Emerging Markets
Corporates Vs. Sovereigns
Lower Risk, Better Return?

October 2021

Traditionally viewed as ‘riskier’ assets, emerging market (EM) corporate bonds tend to have a higher Sharpe ratio and higher credit ratings than their sovereign counterparts. In a post-pandemic world, what might this mean for those considering an EM allocation?

For investors looking for diversification and exposure to the economies of Asia, Latin America, Eastern Europe and the Middle East, an allocation to the emerging market (EM) hard currency sovereign universe may be the obvious choice. It provides exposure to over 50 countries at different stages of economic development, and lower volatility due to the lower currency risk.

However, we believe the EM hard currency corporate universe is a more attractive asset class than its sovereign counterpart. It’s a multi-asset global opportunity set, providing investors the ability to rotate into different regions, sectors and sub-asset classes.

As outlined below, the corporate universe also offers additional benefits compared to the sovereign market.

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Prior to joining Muzinich, Warren worked for Schroders, where he was a Global Portfolio Manager, and later the Senior Portfolio Manager for Global Emerging Markets. In the latter role, he managed about $2 billion and helped to develop the firm’s emerging markets corporate capabilities. Previously, Warren was the Head of European Money Markets at UniCredito Italiano. Warren has a BSc in Mathematics for Business from the Middlesex University London, and later received his MSc in Shipping Trade and Finance from the CASS Business School. He holds the Chartered Financial Analyst designation.

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Capital at risk. The value of investments and the income from them may fall as well as rise and is not guaranteed. Investors may not get back the full amount invested.
Equities are lower down the capital structure, and local currency bonds are hurt by currency fluctuations. Both are therefore more volatile, which reduces their Sharpe ratio.

Unlike developed market bonds, EM assets are not separated into investment grade and high yield. Therefore, investors do not have to rotate their allocation over the economic cycle during periods where high yield or investment grade do better.

US Treasury rallies are also already priced into EM corporates, unlike asset classes such as US high yield.

A look at the underlying composition of the corporate and sovereign markets also explains why the corporate segment is potentially more attractive.

Sovereigns have a larger distressed bucket and more duration risk than corporates, yet the yields are similar. Therefore, sovereign investors are not being compensated for the additional duration and credit risk.

To get the same EM exposure, investors only take half the beta by allocating to the corporate market (Fig. 3). This is also played out in the total return of both asset classes (Fig. 4).

EM corporates have generally performed better over 5 years because of their lower beta during periods of market volatility. Investors are potentially paid a higher return with lower volatility for choosing corporate risk over sovereign (Fig. 5). Therefore, in our view there is little rationale to owning sovereigns.

## Characteristics

<table>
<thead>
<tr>
<th></th>
<th>EM Corporates</th>
<th>EM Sovereigns</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yield to Worst</td>
<td>3.84%</td>
<td>3.78%</td>
</tr>
<tr>
<td>Duration to Worst</td>
<td>5.48</td>
<td>8.34</td>
</tr>
<tr>
<td>Market Value ($bn)</td>
<td>$1,852</td>
<td>$1,272</td>
</tr>
<tr>
<td>Average Rating</td>
<td>BBB2</td>
<td>BBB3</td>
</tr>
<tr>
<td>Single-A and above</td>
<td>33.45%</td>
<td>26.91%</td>
</tr>
<tr>
<td>BBB</td>
<td>34.53%</td>
<td>36.64%</td>
</tr>
<tr>
<td>BB</td>
<td>21.90%</td>
<td>11.89%</td>
</tr>
<tr>
<td>Single-B</td>
<td>8.07%</td>
<td>20.08%</td>
</tr>
<tr>
<td>CCC and below</td>
<td>2.06%</td>
<td>4.48%</td>
</tr>
</tbody>
</table>

Source: ICE Index Platform. ICE BofA Emerging Markets External Sovereign Index (EMGB) and ICE BofA Emerging Markets Corporate Plus Index (EMCB), as of 30th September 2021. For illustrative purposes only.
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**Leverage - Falling versus Flat**

EM corporates are also in a strong position from a fundamental perspective. The reopening of economies following Covid-19 has led to a huge increase in economic growth. Higher volumes and stronger prices have resulted in greater revenue streams.

Corporate leverage is expected to return to levels not seen since 2011 (Fig. 6) and this is likely to result in an increase in rising stars. The opposite is true in the sovereign space (Fig. 7).

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Index Descriptions

EMCB - The ICE BofA ML Emerging Markets Corporate Plus Index tracks the performance of the U.S. dollar and euro denominated emerging markets non-sovereign debt publicly issued in the major domestic and eurobond markets. Qualifying issuers must have risk exposure to countries other than members of the FX G10, all Western European countries, and territories of the U.S. and Western European countries.

EMGB - The ICE BofA ML Emerging Markets External Sovereign Index tracks the performance of US dollar and euro denominated emerging markets sovereign debt publicly issued in the major domestic and eurobond markets. Qualifying securities must have risk exposure to countries other than members of the FX-G10, all Western European countries and territories of the US and Western European countries.

EMHB - ICE BofA High Yield Emerging Markets Corporate Plus Index is a subset of The ICE BofA Emerging Markets Corporate Plus Index including all securities rated AAA through BBB3, inclusive.

EMIB - The ICE BofA ML High Grade Emerging Markets Corporate Plus Index is a subset of the ICE BofA ML Emerging Markets Corporate Plus Index (EMCB) including all securities rated AAA through BBB3, inclusive.

You cannot invest directly in an index, which also does not take into account trading commissions or costs. The volatility of indices may be materially different from the volatility performance of an account.