Hartford Schroders Emerging Markets Multi-Sector Bond Tickers **A:** SMSVX **F:** HFZFX **I:** SMSNX **R3:** HFZRX **R4:** HFZSX **R5:** HFZTX **Y:** HFZYX

Why investors are wrong to overlook emerging market debt

Some investors see emerging market debt as obscure and risky, but the view doesn't stack up with our research. It can form a valuable part of investors' core fixed-income exposure.

Insight from sub-adviser Schroder Investment Management

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Key Points

- Misperceptions about EM debt have led to the asset class being underrepresented in client portfolios
- EM debt hasn't historically been riskier than high-yield bonds
- EMD's historical income advantage in yield and spread are two reasons why investors should consider making a core allocation to the asset class

Emerging market debt (EMD) is often considered to be an obscure and risky outpost of the fixed-income universe. This view, which we believe is misplaced, has resulted in EMD being under-represented in most portfolios.

- EMD has not been meaningfully riskier than US high-yield bonds
- EMD offers a material and sustained historical income advantage
- Currency risk is lower than many believe, as correlations between emerging market (EM) currencies is very low

The opportunity set is wide and can offer risk-and-return qualities that are similar to, if not potentially better than, more "traditional" fixed-income allocations. Indeed, our analysis demonstrates that a strategic allocation to EMD can improve returns for portfolios of all degrees of sophistication.

<table>
<tr><th colspan="3">Emerging market debt – the basics</th></tr>
<tr><td>Hard EMD</td><td>US dollar-denominated sovereign and quasi-sovereign emerging market debt</td><td rowspan="2">Yields are directly influenced by movements in US interest rates along with changing perceptions about the creditworthiness of EM borrowers.

Rising US rates have typically been associated with falling returns and vice versa. As these borrowings are in a different currency than that of the borrower, currency movements can impact the cost of servicing debts.</td></tr>
<tr><td>Corporate EMD</td><td>US dollar-denominated corporate emerging market debt</td></tr>
<tr><td>Local EMD</td><td>Sovereign or quasi-sovereign EMD issued in local currency</td><td>Priced in relation to local rather than US interest rates. Local inflation and the exchange rate are key influences. This does not mean returns are immune to changes in US rates.

In the same way that hard and corporate EMD returns have tended to decline when US rates have risen, the same has been true of local EMD, albeit generally to a slightly lesser extent.</td></tr>
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Note: The most widely adopted EMD benchmarks are the diversified indices run by JP Morgan. These limit the weights of those countries with larger debt stocks by only including a specified portion of their debt. The analysis in this paper is based on these indices.

Contrary to popular opinion, lending to EM borrowers isn't riskier than lending to DM issuers

Risk measures stack up well

A common reservation regarding EMD is that lending to EM borrowers is riskier than lending to developed market (DM) bond issuers. This view is not borne out by our data.

For reference, the Bank of America Merrill Lynch US High Yield Index had an average rating of B+ at the end of 2018. In terms of credit risk, with an average credit rating of BBB and 76% of the market rated investment grade (IG), local EMD is the safest of the EMD sectors. Corporate EMD comes next with an average rating of BBB– while the hard EMD market has the weakest credit profile at BB+.[1]

Average default rates also compare well. The average default rate for US high-yield credit from 2001 to 2018 was 3.5%. For hard currency high yield EMD, it was 2.4%, and for high yield EMD corporates it was 3.1%. As with DM sovereigns, default risk is less of an issue for local EMD as countries can simply print money to repay it, albeit with inflationary consequences.
If the worst happens and a default does occur, recovery rates have been very similar in EMD and US HYD. Both have averaged close to 40% over the long term.[2]

Volatility comparison

	Last 5 years			Post-crisis (2010)		
	US	Hard EMD	Corporate EMD	US	Hard EMD	Corporate EMD
BBB	4.0%	5.7%	3.6%	4.3%	6.5%	4.5%
BB	5.2%	5.0%	5.1%	5.7%	6.3%	7.8%
B	4.3%	7.2%	7.7%	5.0%	8.4%	8.7%

Past performance is not a guide to future performance and may not be repeated.
Data as of 12/31/18. Data Sources: ICE BofA Merrill Lynch, JP Morgan, Schroders

Investors may be surprised at the similarity of the volatility figures between the debt types in the table above. What's more, when the different US and EMD duration profiles are accounted for, the IG components of hard and corporate EMD (which make up more than 50% of each market) have not been noticeably more volatile than US credit in the post-crisis world.

In local EMD, volatility is higher when compared side-by-side to the debt types above. While volatility averages around 4% a year before taking currencies into account, it rises to 11-12% for US-dollar-based investors due to the vacillations in foreign exchange markets.

But again, that currency volatility needs to be put in perspective. Some investors may be surprised to learn that this volatility is no higher than the volatility of the US dollar exchange rate with developed-market currencies such as the euro, yen, sterling and Canadian dollar.

Although individual EM currencies can be much more volatile than major developed-market currencies, the aggregate basket of currencies within the local EMD market hasn't been historically. This occurs because the various EM currencies have relatively low correlations with each other, resulting in a substantial diversification benefit among currencies when investing in local EMD.

Income is generally higher

Despite the comparability of risk characteristics and little evidence of worse investor outcomes, EMD offers a material and sustained historical income advantage in terms of yield and spread. This is the most compelling argument to hold EMD as a core allocation.

This yield and spread advantage has also persisted for all of the major credit rating components of each market. The only exception is BB-rated hard EMD, which has averaged a similar yield to BB-rated US bonds.

	Spread advantage for EMD (basis points)				Yield advantage for EMD (basis points)			
	Current	Five-year median	Post-crisis median (2010)	Median since 2001	Current	Five-year median	Post-crisis median (2010)	Median since 2001
IG hard EMD	+67	+69	+61	+50	+78	+116	+89	+89
IG corporate EMD	+68	+77	+77	+73	+67	+92	+98	+98
US HY hard EMD	+103	+80	+33	+3	+107	+118	+38	+38
US HY corp. EMD	+17	+61	+76	+85	+13	+64	+83	+83

Past performance is not indicative of future results. Investors cannot directly invest in an index. Data as of 12/31/18. IG hard EMD & US HY hard EMD are represented by the JPM EMBI Global Diversified Index. IG corporate EMD and US HY corporate EMD are represented by the JP Morgan CEMBI Broad Diversified Index.

Local EMD is slightly different. As alluded to earlier, yields are largely driven by local interest rates and views of local inflation. Both tend to be higher in emerging economies, so local EMD's persistent yield pick-up over developed-market government bonds needs to be evaluated on a real (inflation-adjusted) basis to make a fair comparison. Even on this basis, however, local EMD has had a persistent advantage over developed-market government bonds.

What should be flagged is that local EMD has still underperformed hard and corporate EMD and US bonds over recent years due to currency impact. Currencies have become the macroeconomic shock absorber for EM countries when faced with sharp withdrawals of liquidity. Such withdrawals are generally caused by a strong rise in the US dollar.

The longer-term structural story for EM currency appreciation remains sound in our view, and any weakness in the dollar could provide relief in the short term. However, local EMD investors should expect currency volatility to remain a feature.

A diverse universe

Emerging-market economies now represent around 40% of global GDP,[3] which is twice their level at the turn of the millennium. In addition, EMD represents 18% of the global bond market.[4] But most investors hold less, and many hold none at all.

Emerging asset markets are continually evolving in terms of their exposures, breadth, and depth. The diversity of the opportunity set and potential for superior risk-adjusted returns advocate more significant representation among fixed-income portfolios than is currently the case.

To learn more about EMD, please contact your Hartford Funds Advisor Consultant

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Our benchmark is the investor.®

[1]**Sources:** Schroders, Bloomberg, and J.P. Morgan
[2]**Source:** J. P. Morgan
[3]**Source:** IMF, 2018
[4]**Source:** Bank of America Merrill Lynch, 2018

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Investors should carefully consider a fund's investment objectives, risks, charges and expenses. This and other important information is contained in a fund's full prospectus and summary prospectus, which can be obtained by visiting hartfordfunds.com. Please read it carefully before investing

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