

Emerging-markets bonds for income-seekers?

The quality of these bonds is on the rise as developing countries become more stable, economically and politically

BY JADE HEMEON

WITH INTEREST RATES ON Canadian fixed-income securities hovering near rock bottom, emerging-markets bonds could provide some of the answers for income-seeking clients.

Typically, bonds issued by emerging-markets governments and corporations pay significantly higher yields than bonds issued in developed countries.

"The big attraction of emerging-markets bonds is the higher yield relative to domestic bonds, and this is desirable for investors looking for cash flow," says David Kunselman, portfolio manager with **Excel Funds Management Inc.** of Mississauga, Ont. "An investment in bonds is a good way for investors who have never dipped their toes into emerging markets to begin."

The quality of emerging-markets bonds is on the rise as these countries become more stable, both politically and economically, currencies strengthen and credit ratings improve.

Some investment-grade emer-

ging-market bonds offer higher yields than non-investment-grade "junk" bonds trading in domestic markets, and with less risk.

However, it's important to remember that emerging markets have cleaned up their financial regulations and fiscal and monetary regimes only in recent years, and there is greater volatility and less liquidity than for North American securities.

"Emerging-markets bonds have become a viable niche, due to the improving credit quality of developing nations," says Rudy Luukko, investment funds and personal finance editor with Toronto-based **Morningstar Canada**. "These days, the most financially challenged countries, in terms of sovereign debt, are countries such as Greece and Italy rather than emerging markets. There's been a shift in risk in recent years."

Some emerging markets are now judged to be less risky borrowers than several western European countries.

The once debt-heavy emerging markets have an average ratio of government debt to gross domestic product of less than 40%, according to the International Monetary Fund.

By contrast, debt has been rising rapidly in the developed countries, and the G20 nations now have an unwieldy average debt/GDP ratio of more than 90%. In Greece, this ratio is a staggering 130%.

Since 2008, developed countries have experienced 68 downgrades in their credit ratings, while emerging markets have been experi-

encing upgrades. These rating increases are largely as a result of the improved fiscal health of emerging countries.

Currently, 55% of emerging-market debt is rated investment-grade (BBB) or better, a significant increase from just 2% in 1993.

This shift has led to the introduction of handful of emerging-market bond funds available to Canadians, many of them launched during the past year or so. Choices include mutual funds from **AGF Funds Inc.**, **RBC Global Asset Management Inc.**, **Invesco Ltd.** and **Manulife Financial Corp.** (all based in Toronto).

Excel Funds, for its part, introduced two funds a year ago: Excel EM High Income Fund, an actively managed portfolio of sovereign and corporate emerging-market bonds; and Excel EM Capital Income Fund, which bases its returns on Excel EM High Income Fund but converts the interest income into capital gains, thereby generating tax-efficient returns.

Emerging-market bonds are also available as exchange-traded funds from **Bank of Montreal** and the iShares division of Toronto-based **BlackRock Asset Management Canada Ltd.**

As an example of the higher returns offered by emerging-market bonds, AGF Emerging Markets Bond Fund currently has a yield of 6.8%, while AGF Canadian Bond Fund is yielding 3.3%.

Allocating a portion of a client's fixed-income assets to emerging-market debt can provide compelling diversification benefits as well

as an attractive income stream, as emerging-market assets behave differently than those in developed countries.

Jane Lesslie, vice president and senior portfolio manager, global fixed-income and currencies, emerging markets, for **RBC Asset Management (U.K.) Ltd.**, says the correlation in price movements between emerging-market bonds and Canadian bonds is significantly lower than it is between Canadian and U.S. bonds or between Canadian government bonds and Canadian high-yielding corporate bonds.

As is often the case, higher returns come with a higher level of risk. The governments of some emerging nations have historically been less stable than those of the developed world, including Canada and the U.S. And in some countries, such as China, corporate transparency and financial regulations are still muddy.

The variables of an issuer's economic or financial performance could ultimately affect its ability to meet interest payment and redemption obligations.

"When we look for higher yield, we look for sustainability," says Tom Nakamura, vice president at Toronto-based **AGF Management Ltd.** and co-manager of AGF Emerging Markets Bond Fund. "Unlike mature economies that have already seen the benefits of a rising middle class and greater incomes, emerging countries are in the early stages of development. As their economies grow and become more efficient, the swelling ranks

of the middle class will provide a strong underpinning to growth and financial stability."

Currencies in emerging markets have traditionally been more volatile, but as these countries' economies expand and stabilize, many of their currencies have risen in value.

Although some mutual funds restrict their investments to foreign bonds issued in U.S. dollars and then hedge the currency exposure back to Canadian dollars to remove currency risk for Canadians, others hold a mix of US\$-denominated and foreign-denominated bonds. Fund portfolio managers also may seek to augment returns strategically through the appreciation of emerging markets' currencies.

For example, Lesslie says, a Russia government bond denominated in rubles recently had a yield of 10%, about double the yield on a comparable US\$-denominated Russian bond and far above the 1.5% yield on a five-year Canadian government bond.

Nakamura says the AGF fund will, at times, use a derivatives based "overlay" to increase its exposure to selected emerging-market currencies beyond that offered by the actual bond holdings.

"In the long run, we expect the US\$ to decline relative to emerging-market currencies," Nakamura says. "Emerging markets' currencies are gaining credibility as their central banks become more transparent, credible and predictable."

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