Chapter 107

Emerging Market Sovereign Debts as a Means for Profit Maximization and Portfolio Diversification

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ABSTRACT

The case for emerging markets debts (EMD) has convinced many investors. This is an asset class that has been experiencing an increase in inflows and is getting international investors attention. During the past two decades, cross-border inflows into 'emerging market' debt instruments have rose rapidly. Over twelve trillion dollar is currently invested in 'Emerging Markets' debt. This asset classes has delivered strong returns over time and deserves consideration. Therefore, this paper is intended to show how and why Emerging Market debts are vital instrument in portfolio diversification by using descriptive analysis. The performance assessment has made by noting the unique statistical attributes of 'emerging market' bond returns, such as their correlation with other asset classes and also by taking their annualized volatility rate and Sharpe ratios. The assessment has done based on compiled data from known sources such as JP Morgan, Bloomberg and other well known secondary data sources.

ORGANIZATION BACKGROUND

When a portfolio's holdings do not rise and fall in lockstep, diversification can provide benefits. Thus, one benefit of allocating portfolio to 'emerging markets', in addition to diversifying among securities, is to help additional diversification of the portfolio. As it is widely believed that emerging markets debt and equity instruments historically have been more volatile than the developed market equities and fixed income, when returns of individual holdings vary exposure to these markets actually can reduces a portfolio's overall volatility.

Before two decades, only few investors would have considered emerging market sovereign debt instruments as a viable investment option. Political instability, social unrest, and economic turmoil were status quo for many emerging market countries. With upgraded infrastructure, stronger property rights laws, and increased political and economic stability, emerging market countries have grown tremendously over the last two decades (Ari P., 2013).

More than 80% of the world's people live in emerging markets such as Brazil, China, Mexico and Indonesia.[1] Many of these markets have young, expanding populations, a rising middle class, and improving economic and political stability—leading to growth opportunities in these economies. Most surprising to investors, many emerging market countries now offer greater fiscal stability than many developed markets. Today's emerging markets have captured the world's attention—and with good reason. According to reports, till the first quarter of 2013, more than 12 trillion US dollar is invested in 'emerging markets' debt. Although this asset class is experiencing an increase in inflows, it is receiving much attention from investors (John M., 2013).

'Emerging markets' are growing rapidly in size and importance relative to the global economy and capital markets. Driving this growth are economic development, a growing middle class, rich natural resources, and freer global trade. 'Emerging market' debt is mainly issued by sovereign issuers. Debts issued by corporations debt does exist in this category; however, corporations in developing countries in general tend to borrow money from local banks and other sources, as public debt issuance of corporate debts requires both sufficiently developed markets and large borrowing needs. Sovereign issuance in these markets has historically been primarily issued in foreign currencies, either US Dollars or Euros (Wikipedia, 2013). Nowadays most of 'emerging market' governments demand little support from G-7 nations. Due to high internal growth, economic development and prosperous macroeconomic factors, several 'emerging market' sovereigns are making a substantial shift to local currency debt issuance (BlueBay, 2012).

As many reports indicated, historically increased risk aversion in global financial markets has cut down the flows of capital into 'emerging market' debt products. However, cross-border inflows into 'emerging market' local currency bonds have grown over the past three years. These growing interests of foreign investors in 'emerging market' debt could partly reflect the much argued shortage of global safe assets (Caballero, Farhi and Gourinchas, 2008; Gourinchas and Jeanne, 2012). Specifically, starting from the beginning of the euro area debt crisis that was in 2010, the returns on emerging market local currency sovereign bonds have moved closely with those of safe assets. At the same time, the recent growth has been accompanied by a very low global interest rates and exceptional monetary easing by developed economies that will almost certainly end at some point (Ken M., et al., 2012).

The amount and finesse of the investable universe of debts issued in emerging markets have increased considerably over the last decades. Over the last decade, investors looking for greater diversification in their portfolios have progressively turned to 'emerging markets' debt. For this the JP Morgan Emerging Markets Bond Index (EMBI) Global Diversified Index is a good indicator. The index that represent the Investment-grade countries increased from less than 2% in 1994 to 57% in 2010 (Luis & Harry P., 2012). Surprisingly, at the end of September 2013, the rate has increased and now 83% of countries in J.P. Morgan GBI-EM Global Diversified Index were rated as investment grade[2].

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