Insights

How to capitalize on a low return environment

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Given the investment environment we find ourselves in today, namely that of artificially low government bond yields as a result of global central bank distortions, investors worldwide are rightfully asking the question "How do we invest money in a low return environment?"

In this paper we put forward three possible solutions for investors to consider, namely deploy risk to maximise your return potential, deploy risk in the area of greatest inefficiency and deploy risk where sentiment leads to mispricing opportunities.

1. Deploy risk where you are being paid to take it

Fig.1 Yield comparison by asset class – hard currency

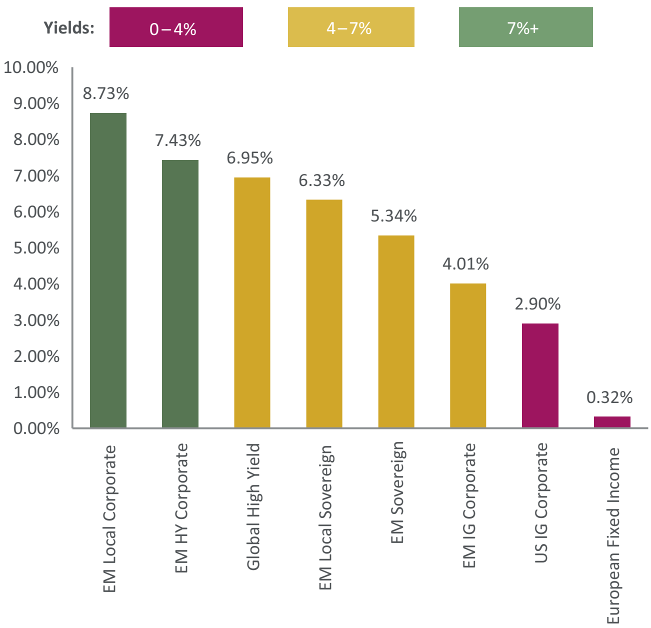


Fig. 2 Yield comparison by country – local currency

Negative | 0–1% | 1%–2% | 2%–5% | 5%+

	1Y	2Y	3Y	4Y	5Y	6Y	7Y	8Y	9Y	10Y	15Y	20Y	30Y
Germany	-0.62	-0.66	-0.66	-0.63	-0.57	-0.54	-0.45	-0.38	-0.26	-0.13	-0.08	0.12	0.38
Japan	-0.32	-0.30	-0.29	-0.30	-0.31	-0.31	-0.31	-0.30	-0.27	-0.22	-0.10	0.08	0.14
UK	0.15	0.10	0.17	0.28	0.35	0.51	0.65	0.78		0.87	1.40	1.57	1.70
USA	0.43	0.58	0.69		1.00		1.28			1.47			2.28
Brazil	13.34	12.78	12.43	12.27	12.13		12.05			12.07			
China	2.98	3.18	3.07	3.09	3.28		3.38			3.40	3.74	4.00	4.14
India	7.03	7.04	7.14		7.39	7.53	7.53	7.54	7.59	7.45			
Mexico	4.41	5.00	5.23	5.34	5.47	5.62	5.76	5.83		5.90	6.21	6.43	6.49
Russia	9.73	9.35	8.98		8.46					8.29			

Source: BlueBay Asset Management, Bloomberg, as at 30 June 2016

Looking at the yield available on various risk asset classes, you can see that in both hard and local currency markets, the regions that in our view offer the highest return potential are in emerging markets (EM). While in developed markets (DM), yields are significantly lower and, in an increasing number of instances, turning negative.

2. Deploy risk in the area of greatest inefficiency

Fig. 3 Dedicated EM corporate investor base has not kept pace with asset class growth

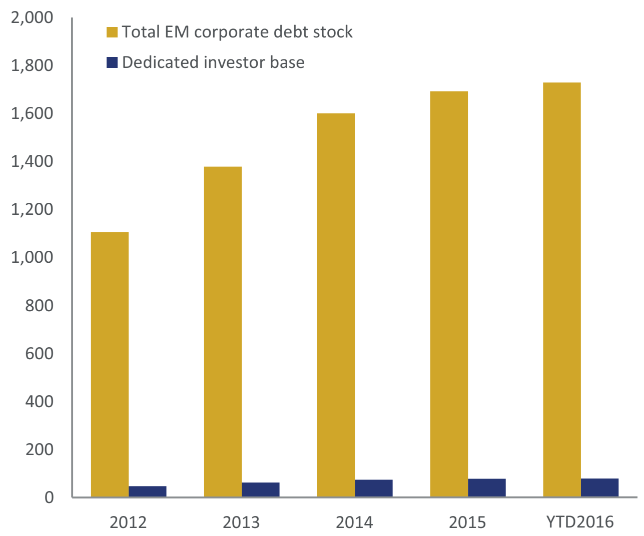
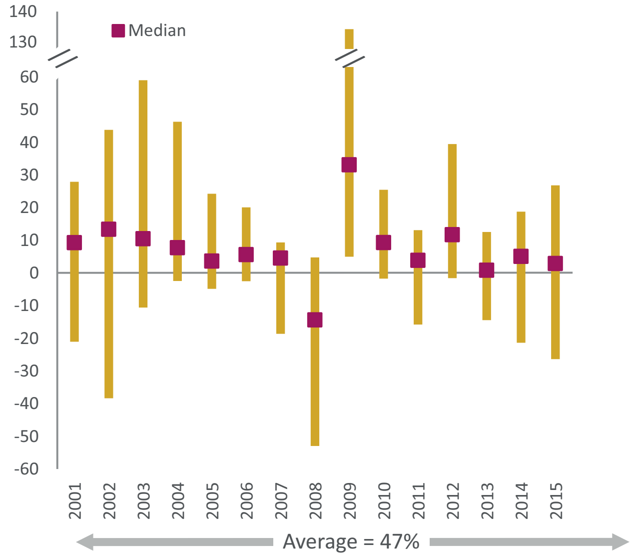


Fig. 4 Significant return dispersion within EM corporate bond markets



Source: JP Morgan, BlueBay Asset Management, as at 30 June 2016. Index used to illustrate return dispersion is the JPMorgan CEMBI Broad Diversified
Note: Chart excludes defaulted credits, actual negative dispersion is higher

Although EM corporate debt as an asset class has been around for nearly a decade, the dedicated investor base has not kept pace with the growth of the investible universe. As a result, we believe this provides plenty of opportunities for the active manager with a dedicated team of specialists to potentially exploit the significant return dispersion available within EM corporate bond markets.

3. Deploy risk where sentiment leads to mispricing

There are a number of common myths surrounding EM corporate debt that are just that. The reality, we believe, is far different.

Myth	The asset class is too small, niche and illiquid	Emerging Market (geo)political risk is too high	Emerging Market companies are too "risky"	There is not enough differentiation within the market to materially benefit
Reality	• US$1.7trn universe • 1,000 companies • 60 countries • 12 sectors	• EM → DM • Brexit • US elections • Global terror	• Better management • Lower leverage • Similar default rate	• ~50% return differential between best and worst credits over 15 years

How can investors successfully navigate these markets?

As you can see, the above solutions all involve allocating capital to EM and EM corporate debt in particular. However, given the heightened risk environment we find ourselves in today (e.g. China, commodities, Federal Reserve interest rate policy, US elections) we feel that adopting a different mindset to the traditionally benchmark-orientated approach is warranted.

The potential benefits of a long-short approach

We feel that a fully unconstrained long/short approach that is designed to take advantage of the dislocations in both rising and falling markets is the optimal way to approach these markets. However, in our opinion, this is no easy task and there are a few critical success factors that we feel are required to navigate these markets successfully.

What should investors look for in an active manager in EM corporate debt?

Don't compromise on resources

EM credit analysis is a labour intensive process so a large, dedicated team of specialist is needed.

Stay liquid

Although liquidity in EM corporates is an improving trend, it is still of vital importance to maintain nimble portfolios.

Bigger is not better

Given constraints of shorting cash bonds in large size, a disciplined approach to capacity is warranted.

Challenge your pre-conceptions

Markets are certainly evolving so the self awareness to challenge your biases is needed.

We believe the BlueBay Emerging Market Corporate Alpha strategy is well equipped to navigate the challenging market environment successfully, and to take full advantage of the potential alpha opportunities on both the long and short side.

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