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Unlocking opportunities: a guide to investing in emerging market corporate debt

60 seconds with the portfolio manager

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This marketing communication is intended for non-professional investors.

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In a constantly-evolving global environment, emerging markets present distinctive opportunities for investors looking to diversify and enhance their returns. Emerging market corporate bonds represent a $1trln+ asset class(1), combining robust fundamentals with strong return potential. Nikolay Menteshashvili and Christopher Mey, portfolio managers, explain in detail why this investment strategy deserves investors attention, how it may offer attractive risk-adjusted returns, and the key requirements for successfully navigating this complex yet promising universe.

Why is emerging market (EM) corporate debt an attractive investment?

Imagine a world where opportunities are abundant, but still remain largely untapped. This is precisely the case in the emerging market corporate bond space. Since the early 2000s, the market has grown from $74 billion to around $1.4 trillion in 2024(2). However, beyond these impressive numbers, it's the diversity of sectors and regions that can make this asset class so appealing to investors.

The investable universe of EM corporate debt spans companies across twelve industries and more than sixty countries. Investors have opportunities to diversify across regions such as LaTam, Asia, Africa and the Middle East. Portfolios can be adjusted by calibrating exposure between more defensive sectors such as utilities and TMT, and more pro-cyclical industries like consumer, financials or industrials. Companies in the EM corporate debt space, often leaders in their respective countries, benefit from strong fundamentals in fast-growing economies with young and dynamic populations. The asset class is predominantly investment grade, but offers a range of credit ratings, allowing investors to adjust exposure based on their risk appetite. According to our calculations(3), investing in EM corporates allows investors to increase diversification whilst potentially achieving strong risk-adjusted returns compared to more traditional fixed income assets.

In short, the asset class opens the door to a dynamic investment opportunity that is attractive in its own right or as a part of a diversified portfolio.

What are the risks to be considered when investing in emerging corporate debt?

The emerging debt asset class has benefited from improvements in economic stability, institutional strength and political decision-making in these countries. Over the past 40 years, emerging market debt has developed at a spectacular pace, and today offers a wide variety of opportunities for investors to capitalize on: government bonds (denominated in USD, EUR, or local currency), corporate debt and emerging markets currencies. As a result of these changes, emerging debt evolved from a niche to a major asset class by the late 1990s.

60 SECONDS
WITH THE FUND MANAGER

(1) Source: Bank of America Securities Research
(2) Source: Bank of America Securities research
(3) Based on calculations of Sharpe ratios and correlations between CEBMI BD, EMBI GD, Bloomberg US Corporate IG, Bloomberg US Corporate HY, Bloomberg Global Aggregate, Bloomberg US Treasury, Bloomberg Euro Aggregate, ICE BofA Euro High Yield, S&P 500 and Nasdaq indices. Calculations based on historical returns for the period from June 2004 to August 2024

What is your investment approach in the EM corporate market?

Our strategy focuses on investments in hard-currency bonds issued by corporate debt issuers that are domiciled or have exposure to EM economies. The corporate issuers in the portfolio vary across credit ratings (including both investment grade bonds with credit rating at or above BBB- and high yield with credit rating below BBB-) as well as across geographies and business segments.

Our investment approach seeks to eliminate companies with excessive ESG (Environmental, Social and Governance) risks, limited liquidity or overly aggressive capital structures from the investment universe. Instead, we target robust corporates that we believe may be mispriced by the market, aiming to create a diversified portfolio capable of outperforming the benchmark. To achieve this, we rely on proprietary quantitative tools to screen for risk reward opportunities.

How does the strategy implement security selection?

Our investment process is predominantly focused on bottom-up[4] issuer selection. The selection is based on rigorous fundamental research that integrates ESG factors. The main objective for us is to identify the issuer's creditworthiness, i.e. the likelihood that it will be able to meet its required debt payments. To assess this, each issuer is analysed and assigned an internal credit rating, which guides our investment decisions. Once we have identified all the risks related to an issuer, we decide whether to invest through our conviction-based approach.

We complement this bottom-up approach with top-down analysis[5] that leverages on Candriam's in-house macroeconomic and EM sovereign research. At this stage, we implement – and regularly update – our view on major macroeconomic drivers of the asset class that include US interest rates, Foreign Exchange, commodities and our outlook on the Chinese economy among others. We also utilize the EM team's expertise in sovereign and geopolitical analysis to adjust exposure to particular geographies and regions.

What are the main strengths of Candriam's EM corporate debt strategy?

Our methodology was developed – and is continuously being improved – to meet our objective of generating risk-adjusted performance. Our multifaceted approach aims to identify investment opportunities through rigorous bottom-up analysis of issuers and instruments, while controlling for risk.

Our team draws on a comprehensive set of analytical tools, developed in-house, to identify investment opportunities. Our process is based on rigorous fundamental analysis and relative value assessments. We seek to avoid the most illiquid parts of the market using proprietary filters. Our process also incorporates ESG factors, which are essential for us to judge the creditworthiness and long-term development potential of countries and companies. ESG integration is a key differentiator of this strategy, enhancing our decision-making with a broader perspective on value and impact. Candriam's market-leading position as a sustainable investment expert allows us to implement best practices in close collaboration with the specialist ESG research team.

We pay close attention to risk, not only when choosing where to invest, but also during the implementation phase. Our internal investment limits, together with an analysis of the overall market environment, guide us in building the portfolio. We only take those risks that we consider worth taking.

Additionally, our dedicated investment team and collaborative decision-making process allow us to remain agile and responsive, leveraging our expertise in the EM space along with complementary product and regional knowledge.

(4) Bottom-Up' management is an investment approach that focuses on the individual characteristics of each company rather than on sector conditions or the overall economic climate.
(5) Top-down allocation is guided by the investment view on the global economy, then progressively focuses on regions, countries, and sectors.

The main risks of the strategy are:

• Risk of capital loss:

There is no guarantee for investors relating to the capital invested in the strategy in question, and investors may not receive back the full amount invested.

• Interest rate risk:

A change in interest rates, resulting in particular from inflation, may cause a risk of losses and reduce the performance of the strategy (especially in the event of a rate increase if the strategy has a positive rate sensitivity and in the event of a rate reduction if the strategy has a negative rate sensitivity). Long term bonds (and related derivatives) are more sensitive to interest rate variations. A change in inflation, in other words a general rise or fall in the cost of living, is one of the factors potentially affecting interest rates.

• Credit risk:

Risk that an issuer or a counterparty will default. This risk includes the risk of changes in credit spreads and default risk. Some strategies may be exposed to the credit market and/or specific issuers in particular whose prices will change based on the expectations of the market as regards their ability to repay their debt. These strategies may also be exposed to the risk that a selected issuer will default, i.e. will be unable to honour its debt repayment, in the form of coupons and/or principal. Depending on whether the strategy is positively or negatively positioned on the credit market and/or some issuers in particular, an upward or downward movement respectively of the credit spreads, or a default, may negatively impact the performance. When evaluating the credit risk of a financial instrument, the Management Company will never rely solely on external ratings.

• Emerging market risk:

Market movements can be stronger and faster on these markets than on the developed markets, which could cause the performance to fall in the event of adverse movements in relation to the positions taken. Volatility may be caused by a global market risk or may be triggered by the vicissitudes of a single security. Sectoral concentration risks may also be prevalent on some emerging markets. These risks may also heighten the volatility. Emerging countries may experience serious political, social, legal and fiscal uncertainties or other events that could have a negative impact on the strategies investing in them. In addition, local depositary and sub-custodial services remain underdeveloped in non-OECD countries and emerging countries, and transactions carried out in these markets are subject to transaction risk and custody risk. In some cases, it may be impossible to recover all or part of the assets invested or delays in delivery when recovering assets may arise.

• Sustainability risk:

The sustainability risk refers to any environmental, social or governance-related event or situation that might affect the performance and/or reputation of issuers invested in.

Sustainability risks may be subdivided into three categories:

- Environmental: environmental events may create physical risks for the companies invested in.

- Social: refers to the risk factors linked to human capital, the supply chain and the way companies manage their impact on society.

- Governance: these aspects are linked to governance structures.

The sustainability risk may be specific to the issuer, depending on its activities and practices, but may also be due to external factors. If an unforeseen event occurs in a specific issuer such as a strike or more generally an environmental disaster, the event could have a negative impact on the performance. In addition, issuers which adapt their activities and/or policies may be less exposed to the sustainability risk.

The risks listed are not exhaustive, and further details on risks are available in regulatory documents.

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