Vanguard

Managing emerging market bond portfolios amid geopolitical uncertainty

Commentary by Nick Eisinger, emerging markets lead strategist, and Liza Ermolenko, senior research analyst

Introduction

Managing asset class-specific risk is critical to generating consistent returns in bond markets. Recent events in Ukraine highlight why investors in emerging market (EM) bonds—perhaps more than in any other area of fixed income—need to be prepared to endure periods of heightened macroeconomic and geopolitical risk in order to access the performance they seek from EM debt.

While EM bonds have not been inherently more volatile than global equities in the recent past[1], headlines around risk events in EMs can be alarming for some investors. A riskier environment can also put an active manager's approach to portfolio construction and risk management under the microscope, as certain risk factors become exacerbated by market volatility.

The bonds of the Russian Federation and Ukraine represent around 3.1% and 2.2% respectively of the J.P. Morgan EMBI Global Diversified Index[2]. Since tensions escalated in December, Ukrainian financial asset prices, including those of sovereign bonds, have been hit hard. Russian assets have also sold off since December, although less so than in Ukraine.

As investors weigh up the ongoing implications for sovereign debt markets as the situation develops, they should bear in mind that a disciplined approach can help to offset some of these short-term risks.

Volatility and risks

So-called "crowded" trades—short-term positions in certain bonds or currencies that have attracted unusually large flows from institutional investors—are one risk to look out for. Crowded positions can arise at any time. However, they can be especially dangerous in an environment of heightened volatility as they are more vulnerable to sudden sell-offs and until they are reduced, they can exacerbate market moves.

Ukrainian credit is a topical example of a recent crowded trade, although there are many other cases in both emerging and developed markets, such as Brazilian and Mexican sovereign bonds. These positions are even more susceptible to losses when global monetary conditions are tightening, as they are now.

[1] **Source:** Bloomberg, JP Morgan and Morningstar Direct as at 31 June 2021. Between 1 July 2001 and 30 June 2021, emerging market hard-currency bonds (as represented by the J.P. Morgan EMBI Global Diversified index) had a lower standard deviation of return and higher return than global equities (as represented by the MSCI ACWI index). All performance calculated in USD. Past performance is not a reliable indicator of future results.

[2] **Source:** J.P Morgan. J.P. Morgan EMBI Global Diversified Index weightings as at 31 January 2022.

Another risk to consider during heightened volatility are low-probability yet high-impact events known as tail risks. These can carry significant downside implications, and geopolitical discord is just one example. Active investors should be aware of the alternative scenarios surrounding a potential risk event and size their positions appropriately so as not to cause significant and lasting damage to their portfolio.

It helps to have a clear understanding of the potential impact of taking on exposure to concentrated and correlated risk factors in a portfolio. These can lead to an unintended increase in portfolio risk if they're not monitored carefully. While correlated risks might not always detract from returns in more forgiving markets, when volatility is up, they can cause significant drawdowns.

Mind your beta

Investors should always be mindful of a portfolio's beta - exposure to the broad direction of bond markets. In times of elevated risk, there is the possibility of contagion of country- or region-specific risks to the wider market. Other areas of EMs—notably countries in Central and Eastern Europe in close proximity to Russia—are at the greatest risk of contagion from the Ukraine conflict.

But making excessive directional bets in an attempt to generate returns (also known as "levered beta")—which can at times fare well in risk-on scenarios—is liable to falter in more volatile environments.

That's not to say there's no place for using beta to express an active view on market direction when you have strong conviction – provided, of course, that it is a deliberate decision that you deem beneficial to performance. However, this is not the same as charging active management fees for a product that derives its returns largely from a passive relationship to beta.

New opportunities

The upside to a riskier backdrop in EM bonds is that it can also create opportunities at attractive valuations for active managers. But in choppier markets, it's imperative to be defensive, disciplined and discerning - focusing on bottom-up security selection and relative value. This has always been at the heart of our approach to active fixed income, in all market environments.

We especially see attractive bonds at favourable valuations in EM high-yield debt – a very varied area of the market where research-based country and bond selection are doubly important.

As the EM bond universe becomes increasingly diversified[3] providing a growing pool of opportunities to work with, taking an approach to active bond management rooted in genuine security selection across diversified sources will only become more important.

Written in collaboration with Kunal Mehta, Head of Fixed Income Specialist Team.

[3] **Source:** J.P Morgan. The J.P. Morgan EMBI Global Diversified Index comprised bonds from 44 issuers as at 31 December 2012 and 69 issuers as at 31 December 2021.

Our active bond funds managed in-house

Vanguard Emerging Markets Bond Fund

Vanguard Global Credit Bond Fund

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