Not invested in Asia fixed income? Here's what you're missing

TERESA KONG, CFA
Portfolio Manager
Matthews Asia

SATYA PATEL
Portfolio Manager
Matthews Asia

Pension plan sponsors could be forgiven for being tired of grappling with low U.S. interest rates. Even though the Federal Reserve has begun to tick rates higher, interest rates around the world remain at or near historic lows. One tactic many asset owners have employed to capture yield outside of the U.S. has been to invest in fixed income in emerging markets.

But while that strategy makes sense intuitively, investors could be missing out on some of the biggest opportunities.

"In the last 20 years, the differentials in growth from Latin America to Asia have widened tremendously," said Teresa Kong, a portfolio manager at Matthews Asia. "Latin America has grown about 1.5% per year on a per capita basis whereas Asia has grown an average of about 7% per year over the last 20 years.[i] That has resulted in incredible opportunities, many of which are not reflected in the opportunity set in the typical asset class definitions."

The problem is that emerging market benchmarks typically underweight Asia. "Current benchmarks, because they are market capitalization weighted, tend to lead to an underinvestment in Asia," Kong said.

She pointed to the Bloomberg Barclays Global-Aggregate index, which has a 20% allocation to Asia. Not only is the allocation small, 17% of that 20% is in Japan, leaving just 3% for the rest of the region. Similarly, the J.P. Morgan Emerging Market Bond Index Global, allocates just 23% to Asia.[ii]

"Any way you cut it," she said, "current benchmarks mean that most institutional investors are under allocated to Asia, both in terms of quantity and quality."

OPPORTUNITY KNOCKS

To be sure, the fact that Asia is under represented in existing emerging-market benchmarks is not because the opportunity set is small.

Matthews Asia portfolio manager Satya Patel explained that the Asian local currency fixed income market totals roughly $10 trillion and includes local currency issues from about 12 countries and companies based in those countries. The U.S. dollar Asian credit universe, which includes investment grade and high yield corporate and sovereign bonds, totals about $830 billion.[iii]

"Asia has a huge opportunity set in these two universes – the local currency universe and the dollar universe," he said.

RETURN AND VOLATILITY

Kong and Patel said that by investing in fixed income in Asia, institutional investors can reap the benefits of attractive returns relative to other regions at comparable or lower volatility levels. In addition, an allocation to Asia fixed income can provide diversification and a cushion from rising U.S. interest rates.

Patel pointed out that from 1999 through December 2016, dollar-denominated Asian high yield universe returned over 10% annually, with annualized volatility around 9%.[iv]

Those numbers beat not only U.S. high yield, but also the European, Latin American and global high yield markets, along with a variety of emerging market fixed income benchmarks.

"No matter what historical time frame you look at, Asia has given you attractive returns with reasonably low volatility, particularly compared to every other high yield asset class out there in the world and a lot of the emerging market benchmarks that you might be looking at," he said.

Kong said there are two key reasons why Asia high yield has returned three percentage points more than U.S. high yield over the last 18 years with the same level of volatility.[v] The first is that the top tier companies in Asia tend to be constrained by the sovereign ceiling.

"Take, for example, India," she said. "India is rated BBB- by the major rating agencies. That means that investors would demand a similar credit premium for a BBB- company in India as everywhere else in the world. But the default frequency of BBB- rated India companies has been less than that of comparable U.S. companies because they represent the blue chips of the country, and would have higher ratings if they weren't constrained by the credit rating of India.

"The second reason for this outsize return has to do with the fact that there is really a dearth of leveraged buyouts in Asia," Kong continued. "In the U.S., leveraged buyouts represent anywhere from 5% to about a third of the market at the peak. Historically, leveraged buyouts have had sub-par results."

The question, of course, is whether now is the right time to allocate assets to Asia.

"If you're considering a regional allocation to Asia, this is really kind of a Goldilocks time to be doing it, in that credit, currencies, and interest rates feel 'just right,'" Patel said. "Credit spreads are reasonably wide, Asian currencies look poised to appreciate over the medium term vs. the U.S. dollar, and interest rates in Asia are reasonably wide and give you a pretty attractive return profile compared to what we see across developed markets." ❖

"Any way you cut it, current benchmarks mean that most institutional investors are under allocated to Asia, both in terms of quantity and quality."

[i] Source: Bloomberg as of December 31, 2016

[ii] Source: Blarclays, JP Morgan as of December 31, 2016

[iii] Source: Asian Development Bank, JP Morgan as of December 31, 2016 or local currency market and October 31, 2017 for USD

[iv] Source: Bloomberg data period from 1999 to December 2016

[v] Source: Bloomberg data period from 1999 to December 2016

Matthews Asia

P&I CONTENT SOLUTIONS GROUP

This sponsored advertorial is published by the P&I Content Solutions Group, a division of Pensions & Investments. The content was not produced by the editors of Pensions & Investments and www.pionline.com and does not represent the views of the publication of its parent company, Crain Communications Inc.