telecoms firm VimpelCom, which in February sold its 51% stake in an Algerian subsidy for US$2.6bn. He explains: "The presence of such a large dollar sum on Vimpelcom's balance sheet acts as a hedge against a decline in the rouble and offsets the currency risk of the company's US-denominated debt. Just because a Russian company borrows in dollars it doesn't necessarily follow it will default if the rouble weakens."

Indeed, this theme, of companies with dollar assets or revenues, is one the investment team actively pursues. Glavan highlights Brazilian beef producers Minerva, JBS and Marfrig as a case in point. All have a domestic cost base, but all export their beef to the US and so book US dollar revenues. This means they actually benefit from a decline in the Brazilian real but are also well positioned, due to their US revenues, to service their US dollar-denominated debt as well.

PERFORMANCE

As at 28 February 2015, the fund had produced a cumulative return of 22.13% since launch. This was ahead of both the comparative index (the JP Morgan Corporate Emerging Market Bond Index, which returned 20.54% in that timeframe) and the sector average, which returned 12.17%. On an annualised basis the fund has returned 6.71% since launch, versus 6.25% from the comparative index and 3.73% from the peer group average.[3]

RECENT DEVELOPMENTS

Towards the end of 2014, the team moved the fund towards a more cautious stance, reducing risk exposures and increasing the cash position to around 10%. From the start of 2015, however, the stance was reversed as the investment team began to identify new opportunities.

Say McDonagh: "Between year-end and the end of January we ran the numbers on emerging market oil and commodities names. Specifically we were looking for companies whose credit is mispriced; who were punished more than they should have been."

One investment in this field was Colombia's Pacific Rubiales, a second was in China's state-owned oil company Sinopec. In the commodities space, meanwhile, the fund initiated a holding in Morocco's state-run phosphate monopoly Office Chérifien des Phosphates (OCP). In 2014, the company, which controls a third of the international market for phosphate, raised US$1.55bn in its debut international bond sale. The company said the capital will be used to increase its output of phosphate rock to US$17bn by 2020.[4]

Looking forward, the investment team believes global markets will experience continued volatility, at least until commodities stabilise, global currency volatility

[3] Source: Lipper as at 28 February 2014. Performance is shown for USD C unless otherwise stated. Total Return, including ongoing charge, but excluding initial charge, net of performance fees income reinvested gross of tax, expressed in share class currency. The impact of the initial charge which may be up to 5% can be material on the performance of your investment. Performance figures including the initial charge are available upon request. Performance for the USD C share class prior to its launch date on 02/03/2012 is for the USD X share class adjusted to reflect the difference in annual management charge. The USD X share class launched on the 31/01/2012.

[4] Reuters: *Morocco's state phosphate firm's profit falls as prices drop*, 15 September 2014

plays out, and US economic data gives a much clearer picture on when the Fed will start raising interest rates.

Meanwhile, with less positive sentiment towards emerging markets as a whole, McDonagh believes market scrutiny towards country fundamentals will intensify, making country differentiation one of the most important themes in 2015. Nonetheless, and despite recent selective forays into, in his view, undervalued oil and gas assets, McDonagh retains something of a wait-and-see stance on future opportunities. He explains: “The market seems to be concentrating on the negative effects of lower oil prices at the moment, including the disinflationary influence as well as lower fiscal and external balances for oil exporters. But, at some point, the benefits of lower oil prices will need to be acknowledged as well, including improved global consumption and a possible delay in Fed rate hikes. We are therefore aware of these potential opportunities in 2015.”

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