Our Thesis Remains in Place to Emerging Markets Bonds

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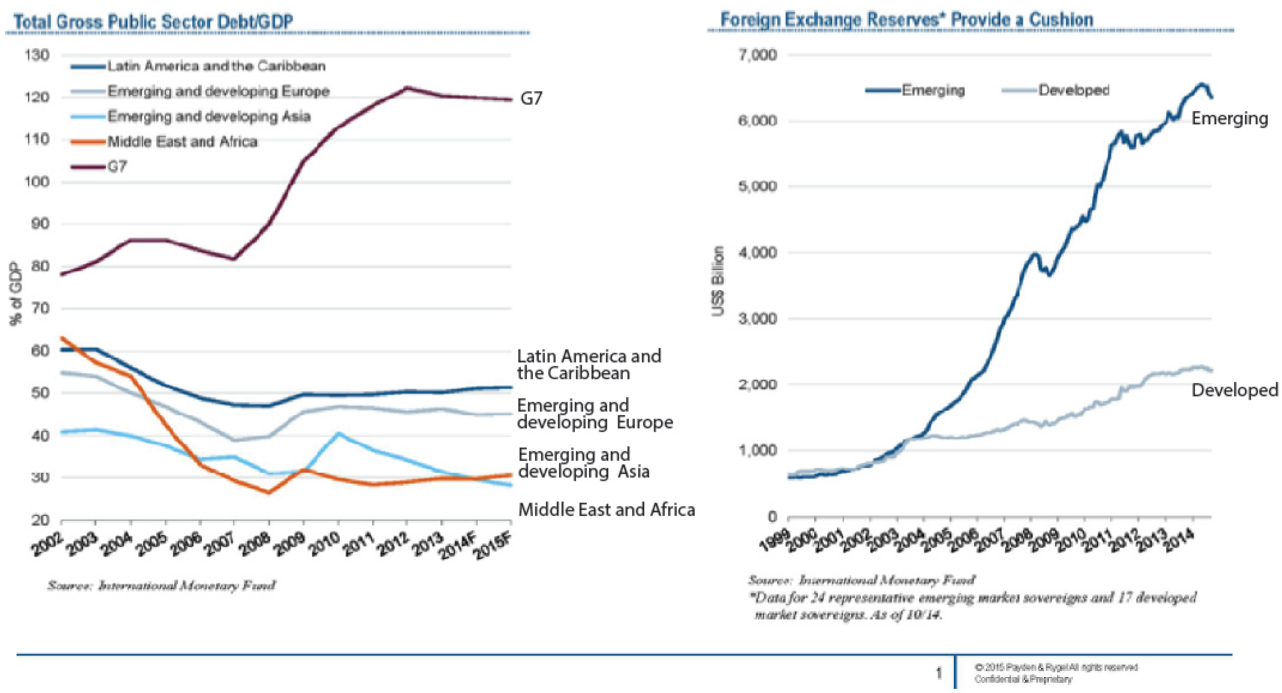
We field questions from clients frequently about the rationale for having emerging markets bonds (EMB) in our portfolio strategies. As we've mentioned in the past, we have this asset class in our strategies for both diversification benefits and to align with two of our long-term themes:

1. Emerging economies will have faster economic growth than developed countries due to the debt burdens of the developed countries.
2. Diversification against the dollar.

In a recent due diligence meeting with our EMB manager, Payden & Regal, we found the following three exhibits very interesting and to help illustrate why to have EMB in client portfolios over the long term.

Exhibit 1: Financial Position Stronger than Developed Countries



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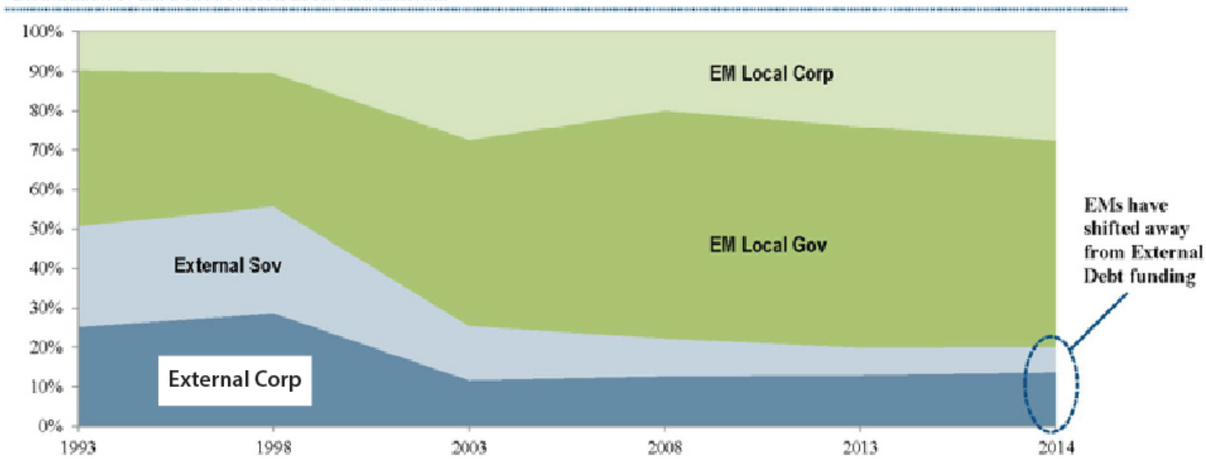
On the above, the left graph shows government debt as a percentage of Gross Domestic Product (GDP) for various countries. A low debt-to-GDP ratio indicates an economy that produces and sells goods and services sufficient to pay back debts without incurring further debt. The purple line represents the G7 developed countries (Canada, France, Germany, Great Britain, Italy, Japan, and the United States). As you can see with the extensive stimulus packages delivered by these governments since the financial crisis of 2008, the debt-to-GDP ratio has increased substantially.

On the other hand, emerging countries (Latin America and the Caribbean, Emerging and developed Europe) have maintained or lowered this key ratio. This is one of the ratios that highlights that emerging countries are in better financial health than the larger, more developed nations.

The right hand side of the same exhibit graph shows the level of foreign currency reserves held by developed and developing countries. Foreign-exchange reserves (also called forex reserves or FX reserves) are assets held by central banks usually in different reserve currencies and used to back its liabilities. Similar to the graph on the left, emerging country central banks have increased the amount of reserves they have at their disposal vs. developed country central banks. This gives the emerging country central banks a bit more flexibility in addressing changes in currency values and inflation.

Exhibit 2: External Debt Financing

Distribution of EM Debt between Local and External



Expect Scarcity of External Debt to Continue in 2015

External sovereign forecasts ($bn)	Gross	Coupons	Amortizations	Total cash flows	Net
Asia	7	4.8	4.0	8.8	-1.8
EMEA	42.5	19.3	25.2	44.5	-3.5
Latin America	20.3	16.2	15.7	31.9	-11.6
Total	69.8	40.3	44.9	85.2	-15.4

Source: JP Morgan

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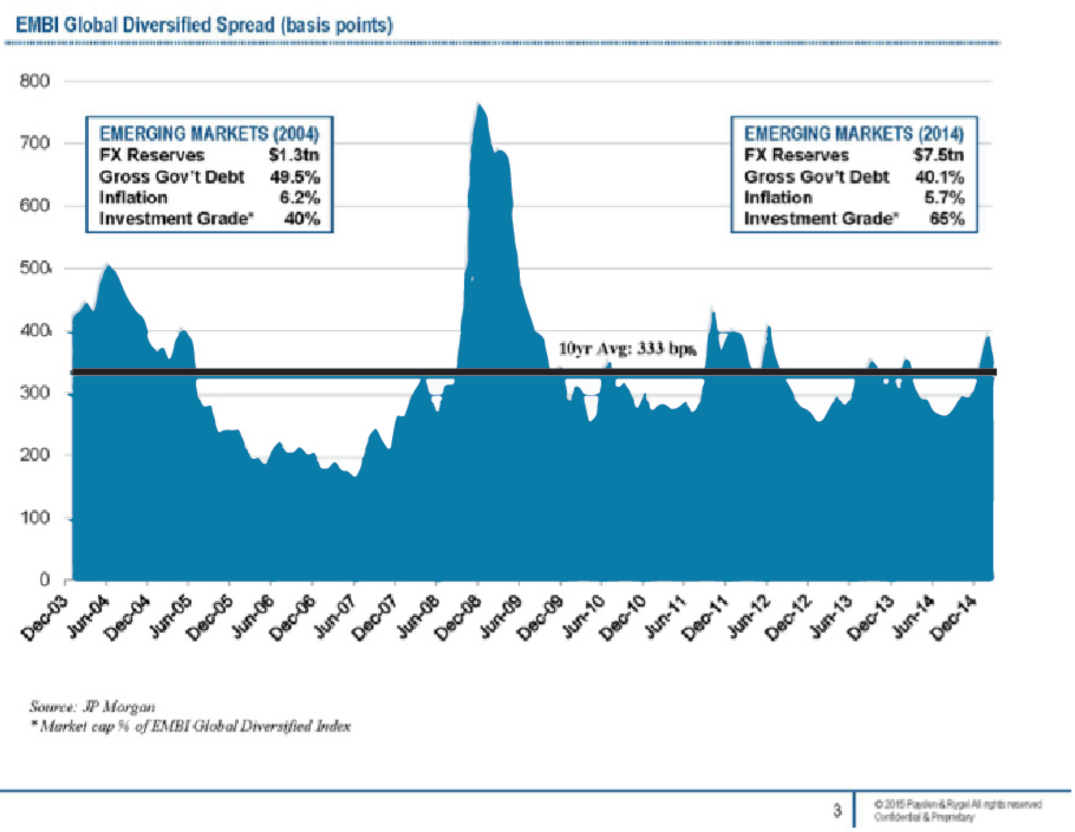
While Exhibit 1 provided a couple of key measures of financial strength, Exhibit 2 shows the change in the financial markets for emerging market bonds. As the graph shows, in the 1990's and early 2000's over half of all debt issued by emerging countries was denominated in hard currency (US dollar, Euro, British Pound), with the remainder issued in the local currency. After the Russian Ruble crisis in 1998 many emerging countries eliminated the currency restrictions (pegs) to the US dollar, allowing the value of their currency to freely float based on market conditions. This change was the key driver in the development of local financial markets and issuance of bonds in local currency. As you can see in the graph, now over 70% of emerging country debt is traded in the local country market in the local national currency. Local markets now have more depth and liquidity than at any time in the past. Although impacted by changes in currency exchange rates, both sovereign governments and corporations have more flexibility and ability to manage this risk than in the recent past with securities issued in local currency.

Exhibit 3: Valuation



The above shows that, despite the improved financial strength and improved foreign currency positions of emerging markets countries, the asset class is trading at levels close to historical averages. The little boxes show the comparison between 2004 and 2014. Foreign currency reserves have increased from $1.3 trillion to $7.5 trillion, government debt has declined from 49.5% to 40.1%, inflation is under control and the number of countries now considered investment grade has increased from 40% of the JBM EMBI Global Diversified Index to 65% today.

So, from an investment standpoint when we compare emerging markets debt to developed country debt, we find emerging more attractive. The financial strength of EMB is better, foreign currency reserves are superior and liquidity is robust. All this and valuations based on spreads to US Treasuries is at historical normal levels.

We remain committed to having emerging markets bonds in our portfolio strategies for the total portfolio benefits of diversification, the exposure to growing economic and financial areas and the diversification versus the dollar. The negative performance of emerging market debt is a clear example of how diversification works. Not all asset classes will perform well at the same time. Some asset classes (like commodities and emerging market debt) may be in a cyclical downtrend while others (like real estate and equities) are in a cyclical uptrend. If we knew which asset class would perform the best, we would not need to diversify. Since we do not have a crystal ball, and cannot forecast which asset class will perform the best, diversification remains the best strategy for long-term success in meeting client goals.