EMD roundtable: SEEKING OUT THE OPPORTUNITIES

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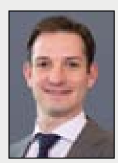
BNP PARIBAS ASSET MANAGEMENT

Chair:

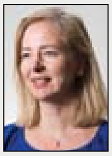
KARAN TALWAR
Emerging Markets Fixed Income Specialist, BNP Paribas Asset Management
Karan is an emerging markets fixed income investment specialist at BNP Paribas Asset Management. He is responsible for enhancing and commercialising the EM fixed income proposition as well as engaging with clients to effectively communicate the firm's offering and service client needs. Karan joined the firm in 2017 and is based in Hong Kong. He was previously at Willis Towers Watson.

Panel:

RICHARD BUTCHER
Managing Director, PTL
Richard joined PTL in 2008, becoming managing director in 2010. He has responsibility for a wide range of clients with a specific focus on governance. Richard is a fellow of the UK's Pensions Management Institute (PMI). He is chair of the PLSA and sits on the association's board. Richard is also a member of The Pensions Regulator's DC practitioner panel, the Mastertrust Association, the DWP trustee panel and he is co-founder of the Association of Member Nominated Trustees, all in the UK.



L.BRYAN CARTER
Head of EMD, BNP Paribas Asset Management
Bryan is the head of emerging market fixed income (EMFI) at BNP Paribas Asset Management. In this role, he is responsible for setting strategy, generating alpha ideas and risk budgeting for the firm's emerging markets fixed income business. Bryan joined the firm in 2016 and is based in London. Prior to joining the firm, Bryan was a portfolio manager at Acadian Asset Management and an economist at T. Rowe Price Associates.



LUCINDA DOWNING
Principal, Aon
Lucinda develops asset class views within Aon's global asset allocation team. She was previously director of balanced funds at Russell Investments, where she structured and managed multi-asset, multi-manager funds. Before then, she was a portfolio manager at State Street Global Advisors, where she managed bond and currency portfolios and created forecasting models. Her 20+ years' work experience has included posts in South Africa and Hong Kong. She has a BSc in Economics from the University of Warwick.

DAN FOX
Associate Director, River & Mercantile Solutions
Daniel is an associate director within the investment team at River & Mercantile, responsible for asset class research and manager selection for use within fiduciary and advisory portfolios.
He co-leads the dedicated manager research team which is responsible for manager selection and monitoring of external funds and, as part of this role, Daniel leads on research within fixed income and alternative asset classes. Additionally he is a member of the Investment Strategy Committee.

REZA MAHMUD
Senior Investment Consultant, PwC
Reza represents PwC's pensions investment consulting business, which focuses on trustee and corporate advice. He helped establish and is a member of PwC's multi-disciplinary investment committee (pensions, insurance, sovereign wealth funds, private wealth). Prior to PwC, he was a multi-asset investment manager at Aviva Life and Pensions, and before that he served with Brunei's sovereign wealth fund.

RACHIT SHARMA
Senior Investment Manager, Railpen Rachit manages a number of pooled funds, government bond portfolios, and overlays in addition to leading work on macro strategy that informs management of the growth fund. Rachit also manages portfolio implementation and capital markets activities including relationships with counterparties and overseeing the outsourced dealing desk.
Before joining Railpen in 2010, Rachit worked in private wealth management advising ultra-high net worth individuals and families on asset allocation.

GRAHAM WARDLE
Managing Director, BESTrustees
Graham joined BESTrustees as a trustee executive in 2006. This followed a 30-year career at a major pensions consultancy where he was responsible for some of their largest clients. He became a director in 2008 and was appointed managing director in 2010. Graham is a trustee of a range of occupational pension schemes across many different industries and with both domestic and overseas sponsors. Graham has a comprehensive knowledge of all the issues affecting trustees.

Chair: Following multiple years of good returns and strong growth within the emerging market debt (EMD) space, 2018 has been quite choppy. What is the general sentiment therefore around EMD investment today, given the fact that the Fed has been raising interest rates, the dollar has been quite strong and there have been negative headlines for various emerging markets like Turkey and Argentina, as well as on-going trade friction between the US and China?

» **Carter**: The most important thing at the moment is the technical position that we see in the market. What's made us more constructive since late August is simply looking at the outflows from the asset class, which have been massive this year. We're down $30 billion in emerging market debt flows year-to-date. We're down about $45 billion from the peak in April. That's a significant outflow environment.

We also see that the dedicated money in EMD is now under-levered, from a very levered position six months ago. For example, looking at currency futures and currency trading conditions in the markets, at the start of April we had the biggest short dollar position in five years in the market against emerging market currencies. We've completely flipped that in the space of two or three months – we're now in a long dollar position versus emerging market currencies, especially Asian currencies.

So, the technical position is now favourable for some sort of positive catalyst to bring investors back in.

» **Chair**: What might those catalysts look like?

» **Carter**: I see several possible catalysts. One would be the Fed. They've confirmed four more hikes over two years. That's not nearly as bad as what we've already been through. It's possible that they start skipping meetings as soon as this December, which would be a huge green light for emerging markets. It always is when the Fed pauses.

It could be growth. We think that growth has stabilised. We've had a downshift in EM ex-China growth from 7 per cent at the beginning of this year now to about 6 per cent. That's still 6 per cent growth. That sounds fantastic sitting where we sit in Europe. We see that stabilising and perhaps re-accelerating into next year.

Then of course there's the tariff – the tariff tiff, as I call it, has been the proximate source of volatility in the market – we think this is mostly

"We need to understand the risks we are taking with the beneficiary's money"

done. China has now elected to take the high road and to cease retaliations. That's completely disarmed Trump. He doesn't know what to do with that kind of response and he's moved on to other battles.

» **Chair**: Do others around the table think this is an interesting time to potentially be adding EMD to portfolios or are we concerned that sentiment might still be quite negative?

» **Downing**: I think investor sentiment is certainly cautious, and I would describe our view as cautiously positive. We also need to take into account the general environment in pensions, which is towards de-risking. So, the appetite from investors isn't that strong, even though we've seen two years of good performance from emerging market debt prior to this year. That might also be for various reasons like governance budgets – investors may not want a separate allocation to EMD for example. They might prefer to have it in a more diversified portfolio.

Having said that, our message to clients is that it's not a bad time to get into EMD now, given the weak performance this year, and that valuations are looking attractive in terms of yields and also currency levels.

» **Chair**: It's interesting to see the valuation component on an absolute basis, but also relative to how they compare with some of the developed markets that have been quite resilient and whether that makes the case stronger or not.

» **Downing**: Real yields have been attractive for a while, and I think there's a general consensus that EM fundamentals are fairly attractive structurally. For example, inflation is generally under control. So EMD is less vulnerable than it has been in past years. Looking forwards, fundamental drivers of EMD returns and current yield levels are positive although global uncertainties are a headwind.

» **Butcher**: As a professional fiduciary, I take a slightly different view of the world. I'm always willing to listen to a story, but I have other considerations that I must bear in mind, and the governance budget that Lucinda *[Downing]* highlighted is a really important observation.

The standards expected of trustees are being ramped up all the time, both by The Pensions Regulator in the UK but also by expectation of our ultimate beneficiaries. So, we're having to take a much more hands-on approach to understanding what it is that we're investing in. We need much greater clarity to be able to look through to the underlying asset, so being told a story isn't the same as buying the story.

We've got to understand it and we've got to be able to dissect it. We've got to be able to look through it and have a much more thorough understanding of the costs of investing right down to quite a granular level; and in the context of defined contribution (DC) investment, we have to be able to then assess those costs in terms of value for members.

We also need to understand the liquidity position, particularly in DC, and understand what risks exist in the underlying assets – for example, might something happen that could reduce liquidity very quickly?

So, just generally, we need to understand the risks we are taking with the beneficiary's money.

» **Wardle**: Just to add to that, from a defined benefit (DB) perspective, it also really depends on where a particular scheme is on its journey. As they get to the de-risking phase, for example, they're less likely to want to invest in something like EMD. A scheme that isn't in that position yet however, provided they can take the volatility with EMD, is more likely to do so and I've certainly got schemes that do allocate, say, 5 per cent to EMD. But you do need to be able to withstand the volatility.

» **Mahmud**: Following that volatility point, there's an emergent issue around transaction costs for fund managers. So, as markets become more choppy, managers may trade in and out more frequently, pushing transaction costs upwards.

» **Butcher**: Absolutely. With this particular type of asset there are multiple layers of intermediation and there are things that could go wrong all the way through. There are restrictions that could go wrong all the way through. We have to bear all of that in mind.

» **Chair**: When market sentiment turns negative, are some of these challenges and some of these concerns brought more to the forefront for pension schemes?

» **Wardle**: Not really. Trustees tend to take strategic rather than tactical decisions, so you wouldn't necessarily sell off because you think the market's variable now.

» **Butcher**: I would agree from the point of view that it's not so much to do with the asset class or the characteristics of the asset class, but more so the fact that it is a changing regulatory environment that applies to trustees.

The evolution of the asset class

» **Chair**: Let's move on to the evolution of the asset class, because it has evolved quite a bit over the past 15 years. EMD has historically been a very hard currency-denominated asset class and now we've moved to a space where it's much more local currency-denominated. There's a lot more corporate bond issuance than even sovereign issuance.

On this basis, how do different allocators look at the emerging market fixed-income space? Are there certain parts of the universe that you think are more compelling for investment opportunities?

» **Fox**: We agree that the markets have developed significantly such that there are some very separate and different drivers of returns. This impacts our approach to allocations.

"A lot of active management in this space has been about beta allocation i.e. how much you allocate and how much risk you take"

So, for example, if we're looking for strategic exposure across the EMD spectrum for clients that like to outsource the asset allocation, we'll look for managers that have the ability to do local, hard, corporates, frontier; as part of our manager research process we would then essentially try and find a manager that's skilled at all of these areas individually as well as at assessing the relative value between them.

Areas where that's not necessarily the case, for example in some fiduciary portfolios where we may want exposures to specific betas, we then look to allocate to purely local/hard corporate managers. This has become more prominent because, if you look beyond the past couple of years where there have been really strong returns for almost all sectors, if you go back to the two years before that, 2014, 2015, to the real large dispersion of returns, what your end client would have experienced, whether you were in hard or local, would have been very different. So, getting the relative value call correct, and understanding what you think will drive the returns, is really important.

So, I think there's perhaps more emphasis on understanding the relative value and drivers now than there used to be.

» **Wardle**: Something I have seen developing is this idea of absolute return-type investments in this space, but of course that relies very much on the manager's skill to do that. But yes, quite a few trustees in the larger

schemes have been looking at that as opposed to just traditional emerging market local currency debt.

» **Carter**: Picking up on the evolution point, the more recent, maybe longer-term evolutions have been with regard to ESG, especially with the European institutional clients, and I think that has staying power. Even passive ESG has become a very large business.

But staying in investment-grade emerging market debt, I think really gets to what the absolute return mandate is seeking, which is reducing the drawdowns, reducing the blowouts, staying out of the defaults and somehow tempering that volatile aspect of the asset class.

» **Fox**: That's quite interesting as I can envisage there being a further divergence there, because some allocators do want access to markets that are truly total return-based, essentially allowing them to go long and short, because I think most of the total return funds that exist now actually have quite high betas to market.

"Institutional allocations tend to be steady, so I don't think we'll see many investors sell – they are in it for the long term"

I think there may be further divergence within the total-return/absolute-return space, where clients may want to access the large market available but with low beta to the overall market. Absolute return approaches may work in this sense in accessing these markets because, as we've seen over the last two years, it is really idiosyncratic with some countries doing very badly, whilst others rally strongly.

» **Chair**: Rachit *[Sharma]*, when you are looking at assessing and allocating to emerging market fixed-income, is your preference to try and identify those asset manager strategies where you're outsourcing a lot of the decision-making to the asset managers to balance the alpha and beta component? Alternatively, do you take a more leading role in trying to find the areas within EMD that are suitable for your investments?

» **Sharma**: We are evolving our thinking on this. First, it seems a lot of active management in this space has been about beta allocation i.e. how much you allocate and how much risk you take. Also if we step back and think about the return drivers of emerging market hard currency compared to local – they are quite distinct. Yes, there's the emerging market theme or label, but hard currency is essentially a credit spread product with limited linkage to the local economy in those countries, whereas local currency markets are very much driven by the domestic interest rate cycle.

So, the drivers are quite distinct and the skillset to manage those is very different. For instance, if you're thinking about domestic rates, you need quite a deep understanding of the domestic dynamics, inflation obviously, which are not that important if you are buying US dollar bonds, for example.

Then, in the correction as well, you saw that dynamic come through in that domestic-rate markets didn't really sell off – you saw emerging market FX and hard currency in emerging market debt sell off first because you can see the common ownership is what's driving price moves there, and a lot of that is international offshore investors. So, I think some of that needs to be factored in, and it goes very much to your point of understanding the risks that one is taking, and they're quite distinct.

Allocating to EMD

» **Chair**: From a trustee standpoint, do you think that a single manager is capable of being able to allocate to the entire emerging market space on your behalf, or do you need to be much more specific in how you decide to access this $20 trillion universe?

» **Butcher**: Every asset manager will be aware of their own limits and they'll have to buy in the skillsets that they need. If you don't ensure that there is quite a deep skillset within the asset manager, then you are exposed to more risk. So you've got to know what it is that you want to buy, what risks you want to take, and then you buy it.

The deeper the skillset, of course, the greater the cost. So that's another factor.

» **Wardle**: It depends on the manager. Some managers are very benchmark-aware, so they will go across maybe a range of 10 or 12 different countries. Others, the ones that are more unconstrained where you are relying on the manager's skill, will generally exclude certain countries and move around quite actively.

» **Chair**: Bryan *[Carter]*, you've been investing for 15 years in emerging markets. How has your style of investing in markets changed over the years?

» **Carter**: It comes back again to who the clients are. At BNP Paribas

Asset Management, we have largely institutional clients – European and Asian clients mainly – and what we find is that there's a spectrum of risk tolerance and that drives the solutions that we provide.

We do customise investing, depending on the needs and the risk tolerance of various clients, but the team that we've constructed to make that scalable is based on asset class. So separating, for example, hard currency from local currency, rates from FX, corporates from sovereigns, keeping frontiers segregated as well – each of these for us is a different alpha. Our process is then able to take the appropriate alphas and put them in the solutions based portfolios as appropriate for the risk tolerance and the alpha targets of each fund.

» **Chair**: Are investors or consultants likely to take advantage of market dislocations, or is the general perception to be very long-term and strategic in allocations?

» **Downing**: Institutional allocations tend to be steady, so I don't think we'll see many investors sell, because they're in it for the long-term. It's a strategic allocation. Saying that, there are opportunities for them to take a little bit more of a tactical twist. Our clients often invest in blended EMD funds – a single manager managing both the local and the hard and the corporate, and therefore the manager can take the decision for them to get more exposure to one sector over another. Investors in multi-asset credit, absolute return funds or our delegated funds can benefit from shifting allocations into and out of EMD. Also, we give advice to our clients, so we can suggest whether they should have bigger allocations in local versus hard, for example.

» **Chair**: Reza *[Mahmud]*, what are your thoughts around trying to be more tactical versus being quite strategic in your allocations?

"Some EM currencies have been correlated to market risk-on and risk-off environments"

» **Mahmud**: Asset owners should focus on a holistic, strategic perspective and instead delegate day-to-day responsibility of managing near-term risks and opportunities to their asset managers. The questions clients can ask are things like 'emerging markets have become more volatile, how much exposure do we have, directly or indirectly?' So, they are effectively looking for guidance on whether their current strategy is still appropriate going forward.

» **Sharma**: I think we need to be more tactical in the EM space because that's what drives some of the returns in the asset class.

I think the tactical opportunity this year, potentially, has been not necessarily just withdrawing from the asset class, but also tilting the portfolios. To the extent that the losses have been triggered by idiosyncratic situations, there's been a great opportunity to have been significantly overweight higher-quality assets in emerging markets versus lower-quality.

If you think about the universe, countries that issue the most debt will have the highest weighting in the debt benchmarks versus countries that have higher weighting in the equity benchmarks in emerging markets, and the difference in currency performance has been very meaningful. That's been the case even within the debt universe.

But clearly, that's not the kind of bet that trustees and consultants are taking.

» **Mahmud**: There's the governance point – I help build investment committees and asset owners shouldn't use up too much of their limited time available focused on forecasting short-term markets. They need to know what their exposures are, and be prepared to address surprises or ideally, exploit strategic opportunities – but they don't want to get caught up with the noise of watching the news all day.

» **Fox**: I completely agree. It kind of depends, on the client-side anyway, what management set-up you have as well. Within fiduciary-type portfolios where we can move almost always on the same day, you do have the ability to be tactical and trade straight away, albeit most of the set-ups we see are not quite there yet.

Then, with those clients with limited governance budgets and who don't necessarily have the ability to move quickly, it makes sense to move the asset allocation decision

onto managers that have perhaps a broad bond/multi-asset credit-type mandate who can invest across the whole spectrum.

But what we've typically found even there is, although they are able to trade between the asset classes almost unconstrained, typically managers stay anchored to a set benchmark. We don't really see substantial moves. It might be 5 per cent here and there, but nothing significant.

» **Sharma**: The other way to potentially outperform or to have another source of return, apart from being tactical, is to be extremely strategic, so you either need to be contrarian, or you need to be ahead of the market. For example, one of the best performing bond markets of the last few years has been Chinese bonds. Access to the Chinese domestic bond market has been improving, particularly in the last 12 to 15 months, but that's not really there in people's portfolios yet.

Obviously, over the next few years, there'll be massive capital flows there, but by that point the opportunity set will look quite different.

» **Chair**: There's clearly a sense in the room that allocations by pension fund investors are generally quite strategic and long term; but, saying that, there have been outflows from the asset class and some investors are tending to be reactive, potentially selling at the bottom; so maybe they aren't as long term as they should be, potentially?

What kind of experience have you had with clients through some of the recent sell-offs? Have clients been able to withstand the volatility and remain invested?

» **Carter**: For us broadly yes, but that's because we're somewhat unique as a firm in that we're a large firm that's been building an emerging market debt business. So, we've had the benefit of actually collecting money this year, which I recognise is unusual.

But we do hear that some have been reducing their allocations to EM debt this year, which seems somewhat reactive.

"China is suddenly going to become a dominant allocation in your portfolio"

The evolution has been partly driven by a motivation of perceived protection. Similarly, as I mentioned earlier, there has been an accelerated move towards ESG investing, as many investors – especially on the continent – see it as a way of reducing 'blow-up' risk, the volatility risk.

Investment grade (IG) has also been an outperformer this year. We have several clients that are in IG-only portfolios. We have a couple of UCITs funds that are IG-only and those have done dramatically well, and now you're looking at 4.25 per cent yield with trailing volatility of 1.3 per cent, so your yield to vol ratio is just extraordinary, even now, looking at an IG-only EMD set. That's been the evolution of it.

Opportunities

» **Chair**: Just looking at correlations, some of the EM currencies have been quite volatile and quite correlated to market risk-on and risk-off environments, and we have had some of the high-yield spreads also quite correlated to, again, the broad market environment. But have there been parts of the EM complex that are arguably not just part of this entire homogenous set, that potentially offer good diversification opportunities within the asset class, be it investment grade, hard currency, short duration, or some other component?

» **Sharma**: I think the local Chinese market as I mentioned earlier is one example – and I think the potential for that to develop and influence not just the asset class but the broader universe is massive, because of the size of the market and because of how influential the Chinese economy is today globally.

» **Downing**: China is a good one to mention because of the fact that its economic cycle isn't so synchronised to the US, but you do have to take into account that there is risk out there for China. We haven't seen many emerging debt managers moving into Chinese bonds, but I do think there's a fascinating development there both in terms of emerging debt and equity markets.

» **Mahmud**: On the correlation and contagion point I think the China effect could be changing and may be under-estimated. China is massively ramping up infrastructure investment as part of its US$1-8Tr Belt and

Road project that spans over 60 countries. I'm seeing potentially transformational change to these countries, especially the smaller ones and that's already happening now, and not just a grand, abstract vision for the distant future.

If China sneezes, these projects can be impacted, whether they are in the Middle-East, Africa or Asia. So far China has been very fortunate at managing its economy and its policies, but surprises do happen. So, political-economic linkages and market correlations could be higher than 10, 20 years ago.

» **Fox**: Where we've been comfortable with some of our managers is where they've had some allocation to frontier markets or countries where there is genuine idiosyncrasy, so their performance isn't as tied to for example US rising rates or the US dollar, and therefore they have a little bit more control of their own destiny.

Where we have been cutting allocations, at the start of the year for example, wasn't necessarily in response to falling values or negative performance as such, but more so because we thought US rates may rise quicker than anticipated; also we feel that geopolitical tensions between China and the US are actually quite underplayed at the moment, and it actually might be a longer-term phenomenon than perhaps was being priced into markets. That's why we react – so it's more to the macroeconomic environment rather than performance.

"The bigger picture is about the global economic engines"

» **Chair**: How different can economic cycles be across different countries and can that fundamentally lead to some diversification?

» **Carter**: There is some diversity in the economic cycles that you get exposure to when you invest in emerging market debt, but this is a micro-phenomenon. For example, some countries have been cutting interest rates this year - Colombia, Brazil, Russia, South Africa - and that gives you some diversity and, at least over finite periods of time, diversification within the sources of return.

But the bigger picture is really about the global economic engines. To date, we've had two global economic engines – the US and Europe, and all emerging markets have essentially fallen into those two spheres. But the big news is China. China is about to change everything. It may already have changed everything. It is both exciting and terrifying.

It's exciting because it gives us much more diversification at the uber-macro level. They are able to ease liquidity even as liquidity conditions are tightening elsewhere. They are able to move the exchange rate in a different way, intentionally if they want to.

For an emerging market investor, the terrifying thing is, it's about to dominate your portfolio and you don't realise it yet, but MSCI is proposing to quadruple the weight of China onshore shares in the index. It's about to go into the Barclays Bloomberg Global Aggregate with a weight of 6 per cent in April of next year. Very few clients that I have spoken to are prepared for this change or have been bothered to gain access to the onshore Chinese bond market.

Lastly, right now onshore Chinese bonds are not in your local bond index. If you're a local EMD bond investor, it's going to go from zero to 10 per cent or zero to 15 per cent of your EMD IG-only benchmark weight once full inclusion takes place. So, China is suddenly going to become a dominant allocation in your portfolio, which is again both good and bad depending on your perspective.

» **Sharma**: And as Reza *[Mahmud]* alluded to earlier, the Asian

"I would say, on the sovereign side, China scores relatively favourably"

economies surrounding China essentially have growth geared to what's happening in the Chinese cycle.

» **Chair**: How are investors looking at this space? Is it too big to ignore any longer? If it's not in benchmarks, how do you push it to be?

» **Wardle**: It will come into benchmarks – that's the interesting point. That's what will make the difference. Certainly none of the schemes that I'm involved with in EMD have any exposure to China at the moment, but we will see that changing.

» **Chair**: And you would wait for the index inclusion to happen before formalising that?

» **Wardle**: Probably, yes.

» **Butcher**: It depends - you're running a portfolio of assets with the help of a firm of consultants and a bunch of investment managers. They tell you a story and you decide whether you're going to buy it. Inclusion in an index is likely the way that most will formalise it. You might well have some investment already.

The key thing is that trustees aren't listening to these arguments. They're not aware of these arguments. These arguments have to be put to the trustees. We've got to deal with death claims. We've got to deal with value for money assessments. We've got to get annual benefit statements out on time. We've got a lot of other stuff that we need to do. We're not reading the *FT* with a microscope every single morning. We're looking for other people to come to us, tell us the story, give us the facts that we need in order to make decisions, and then we'll make decisions.

But we have to make those decisions at the right level.

» **Chair**: Any further thoughts on China?

» **Downing**: We're interested. We certainly have researched it as it is such an exciting area and certainly will be a major theme for investment markets in the next decade. So, actually, I have a question for the managers around the table. Are you allocating into China? Are you going ahead of the benchmark? And if so, how do you evaluate the risk?

» **Carter**: We are and we have local markets analysts. We're building a team in Shanghai. We actually manage an onshore Chinese bond fund, and we've managed that since 2010, so we do have a meaningful track record here. We were one of the first Western asset managers to have an onshore Chinese licence. We do have a track record here and we've had a large allocation in several of our EMD funds to onshore Chinese bonds in anticipation of the impending benchmark inclusion.

» **Mahmud**: Bryan *[Carter]*, you mentioned ESG. Is that helping things to improve the corporate governance of these firms? Or is it very early days?

» **Carter**: I would say, on the sovereign side, China scores relatively favourably, because they've made such large investments, especially on the green side, and they've actually become a green bond hub successfully. In terms of ESG footprint and with regard to SRI ratings, we have a problem with data. Everybody has a problem with data, because you need transparency. You need transparency on the governance, you need transparency on the numbers, on the investments, and so it's very difficult to have reliable SRI ratings on corporates.

» **Chair**: Dan *[Fox]*, I would be curious to get your views on how you are looking at spaces like onshore China and even India.

» **Fox**: We've got a very small allocation to local debt at the moment and then, within that, we let our allocated manager make the decision over China. I don't think as a standalone investment, at the moment, we would make a sizeable standalone allocation; we don't see it as compensating enough in terms of relative spreads although we do acknowledge that there's going to be huge flows that should benefit there, but we think yields are already fairly tight.

We've been fairly cautious to emerging markets, and given the risk of trade tensions between the US and China escalating further, it's not an area we have been investing in. Whilst we acknowledge that within our overall portfolio we will have exposure, we're expecting our manager to manage that for us.

Looking ahead

» **Chair**: In terms of the client portfolios that you're involved in, just broadly speaking, would you expect the allocation to emerging market fixed income to increase or decrease if you're looking at it over a five-year investment horizon, just from a strategic standpoint?

» **Wardle**: I would probably expect it to decrease. From a DB perspective, as the schemes are maturing more and more, they will probably decrease their allocations. Then even from a DC perspective, there will perhaps be less appetite for EMD in that space.

» **Mahmud**: It depends. For asset owners who have limited resources for governance, exposure to volatile EMD directly will be challenging. However, they may have increasing exposure via their diversified growth fund or a multi-asset bond fund manager. For example, given that many asset classes have become expensive, this is one way they can diversify to broaden their universe and access better valued opportunities over time.

» **Fox**: I'd say from return-seeking fixed-income, over five years it will increase; but for our client portfolios over the next six months to a year, I don't anticipate much change from the current position. If EMD continues to cheapen a lot more from hereon then that might change, but otherwise allocations will remain at similar levels to where they are now. But over five years, I think we will see an increase.

» **Downing**: I think, within the return-seeking part of the portfolio, EM exposure will increase. Investors will always have a demand for return-seeking assets and always want higher yield. They'll always want diversification. Also, the emerging market universe is increasing, so that would all mean a bigger allocation to emerging. I think frontier market investing is very much overlooked at the moment too.

» **Butcher**: Again, coming from a slightly different perspective, I can see pressure for it to reduce just because of the pressure on trustees. We're expected to understand more, to know more, to ask more questions, so the more complex the asset class, the less likely it is to be considered. That's not necessarily because it's the right investment or the wrong investment. It's just that we haven't got as much time and we're expected to do more and more and more with that little time that we have.

» **Sharma**: I think it's more a question of change. So, for instance, the inclusion of China in the benchmarks is a big, big event – a structural event that changes how global bond portfolios are constructed and composed over a strategic horizon. You can also imagine that if China's seen in one way as part of the emerging market universe, then capital will have to be allocated there. That will be at the expense of the rest of the emerging market universe as well.

» **Chair**: How do you see the emerging market fixed-income proposition developing over the next three to five years? Where are your interests?

» **Carter**: Structurally, Asia is interesting. The wealth creation, the growth of wealth management and asset management in Asia is incredibly powerful and they're going to be buying emerging market bonds. We already see it. We see it in the way they allocate. Proximity wise, they're currently buying Asian bonds, but I expect wealth in China in particular to go global relatively soon and that's going to be an important offset for the de-risking taking place in Europe, or cyclical factors pushing US investors out of the EMD asset class.

Another thing to note – and this is very short-term in nature – is that I've been to Italy a few times over the past couple of months and Italian investors in particular, and actually European investors in aggregate, do see emerging markets as a little bit of a place to hide when interest rates are rising. In the case of Italy, rising very fast. In the case of core Europe, rising a bit more slowly. But that's an interesting phenomenon. It's a short-term phenomenon over the next three to five years. But there has been buying going on for that reason as well recently. ■