Schroders

Schroder Emerging Market Debt Relative

Strategy Overview

Summary

The Schroder Emerging Market Debt (EMD) Relative strategy is a relative return multi-sector strategy that integrates sovereign hard currency debt, local currency rates and currencies, and emerging market corporate debt within an actively managed, strategic asset allocation framework.

Using this approach, we capture the full opportunity set in Emerging Market (EM) fixed income while managing these four alpha sources in an integrated manner with the goal of pursuing the highest risk-adjusted returns available within the asset class.

Firm highlights

- Founded in 1804, with a strong family presence to this day
- Asset management is our main business
- Over 740 investment professionals worldwide
- Truly global reach: based in London, with offices in 32 countries
- Expertise in Fixed Income, Equities, Multi-Asset, Solutions, and Alternatives

Team highlights

- Geographically dispersed, highly experienced team based in New York and Singapore
- Pioneers in the multi-sector EMD approach
- The team draws on the expertise of a team of 40+ global credit analysts

Key features

- The strategy uses an integrated approach to the main sectors of EM fixed income, insuring that portfolio risks are assessed in the most comprehensive manner
- The strategy is less benchmark-constrained than typical hard currency sovereign-based strategies, which provides the flexibility to pursue the most attractive investment
- Portfolio construction uses a proven investment approach: an intrinsic rating process; corporate relative value recommendations; a proprietary EM liquidity index; and a transparent portfolio construction framework where the underlying assumptions of expected returns are made explicit

Investment objective

The strategy uses a benchmark index consisting of 1/3 JP Morgan EMBI Global Diversified, 1/3 JP Morgan GBI-EM Global Diversified and 1/3 JPM Morgan CEMBI Broad Diversified.[1] The strategy seeks to outperform this index by 200-plus basis points over a typical market cycle.

[1] JP Morgan EMBI Global Diversified, JP Morgan GBI-EM Global Diversified and JPM Morgan CEMBI Broad Diversified are unmanaged portfolios of local and global emerging market debt securities used as a point of comparison for the strategy. No strategy can guarantee that its performance will exceed or match the performance of its benchmark.

All data and statistics as of December 31, 2018.

Investment philosophy

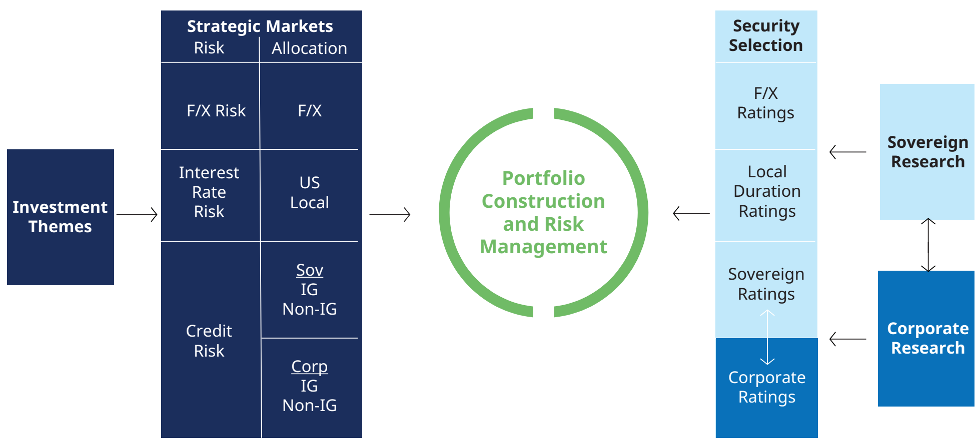
- As investors seek to access the full range of EMD fixed income opportunities with increased allocations to the asset class, a dynamic, integrated approach to the four primary sources of alpha, rather than investing in any of the sectors on a standalone basis, provides the opportunity to maximize both absolute and risk-adjusted returns while minimizing risk.
- The multi-sector approach emphasizes the identification and minimization of key risk factors, stress testing and global scenario analysis for the portfolio as a whole and for each sector.

Investment process

Schroders' multi-sector approach to EMD follows a disciplined investment process. We begin with a top-down strategic market asset allocation process that takes into account a wide variety of information from both external and internal sources. We pay close attention to the overall liquidity environment in EMD as that has been a major driver of historical returns.

We also continually monitor sovereign and corporate sector valuations – both investment grade and high yield – and local yield and historical F/X valuations to understand what value may be present at any given time.

We distill this information into a score about the attractiveness of various sectors within EMD on a monthly basis. We divide the EMD universe into Strategic Market Allocations, which are meant to serve as longer-term anchors to the portfolio.



Source: Schroders.

We then move on to our analysis which develops the USD sovereign, F/X and local duration ratings. Our Sovereign Credit Model utilizes 10 factors which are specifically based upon external, growth and public debt dynamics, and not market data. Sovereign Credit Model output is also stress tested at the country level to help determine our intrinsic country credit ratings.

Finally, we add to this our qualitative research from a global team that is focused on the markets every day. This is important, of course, because models aren't infallible, and they can't measure every factor at work. We rate these countries on a scale ranging from Improving, Moderately Improving, Stable, Moderately Declining, and Declining.

Investment process (continued)

Once all of that information is aggregated and analyzed, we develop our own Intrinsic Rating for each country, which is its fundamental rating after the credit trajectory, market technicals and potential catalysts are factored in. Our Intrinsic Ratings are on the AAA to C scale, much like the rating agencies. Opportunity exists when there is a divergence between the levels at which the rating agencies, current market price and Schroders collective research value a credit. We rank all of the sovereigns within the specific Intrinsic Rating groups (AA, A, BBB, and so on). From there we can assign a sovereign rating on a scale from 1-4, with 1 being the most attractive. (1 is a buy, 2 is an overweight, 3 is an underweight, and 4 is a sell).

Therefore, a 2 MI would represent a moderately improving credit that is a candidate for overweighting (subject to overall portfolio fit, of course).

Local duration and F/X ratings are separately developed using much of the same input, but reflecting the fact that these assets do have different valuation drivers. We use qualitative factors (such as the steepness of the yield curve and changes in CPI) and market drivers (such as the policy framework and current local bond valuations). Our rating range for F/X and Local Duration is Overweight, Market Weight and Underweight.

Risk management

The Schroder EMD Relative strategy focuses on achieving the highest risk-adjusted returns possible. Each position is stress tested for fundamental country degradation and a potential negative global macro environment.

From time to time, the strategy uses derivatives to hedge risk or, less frequently, to incorporate risk in countries where access to local currency markets is limited. These derivatives may include interest rate futures, interest rate swaps, credit default swaps, credit linked notes, currency forwards, and options.

Diversification Rules

- Portfolio duration cannot deviate more than two years from benchmark
- Maximum 30% country limit
- Maximum 40% allocation to Corporate Issuers
- Maximum 50% allocation to Local Currency (unhedged)
- Prudent issuer concentration limits by corporate rating level

Why Schroders for Emerging Market Debt Relative?

- Adopting a less benchmark-constrained approach than traditional sovereign-based strategies, Schroder EMD Relative insures investors have exposure to the team's best ideas. At the same time, additional exposure to local currency rates, currency, and corporate debt incorporates special considerations to minimize interrelated risk factors such as correlations, country exposure, and liquidity that are typically absent in separate allocations to different sectors of emerging market debt.
- A disciplined investment process with an emphasis on risk-adjusted returns through stress testing, global scenario analysis and key risk factor review allows investors to be confident that underlying portfolio assumptions are thoroughly and transparently examined.
- Schroders operates an expansive global EMD platform, with deep and highly experienced management teams in multiple time zones. Our macro, quantitative, and credit teams are among the largest in the business with significant presence in major EM markets.

Risk disclosures

All investments involve risks including the risk of possible loss of principal. The strategy will be affected by the investment decisions, techniques, and risk analyses of the investment team, and there is no guarantee that the strategy will achieve its investment objective. The values of the investments held by the portfolio may fluctuate in response to actual or perceived issuer, political, market, and economic factors influencing the financial markets generally, or relevant industries or sectors within them. Fluctuations may be more pronounced if the strategy invests substantially in one country or group of countries or in companies with smaller market capitalization. These risks exist to a greater extent in emerging markets than in developed markets. The market value of the portfolio may decline as a result of a number of other factors, including interest rate risk, credit risk, inflation/deflation risk, mortgage and asset-backed securities risk, U.S. Government securities risk, foreign investment risk, currency risk, derivatives risk, leverage risk and liquidity risk. Frequent trading of the portfolio may result in relatively high transaction costs and may result in taxable capital gains.