The Emerging Asian Debt Market: Looking Beyond the Indexes

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If you look closely at a flat-projection map of the world - the standard Mercator projection, with the longitude and latitude lines superimposed, you would see that the squares are only square along the equator. The further away you get from the equator, the longer the grid squares are. But the latitudinal lines are all the same distance from each other, from north to south. But on the map, as you get closer to the poles, your grid squares become more and more rectangular, until they appear 2 to 3 times as long, north to south, on the map, as they are from east to west.

What's more, Greenland - dinky little Greenland - looks as big as the African continent. In reality, Africa is 14 times bigger than Greenland. And Antarctica looks huge! But in reality, Antarctica is one of the smallest continents.

Well, the same distorting effects occur with the indexing techniques investors commonly use to create debt market benchmarks.

Consider: Bond market indexes are built using the total debt market float to construct the benchmark. They are weighted by the total amount of debt outstanding. The more debt a country issues, the worse the fundamentals may become - but the greater weighting that country has achieves in the indexes.

Meanwhile, countries that actually have stronger balance sheets, and which issue more moderate amounts of debt in relation to GDP become substantially underweighted in global debt benchmarks.

As a result, global bond indexes, weighted by the total float, are doomed to lag the true performance of the world debt markets. The more institutional funds rely on indexing strategies and ETFs, the more distorted the market becomes. Countries have a perverse incentive to issue debt to attract capital tied to indexes, while the index fund investors themselves wind up

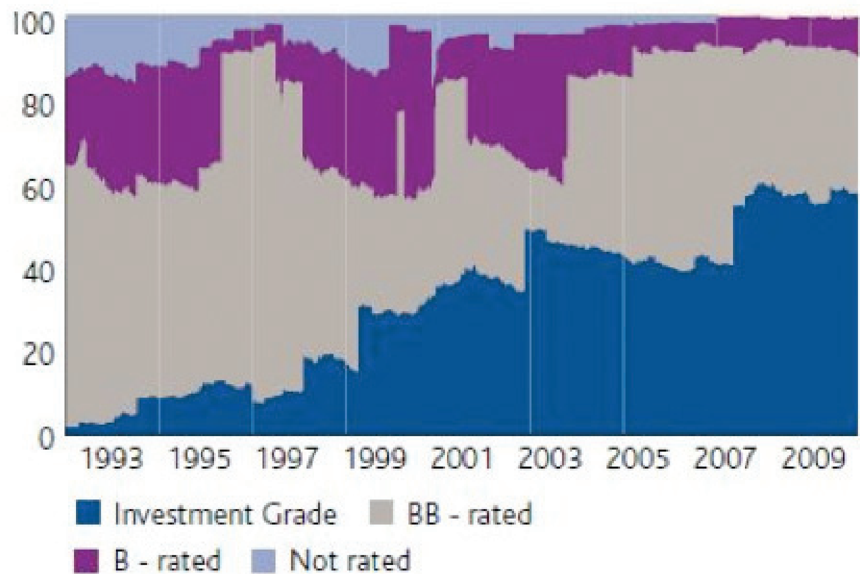
underinvesting in markets with better fundamentals.

The result: Yields in underinvested debt markets may well be unnaturally high, considering their strong balance sheets.

Consider this: debt-ridden Greece, a total basket case, represented just 0.44 percent of global GNP, according to the International Monetary Fund's 2010 World Economic Outlook.[1] But Greek sovereign debt represented several times that weighting in the global debt markets, according to Gerald Hwang, an emerging debt expert with Matthews Funds. "If you were an index investor, you would have been a buyer of Greek bonds at the precise time when you want to run away!" Hwang observes.[2]

Anthony Michael, head of Aberdeen's Asia-Pacific Income Fund, takes similar notice of the funhouse-mirror distortion effect that debt-weighted indexing has on capital flows into the global emerging bond markets: "If you index based purely on debt levels, you get an index with Mexico, Brazil and Russia leading. But if you weight your index via creditworthiness, interest rate outlook and currency appreciation - the real key drivers of bond performance, you have Malaysia, Singapore and Indonesia at the top!" observes Michael.

The result is that huge amounts of capital are funneled to less efficient bond markets in more debt-ridden countries with weaker capital structures - at the expense of the comparatively sound emerging Asian economies. These Asian economies tend to have solid balance sheets, substantial sovereign reserve funds (especially in the case of China), and far superior anticipated growth rates than those markets attracting index money. Consequently, despite Asia's solid economic fundamentals, Asian debt ex-Japan sports a yield spread of around 100 basis points over U.S. debt - significantly above its long-term average spread of 66 basis points.



Source: J.P.Morgan, Oct 2010

Asia Ascendant

Asia already went through its crisis in 1997 and 1998. Since that time, Asian governments have managed to grow substantially even as they substantially deleveraged (take that, Keynesians!) As a result, the trend in Asia has been towards a substantial improvement in credit quality across the board, as the chart shows: In the late 90s, less than 20 percent of the Asian debt market was rated investment grade or better - and some 10 percent wasn't even rated at all. Today more than half of the debt issued in Asian markets is investment grade (BBB) or better, and the percentage of unrated debt is nearly nil.[3]

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That is a truly remarkable capital evolution -all within a decade. As if to punctuate the progress, Fitch and Moody's each recently upgraded Indonesian debt to investment grade -- which itself should make Indonesia eligible for investment from a wider variety of sources, and ultimately reduce the cost of capital substantially. In turn, this should result in a greater flow of investment

1 http://www.imf.org/external/pubs/ft/weo/2010/02/index.htm

2 http://matthewsasia.com/resources/docs/pdf/webcast/The_Case_For_Fixed_Income_Transcript.pdf

3 http://www.aberdeen-asset.us/doc.nsf/Lit/

dollars to the region and boost economic growth.

Diversification Benefit and Portfolio Effects

To understand the potential role of a substantial allocation to emerging market debt -- and Asian emerging market debt in particular -- you should understand that there are really two separate Asian debt markets. One market denominates its debt in dollars, while the other market denominates its debt in terms of local currencies. A strengthening currency situation and improving balance sheets have enabled their credit markets to issue more debt in local currency - which helps insulate Asia's economies from external shocks, and has been a big factor in sheltering Asia from the Euro mess. Asia has been a valuable diversifier against the Eurozone's troubles, sluggish economic performance in the U.S., and even the U.S. high yield market.

Asia has a nice tailwind in this respect, too, argues Anthony Michael: The emerging middle classes in Asia are forming a domestic demand counterweight to their historically export-driven economies. This dynamic changes central bank incentives dramatically. Where an export-driven economy would seek to keep its currency weak to boost sales abroad, bankers in a domestic demand economy have a powerful incentive for a moderate monetary policy, balancing export needs with the desire to maintain the middle class's standard of living, and keep the currency sound - so their new middle classes can buy cell phones and computers and appliances and all the other things that westerners take for granted.

How Best to Participate?

If indexing is suboptimal, then what are the alternatives? Well, you could attempt to select individual issues yourself - but this is extremely time-consuming. Furthermore, there are issues with the way business is sometimes done in Asia that can be inscrutable to the outside investor. One potential issue: Some companies are still very closely held among family members - who may strip the company of its equity at the expense of bondholders. Again, indexing is not a strategy for avoiding this phenomenon - the indexer must buy the bad along with the good.

Further, as fast as Asia is growing, its markets are still tight, from an institutional investor's perspective. A sudden influx of hot money, or a sudden pullout can create liquidity problems for large, actively managed open-end funds.

One advisor, John Cole Scott, Portfolio Manager, Executive VP with Closed-End Fund Advisors, with $75 million under management, suggests (naturally enough!) using closed-end funds for exposure to this market. Why? Two reasons: The first has to do with the relatively illiquid nature of the Asian emerging debt markets. "A closed-ended investment company's shareholders buy and sell shares between each other on the public market (never impacting the portfolio manager's investment decisions). The fund itself never has to redeem shares and can avoid the potential spiraling impact of redemptions causing selling in the fund's positions - which can lead to individual positions and NAV to fall further, Scott explains. "This can lead to another round of redemption pressures and more forced selling for open-ended funds' portfolio."

The second reason has to do with the way closed-end funds are traded. ETFs, by their nature, are nearly always priced very close to their NAVs on the exchanges. But closed-end fund shares frequently sell for a discount from their NAVs. But the Income that a bond portfolio produces is not discounted, other than via the fund's expense ratio. This can mean a significant boost in an investor's cash on cash return. "This provides investors a way to positively leverage investments over time," Scott says.

As of mid-April 2012, the Aberdeen Asia Pacific income fund is selling at a modest 2.55 percent discount from NAV - somewhat lower than its long-term average discount of 4.12 percent over the last three years. ■