EXCEL FUNDS

The Authority in Emerging Markets™

Filling the Income Gap

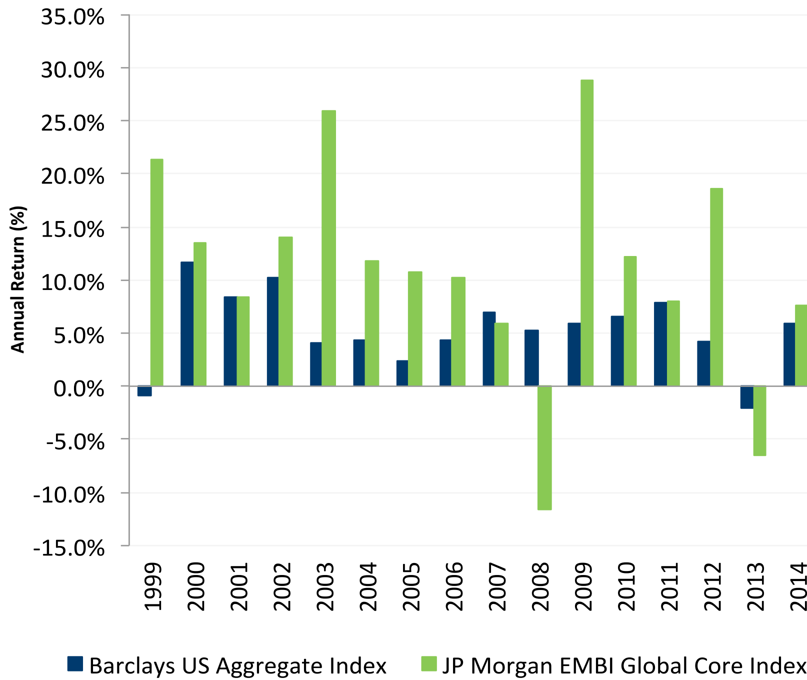
The compelling case for investing in

EMERGING MARKET DEBT

NOVEMBER, 2015

THE COMPELLING CASE FOR INVESTING IN EMERGING MARKET DEBT

The geographically diversified emerging market debt universe is significantly larger and less risky than it was 15 years ago and currently provides substantially greater total returns than developed markets, making it an ideal solution for income seeking investors.[1]



Source: Bloomberg data, as at June, 2015.

As emerging markets (referred to interchangeably as EM or EMs) mature into the drivers of global growth, the structural case for investing in emerging market debt (EMD) has become increasingly convincing. As a result, the once niche asset class has rapidly evolved into a fully integrated segment of the global bond market and is attracting growing interest from both institutional and retail investors.

More importantly, EMD on average, has provided superior returns relative to developed market (DM or DMs) debt and is an ideal solution for income-seeking investors in the current low interest rate environment present in DMs, where yields are normally about one-third of those in EMs.

[1] Bloomberg data, as of June, 2015.

In addition to higher yields, EMD also provides credit quality, duration and currency diversification, and has a low correlation to other asset classes, making it an ideal addition to investors' portfolios.

EM fixed income has low correlation to other asset classes

	EM Bonds	Global Equities	EM Equities	Canadian Equities	US Equities	Canadian Bonds
EM Bonds	1.00	0.25	0.33	0.00	0.25	0.33
Global Equities	0.25	1.00	0.59	0.71	0.89	-0.29
EM Equities	0.33	0.59	1.00	0.41	0.36	-0.07
Canadian Equities	0.00	0.71	0.41	1.00	0.64	-0.30
US Equities	0.25	0.89	0.36	0.64	1.00	-0.30
Canadian Bonds	0.33	-0.29	-0.07	-0.30	-0.30	1.00

Source: Bloomberg, Excel Investment Counsel, Table based on 5 Year correlation from September 30, 2010 to September 30, 2015.

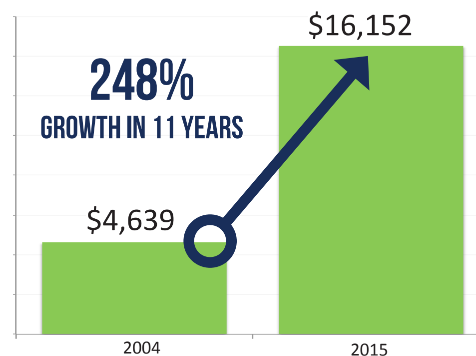
Emerging Market Bonds represented by 50% JP Morgan EMBI Global Composite TR Index and 50% JP Morgan GBI-EM Global Diversified TR Index. Global Equities are represented by the MSCI World TR Index. Emerging Market Equities are represented by the MSCI Emerging Markets TR Index. Canadian Equities are represented by the S&P TSX TR Index. US Equities are represented by the S&P 500 TR Index. Canadian Bonds are represented by DEX Universe Bond TR Index.

GROWING SIZE OF EM DEBT MARKET SUPPORTS GREATER ASSET ALLOCATION

The size of the EMD universe has grown by approximately 14% per year between 2000 and 2014 to reach over US$15 trillion or almost 14% of all bonds issued globally.[2] When compared to the global investment-grade bond market, the importance of EMD is even more meaningful. EMD represents almost 33% of the US$45 trillion investment-grade bond market using the Barclays Capital Global Aggregate Bond Index as a proxy for the global investment grade bond market.[3]

The case for EMD is further enhanced by the fact that the pace of growth of EM corporate debt is significantly faster than that of DM corporate debt – which from an asset allocation standpoint means that a greater portion of investors' asset should be allocated to EM bonds.[4]

The breadth of the EM fixed income market



Source: BAML Research data, as of April 30, 2015

[2] BAML: Size and Structure of Global Emerging Market Debt, July 10, 2015.

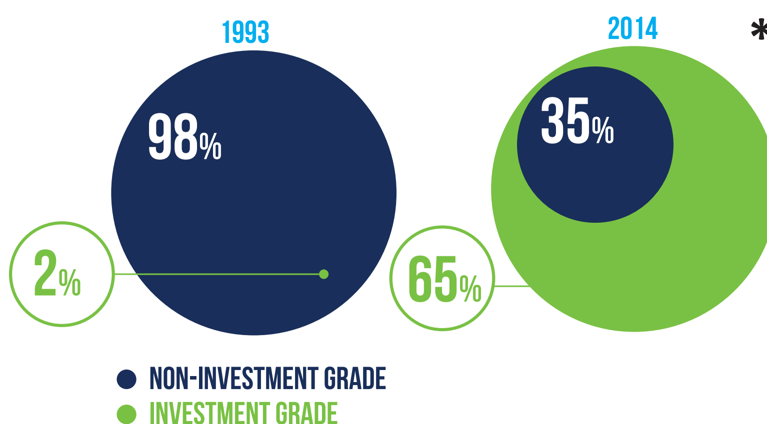
[3] Lazard Asset Management: An Asset Class in its own Right, Updated October 3, 2014.

[4] Credit Suisse: Emerging Capital Markets: The Road to 2030, June 23, 2014.

EMD has come a long way since the 1990s, when EMs were plagued by various crises such as the Mexican 'Tequila' Crisis (1994), the Asian Debt Crisis (1997) and the Russian Ruble Crisis (1998). Then, the asset class was viewed as high risk - a rating that reflected high incidence of defaults.

However, this is no longer the case. EM countries have learned from their past mistakes and instituted structural adjustment and policy measures to put their economies in order. As a result, the debt-to-GDP ratio of emerging markets has fallen dramatically since the turn of the century, giving emerging market policymakers greater flexibility to implement fiscal and monetary policies that facilitate macroeconomic stability.

The credit quality of EM sovereign fixed income has dramatically improved



* The above graph is representative of the JP Morgan EMBI Global Diversified Index.

THE SHIFT TO LOCAL CURRENCY DEBT

One of the most important developments in EMD issuance is the shift to local currency debt. Traditionally, the greater portion of EM bonds was denominated in either U.S. dollars or euros. However, in recent years, EM nations have opted to issue bonds in their own currency. Domestic debt currently accounts for almost 86% of total global EM debt outstanding.[2]

On average, total EM domestic debt stock has grown approximately 15% per year since 2000, with Brazil, Russia, India and China accounting for 59% of all domestic EM debt.[2]

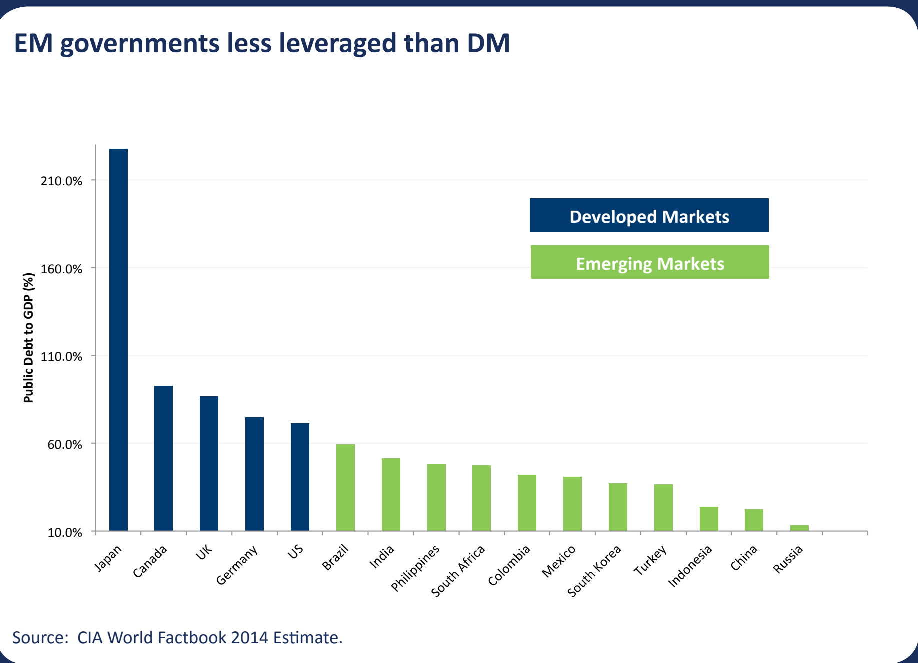
The shift to issuing debt in local currencies has resulted from improved credit ratings of emerging countries; significantly higher economic growth; substantially lower debt levels; and much higher foreign reserves – resulting in EM countries becoming less dependent on external currencies. Incidentally, bonds issued in local currency are not as susceptible to swings in the U.S. dollar or euro, reducing currency risk for investors.

[2] BAML: Size and Structure of Global Emerging Market Debt, July 10, 2015.

The resulting stronger macroeconomic profiles of EMs, which in turn contribute to the attractiveness of their debt, can be attributed to 5 factors: (i) greater fiscal and monetary stability, (ii) faster economic growth, (iii) improving credit ratings, (iv) higher foreign reserves, and (v) the declining risk of defaulting on their debt.

(i) Greater Fiscal and Monetary Stability

EM governments have been implementing more policy measures since the late 1990s to strengthen the financial infrastructure of their economies. As a result, the debt-to-GDP ratio of EMs has fallen dramatically and is currently, on average, about 35%.[5] Comparatively, the debt-to-GDP ratio of DMs has risen sharply since the 2007-08 financial crisis and is on average over 100%, putting EM economies on sounder footing than their DM counterparts.[5]

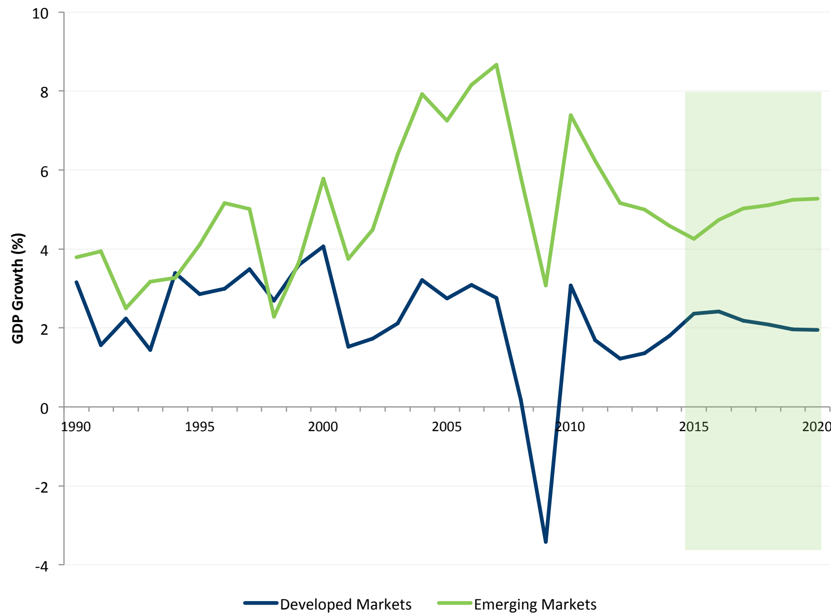


[5] CIA World Factbook 2014.

(ii) Faster Economic Growth

While growth rates diverge across the universe of EMs they are, on average, growing more than twice as fast as DMs and are expected to develop at an even greater pace over the next two decades. Approximately 70% of global growth is forecast to come from EMs in 2015.[6] The primary drivers are a an expanding middle class, increasing spending on consumer goods, industrialization, and accelerated infrastructure development.

EM outgrowing DM consistently



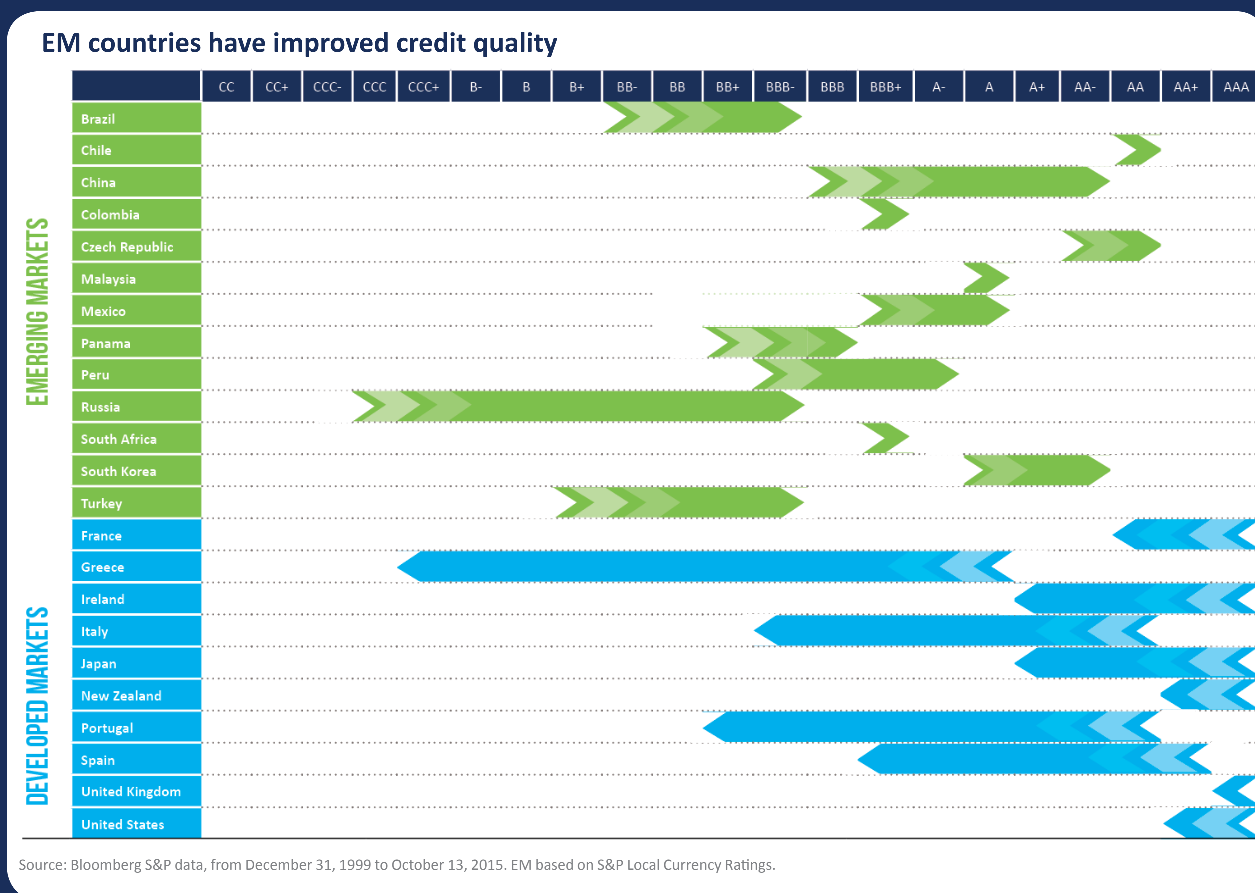
Source: IMF World Economic Outlook Database, April, 2015.

[6] International Monetary Fund, World Economic Outlook, April, 2015.

(iii) Improved Credit Ratings

Sound fiscal and monetary policies, larger foreign reserves and lower debt levels have resulted in credit upgrades for an increasing number of EM countries. In 1992, only 2% of EM debt was rated investment grade, compared to 65% today, reducing the risk premium of investing in the asset class. [7]

Additionally, the government debt-to-GDP ratio of developed countries is on average about 100%, compared to approximately 35% for emerging markets.[5] High DM debt levels are a drag on their economies and are a significant contributor to their lower economic growth.



[5] CIA World Factbook 2014.

[7] Referencing the constituents of the JP Morgan EMBI Global Diversified Index.

(iv) Larger Foreign Reserves

EMs have significantly larger foreign reserves than DMs, giving their governments the ability to repay their external debt and maintain currency stability. For example, the foreign reserves of seven of the largest EMs – China, Brazil, India, Mexico, Turkey, Indonesia and Russia – currently amounts to over US$4.9 billion compared to US$1.5 billion for the seven largest DMs - Japan, France, Canada, UK, Italy, Germany and the USA.[8] Strong foreign reserves in EM countries are an important contributor to their improving credit ratings.

Source: Bloomberg as at October 13, 2015.
E7 comprised of: China, Brazil, India, Mexico, Turkey, Indonesia and Russia.
G7 comprised of: Japan, France, Canada, UK, Italy, Germany and US.

(v) Declining Risk of Default

All of the aforementioned factors have helped to significantly lower the risk of default in EM countries. To recapitulate, EM governments have learned valuable lessons from the sovereign debt crises and currency devaluations of the mid-to-late-1980s and have since adopted prudent monetary and fiscal policies which have made their economies more stable. They are experiencing strong economic growth, have introduced flexible currency exchange rates, accumulated vast reserves of foreign currencies and reduced their debt levels. These structural improvements in their macro conditions have improved their creditworthiness, lowering the risk of default.

In addition, the majority of EM bonds are now issued in local currency. These bonds are less susceptible to swings in the U.S. dollar, reducing currency exposure. Strong foreign reserves in EM countries are also an important indicator of their ability to repay their foreign debt. High foreign reserves provides governments with the ability to stabilize exchange rates and provide a more favourable economic environment or to purchase its domestic currency to protect the country from attacks by speculators. They are also an important indicator of a country's ability to repay its foreign debt.

[8] Bloomberg data, as at October 13, 2015.

FILLING THE INCOME GAP

After almost three decades of declining interest rates in DMs, culminating in record-low interest rates to stimulate economic recovery following the 2007-08 financial crisis, investors now find themselves earning very little interest income from bonds issued by DM countries, such as Canada, Germany and the U.S.

However, the scenario is different in EMs where higher interest rates equate to higher yields for investors. This in large part is due to stronger economic growth in emerging countries which have contributed to inflation. As a result, higher interest rates have been used as a monetary policy tool to temper rising inflation. Currently, interest rates in EM countries are significantly higher than in DM countries.

Should interest rates fall in EMs, investors will benefit in another way from holding EM debt, that is, from bond price appreciation. Therefore, by owning EM government and high quality corporate bonds, investors gain the overall benefit of more attractive interest rates in emerging countries but also have the longer-term potential of greater bond price appreciation.

THE RATIONALE FOR ACTIVE MANAGEMENT OF EMD

EXCEL HIGH INCOME FUND

Active management of an EMD portfolio allows for tactical shifts in country, currency and interest rate risks based on changing market conditions to enhance returns.

The Excel High Income Fund is co-managed by Excel Investment Counsel Inc. and Amundi S.A. and is sub-advised by Amundi Canada Inc. Amundi is one of the world's largest asset managers with over US$1 trillion in assets under management.[9]

THE MANDATE OF THE FUND IS:

- *Invests 100% in average-rated investment-grade quality EM bonds, both sovereign and corporate*
- *Exposure to 45 to 50 countries, at any one time*
- *Diversified exposure to 100 positions*
- *Blend of hard currency (USD/Euro) and local currency bonds*
- *$0.025 distribution per unit/month*
- *Actively focused on: country selection, security selection and currency management overlay*

A COMPELLING CASE

The case for higher allocation to EM debt is very compelling. EM economies have been able to withstand global market turbulence better than their DM counterparts in recent years and currently represent the world's most dynamic growth opportunity. Concurrently, EM debt has become a viable asset class which provides higher returns with significant diversification benefits and reduced risk. It is therefore imperative for investors seeking to fill their income gap to invest in EM debt.

[9] AUM data as at September 30, 2015.

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