

The Seven Deadly Sins of Emerging Markets Debt Benchmarks

ARTISAN PARTNERS EMSIGHTS CAPITAL GROUP

Emerging markets debt (EMD) has long languished under a cloud of skepticism and disappointment. Complexities and unique risks embedded in the asset class tend to intimidate investors, while limitations of the widely followed EMD benchmarks perpetuate myths of volatility, unpredictability and fragility. Many investors who have approached the asset class through the lens of the benchmark have had unpleasant experiences marked by disappointing performance and vertigo-inducing volatility. But investing in EMD does not have to be this way; a different approach to investing can yield positive, alpha-generating outcomes.

Understanding embedded uncertainties in the asset class and thoughtfully managing around the benchmark limitations can help investors steer clear of unnecessary risks and achieve a more favorable, smoother outcome. Let’s explore the seven EMD benchmark constraints—or seven deadly sins—that contribute to the asset class’s checkered reputation. When considered individually, each sin may seem insubstantial, yet when combined, they have led many EMD benchmarks to fall short in demonstrating the diversifying and opportunistic attributes of the asset class.

1. Excluded Countries, Excluded Opportunities

All benchmark providers establish strict criteria for inclusion to ensure their



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benchmarks are a comprehensive, investable and unambiguous measure of the market they are tracking. In the case of EMD, that screening process ends up excluding from consideration a large subset of the EMD-investible universe. This limitation is

particularly pronounced in the local market, where the J.P. Morgan GBI-EM Global Diversified Index (local benchmark) currently includes 18 countries. In comparison, we have identified an additional 49 investible local markets.

Source: Artisan Partners/J.P. Morgan. As of 31 Mar 2024. “Local EM Index” is based off the J.P. Morgan Government Bond Index-Emerging Markets Global Diversified Index. Green colored countries represent a portion of the trading markets accessible by the EMSights Capital Group.

2. Market Capitalization Weighted

Country allocations in EMD benchmarks are determined by market capitalization, meaning that the more indebted a country is or the more debt it issues, the larger its weight

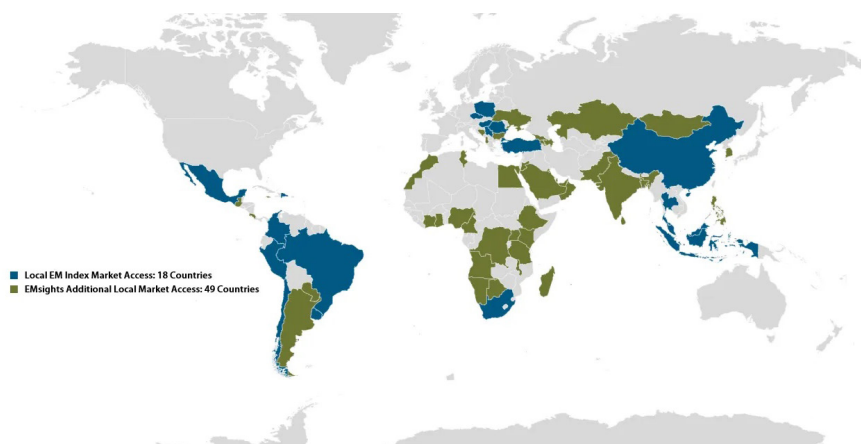


Exhibit 1: EMSights Additional Local Market Access vs. Local Benchmark Market Access

in the benchmark. This is counter-intuitive to what we believe makes fundamentally sound investments—typically, the more indebted a country is, the more risk and volatility associated with it.

The market capitalization methodology also obscures the lack of diversity in benchmarks, which are more concentrated than investors realize. The J.P. Morgan EMBI Global Diversified Index (hard currency benchmark) consists of 69 countries, with the 26 largest country weightings amounting to 80% of the benchmark and the 26 smallest country weightings amounting to only 5.0%. Several countries and instruments are excluded altogether.

3. Diversification Illusion

Investors often assume benchmarks are diversified given their wide scope; however, a closer look at the underlying constituents reveals a different story.

The local currency benchmark consists of 18 countries; only nine of them have weights >5% but account for 82% of the benchmark. These countries may seem to adequately represent the broader market as they cover all major regions and run the gamut of political regimes. However, their currencies have exhibited a high positive pairwise correlation over the past three years. When we expand the analysis to currencies outside the benchmark, the pairwise correlation drops to nearly zero, a notable improvement.

Benchmark currencies also exhibit greater volatility as capital inflows and outflows in the asset class are primarily directed towards or funded by countries within the benchmarks. The upshot of this trend is a benchmark skewed towards more volatile currencies.

Lastly, benchmarks are constructed based on pre-defined criteria with little attention to underlying constituent characteristics. This results in outsized exposure to certain risk factors over time, such as oil. Oil-producing countries have made up 26%-48% of the hard currency benchmark over the last 20 years, with the exposure swinging randomly.

4. More Coverage, More Efficient

EMD encompasses a diverse range of countries, each presenting unique complexities that necessitate investors to have a deep understanding of the markets. While leading sell-side research firms disseminate information, their coverage typically focuses on countries in the EMD benchmarks, with only a handful extending beyond that. The disproportionate attention given to benchmark countries increases market efficiency among that group and leaves inefficiencies in markets outside the benchmarks' scope. We perceive greater potential opportunities and additional sources for alpha generation in countries that are less efficient and not part of the benchmark.

5. Non-EM Risk Is an Ever-Present Danger

Obtaining pure exposure to EM risks is nearly impossible due to the influence of exogenous factors on the asset class. In turn, a significant portion of EMD benchmark returns are dictated by non-EM risks.

Duration is one of the primary non-EM risks inherent in EMD benchmarks. The hard currency benchmark has historically exhibited six to eight years of US duration. This has proven to be beneficial in some environments but a challenge in others. Across nearly all environments, though, US duration has been a dominant driver of benchmark returns, overpowering idiosyncratic country-driven returns and eroding some of the asset class's diversification benefits. Over the past 20 years, US duration has accounted for 43% of the benchmark's 5.58% annualized return.

Another non-EM risk embedded in benchmarks is the influence of the EUR/USD exchange rate on local currency debt. The five Eastern European countries represented in the local currency benchmark, accounting for over 20% of the benchmark, exhibit an almost perfect positive correlation to the euro

(when traded relative to the dollar). In turn, purchasing local debt issued by any of these countries effectively provides exposure to the euro. However, if these currency investments are traded against the euro, rather than the dollar, the pairwise correlation between the currencies decreases to 0.1, and their volatility is halved.

6. Low Spread Securities

Within the hard currency benchmark, 50.2% of the bonds had spreads narrower than 150bps as of March 31, 2024. For many investors, the transaction costs of investing in these bonds can outweigh the potential return benefits.

7. Defaulted Countries Remain in The Benchmark

EM sovereign debt benchmarks permit defaulted bonds to remain in the benchmark, presenting a unique quirk in the methodology. Occasionally there are hidden gems within defaulted or distressed countries, but most of the time these are non-performing bonds that sit in the benchmark, do not pay coupons and weigh on performance. Other fixed income benchmarks, such as corporate (EM and non-EM) benchmarks, remove defaulted securities at the next rebalancing period.

THE UNCONSTRAINED ADVANTAGE

In an ever-changing world, flexibility is an advantage. Regardless of news, valuations and sentiment, the benchmarks remain rigid in their construction and inclusion criteria with few exceptions. As an active, benchmark-agnostic investor, our dynamic process and broad investment universe allow us to thoughtfully manage around the seven deadly sins of EMD benchmarks and capture the entire opportunity set.

Carefully consider the Fund's investment objective, risks and charges and expenses. This and other important information is contained in the Fund's prospectus and summary prospectus, which can be obtained by calling 800.344.1770. Read carefully before investing. Current and future portfolio holdings are subject to risk.

The value of portfolio securities selected by the investment team may rise or fall in response to company, market, economic, political, regulatory or other news, at times greater than the market or benchmark index. International investments involve special risks, including currency fluctuation, lower liquidity, different accounting methods and economic and political systems, and higher transaction costs. These risks typically are greater in emerging and less developed markets, including frontier markets, and include new and rapidly changing political and economic structures, which may cause instability; underdeveloped securities markets; and higher likelihood of high levels of inflation, deflation or currency devaluations. Fixed income securities carry interest rate risk and credit risk for both the issuer and counterparty and investors may lose principal value. In general, when interest rates rise, fixed income values fall. High yield securities (junk bonds) are speculative, experience greater price volatility and have a higher degree of credit and liquidity risk than bonds with a higher credit rating. Use of derivatives may create investment leverage and increase the likelihood of volatility and risk of loss in excess of the amount invested.

Past performance does not guarantee and is not a reliable indicator of future results.

This summary represents the views of the Artisan Partners EMSights Capital Group, managers of the Artisan Global Unconstrained and Emerging Markets Debt Opportunities Funds, as of 30 April 2024. Those views are subject to change and Artisan Partners disclaims any obligation to advise investors of such changes.

The J.P. Morgan (JPM) EMB Hard Currency/Local currency 50-50 is an unmanaged, blended index consisting of 50% JPM Government Bond Index-Emerging Market Global Diversified (GBIEMGD), an index of local-currency bonds with maturities of more than one year issued by EM governments; 25% JPM Emerging Markets Bond Index-Global Diversified (EMBIGD), an index of USD-denominated bonds with maturities of more than one year issued by EM governments; and 25% JPM Corporate Emerging Market Bond Index-Broad Diversified (CEMBIBD), an index of USD-denominated EM corporate bonds. The index(es) are unmanaged; include net reinvested dividends; do not reflect fees or expenses; and are not available for direct investment.

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