RBC BlueBay Asset Management

In praise of unconstrained investing

For professional investors only | Marketing communication

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"In emerging markets, the universe is so diverse that geopolitical events and significant policy decisions are part and parcel of the investment landscape."

One thing is always certain in the markets – change is a constant. New regional headwinds can create fresh challenges for economies and investors alike, and in recent years a series of developments – the potential of new tariff regimes, fears of inflation and stagflation, and possible outcomes of conflicts in Ukraine and the Middle East – have contributed to an ongoing sense of nervousness among investors.

In emerging markets, the universe is so diverse that geopolitical events and significant policy decisions are part and parcel of the investment landscape, often driving the volatility and dispersion that can be harnessed to generate returns.

However, the volatility that can crop up in emerging markets debt ("EMD") has led investors to closely scrutinise the timing of capital deployment, as well as the characteristics of the underlying beta of the sub-asset classes. Much of the interest in recent years has focused on strategies that are capable of delivering returns, whilst navigating volatility through asset allocation.

In response, we have seen a proliferation of new unconstrained/total return/absolute return strategies in the EMD universe – each one with its own philosophy and unique portfolio construction approach, but all promising a smoother return experience. The presumed superiority of such strategies over traditional approaches has, however, been subject to much debate.

We believe this debate took a more urgent turn in 2018-2019, as well as in 2020, for two principal reasons. Firstly, an increase in market volatility prompted investors to reflect on how best to access the opportunity set. Secondly, many of the unconstrained strategies have delivered mixed return profiles, highlighting our long-held belief that it takes several market cycles to test and determine the true merits of such an approach.

Leo Tolstoy wrote in Anna Karenina, *"happy families are all alike; but every unhappy family is unhappy in its own way."* Oddly, that quote resonates in the current context, only in reverse. Many benchmarked strategies are made from the similar, often indistinguishable, cast and they tend to provide homogeneous investor experiences, with mixed track records across multiple economic cycles.

In contrast, the world of unconstrained EMD strategies, which have generally been more successful, requires close scrutiny as each is unique in its approach.

In our view, success in EMD unconstrained investing depends on three factors: 1) concentrated position sizing adjusted for asset volatility, 2) the use of derivative instruments as tools for hedging, and 3) overall nimble and dynamic portfolio construction.

Position sizing discipline is a key issue here, especially in the context of an asset class with a highly disparate profile of volatilities. No less important is systematic capacity management, as well as a focus on well-rounded security analysis (including fundamentals, valuations and technical factors). A lack of focus on the latter can often lead to less successful strategies.

In this paper, we take a closer look at an unconstrained approach to EMD investing, focusing on the following areas:

- **Why we believe an unconstrained approach makes sense for the asset class.**
- **The various formats of unconstrained strategies available in the market.**
- **The 'four pillars' of unconstrained strategy implementation.**
- **Why we believe a high conviction total return approach is superior for unconstrained EMD investing.**

Why an unconstrained approach to EMD investing makes sense

Historically, we have seen most investors allocating to EMD via benchmarked solutions – either through single sub-asset class exposure or through a multi-asset, well-diversified approach. While there is merit in each of these solutions during certain parts of the economic cycle, a benchmark agnostic – aka 'unconstrained' – strategy can open up a portfolio to a wider opportunity set, offering a potentially value-additive approach.

1. Value and volatility

EMD offers investors many benefits, but these also come with potential pitfalls. On one hand, it is a portfolio diversifier, rich in idiosyncratic return drivers ranging from highly rated investment grade companies in large Asian economies to the local currencies of various frontier markets such as those of Sub-Saharan Africa.

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It also serves as a store of value – current yields range from 4–7% at the index level and rise to around 8% when investors look at instruments rated single-B or below[1]. This attractive yield premium offered by EMD is apparent when comparing the asset class against developed market instruments with similar rating and duration risk profiles (Charts 1 and 2).

EM versus other asset classes

Chart 1: Credit rating relative to yield

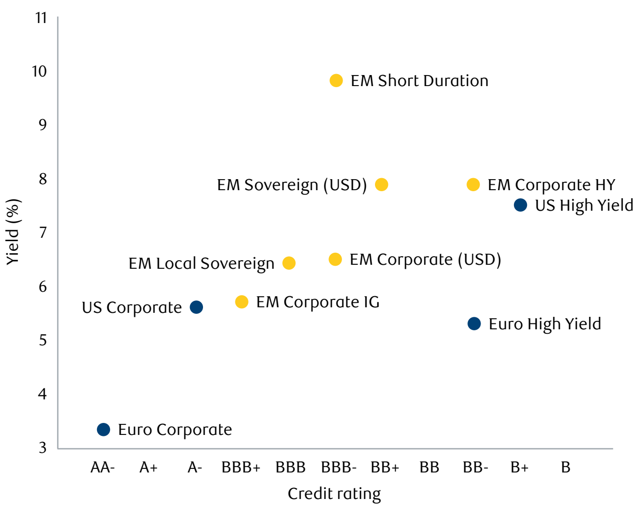
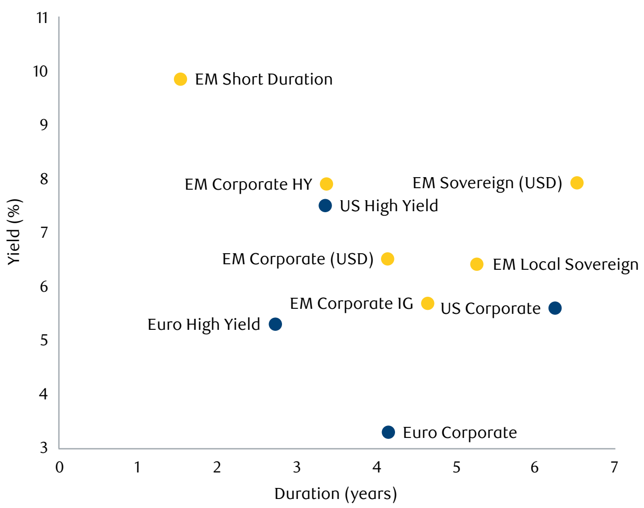


Chart 2: Duration relative to yield



Source: JPMorgan, BofA, Bloomberg. as at 31 December 2024.
Note: EM Corporate (USD) = JPM CEMBI Diversified; EM Sovereign (USD) = JPM EMBI Global Diversified; EM Local Sovereign = JPM GBI-EM Global Diversified USD unhedged; US High Yield = BofA US High Yield Master II; US Corporate = BofA US Corporate Master; Euro High Yield = BofA Euro HY Index; Euro Corporate = BofA Euro Corporate Index; EM Corporate HY = JPM CEMBI Diversified HY, and EM Corporate IG = JPM CEMBI Diversified IG.

[1] Bloomberg.

The potential value in the asset class becomes even more evident during periods of positive sentiment, when EMD investors can experience returns ranging from 5% to 16% (eg 2012, 2017 and 2019) (Chart 3).

Chart 3: EMD sub-asset class returns

2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
EM Sov IG 9.2%	EM Corp HY 23.0%	EM Corp HY -0.2%	EM Sov IG 9.7%	EM Sov HY 4.3%	EM Corp HY 17.6%	EM Sov HY 11.4%	EM Corp IG -0.7%	EM Sov IG 16.6%	EM Sov IG 8.9%	EM Corp HY 1.2%	EM Corp HY -10.9%	EM Sov HY 15.3%	EM Corp HY 13.0%
EM Corp IG 5.4%	EM Sov HY 21.5%	EM Sov HY -0.8%	EM Corp IG 8.2%	EM Corp IG 1.3%	EM Sov HY 13.7%	EM Corp HY 10.4%	EM Sov IG -2.4%	EM Sov HY 13.5%	EM Corp IG 7.6%	EM Corp IG 0.0%	EM Corp IG -14.5%	EM Corp HY 10.3%	EM Sov HY 10.7%
EM Sov HY 4.9%	EM Corp IG 15.1%	EM Corp IG -2.4%	EM Sov HY 3.4%	EM Corp HY 1.0%	EM Sov IG 7.0%	EM Sov IG 9.2%	EM Corp HY -3.1%	EM Corp HY 14.8%	EM Corp HY 6.6%	EM Sov HY -1.5%	EM Sov HY -15.7%	EM Corp IG 7.2%	EM Corp IG 5.1%
EM Corp HY -2.6%	EM Sov IG 14.8%	EM Sov IG -7.6%	EM Corp HY 0.3%	EM Sov IG -1.1%	EM Corp IG 6.4%	EM Corp IG 6.3%	EM Sov HY -6.2%	EM Corp IG 12.7%	EM Sov HY 0.8%	EM Sov IG -1.9%	EM Sov IG -19.8%	EM Sov IG 7.1%	EM Sov IG 0.32%

Difference between the best and worst performing EM credit sub-components

11.8%	8.2%	7.5%	9.4%	5.5%	11.2%	5.1%	5.5%	3.9%	8.1%	2.3%	8.9%	7.9%	12.7%

■ EM Sovereign IG ■ EM Corporate HY ■ EM Corporate IG ■ EM Sovereign HY

Source: Bloomberg. as at 31 December 2024.

However, as with all volatile asset classes, EMD is also prone to periods of meaningful devaluation, pushing up yields with the potential to incur significant short-term losses. This turbulence, measured through annualised volatility, is an important signal to investors that they should not expect uninterrupted positive returns from the asset class through carry alone.

EMD assets are also driven by technical factors, such as positioning or liquidity, to a greater extent than other core fixed income asset classes, as EMD generally accounts for a much smaller proportion of institutional investors' strategic allocation. As a result, off-benchmark tactical allocations by institutional investors (so-called 'tourist money') can exaggerate price moves in both positive and negative directions, accentuating overall volatility, although the degree of sensitivity to these moves can vary across the sub-asset classes.

One conclusion we can draw from this is that a long only benchmarked solution targeting any EMD sub-asset class can prove successful during certain parts of the economic cycle, but the overall success of such investments depends as much on the timing of investment as it does on manager skill and selection of underlying beta.

> **"EMD assets are also driven by technical factors, such as positioning or liquidity, to a greater extent than other core fixed income asset classes."**

As we show in this paper, an unconstrained solution explicitly targeting downside protection, while capturing most of the upside, can smoothen the volatility of investments over the long term.

2. Asset allocation

EMD comprises four main sub-asset classes:

- USD-denominated sovereign debt (denoted by JPMorgan EMBI Global Diversified Index).
- USD-denominated corporate debt (denoted by JPMorgan CEMBI Diversified Index).
- Local currency-denominated sovereign debt (denoted by JPMorgan GBI-EM Global Diversified Index).
- Local-currency denominated corporate debt (denoted by BofA ML EM Non-Sovereign Debt Index).

Although these sub-asset classes exhibit broadly high inter-correlation over the long term, during periods of drawdown, this correlation can weaken.

Additionally, in the world of EM, both US dollar and local currency-denominated corporate asset classes generally exhibit less volatility compared to the respective sovereign asset classes. This is partly because the various sub-asset classes have differing sources of returns (interest rates and spreads for hard currency sectors; local rates and FX for the local currency sectors), driven by idiosyncratic fundamental and technical factors.

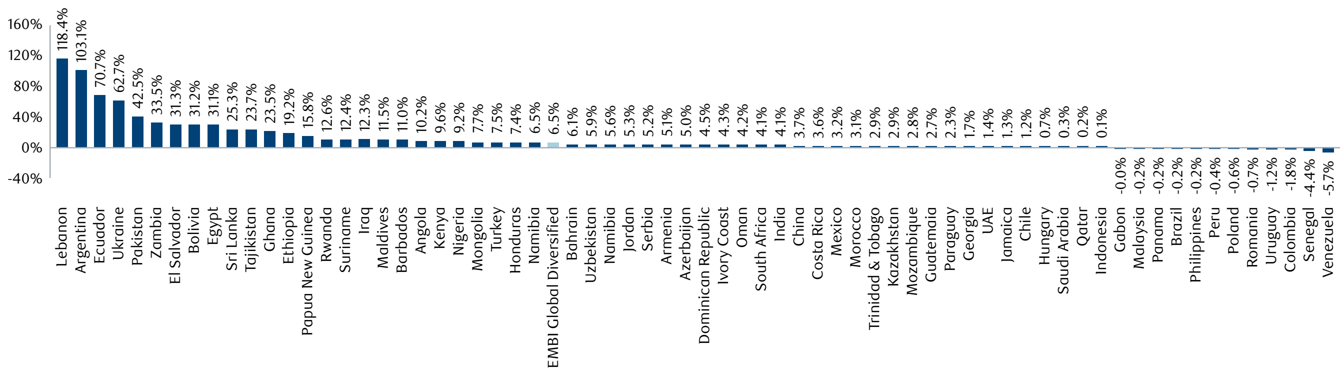
As a result, active asset allocation across these sub-asset classes can be an important source of value, as demonstrated by the dispersion between best and worst asset class returns (Chart 3).

Even within a single sub-asset class itself, the various constituents can produce highly differentiated returns. Charts 4, 5 and 6 show how the various components of both hard and local currency sovereign debt indices produced markedly differentiated returns during 2024.

> **"In the world of EM, both US dollar and local currency-denominated corporate asset classes generally exhibit less volatility compared to the respective sovereign asset classes."**

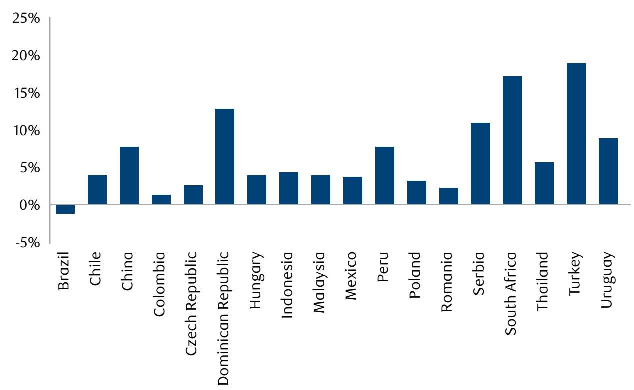
If investors can take advantage of these dispersions through both active asset allocation and security selection, it should be possible to produce better returns. In our view, only an unconstrained strategy can consistently exploit the full spectrum of opportunities, making it a compelling solution for investors looking for superior returns.

Chart 4: Hard currency – country returns (%)



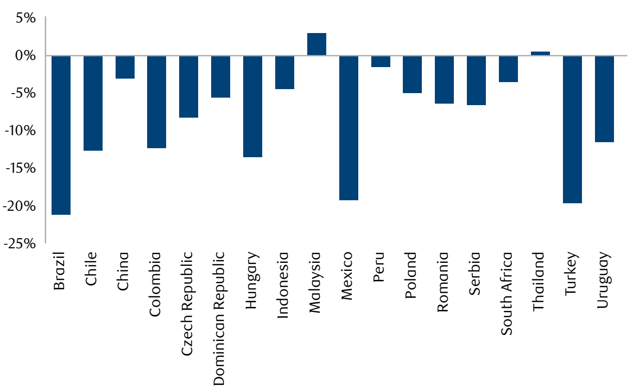
Source: Bloomberg, JP Morgan, as at 31 December 2024. Index: JPM EMBI Global Diversified Index.
For illustrative purposes only. There is no assurance that any of the trends depicted or described herein will continue.

Chart 5: Local currency – interest rate returns (%)



Source: Bloomberg, JP Morgan, as at 31 December 2024.
Index: JPM GBI-EM Global Diversified Index, unhedged in USD.

Chart 6: Local currency – FX returns (%)



Source: Bloomberg, JP Morgan, as at 31 December 2024.
Index: JPM GBI-EM Global Diversified Index, unhedged in USD.

3. Off-benchmark opportunity set

Although the EMD universe benchmarks are generally robust and suitably diversified, we often find greater value in off-benchmark investments, as highlight below:

a) **Local currency corporate assets** are often not part of investors' permitted security universe, but our experience shows that, on a highly selective basis and liquidity permitting, it is possible to add value using these instruments.

b) Technical support from **index inclusion** can often be a powerful source of returns. Middle Eastern countries such as Qatar and Saudi Arabia – where the spreads were attractive relative to the rating but the instruments were not part of the JPMorgan EMBI Global Diversified Index until February 2019 – strongly benefitted throughout 2018 from the technical support coming from expected Indian local currency inclusion in 2024.

c) Across the vast EMD opportunity sets it is often possible to find instruments that do not strictly satisfy the benchmark criteria but can provide **asymmetric return profiles**. Examples include very short duration but high carry local currency investments such as Egyptian T-bills.

Although some of these investments can be held on an off-benchmark basis in traditional benchmarked portfolios, only an unconstrained strategy can capitalise on these opportunities with statistical significance, due to potentially much larger position sizing.

4. Asymmetry of hedging

Fortunately for an EMD investor, it is possible to select hedging instruments that offer asymmetric return profiles. Due to the inefficiency of the asset class, well-recognised risk factors can be notably underpriced, offering an efficient way of hedging some of the risks. We utilise single country CDS, EM FX, and other derivative instruments such as options or futures, to hedge some of these downsides, as appropriate.

> **"Fortunately for an EMD investor, it is possible to select hedging instruments that offer asymmetric return profiles."**

One example of this comes from the Russia-Ukraine conflict. In the third quarter of 2021, we had very high concerns around the escalating situation and the build-up of forces at the border of Ukraine. Our view, contrary to the market, was that there was a high possibility of a Russian attack on Ukraine at the start of 2022, which would likely be followed by major western sanctions on Russia, further weighing on its asset performance.

For this reason, in addition to selling all Russian holdings, we added Russian CDS, a short in RUB and a curve inversion trade in Russian rates.

In the first quarter of 2022, Russia began a full scale invasion of Ukraine – as expected, markets sold off sharply, with Russian assets, CDS and currency reacting the most aggressively. As a result, our hedges proved to be very successful in protecting the portfolio from the downside.

Such hedging strategies, when systematically implemented, provide downside protection and help preserve returns for investors during market drawdowns.

Summary

Benchmarked strategies, whether single or multi sector, provide the illusion of discipline through strict risk budgets and guidelines, but can restrict investors' ability to both generate and preserve superior returns across market cycles.

Given the many twists and turns of the EMD asset class, its technical nature, vast opportunity set and inefficiency, which can all lead to asymmetry of returns, we have found that an unconstrained strategy is best placed to meet the needs of clients looking to harness the optimal returns in a risk-adjusted manner.

The variations of unconstrained strategies (UCITS compliant)

In general, investors can access three main categories of unconstrained EMD products which are UCITS compliant, each with their own key characteristics:

Absolute return: very low beta bias ('absolute return' approach)*

- Explicit absolute return bias with the aim of generating positive returns in all market scenarios
- Tendency towards structurally cautious portfolio construction

Although this structure typically enables good performance in bear markets, it can fall significantly behind when the market rallies. We find this approach lacking, mainly due to the fact that its inability to capture upside is fundamentally at odds with the basic premise of investing in EMD, which is to benefit from potentially strong returns.

*UCITS-compliant vehicles are generally unable to physically short assets or borrow, thereby impeding the ability to create true market neutral strategies.

Total return: diversified multi-sleeve ('multi-sleeve' approach)

- Total return structure run in multiple sleeves
- Each sleeve managed broadly in line with a benchmark
- Additional downside protection sleeve
- Over-diversified

There are several ways this structure can face challenges. The primary difficulty is the likelihood of duplication of trade ideas across sleeves, due to the overlap of countries and risk factors. Moreover, the upside/downside capture statistics are not compellingly asymmetrical.

Total return: integrated, high conviction ('high conviction total return' approach)

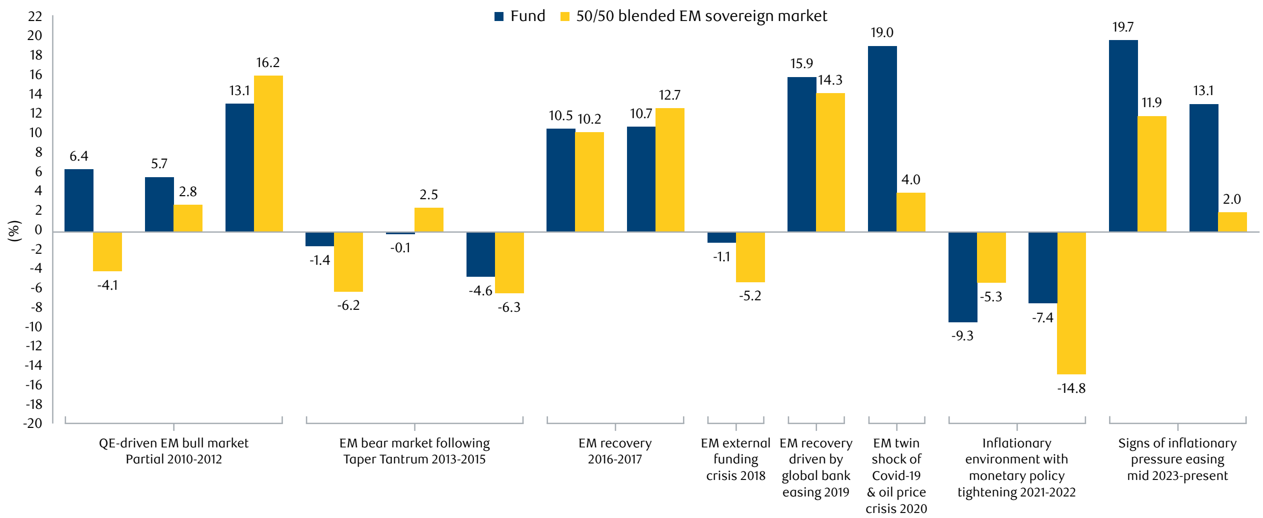
- High conviction, high concentration allocations (not a closeted benchmark approach)
- Fully flexible across key risk parameters
- Not structurally cautious

In our view, this approach produces the best results in the unconstrained EMD space. BlueBay's unconstrained EMD strategy, managed by the EM Debt team, follows this philosophy and has been tested across market cycles over its 10-year plus track record. We believe its strong, risk-adjusted, long-term returns, as well as excellent peer rankings, are testament to the effectiveness of the strategy.

BlueBay EM Unconstrained strategy: providing upside capture and downside protection

Since 2010, the performance of our unconstrained strategy, which has witnessed multiple bull and bear markets, demonstrates that the risk-adjusted return can be attractive over the long term (Chart 7). And looking at recent years, it is evident that our strategy has performed well against a volatile market. During a very difficult 2022, the fund returned -7.36% (compared to -14.74% in the reference blended index), which is equivalent to approximately 50% downside protection. In 2023, the fund generated 19.68% for the year. This return profile is consistent across various time periods and business cycles. **On a trailing 3-year basis, the fund has captured on average 103.93% upside, while capturing only 50.79% of the downside when compared to the 50/50 blended EM sovereign market.**

Chart 7: A compelling 10-year plus track record spanning multiple market cycles

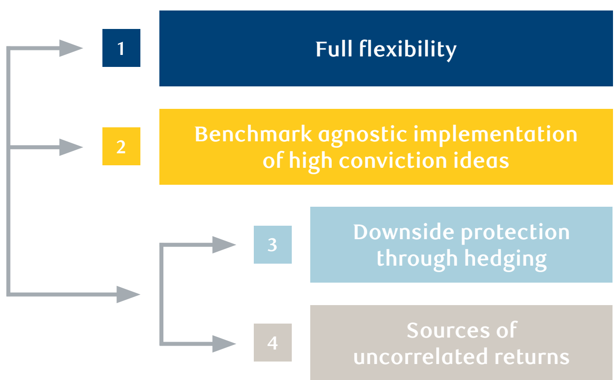


Source: RBC GAM, as at 31 December 2024. This fund does not have an official benchmark and is actively managed. The 50/50 blended sovereign market is: 50% JPM EMBI Global Diversified Index and 50% JPM GBI – EM Global Diversified Index (USD unhedged). Past performance is not indicative of future results. The return on your investment may increase or decrease as a result of currency fluctuations if your investment is made in a currency other than that used in the past performance calculation. Fees and other expenses will have a negative effect on investment returns.

Differentiation through implementation

The success of an unconstrained strategy is determined by both the access to the full spectrum of the opportunity set and robust implementation. We believe there are four core pillars to consider when constructing an unconstrained EMD portfolio. Of the three main categories of unconstrained EMD portfolios, 'absolute return' and 'multi-sleeve' can draw on select combinations of these four elements (Chart 8).

Chart 8: EMD unconstrained – the four pillars of implementation



Source: RBC GAM.

However, we believe it is only the third approach – 'high conviction total return' – that has the ability to combine all four elements into one well-balanced strategy, making it a better choice for investors.

Using the BlueBay Emerging Market Unconstrained Bond strategy as a practical example, we outline each element to make the case as to why combining all four elements is optimal for returns.

Four pillars of implementation applied to the strategy:

1. Full flexibility

By design, the strategy is fully flexible, with the ability to hold up to 100% in both hard and local currency sovereign debt, although EM corporate allocations are restricted to 50%. Due to its design as a UCITS product with daily liquidity, cash is limited to 50% with no ability to engage in physical borrowing/leverage, although synthetic leverage can arise due to the use of derivatives.We have the ability to be nimble and active in terms of altering the risk sensitivities; we can respond relatively quickly to changing market themes and tactically assume a net short bias, should that be in the best interests of the strategy.

Practical application – flexibility in risk management
For example, at time of rapid US dollar strengthening, it can be appropriate to take the exact opposite positioning, such as being net short EM currencies. The strategy can help to protect on the downside and has proven successful on multiple occasions, such as in late 2016 (Trump's election), during 2018, and in 2020 amidst Covid-19 shocks (Charts 9 and 10).

In 2022, stickier-than-expected inflation and resilient US growth data led the market to price out US rate cuts for the year. We sharply reduced FX exposure, as the front end of US rates repriced and the US dollar continued its strong performance.

Such flexibility is also apparent in utilising currency exposures (Chart 11). Rather than positioning the portfolio with a structurally long or short bias to EM currencies, we attempt to judiciously anticipate the market environment for EM FX and position the portfolio accordingly. For example, during the Covid-19 crisis, we progressively reduced our EM currency exposure but subsequently added it back as markets stabilised.

2. Benchmark-agnostic implementation of best trade ideas
The portfolio is constructed utilising only best-ideas trades – typically 40-50 at any one point in time. In part, our high conviction around certain ideas can result in the implementation of larger individual positions, occasionally amounting to 10% or more.

Such concentrated implementation of high conviction ideas aims to achieve two goals:

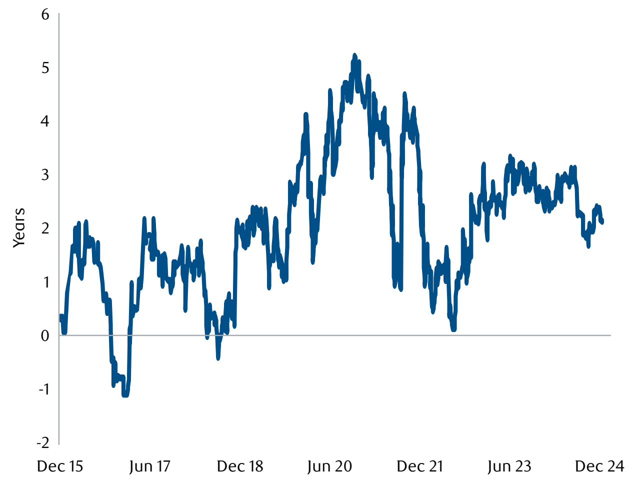
1. The smaller number of positions allows for a quicker turnaround in the portfolio characteristics, should the markets go against our expectations.
2. We believe it can protect the portfolio from over-diversification of returns. This philosophy of implementation is also often benchmark agnostic.

3. Downside management
It is important to recognise that markets can always surprise us, rendering some trades ineffective.

However, the philosophy of unconstrained portfolio management provides a two-fold approach to managing downside.

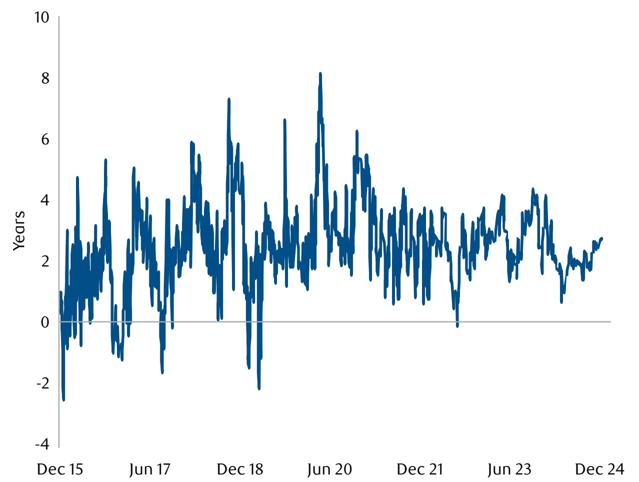
1. **Protection through hedging**: using an expansive hedging toolkit, we are able to manage downside more effectively.
2. **Sources of uncorrelated returns**: across the universe of EM assets, we often find assets with return profiles that we believe are uncorrelated to broader downside in the market.

Chart 9: Local interest rate duration



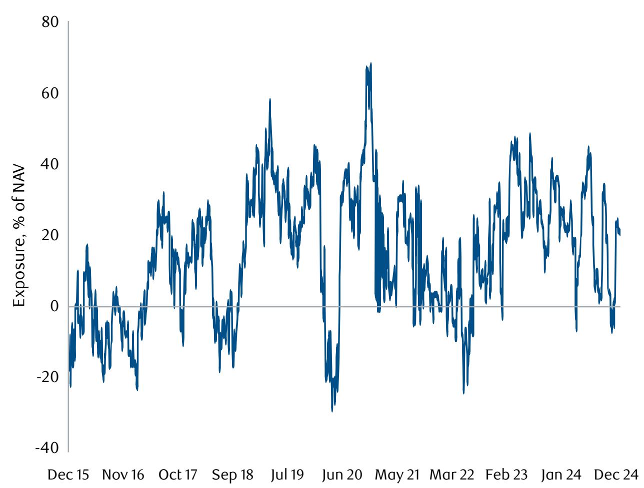
Source: RBC GAM, from 31 December 2015 to 31 December 2024.

Chart 10: Spread duration



Source: RBC GAM, from 31 December 2015 to 31 December 2024.

Chart 11: Currency flexibility – FX delta (+1%)



Source: RBC GAM, from 31 December 2015 to 31 December 2024.

Conclusion

Investors today are offered a variety of choices in EMD strategies, some benchmarked and some unconstrained.

Assuming the underlying objective is to generate attractive risk-adjusted returns over the longer term (5-7 years), we believe that **active asset allocation, dynamic risk management, downside protection and uncorrelated sources of returns** must form part of an investor's portfolio.

In our experience, it is often difficult to combine all of these elements in a single portfolio, due to restrictive benchmark-driven guidelines and risk budgets.

This is why, over the long run, the performance of unconstrained strategies tends to be demonstrably superior to a diversified market beta, but still with an overall lower volatility. Our strategy has generated an annualised return since inception that is 257bps higher than the diversified sovereign market 'beta' return, but with a 85bps reduction in annualised volatility (Chart 12) (based on monthly returns since inception of the fund).

Based on this, we also conclude that within the various categories of EMD unconstrained strategies, a '**high conviction total return**' approach is most suitable for generating superior returns in the long term.

This approach offers investors the capability to harness the power of all four elements of implementation at any time, combining high conviction with unconstrained implementation to deliver potentially compelling results.

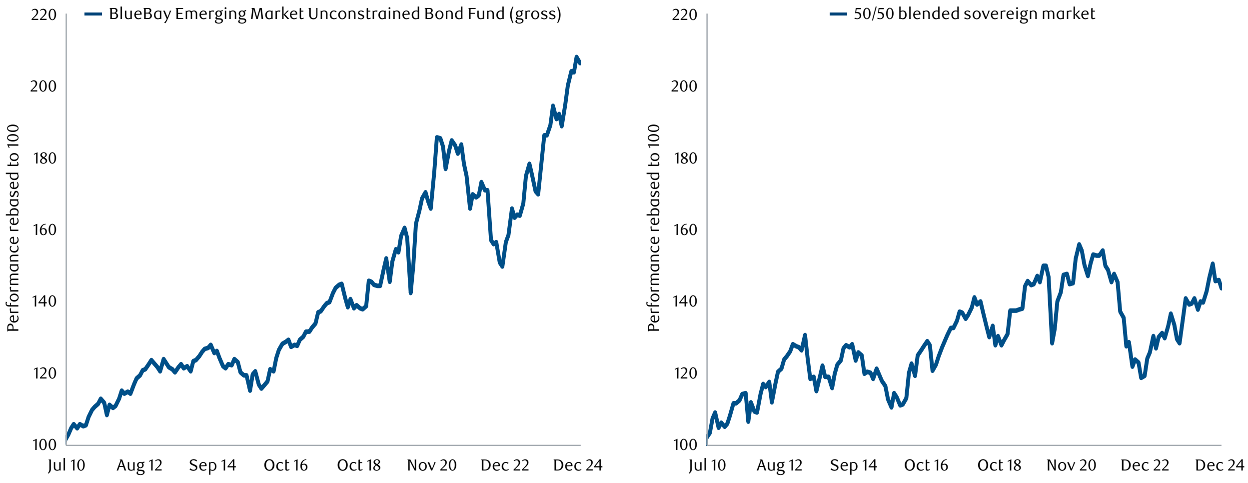
It is also worth noting that the success of these portfolios is inextricably linked to the overall robustness of the investment process and philosophy. For example, it is often a mistake to focus on EMD assets via long-term fundamental analysis only, especially given that certain liquid EMD sectors are more driven by technical factors, such as EM FX. Robust technical analysis is therefore important to add value through these assets.

Additionally, appropriate position sizing, adjusted for the relevant volatility profile is crucial, as EMD assets often demonstrate highly disparate volatilities.

Finally, systematic capacity management for the overall strategy is crucial, given the nimble and dynamic nature of these portfolios.

Our EM Debt team remains conscious of these pitfalls as we work to deliver the best possible long-term performance for our investors.

Chart 12: EM Unconstrained versus 50/50 blended sovereign market



Source: RBC GAM, as at 31 December 2024. The 50/50 blended sovereign market is 50% JPM EMBI Global Diversified and 50% JPM GBI – EM Global Diversfied USD unhedged. This fund is considered to be actively managed and does not have a benchmark to define the portfolio composition of the fund or as a performance target. The above is for information purposes only. Performance is measured against the 50% JPM EMBI Global Diversified and 50% JPM GBI – EM Global Diversified USD unhedged indices because at least 50% of the fund's assets will be exposed to hard currency or local currency debt instruments issued by sovereign EM issuers as well as currencies and interest rates.

Authors

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Polina is Head of BlueBay Emerging Markets and Senior Portfolio Manager. In addition to oversight of investments across all EM strategies, Polina is also a lead portfolio manager for several flagship funds in EM sovereign, credit and local markets, including long only and alternative products. Polina started her career in emerging markets after the Russian financial crisis in 1998 and has, since then, gained expertise across a broad range of emerging market financial assets.

Polina joined BlueBay Asset Management (which is now part of RBC Global Asset Management) in July 2005 from UBS where she was a credit analyst in EM corporate research. Her role encompassed coverage of EM issuers as well as research support for primary issuance of corporate debt. Prior to this, Polina was with Alliance Capital where she was an emerging markets equity analyst and then moved on to pioneer emerging markets quantitative research at the firm. She started her career in a macro research boutique in Russia. Polina holds an MSc (Hons) in Finance from the People's Friendship University of Russia, Moscow and is a CFA charterholder.

Anthony Kettle

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Anthony is a BlueBay Senior Portfolio Manager within the Emerging Markets Team. Anthony joined BlueBay Asset Management (which is now part of RBC Global Asset Management) in March 2006 and his primary portfolio management responsibilities include the EM long-short credit strategy, the EM Unconstrained Bond Fund and the suite of EM Corporate long only funds. Prior to joining BlueBay, he held a management position at National Australia Bank. Anthony holds a Bachelor of Commerce degree from the University of Melbourne, a Graduate Diploma in Applied Finance and Investment from the Australian Securities and Investments Commission, is a CFA charterholder, and holds the CFA Certificate in ESG Investing.

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Brent joined BlueBay Asset Management (which is now part of RBC Global Asset Management) in March 2014 as a BlueBay Portfolio Manager within the Emerging Markets Team specialising in EM local corporate bond portfolios. Brent has been the lead portfolio manager for the EM Local Currency Corporate Debt Strategy from its inception in July 2014. In September 2017, Brent was appointed Senior Portfolio Manager for the EM sovereign local currency portfolios, working closely with the sovereign debt specialists. Prior to joining BlueBay, Brent worked for 12 years on the sell-side, for Credit Suisse, Barclays Capital and Deutsche Bank, in emerging markets as a local currency fixed income, rates and FX trader. He holds a BEng (Industrial Engineering) degree from the University of Pretoria in South Africa.

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