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In EM Debt, Investment Management Is Risk Management

Michael Cirami, CFA, Co-Director of the Global Income Group at Eaton Vance, discusses the outlook for opportunity and risk across emerging debt markets.

P&I: Emerging markets have been challenging for investors over the past few years. What's different now compared to the last decade? And what do you expect will drive future performance in the medium and long term?

Michael Cirami: It's a very straightforward question, but brings a complicated answer. Emerging debt markets have broken down over the last decade from a very homogenous group into a very fragmented group of assets. The market used to be nearly all dollar-denominated bonds, and you had high U.S. interest rates and high spreads, and there was an opportunity to take part in a re-rating of an asset class. But today, a lot of these stories have played out as those countries have matured and seen significant credit improvement, like Poland, Brazil and Mexico. Now, other types of debt are also attracting the interest of international investors, like local debt and EM corporate debt.

Over the last five years or so, there has been a lot of support in the dollar-denominated space from U.S. Treasuries, and in 2014, EM dollar-bonds did very well because of U.S. Treasuries. By contrast, the last few years have been very challenging for local debt, with losses coming from local currency weakness and a strengthening dollar. So the "emerging market" aspect of emerging market debt (EMD) has not done very well.

With respect to the standard EMD benchmarks, and the mix of countries in those benchmarks, we believe that the opportunities in the index are modest. Our team expects returns of about 4% for the broad asset class, taking a blend of these different EMD categories. Not as good as some of the best years but certainly not as bad as some of the worst. But unconstrained investors can pick from a very heterogeneous group of countries, which gives a lot of space for active managers to potentially deliver superior portfolios, compared to what the benchmarks have to offer.

P&I: So what do you see as the right way to assess opportunity across this fragmented EM landscape?

Michael Cirami: First, we would avoid using EMD benchmarks as a starting point for portfolio construction. They can be helpful in benchmarking asset class returns, but they have significant challenges with respect to representing the best

EMD has to offer. Capitalization-weighted benchmarks are too concentrated in heavily indebted countries, and it's not clear why an investor would want to own debt just because it's the most prevalent. The most popular local bond benchmark is also very concentrated geographically, comprising only 16 countries — whereas our team looks at local market opportunities from a set of approximately 90 countries.

Second, investors need to evaluate the fundamentals of individual countries. We believe that policies matter a lot. We're looking for good policies and movement toward freer markets. We believe such policies have a positive potential impact on economic growth and return on capital.

Finally, investors need to evaluate how risk factors are being priced by the market — because those are the building blocks of opportunity. We think it's great that the opportunity set is so diverse, but in some respects, even calling it an asset class becomes challenging. To make sense of it, we suggest that investors decompose the different components of price in EM debt. With dollar bonds, for example, you have U.S. Treasury risks and the spread on top of that. In local bonds, you have local interest rate curves and foreign exchange rates. So, we want to formulate views on currencies, credit spreads and on rates in various markets around the world, from Argentina to Turkey to Zambia. And in the corporate debt space, there is, in a sense, a spread on top of a spread. For example, a Polish corporate bond would have a spread over the Polish government spread over U.S. Treasuries.

Looking at such risk factors, we formulate views on how sovereign credits are being priced, how corporate credit is being priced relative to sovereign credit, and other factors. We evaluate these kinds of risk factors looking for anomalies — comparing market prices to fundamentals and looking for some disconnect between the two that leads to investment opportunity.

As investors, we aren't micromanaging overweights and underweights relative to the benchmark. Rather, we are going out and hunting for things that are mispriced within the emerging debt space. Those are the assets we want to own — and the only assets we want to own.

P&I: Looking at the EM world this way, where are you finding opportunity?

Michael Cirami: In the big picture, when we think about risk factors in EMD, we do think there is more opportunity in the rate space right now, compared to f/x and credit markets. So despite a reasonable expectation that U.S. interest rates may rise, and the U.S. curve may flatten a bit, we think that investors should still be looking at rates in EM debt markets.

Beyond that, while most investors are focused on big topics like Russia, or the ECB, or China, we think it's more important to pay attention to small, idiosyncratic markets that don't make the front pages of the newspapers. For example, we have been invested for a number of years in the Serbian local bond market. Nominal rates are high, north of 10%. The yield curve is steep and reasonably attractive. Real rates, we think will need to come down. And structural

reforms are being put in place. Sri Lanka is another example of a market with potentially strong opportunity. And no one would call India a small country, but it is drastically underrepresented in the benchmark, relative to the size of the opportunity we see there.

I should add that we view EMD as a medium- to long-term opportunity. It's not a short-term trading asset class. We are often looking for re-ratings of countries, which can be a multi-year process. Serbia, for example, is going through a multi-year process of convergence towards EU norms. In our view, opportunity often depends on the implementation of these kinds of long-term structural reforms. Argentina falls into that bucket. We think there is a lot of room for policy improvement, and the market has recently taken on that view.

Of course, investors need to be savvy about knowing when the reform story has played itself out. Over the last decade, Poland has made dramatic reforms, but it's now fully priced in, which leaves little opportunity on the credit side. The Republic of Georgia in the sovereign space is a similar story, where a decade of reform is largely incorporated into the pricing of sovereign assets there.

The Holy Grail for EMD investors is finding a market on the verge of a re-rating, where assets are cheap and reform is on the horizon, and the investor expects that change is indeed coming.

P&I: Do off-benchmark and idiosyncratic opportunities raise any specific risks that investors need to be careful of?

Michael Cirami: Our view is that investment management is risk management. It is an all-consuming topic for our investment team, not just the risk management teams that operate firm-wide. Now, in EMD there are large, well-known risks, like liquidity. We think one should always be concerned about liquidity, but I don't think the issues are any more acute in EMD vis-à-vis other markets. Investors are often surprised to learn that, contrary to expectation, some local bonds are actually more liquid than their dollar-denominated counterparts. Currency risk is ever-present. But there are innovative ways to protect investors in a strong-dollar environment. For example, in markets like Hungary or Poland, instead of funding positions with dollars, one could fund local positions in those countries with euros.

But we believe micro risks are even more critical, because they are so often overlooked. These would be the risks associated with idea implementation. How do you structure and settle your trades? How do you enter a market? How do you exit the market? For example, in Nigeria, where we have been active for years, investors need a certificate of currency importation when bringing money into the country. Without one, it can be difficult to get your money out. These are unglamorous, but vital, aspects of risk management. Investors need robust infrastructure and the right skill set to identify risks at every step of the investment process, to make sure they are being compensated for those risks, and to minimize those risks where compensation is lacking. ❖

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Eaton Vance Management Investment Strategies

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\$309,285*

Worldwide AUM (\$Millions)

\$144,959*

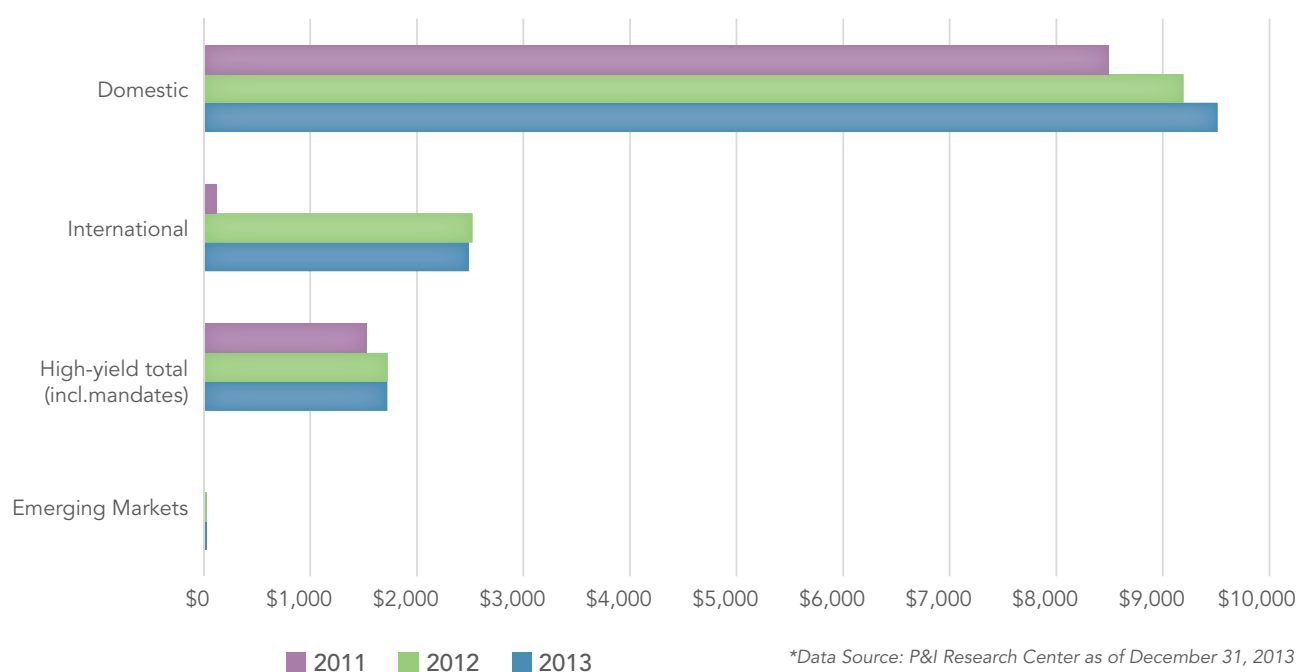
Worldwide AUM (\$Millions)

\$97,928*

U.S. Institutional Tax-exempt AUM (\$Millions)

*Data Source: P&I Research Center. Eaton Vance Management, Parametric Portfolio Associates and Atlanta Capital Management Co. LLC combined AUM figures as of December 31, 2013

Fixed Income*



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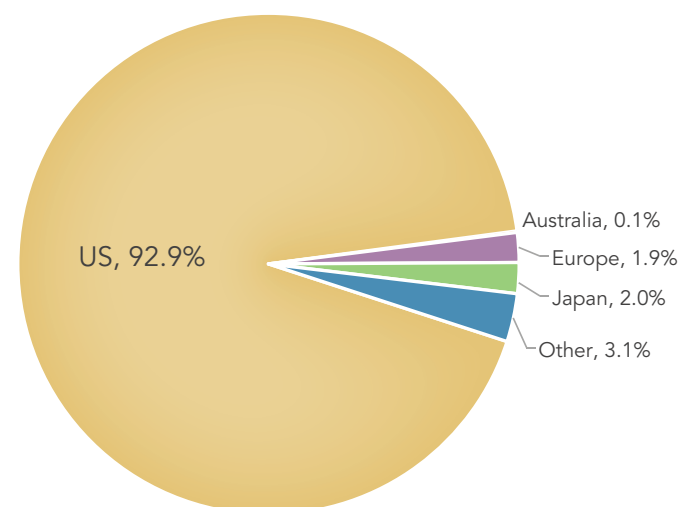
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Firm year-over-year AUM data*



AUM by Client Location*



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