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Commentary: Why not try a better approach to emerging markets debt?

By ROBERT KOENIGSBERGER

For several years, investors have been disappointed when investing in indexes related to emerging markets, continuing to repeat past mistakes. At the same time, investors have been shifting their approach to investing in developed markets fixed income. By adding opportunities in private credit in developed markets, they have managed to unlock more promising returns.

So why hasn't this same strategy spread to emerging markets debt? Rather than evolve, emerging markets debt has been languishing in an outdated approach that has often failed investors in terms of both returns and risk, casting a negative cloud over the asset class.

It's time to abandon this old approach and apply successful developed-markets insights and practices to emerging markets debt.

Questions have been swirling around the asset class recently, given wide-ranging tariffs promised by President Donald Trump and the strengthening dollar — factors that have once again negatively impacted the indexes. Yet, the traditional case for emerging markets remains valid.

Robert Koenigsberger said the question he hears the most from investors is whether China is investible.

Compared to their developed market counterparts, emerging economies enjoy higher growth, lower debt ratios, and higher spreads relative to leverage.

More importantly, since the turn of this past century, emerging markets debt has offered larger returns, better Sharpe ratios (returns relative to volatility) and higher yields. The disconnect between these higher returns and the experiences of many emerging markets investors are explained by more than oversimplified investment approaches that relied on distorted and misleading indexes. They have also involved repeated behavioral mishaps that are akin to taking a myopic, musical chairs approach to emerging markets debt investing instead of establishing a more nuanced investment framework. Passive investing and closet-benchmark-tracking have forced too many investors to own shaky names resulting in unbalanced portfolios that are subject to significant downside risks.

When Gramercy Funds Management launched in 1998, Argentina constituted 18% of the emerging markets bond index (EMBI), forcing passive investors and closet index chasers to place a fifth of their money in a country that was widely seen as default prone. More recently, in 2022, the same index forced investors to own a considerable amount of Russian and Ukrainian bonds on the eve of the Russian invasion. Emerging markets debt indexed-based investing has done more damage to emerging markets debt investors than any other factor. Rating agencies assigning high ratings to those credits exacerbate the problem by lulling investors into a false sense of security.

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No wonder the dedicated asset class saw outflows of almost $20 billion in 2024, a year of record investments of over $1.2 trillion into fixed-income funds globally, according to figures from J.P. Morgan. This phenomenon is even more striking given that, on a stand-alone and repeated basis, emerging markets bond issuers consistently benefited from massive over subscription due to crossover funds seeking attractive off-benchmark opportunities in owning emerging markets. Still, even this more opportunistic approach falls short of unleashing the significant potential of this asset class.

Higher returns, and less risk, is possible in emerging markets

This "better approach" focuses on capturing the high returns available in emerging markets debt by securing the significant upside and materially reducing the threat of non-recoverable mistakes. It explicitly distances itself from the volatility markets have seen recently, and from the missteps that have left investors disillusioned with the emerging markets debt asset class as a whole.

For one thing, dollar-denominated loans can all but eliminate currency risk from the strengthening dollar, while heavily covenanted loans with hard collateral can protect investments against Trump tariff-related pressures. Instead of blanket investments in this complex environment, country-by-country, company-by-company analysis is key to identifying specific opportunities.

This approach is then anchored by a barbell strategy, where the left side is dominated by carefully structured and secured single best ideas in private and public credit in emerging markets. In addition to the direct benefit of high-quality yield, this carry also permits investors to hold on allocating to the other side of the barbell, which is more risky credit and special situations exposure, until these opportunities present themselves in a compelling fashion. The overall portfolio strikes the right balance in achieving good upside/downside capture features, allowing investors to combine both strategic and opportunistic exposures in a highly selective manner that emphasizes careful security selection and both correlated and uncorrelated collateral.

What it takes to implement

The implementation of this approach, anchored by strong, active emerging markets debt capabilities, also requires a "special sauce" of private credit in emerging markets. This resembles direct lending in developed markets 15 years ago — that is, offering high, risk-adjusted returns and low leverage. Like developed markets, private credit in emerging markets should serve as a good complement, and often substitute, for both traditional emerging markets debt and emerging markets equity allocations. The sacrifice of liquidity that it entails turns out to be more perceived than real. After all, if an investor intends to have a medium to long-term allocation to emerging markets debt, then why suffer the opportunity cost of 500-1000 basis points that comes with the notion that all of the portfolio must be in public market securities, let alone the inferior credit metrics and bespoke structuring?

Emerging markets investors have been stuck with an old investing approach for too long. The alternative hybrid approach, which combines high-conviction private credit and public credit, has seen developed markets investors continue to flock in that direction. It can also work in emerging markets if investors both shed old mindsets and look to expand their horizons and capabilities.

Now is the time for savvy investors to start benefiting from this better approach to emerging markets.

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