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Investing

Emerging markets bonds gain more institutional fans

By Thao Hua

Emerging markets debt is hitting record inflows as institutional investors turn to developing nations to bolster fixed-income returns.

So far this year, emerging markets bonds have attracted \$12.8 billion, about 60% more than the \$8 billion recorded for all of last year.

This year's inflows also surpassed the previous annual record set in 2005, when emerging markets bond strategies attracted a total of \$9.7 billion in assets, according to Cambridge, Mass.-based industry data provider Emerging Portfolio Fund Research Inc.

"This is a group of countries with relatively strong balance sheets offering attractive levels of yield," said Michael Gomez, executive vice president and co-head of the emerging markets portfolio management team at Pacific Investment Management Co. based in Munich. "Pension funds are recognizing that."

Kevin Daly, emerging markets debt portfolio manager at Aberdeen Asset Management based in London, added: "The perception in the past has been that emerging markets bonds are too risky, but that's changing. There's a growing realization among investors that fiscal and monetary reforms in some of these nations have improved dramatically."

A flood of new issues and relatively weaker economic outlooks have had the opposite effect in some developed countries. Greece's government bonds were downgraded to junk status by Standard & Poor's last week, while emerging markets such as Brazil have seen credit ratings climb in recent years. By September 2009, all three major credit rating agencies — S&P, Fitch Ratings and Moody's Investors Service — had rated Brazil the lowest investment grade at BBB- up from BB+.

Many other developing countries have had credit upgrades in the past several years. S&P, for example, moved China up to A+ from A in 2008.

"The fundamentals of issuers in some emerging markets are a lot better than some of those in developed markets," said Cameron Brandt, global markets analyst at EPFR Global. "Investors are also diversifying away from U.S. (government bond) exposure as a way of hedging against a widely predicted weakening of the dollar compared to emerging markets currencies."

"Yield hunger is certainly another factor."

Outperform Treasury bonds

In the one-, three- and five-year periods ended March 31, the U.S.-dollar denominated J.P. Morgan Emerging Markets Bond Index Global index outperformed U.S. Treasury bonds by 30.3 percentage points, 1.25 percentage points and 4.1 percentage points, respectively, on an annualized basis. The J.P. Morgan Government Bond Index-Emerging Markets Global Diversified index, which is denominated in local currency, returned 37.81 percentage points, 5.5 percentage points and 6.9 percentage points above



CHANGING: Kevin Daly said the perception that emerging markets debt is too risky is no longer true, thanks to a host of both fiscal and monetary reforms.

U.S. Treasury bonds on an annualized basis for the same three periods.

(Investment-grade issues make up more than 50% of the J.P. Morgan EMBI Global, according to data from J.P. Morgan Chase & Co., New York.)

"In general, we see potential in emerging markets, and are no doubt looking into whether to increase our allocation," said Anders H. Svennesen, vice president and beta portfolio manager at ATP, Hilleroed, Denmark, which had total assets of about 417 billion Danish kroner (\$73.9 billion). According to the pension fund's annual report for the year ended Dec. 31, its emerging markets bond portfolio returned 35.7% for the year.

"It was an exceptional year for emerging markets bonds in 2009," Mr. Svennesen added.

ATP started investing in emerging markets bonds in 2001, gradually increasing the allocation that now accounts for 1.3% of total assets and 2.5% of the portfolio's risk allocation. PIMCO manages about 60% of the emerging markets bond portfolio, and the remainder is managed by Stone Harbor Investment Partners LP, New York. ATP is invested in both dollar-denominated and local currency paper.

Leen Meijaard, managing director and head of institutional business for Europe, the Middle East and Africa at BlackRock Inc. in London, said the heightened interest in emerging markets bonds follows a similar institutional pattern in emerging markets equity. Mr. Meijaard estimated BlackRock has won between five and 10 mandates so far this year, averaging \$50 million to \$150 million each.

Emerging markets inflows

Other managers reporting increasing inflows in emerging markets bond strategies include:

- PIMCO managed \$36 billion in dedicated active emerging markets debt strategies as of March 31, a 44% increase from the \$25 billion recorded a year ago. The figure does not include emerging markets bonds invested as part of global bond strategies, which on average have increased to a range of about 8% to 10% from about 4% to 5% five years ago, according to Mr. Gomez.

- Stone Harbor's assets under management in emerging markets bond strategies increased more than 50% in the year ended March 31 to \$13 billion from \$8.3 billion. Another \$2.6 billion is committed but not funded, said Peter Wilby, chief investment officer. Stone Harbor, which has a total of \$22.5 billion in assets under management, has been winning emerging markets debt mandates ranging from \$50 million to \$1

billion. "There's a lot going on," Mr. Wilby added.

- Aberdeen has seen assets increase about 10% in the year ended March 31, and now has about \$10 billion in assets under management in dedicated emerging markets debt strategies. The firm also is a finalist in at least five searches with estimated portfolio sizes of \$50 million to \$500 million.

- Ashmore Investment Management Ltd., London, reported about \$800 million in asset inflows in emerging markets debt, in the first quarter, both dollar-denominated and local currency, according to a financial update. Jerome Booth, head of research, said sovereign wealth funds have contributed a large part of the growth in emerging markets debt strategies overall, and they now account for about a quarter of the firm's total \$33 billion in assets under management.

- London-based emerging markets debt hedge fund manager Finisterre Capital LLP, which was established in 2002, surpassed the \$1 billion mark for the first time to \$1.03 billion in the quarter ended March 31, largely due to a \$250 million investment from the \$129.4 billion New York State Common Retirement Fund, Albany. Finisterre's assets under management totaled \$420 million a year ago.

Some hurdles remain for investors, according to pension fund officials and money managers. Diminished transparency, political uncertainty and regulatory inconsistencies are some issues that worry investors. Access remains problematic, particularly in certain "hot" developing markets such as China and India. Furthermore, contagion fears persist; last week's credit rating downgrades of Greece, Portugal and Spain spurred the biggest fall in emerging markets bonds in months.

"Contagion risk is relevant and we certainly don't want to overlook that possibility," said Hanna Hiidenpalo, CIO of Tapiola Mutual Pension Insurance Co., Tapiola, Finland, a multiemployer defined benefit pension fund with about €9 billion (\$12 billion) in assets.

"In our opinion, emerging markets offer us the possibility to diversify our investments and we also believe in long-term strategic outlook of this asset class," said Ms. Hiidenpalo, who added that fund officials are planning to allocate several hundred million euros to emerging markets debt in the short to medium term.

Third of GDP growth

Emerging markets together account for at least a third of the worldwide growth in gross domestic product. Traditionally, investors have preferred dollar-based emerging markets government bonds, but recent mandates have been dominated by local-currency debt, managers said. Furthermore, some larger investors are beginning to divide government and corporate bonds into separate strategies.

Some European, Middle Eastern and Asian institutional investors might have as much as 7% of their total assets invested in emerging markets debt, compared with U.S. funds' average allocation of less than 1%.

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PRESERVING HISTORY

Aberdeen keeps race in Philadelphia

Aberdeen Asset Management Inc. is helping to preserve a piece of local history in Philadelphia, its home city in the U.S.

The firm, based in Aberdeen, Scotland, earlier this month agreed to be the lead sponsor in the Dad Vail Regatta, recently renamed Aberdeen Dad Vail Regatta.

Now in its 72nd year, the regatta has been held in Philadelphia for more than 50 years and attracts thousands of rowers from more than 100 colleges and universities nationwide.

Gary Marshall, Aberdeen's U.S. CEO in Philadelphia, said financial problems had led event organizers to initially propose a new sponsor and moving the event to Rumson, N.J. But that plan fell through last year, and Aberdeen subsequently stepped in to provide financial support in a four-year agreement.

"This is clearly a major local event that's recognized across the U.S. and internationally," Mr. Marshall added.

The May 7-8 event also kicks off Aberdeen AM's first major U.S. public relations campaign, which will include television advertising. Mr. Marshall declined to reveal how much Aberdeen has allocated for the PR campaign. Assets under management at Aberdeen AM totaled £143.8 billion (\$221.4 billion) as of Dec. 31.

The firm also sponsors the Aberdeen Asset Management Universities Boat Race held annually on the River Dee in Aberdeen.

— THAO HUA

But within the next three to five years, U.S. pension funds' exposure to emerging markets debt could climb to 5% to 7%, sources said.

"Worldwide, pension funds are starting from a position of close to zero allocation (to emerging markets), and yet assets are more than \$17 trillion," according to J.P. Morgan Chase's recently published paper, "Emerging Market Outlook and Strategy for 2010." "New and growing sources of inflows include high-grade crossover investors, U.S. pension allocations, sovereign wealth funds and Japanese investment trust allocations." ■