November 2012

Special Report

EMERGING MARKETS 2012

hubbis

FOREWORD

Emerging market opportunities are no longer exotic. And the dynamics in Western markets which have shifted attention towards opportunities in developing economies look set to continue. Threadneedle Investments, which has been managing emerging market debt portfolios for over 15 years, hold a very positive view of the long-term outlook for emerging markets.

Our optimism is due to: ratings upgrades reflecting positive fundamentals; emerging market default risk is lower; fiscal and monetary policies are mostly appropriate; the likelihood of capital outflows is at historical lows; and emerging markets are growing faster than developed markets.

At Threadneedle, we believe that it's all about assessing how and where emerging market assets fit into portfolios – and the role they play within them.

Emerging market debt, specifically, should be considered a mainstream asset class. The focus is now on understanding suitable sub-sectors – ranging from local currency to US dollar sovereign to emerging market corporates – to meet individual investment objectives and profiles.

At the same time, emerging market equities continue to attract strategic allocations from institutional investors. Being selective with emerging market stocks will help investors to focus on those which can exploit structural growth trends and even countries with better growth and reform prospects.

Ultimately, with global fundamentals likely to remain challenging, at least in the short term, the most attractive opportunities are expected to remain in markets where there is strong growth potential, positive demographic trends and structural change.

Previous (mis)perceptions that emerging markets are illiquid and represent higher risk can no longer be part of conversations about access to emerging market assets. The emerging market investment scenario has changed profoundly and in today's world, emerging market exposure should form an integral part of a well balanced portfolio.

On behalf of Threadneedle Investments, we are delighted to partner with Hubbis to provide further thought-leadership on the topic of emerging markets.

Gerard Clancy
Executive Director, Wholesale Distribution, Asia Pacific
Threadneedle Investments

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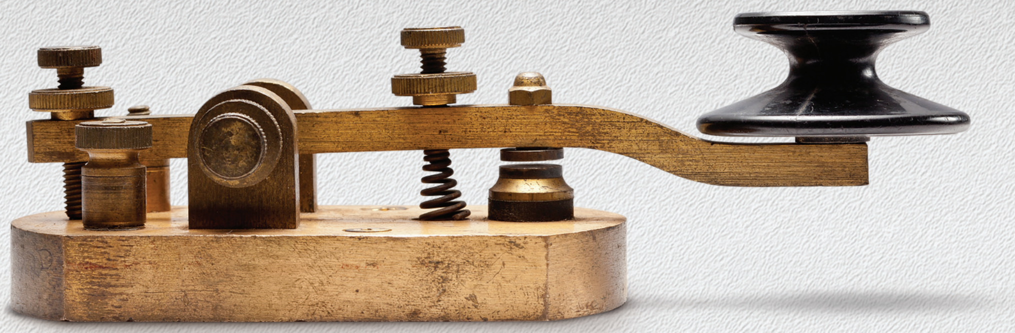

WHEN A FIXED INCOME INVESTOR SENDS OUT AN SOS SIGNAL, IT SHOULDN'T FALL ON DEAF EARS.

Fixed income can feel like a murky sea of rates, yields, and maturities. So even experienced investors appreciate it when someone helps light the way.

This is just what our fixed income professionals do all the time at AllianceBernstein. We believe that using both fundamental and quantitative research helps us spot opportunities as well as risks.

We also feel that this financial agility is one of the reasons clients trust us with $240 billion in fixed income assets worldwide.[1]

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[1] Source: AllianceBernstein, as of August 31, 2012.

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Q&A

A MORE STRATEGIC APPROACH TO EMERGING MARKETS

Simon Godfrey, head of investment specialists in the emerging markets group at BNP Paribas Investment Partners in Asia, explains where to find opportunities in emerging markets, and how to view their role within portfolios in today's risk-on / risk-off world.

As you look at various developing and maturing markets in Asia, where are the most attractive opportunities on a risk-weighted basis?

We believe that the most attractive opportunities are in markets where there is strong growth, positive demographic trends and structural change.

> The performance of a broad-based index of emerging market stocks may not produce the returns it once did.

Today, the countries of ASEAN, notably Thailand, Indonesia and the Philippines, are within this category. India has shown significant promise, though political issues have held it back recently – we believe that once these can be resolved then a lot of potential will be unleashed. China has a vast domestic stock market with many companies to exploit the transformation of that huge economy from export-led to consumption-led – that is, if you as an investor have the wherewithal to find them, because tomorrow's winners may not be the same as the past winners in that market.

Can emerging markets offer the potential returns that they once could?

We believe that as an asset class, the performance of a broad-based index of emerging market stocks may not produce the returns it once did as the "discovery" of emerging markets by mainstream investors has already taken place.

In addition, this investment area is currently changing with some of the more developed countries and largest economies in the universe (BRIC and countries such as Korea, Mexico, Turkey) have to a certain extent "emerged" and the growth dynamic going forward may depend increasingly on internal demand, the agenda of reforms may also slow and indeed investors may have to adjust to more mature rates of growth.

Simon Godfrey

BNP Paribas Investment Partners

Another factor is that the abnormally-high profitability of emerging market companies may be on the wane in some more established emerging market countries as input costs have risen. An investor who invests passively in the index may well be disappointed as some large companies will not produce the returns they have in the past.

However, given the vast nature of the asset class, we do believe that those willing to be more selective with stocks, focusing on those which can exploit structural growth trends and even countries with better growth and reform prospects, should still experience superior returns.

To what extent do emerging markets offer a diversification of risk in today's market environment?

Due to the globalisation of capital flows and the macro-driven nature of financial markets since 2008 (risk on / risk off), then adding emerging market exposure to a global portfolio has not added greatly to diversification from a statistical perspective over the last three to four years.

However, there is a clear decoupling of economic fundamentals between emerging markets and developed markets – to the advantage of emerging markets – and this should be reflected in differentiated medium-term performance.

Another source of diversification may be emerging market currencies, which may appreciate due to better fundamentals, terms of trade and foreign direct investment.

What common mistakes and misconceptions exist around emerging markets investing, and what should wealth management be doing to (re)educate clients?

There is a perception that emerging markets are illiquid and represent higher risk. While this may be true in some cases, the BRIC countries are all part of the world's top 10 economies and many of stock markets include major banks and resource companies which are traded in Hong Kong, London and New York.

Fundamentals for many emerging markets are good on a stand-alone basis, and even better when compared with developed markets – these include levels of public debt to GDP, and the potential for further monetary easing, medium-term reforms and the ability to stimulate growth.

The size of emerging economies is already woefully under-represented in standard equity benchmarks and particularly in typical investors' portfolios.

What specific issues should advisers discuss with clients when advising on emerging market investment in today's risk-off world?

Investors should see emerging market exposure as part of a diversified portfolio in a globalised world. The asset class should retain a lot of potential – but investors will have to be patient and not expect emerging markets to outperform in all periods and under all circumstances.

The current circumstances may remain volatile but investing is about knowing when such risks are already priced in; it would appear to us that this is currently the case.

Is the concept of "emerging markets" even relevant in today's environment? How else could investors allocate assets to growth-oriented markets?

The concept is still very relevant as there is material difference in what we refer to as developed markets and emerging markets – in terms of investor bases, whether real institutional investors exist and bring stability and transparency, the stability of legal and political systems, etc.

Economic strength through total GDP and GDP growth and stock market captialisation are only one part of the equation. And the risks described above, where they exist, need to be priced in, meaning that investors should expect higher returns from investing there.

However, markets are developing at different speeds and markets such as Brazil (a dynamic and democratic economy) and China (highly-regulated and hugely-influential economically and politically) are already showing some of the characteristics of developed markets, and could arguably be more important to have in investor portfolios than some of the smaller ones in the latter category.

So where do emerging markets as an investment class fit in client portfolios?

The current US dollar weight of emerging markets in global GDP is around 30%, and in global equity indices around 13%. Most investors only invest a fraction of that amount.

Simple arithmetic demands that the rate of both will increase, therefore already to catch up to these percentages, investors need to invest more today. What is the opportunity cost? Owning less US Treasuries at less than 2% yields?

In order to provide sufficient diversification and make a meaningful contribution to returns, emerging markets should take a significant amount of an investor's portfolio, though they should not be invested to the exclusion of other asset classes and liquid investments.

Emerging markets are today mainstream investments in equities and bonds just like any other investment nonetheless. They don't need to be treated as a special category in portfolios.

What's likely to be hot – and not – in 2012/2013? Why?

Emerging market equities are likely to make a comeback as they have been out of favour – except for sporadic rallies – since 2009.

With dividend yields higher than sovereign debt yields in some countries there may be some re-thinking of the risk-reward opportunity.

Are investors looking at frontier markets? If so, what profile of investor and which markets?

Frontier markets, due to their low liquidity, are not yet part of mainstream investor portfolios. They have actually lagged the more traditional emerging markets and present an opportunity to catch up in terms of average valuation.

Due to their esoteric and not-yet-mature nature, the type of investor who is attracted to these markets are professional investors looking for returns and diversification, in order to add alpha to their portfolios, either directly in frontier markets or through pooled funds or adventurous private investors.

For the latter category, the scarcity of suitable investment vehicles means that there is still much excitement but relatively few flows into frontier markets.

How do considerations (especially suitability) with frontier markets differ with those for emerging markets?

A frontier markets investment, as we have seen, should be part of a diversified portfolio. Both are categories of international equities and for the well-informed investor, as long as expectations have been correctly aligned, they are suitable in this context.

However, due to the reduced liquidity and lower number of potential investments, smaller investment amounts may need to be considered for this sub-category. ■

"With dividend yields higher than sovereign debt yields in some countries there may be some re-thinking of the risk-reward opportunity."

Feature article

FINDING OPPORTUNITIES IN EMERGING MARKETS

Emerging market opportunities look more plentiful for investors to explore, and access is improving with a wider range of products and vehicles. It is all about choosing the right one(s).

As an investment opportunity, or asset class, emerging markets are making significant inroads as a key part of investor portfolios.

The fundamentals and outlook are positive – as highlighted by various articles in later chapters – therefore offering potential opportunities for higher returns than developed markets.

For example, global interest rates could stay low for the coming years with the unsettled European crisis and

> While the stand-alone risks of emerging markets are higher, their inclusion could enhance the risk/return profile in a well-managed global portfolio.

Henderson Horizon Asian Dividend Income Fund

Fixed income products usually give you regular payouts with lower capital growth. While most equity funds offer the reverse. Now you can have the best of both worlds with the Henderson Horizon Asian Dividend Income Fund. The Fund handpicks prime Asian stocks for sustainable dividends. And for the year ending 2011, the Fund paid an attractive yield of 6.87%*. So, look to the vibrancy of Asia to enjoy an attractive regular income and potential capital growth.

Historical Annual Distribution Yield	
2007	4.91%
2008	5.51%
2009	4.61%
2010	5.94%
2011	6.87%

* The distribution rate is calculated based on the NAV price on the record date. Annual distribution rate is the total sum of the distribution rate for the 4 quarters of the relevant year. Positive distribution rate does not imply positive return. Intended quarterly dividend distribution and yield can fluctuate and are not guaranteed. Past distribution yield is not necessarily indicative of future or likely distributions or yield.

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Henderson GLOBAL INVESTORS

tepid global economic growth prospects, while inflation pressures remain stubbornly high.

Charles Chui, director, asset management, at Falcon Private Bank, points to the better demographics and underdeveloped infrastructure in emerging markets – such as telecoms, railways and general need for construction.

"While the stand-alone risks of emerging markets are higher, their inclusion could enhance the risk/return profile in a well-managed global portfolio, especially for clients with discretionary mandates," says Chui.

Tony Edwards, chief executive officer of Robeco in Asia Pacific, adds that there is a lot of potential to take advantage of the market inefficiencies in the "emerging markets" category to generate higher returns, rather than taking more market risk.

Amy Cho

Pictet Asia

"Investors are more focused on Asia because they have a home bias and are more comfortable with accessing local opportunities"

WHERE TO LOOK

Most investors generally know the names of companies they want to get exposure to in the developed markets, and can in most cases do this directly, if they want to.

When it comes to emerging markets, however, most people don't know which markets or sectors to invest in.

Says Amy Cho, managing director and regional head of business development for Asia Pacific (ex Japan) at Pictet: "They are more focused on Asia because they have a home bias and are more comfortable with accessing local opportunities. For instance, anything relating to China can be appealing, especially for Hong Kong investors."

"Often they want to invest in their home market, and possibly a little within their home region, but they then miss out on the rest of the world," adds Sandro Steiner, partner and managing director of independent asset manager OLZ Wealth Management.

Within these trends, there is increasing competition between mutual funds, direct investing and ETFs.

Firms like OLZ, for example, can offer investors an efficient, diversified emerging market fund which has access to over 400 liquid emerging stocks. "With our optimisation process, we select and weight stocks based on their risk and diversification attributions," he explains.

"While reducing initial (fund) costs and reducing running fund costs, the client gets a fair chance to make an interesting return per the amount of risk they are taking on."

At Bank of East Asia, meanwhile, the focus is on giving clients access to emerging markets fixed income, and to a lesser extent access to emerging markets equities.

"This mirrors the demand we see from investors," says Alfred Mak, head of investment products and advisory.

Cho at Pictet agrees. "Given the global environment of low growth and low interest rates, investors are particularly keen looking for income products like high-yield bonds and high-dividend equity funds."

Further, adds Stephen Grundlingh, co-chief executive officer, Templeton Asset Management, Singapore, and regional head, South-east Asia, Franklin Templeton Investments, while some of the markets in Asia traditionally referred to as emerging have seen some growth tapering off, he sees new opportunities in the so-called "frontier" markets, such as Cambodia and Vietnam, to name just two.

"Consequently we have launched a Frontier Markets Fund, which includes countries in Africa and emerging Europe, to capitalise on these new growth markets," he says.

BEING REALISTIC

At the same time, market experts are also quick to offer caution in being able to properly manage investors' return expectations.

Sandro Steiner

OLZ Wealth Management

"Often they want to invest in their home market... but they then miss out on the rest of the world"

"Emerging markets can still offer the healthy returns they once did," says Nick Hoar, managing director, head of Asia Pacific, Neuberger Berman.

But rather than returns being driven by commodity-related firms which rely on strong global growth, Hoar says he believes returns will be sourced from local consumer and infrastructure growth, which tend to be found with small and medium-sized companies.

Chui at Falcon Private Bank agrees that consumption demand from emerging markets is expected to continue.

He points to consumer goods with solid brand recognition – such as fast-food chains, branded luxury goods, cosmetics, and consumer staples – and proven track-records that could be replicated in emerging markets as good ways to play the long-term growth theme in these countries. And without the local market volatility and worries about corporate governance.

Fundamentally, it is all about where future earnings will come from, explains Lennie Lim, managing director, regional head, Asia, Legg Mason. "There are a lot of domestically-focused companies in local markets, and this is where investors are likely to find the biggest value going forward."

In China, for example, given the amount of consumers participating in the consumption story, along with the increasing industrialisation and the current low representation of Chinese stocks in the MSCI World Index, these trends all point to a very positive outlook for Chinese stocks going forward, predicts Lim.

Having said this, developed markets should not be overlooked. The US, for example, was the only major market to post positive returns from June 2011 to June 2012, he adds, out-performing markets such as the emerging markets, China, Europe and commodities.

"This is where professional investment advice pays dividend to investors," says Lim. "Our US affiliates, Royce & Associates, have consistently been advocating the US market."

At the same time, trading costs in emerging markets could be higher than developed markets. The lower market liquidity also means high prices impacting costs.

"Custodian costs, withholding taxes, currency risks, political risks and market efficiency should also be carefully considered," explains Chui.

> Trading costs in emerging markets could be higher than developed markets. The lower market liquidity also means high prices impacting costs.

There are also policy issues to consider. For instance, emerging market economies have already started cutting interest rates, which some market players have long anticipated.

"Investors should look for investment opportunities to preserve their purchasing power by investing in high-dividend yielding stocks such as REITs, utilities and telecoms," says Chui, "and diversified investment portfolios in fixed income and precious metals."

Stephen Grundlingh

Franklin Templeton Investments

"We take corporate governance very seriously"

AT THE FRONTIER

The potential for finding sustainable opportunities in frontier markets continue to be debated by the investment and advisory communities.

To put frontier markets in perspective, their total market capitalisation would be equivalent to only 5% of emerging markets capitalisation, explains Hoar.

"Then if one looks strictly at the MSCI Frontier Markets index, one will note the index is highly skewed to Middle Eastern countries," he says. For example, Kuwait alone is over 25% of the index; therefore, the index may not be as diversified as the investor would expect.

The local frontier markets may also not offer the desired liquidity or the best governance.

"We believe investing in a broad set of companies that have combined emerging market and frontier exposure, or alternatively finding developed-market listed companies with frontier market assets or revenue exposure, may offer [investors] better risk-adjusted returns," says Hoar.

"We take corporate governance very seriously," adds Grundlingh at Franklin Templeton Investments.

"And therefore it is critical to have analysts based in these regions who are local, speak the native language, and are able to visit and meet with the management of the companies we invest in."

Today, the firm's emerging markets group under Dr Mark Mobius has over 50 analysts conducting detailed investment research across 17 emerging market countries.

As a result, he adds, investors should look to invest with fund companies that have a good track record of adding value through on-the-ground analysis and research.

For Mak, he says the bank doesn't try to go for exotic, or frontier markets, rather the more traditional developing markets in Latin America and Asia. "We advise clients to buy funds that give them access across emerging markets rather than single countries."

Alfred Mak

Bank of East Asia

"The focus is on giving clients access to emerging markets fixed income, and to a lesser extent emerging markets equities"

Co-published article

EMERGING MARKET DEBT – THE NEW SAFE HAVEN?

The investment rules we grew up with no longer hold. The emerging market investment scenario has changed profoundly. Emerging market debt has never been so popular, says Henry Stipp, emerging market debt fund manager, Threadneedle Investments.

Both the US Federal Reserve's decision to embark on a third round of Quantitative Easing (QE) in September 2012, and the launch of the European Central Bank's plan to buy bonds of troubled peripheral sovereigns, were designed to boost the US and Eurozone economies.

However, the emerging economies have proved to be among the main beneficiaries of these measures.

With yields on core government bonds falling to paltry levels, increasing numbers of investors are willing to explore the potential offered by emerging market debt.

A huge amount of cash is searching for income and demand is growing thanks to QE (in Japan and the UK as well as the US and Europe). Moreover, the fundamentals of the emerging world are very appealing, particularly in relation to the developed economies.

SOURCE OF RISK SHIFTS TO ADVANCED ECONOMIES

Gone are the days when investors were told to shun emerging market debt. The source of much of the world's investment risk has changed. Most of today's investment risks emanate from the developed world rather than emerging markets.

In the 1980s and 1990s, emerging markets were the main source of turmoil: chaotic politics, high levels of debt and liquidity problems led to crises in Mexico, Russia, Asia and Argentina, amongst others.

Emerging market bonds now represent a conservative asset class over the long term, offering a stellar risk/reward ratio, very attractive yields and excellent diversification benefits.

While emerging markets are not immune to difficulties, clearly the developed world is now the main source of risk for global investors.

The foundations of the 2007/08 global credit crunch were laid in the US housing market, while today it is the Eurozone crisis that is now striking fear into investors.

Henry Stipp

Threadneedle Investments

"Emerging market bonds now represent a conservative asset class over the long term"

RATINGS ACTIONS REFLECT POSITIVE FUNDAMENTALS

This point is illustrated by examining the ratio of upgrades to downgrades by ratings agencies such as Standard & Poor's and Moody's.

Rating actions demonstrate the changing investment landscape. Over the past 12 months, there have been 11 downgrades in developed markets (most notably the US, Spain, Italy, Ireland and Portugal) and no upgrades.In Latin America, the ratio is eight upgrades to four downgrades. In Asia, the ratio is four upgrades to one downgrade. Even in Eastern Europe, there have been more upgrades (four) than downgrades (three).

The rating agencies clearly see lower risks in emerging markets.

RISK OF EMERGING MARKET DEFAULT IS LOWER

One factor to explain why we have seen so many upgrades happening to emerging market countries by the rating agencies recently is because of the default risk of these countries dramatically decreasing.

The healthy state of public finances in the emerging world reflects a number of fundamental factors.

Since the 1990s, emerging markets have been forced to improve their economic and monetary management and restructure their banking systems.

Whilst public debt in advanced markets has been rising for five years and is continuing to do so as austerity measures are being overshadowed by weak GDP growth, emerging markets have seen public debt falling.

The IMF estimates that advanced markets' public debt stands at around 100% of GDP and rising; the equivalent figure for emerging markets is around 40% and falling.

In addition, the risk of emerging market default has been lessened because an increasing proportion of debt is being issued in local currencies.

RISK OF CAPITAL OUTFLOWS IS LOWER

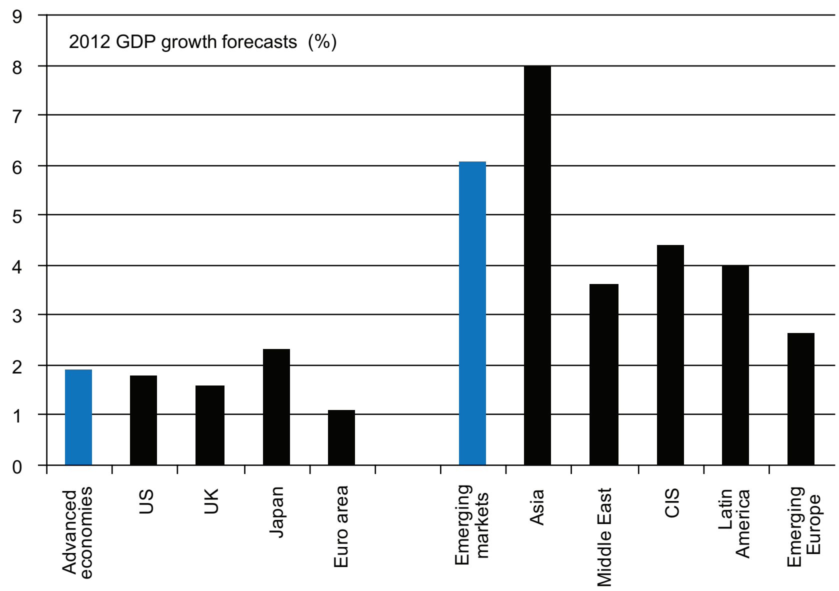
With weakness in developed markets, a lot of money has flowed into emerging market assets.

But the risk of that money flowing out again when developed markets recover is lower than it would have been in previous cycles.

Central banks' reserves have almost doubled since 2005, while foreign

"Investors are becoming attuned to the growing maturity of emerging markets."

The growth differential is daunting



Source: IMF World Economic Outlook, September 2011

portfolio investments are a much lower proportion of those reserves than was the case five years ago. In Brazil and Hungary, for example, the proportion of foreign portfolio investments to central bank reserves has halved.

EMERGING MARKETS ARE GROWING FASTER

The fact that emerging markets are generating superior growth compared with their developed counterparts is well known. The size of the differential, however, is stark.

IMF forecasts have emerging markets as a whole growing at around 6% in 2012, with advanced economies trailing behind at 2%. This difference suggests that emerging economies are becoming increasingly able to stand alone and grow in spite of weakness in the traditional powerhouse economies of the West.

Indeed, trade flows show that trade between emerging markets has increased steadily year-on-year from less than 25% in 2000 to nearly 40% in 2011. Emerging market policymakers appear to have learned the lessons of the past. In general, there is a theme of sensible fiscal policy with deficits firmly under control – less than 2% of GDP in 2012 across the emerging markets universe, compared with nearly 6% among advanced economies (July 2012 IMF Fiscal Monitor update). This gives central banks the scope to use monetary policy as it was intended – to tame inflation when required, and boost growth when necessary.

This is evident from Mexico to Korea and from Brazil to India. Central banks are running counter-cyclical interest rate policies and they are generally working, as growth remains sensitive to monetary policy.

Emerging markets generally (not always) have attractive valuations. However, despite the markedly-strong and continuously-improving economic fundamentals seen across many emerging markets over the past decade, these are still not priced in to a large extent.

The asset class offers attractive yields and spreads in relation to the developed world. The search for yield by many investors has led to emerging market debt.

EMERGING MARKET DEBT AT THREADNEEDLE INVESTMENTS

At Threadneedle Investments, within the Threadneedle (Lux) Emerging Market Debt Fund we have pre-

> “The search for yield by many investors has led to emerging market debt.”

ferred Latin America to Eastern Europe since last year, but moved back into Europe early in 2012 when we saw an improvement in sentiment following the announcement of the European Central Bank's Long-Term Refinancing Operation. We reversed this again in April as the tone in Europe worsened. Our strategy also continues to hold an overweight in Mongolia, which we believe should be the biggest beneficiary of any easing of monetary policy in China. Such a development appears increasingly likely given recent weak Chinese data. We are now overweight in Latin America, neutral in Asia and very underweight in Europe. Overall, our positioning is defensive, which we think is appropriate given the volatility of the situation in Europe. We are also holding healthy levels of cash as well as some US Treasuries to help manage duration.

Emerging market fundamentals remain generally stronger than those of the developed world. Balance sheets are in general more robust, fiscal and monetary policies are mostly appropriate, management of foreign exchange reserves is sensible and also growth is strong.

The developing economies also benefit from better demographics that their mature counterparts; the latter typically characterised by ageing populations and increasing dependency ratios, which will place a burden on public finances of these nations.

Emerging markets are now seen as a safer haven and a good opportunity to take advantage of the attractive yields. Investors are becoming attuned to the growing maturity of emerging markets, and this bodes well for the future. ■

Why the Threadneedle (Lux) Emerging Market Debt Fund?

Solid long term performance

- The Fund has returned over 13%, net of fees year-to-date (30 September 2012) and offers a SG$ hedged share class

Clear and disciplined investment approach

- A focus on yield, liquidity and diversification – this is reflected in our fund composition
- Primarily invest in sovereign and quasi-sovereign bonds (companies backed by a public guarantee or control) from a variety of emerging countries, with limited or zero exposure to corporate bonds
- We primarily invest in US$ denominated bonds, with tactical exposure to local currency bonds

High defensiveness in the current uncertain market

- The fund is inherently defensive, thus has lower levels of volatility, give its focus on sovereign and quasi-sovereign bonds

Attractive dividend yields

- The fund pays a monthly dividend, providing investors with a stable stream of income (historically around 6% to 7% on an annualised basis)

Experienced team

- Our emerging market debt team consists of qualified and experienced specialists with a diverse and complimentary range of skills

Robust risk management

- We operate strict liquidity tests for all proposed investments to avoid potential illiquid securities in emerging markets. An independent risk team concurrently conducts scenario analysis and stress testing

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For more information on Threadneedle's thoughts on emerging market debt as an asset class, or the Threadneedle (Lux) Emerging Market Debt Fund, contact:

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EMERGING MARKET EXPOSURE WITH A DIFFERENCE

Matthew Barron, managing director, head of fixed income sales for TD Securities in Asia Pacific, explains the value of getting currency exposure to the emerging markets via high-grade names.

What types of products are you seeing appetite for among private clients?

TD Securities services a group of high-grade frequent borrowers, raising debt across a broad variety of currencies.

A major share of this issuance is in EMTN format which offers a great degree of flexibility and is well-suited to private bank distribution.

An advantage of EMTN, when passported, is these bonds can be sold down into small ticket sizes, making them attractive for private banks to sell to their customers.

The post-sale transparency of a registered EMTN security adds to the attraction.

It doesn't require the bespoke reporting that accompanies much of the structured product which is sold into the private bank market.

The current low yields of the more traditional investor currencies of the region have seen appetite for higher-yielding niche and developing currencies grow over recent years.

Locally this has seen our EMTN offering grow in attraction when compared with Singapore-, Hong Kong- and US-dollar

> "The running yields can be as high as 6% or 7% with an AAA credit, which can further enhance the targeted currency appreciation returns and also plays a role to absorb a certain amount of adverse currency movement."

products, where moving down the credit curve is the only way to add yield.

What types of credits are investors buying in these currencies?

Many of the supranational and agency frequent borrowers have bonds outstanding and continue to issue in emerging and niche currencies, giving investors the choice of some of the highest-grade names available.

The Brazilian real, for example, offer bonds issued by borrowers including the World Bank, IADB, IFC, ADB, EIB and KFW, to name a few.

An investor might not want to invest directly in the local Brazilian bond market because it isn't as developed a market as they would be use to.

For example, the bond formats aren't user-friendly for them, or the settlement systems aren't as clear as they are used to and the Brazilian credits aren't as familiar.

As a result, we give them an EMTN on an AAA-rated credit, allowing the investor to gain the currency exposure they are looking for.

Why is this appealing to investors?

This is a clean format with an obvious coupon, final maturity and a credit they understand.

It enables investors to get exposure to developing countries and also to get exposure to some of the more niche developed market currencies.

The running yields can be as high as 6% or 7% with an AAA credit, which can further enhance the targeted currency appreciation returns and also plays a role to absorb a certain amount of adverse currency movement.

Why would investors want to buy bonds directly rather than via a fund?

Clients serviced by the private banks tend to be reasonably sophisticated with larger amounts of cash to invest.

So buying individual bonds (currencies), individual security selection, is more feasible while they still have the investment size to achieve diversification. ■

Matthew Barron

TD Securities

> "An investor might not want to invest directly in the local Brazilian bond market because it isn't as developed a market as they would be used to."

Co-published article

APPLYING A LOW-VOLATILITY STRATEGY IN EMERGING MARKETS

The possibility of earning returns over the long-term that are comparable with emerging markets – but with distinctly-lower downside risk – is compelling in any market environment, says Pim van Vliet, senior portfolio manager, Robeco Conservative Equity Strategies.

In the long run, reducing losses in down markets adds more return than riding every bull market. The concept of such a low volatility, or conservative equities, strategy is straightforward to understand: when emerging markets rise (for example, as measured by the MSCI Emerging Markets Index), so does the strategy on average; during months when markets decline, the strategy preserves capital by declining to a lesser extent. Such performance can, therefore, preserve capital while yielding attractive long-term returns over time via a cumulative effect. By losing less in down markets, there is less to recover once markets rise.

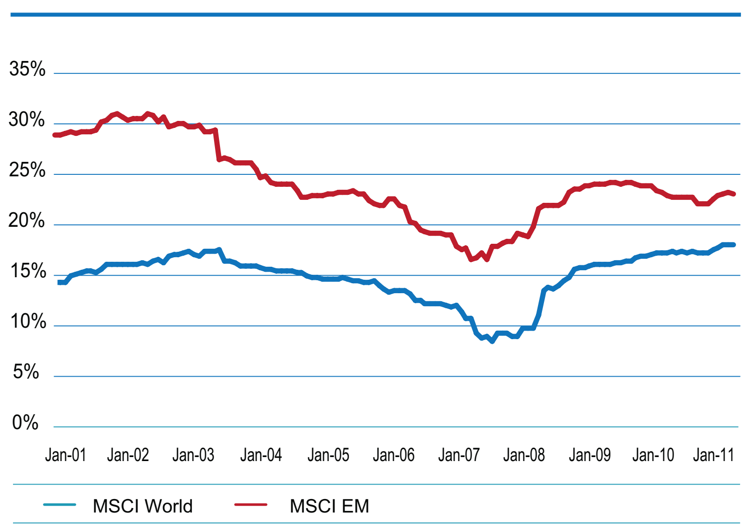
A LOW-VOLATILITY STRATEGY

Making a low-volatility strategy work relies on disciplined management that follows a rules-based approach. Stocks are selected first to reduce risk, and second, to improve return. This takes advantage of a proven but under-utilised premium in equity markets, known as the volatility effect, where low-risk stocks have better risk-adjusted returns than high-risk stocks.

While this is increasingly being applied in developed markets, it is less common for emerging markets.

To make it work in emerging markets, it is important to use a variety of risk-reducing factors when selecting stocks, including forward-looking risk measures that take into account the possibility of future financial distress. Returns are also enhanced by selecting low-volatility stocks which also have attractive valuation and sentiment characteristics.

It is this combination of stock selection criteria that enable the strategy, on the one hand, to preserve capital by losing less when markets decline, Rolling volatility, 5-year investment horizon



Source: Robeco

and on the other hand to have a portfolio that will also do well when markets rise.

Dividend yield is also included in the valuation assessment. In general, low-risk stocks tend to have higher dividend yields, but high-dividend stocks are not always low-risk.

For example, during a severe recession, such as in 2008, many high-dividend stocks became risky and had weak performance.

This different risk-return profile makes a low-volatility strategy an excellent diversifier for income portfolios.

THE VOLATILITY EFFECT IN EMERGING MARKETS

The empirical relationship between risk and return in emerging equity markets has been found to be flat, or even negative.

This is inconsistent with theoretical models such as the Nobel-prize winning Sharpe-Lintner Capital Asset Pricing Model (CAPM), which predict a positive relation.

But it is consistent with the results of studies which have previously examined the empirical relation between risk and return in the US and other developed equity markets.

The flat, or negative, conclusion are, however, robust to considering a universe of large-cap stocks only, to considering longer holding periods, and to controlling for exposures to the size, value and momentum effects.

At the same time, the empirical deviation from the theoretical risk-return relation appears to be growing stronger over time, which might be related to the increasing participation of benchmark-driven investors, in line with the "limits to arbitrage" hypothesis.

Further, there is low correlation between the volatility effects in emerging and developed markets, which argues against a common-factor explanation.

BRIGHT PROSPECTS

As more investors, both large and small, see opportunities in emerging markets – based on, in general, a better financial situation for both governments and companies, healthier growth prospects and, in most cases, a more positive outlook – the prospects for low-volatility strategies seem reasonably bright.

Further, the crisis in the eurozone is dampening sentiment for European and US equities, while emerging markets economies have managed to remain relatively unaffected.

At the same time, this can be seen as a solution for investors in search of yield. Even since early 2011, for example, the yield on Dutch government 10-year bonds has shrunk by half and now stands at less than 2%.

Given that annual dividends from the low-volatility approach are expected to be relatively stable at around 5%, the attraction of funds implementing these strategies should become even more attractive in today's market. ■

ROBECO

FRONTIER MARKETS: ATTRACTIVE GROWTH POTENTIAL

Mark Mobius, executive chairman of the Templeton Emerging Markets Group at Franklin Templeton Investments, says frontier markets can provide investors with an attractive source of long-term growth and diversification, and that market-specific risks are discounted in valuations and can be managed through a rigorous investment process.

Where do frontier markets fit within the categorisation of emerging markets generally?

Frontier markets are a sub-set of emerging markets so share the characteristics of emerging markets generally.

The difference is that frontier-market companies normally have generally lower market capitalisations and liquidity than the more developed emerging markets like the BRIC (Brazil, Russia, India and China) countries.

They also have economies and financial markets that are less developed than most other emerging markets.

However, many of them have experienced strong economic growth, display positive macro-economic fundamentals and have attractive growth potential, in our view.

What common characteristics do frontier markets share?

Frontier markets are geographically and economically diverse. Most African and Middle Eastern countries are included in frontier indexes.

In addition, several countries in Eastern Europe, as well as in Asia and Latin America also have significant representation in the indexes.

In terms of their economic situations, frontier markets range from wealthy Gulf oil-producers, with some of the highest per-capita incomes in the world, to some of the world's most impoverished nations.

Most have in common a desire to introduce market mechanisms to boost economic growth and development.

What does this mean for their attractiveness for investors?

We believe investors keen on high, long-term returns and relatively low correlation with other markets can potentially benefit from investing in frontier-market equities.

Strong economic growth prospects are among the main attractions of frontier markets.

The International Monetary Fund (IMF) has forecast that frontier-market economies will potentially achieve annual growth in excess of 4.4% over the next five years, with

Mark Mobius

Franklin Templeton Investments

countries such as Vietnam, Bangladesh and Nigeria forecast to grow in excess of 6.5% annually.

This potential compares positively with developed world growth, forecast at 2.2% annually over the same period.

In many ways, frontier markets are at an equivalent state of development as were today's emerging markets when they first came to international investors' attention more than two decades ago.

By investing now, we hope to partake in the economic benefits available to these countries from base effects and access to developed technology.

This could feed into premium earnings growth and sharp rises in their capital markets.

What concerns should investors have when investing in frontier markets?

Some investors perceive that the frontier-market growth premium is available only at the cost of heightened risk caused by factors such as political instability, low shareholder protection and corruption.

We would contend that the risks inherent in most frontier markets are more salient but similar to the political, country- and stock-specific risks in any other market, whether developed or emerging.

The real difference, in our view, is a lower degree of understanding and research about frontier markets on the part of the global investment community.

How do you overcome that?

We believe that our on-the-ground, research-oriented and detailed investment model allows us a great deal of insight to better manage this information "gap".

"By investing now, we hope to partake in the economic benefits available to [frontier markets] from base effects and access to developed technology, which could feed into premium earnings growth and sharp rises in their capital markets."

Our investment model requires us to create five-year histories and five-year forecasts for all investments.

We also carry out country and company visits before committing funds, a process we hold to be very valuable, especially in a frontier-market context.

We are particularly cautious where capital controls and investor expropriation could be seen as risks.

But we think this risk is already generally priced into frontier-market stock valuations that often trade at discounts, sometimes wide discounts, to their emerging and developed peers.

Furthermore, many frontier markets have a low correlation to their peers as well as to developed markets.

As such, they could play a valuable role in diversification and portfolio planning.

What else has discouraged investors to date?

Low liquidity and small individual market size in frontier markets are other factors that have discouraged investors.

"Many frontier markets have a low correlation to their peers as well as to developed markets; as such, they could play a valuable role in diversification and portfolio planning."

Certainly, if investors were to look at the S&P Frontier BMI Index, its market capitalisation was around US$200 billion, covering only 36 markets and around 550 stocks.

However, by our own calculations, using data from a number of sources including the World Federation of Exchanges, the frontier-markets universe is far greater and more diverse, with an estimated total market capitalisation around US$1.1 trillion, including more than 7,200 companies and averaging a daily turnover of approximately US$2 billion.

The absence of large investors from these markets reduces the competition for stocks, allowing positions to be accumulated at attractive valuations.

Once accumulated, the positions can sometimes command a premium as other investors seek to enter the market.

Low liquidity, however, does carry some risk in the event of fund redemptions.

Frontier markets are sometimes seen as excessively dependent on commodities and natural resources.

We believe this criticism underplays the diversity of the frontier-market universe.

Some economies, notably those of Kenya and Ukraine, are oriented toward agriculture and domestic spending.

Others, such as Nigeria's and those of the Gulf states, may have been driven by commodities in the past, but they are now seeing some rapid diversification both through overt government measures.

This is also as a result of the development of private domestic demand, as commodity earnings filter through the wider economy.

To what extent is over-concentration a concern?

Funds cleaving closely to frontier-market benchmarks might find themselves unintentionally having a heavy weighting toward one region, one country, or one or sector at the expense of others.

But we generally avoid this situation since our policy is to invest without reference to benchmarks and to build our portfolios from a ground-up, stock-specific perspective. ■

Co-published article

GETTING ACCESS TO EMERGING MARKETS DEBT

Emerging market debt is expected to play an important part of investor portfolios going forward, driven by various macro-economic and other factors, says Eric Delomier of J.P. Morgan Asset Management.

In today's low interest-rate environment, fixed income sectors that provide significant yield pick-up over government bond yields are attractive and will continue to draw significant fund flows from investors. Emerging market debt (EMD) provides this type of yield pick-up.

Further, there are reasons to remain constructive on the structural prospects of EMD over the medium to long term, given that it represents a solution for investors seeking to increase diversification, and yet there is an under-allocation of EMD in portfolios.

Specifically, both from a currency and duration perspective, local currency bonds look attractive over the course of the next few months.

DIVERSIFICATION

Bonds tend to perform better than stocks in periods of economic slowdown or increased risk aversion. Despite the lowering of global growth forecasts and fears of further European peripheral stress, EMD assets have managed to maintain positive returns year to date.

The current environment, characterised by slow but also by positive growth and accommodative monetary policies, remains supportive of the EMD asset class.

Investors are seeking to enhance their portfolio yield while keeping a limited exposure to equities as the growth outlook remains very uncertain.

In line with this, when investing in fixed income, diversification is of paramount importance.

Mutual funds offer a diversified exposure to the asset class with exposures to a wide range of countries in Latin America, Asia, the middle-East, Eastern Europe and Africa.

Eric Delomier

J.P. Morgan Asset Management

> "EMD has evolved from a relatively confidential asset class to a mainstream one over the last few years"

DISPELLING MYTHS

EMD consists of not one, but three separate asset classes: dollar denominated government debt, typically referred to as "sovereign debt"; dollar-denominated emerging market (EM) corporate debt; and local currency government debt.

These EMD asset classes vary not so much in terms of their geographical composition or their credit quality but in the type of exposure to global markets that they imply.

Buying local currency debt means taking exposure to EM FX trends, while the US dollar-based assets include a US Treasury component. When global growth is strong, EM FX will tend to appreciate, and Treasury yields will tend to rise. These factors favour local-currency debt.

During less booming periods, Treasury yields will likely decline and EM FX will remain stable or sell off, tilting the scales toward dollar-based assets. Investors should consider the characteristics of each of the three asset classes to see which suit their particular objectives.

In addition, when investing in EMD, selecting the right countries, issuers and securities are critical to a successful investment.

Investors should therefore be looking for a manager that has the expertise and experience to identify investment opportunities globally.

EMD IN PORTFOLIOS

An EMD exposure allows investors to enhance the yield on their fixed income portfolio while ensuring that they are able to achieve sufficient geographic diversification.

Specifically, in an environment where investors are concerned with the growth outlook in the developed world, there is an increasing focus on income-generating products that deliver stable returns in a low-growth and low-yield environment.

Combining EMD with a few other asset classes, such as high-yield corporate bonds and high-dividend stocks may allow investors to fulfill a desire for stable income.

At the same time, EMD has evolved from a relatively confidential asset class to a mainstream one over the last few years. The key to provide meaningful advice on EMD to investors is to ensure they are directed to the suitable sub-sectors (local currency, US dollar sovereign or EM corporate) that best meet their requirements.

ACCESSING EMD

A good way to gain exposure to EMD is through funds invested in these markets. These funds typically consist of diversified portfolios of bonds that often include 100 to 200 different instruments. Such diversification enables investors to spread their exposure across many different instruments, therefore reducing the overall risk of their portfolio. That is very difficult for individual investors to achieve as bonds are traded in large minimum size that are beyond the means of most individual investors.

As a result, most individual investors would not be able to construct a diversified portfolio of EMD bonds. The benefit of a mutual fund for EMD, therefore, is that it enables investors to get a diversified exposure to the sector. It also enables investors to benefit from the expertise of professional investors who add value on top of the benchmark by selecting the best countries and sub-sectors. ■

J.P.Morgan
Asset Management

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Feature article

BUILDING EMERGING MARKETS INTO PORTFOLIOS

Where and how emerging markets fit into investor portfolios is a hotter topic than ever before as the asset class becomes more of a stand-alone proposition. Yet investors need to make sure they understand the challenges and risks – as well as the opportunities they perceive – to clear up some common misconceptions which exist.

Emerging markets are, quite justifiably, now considered by many investors and advisers as a stand-alone investment class in client portfolios.

In particular, given the muted growth and low yields offered in developed markets, emerging market equities can offer an area of potential long-term capital appreciation driven by exposure to local factors of consumption and infrastructure spending.

While developed market companies may source revenues from emerging markets, they have to also contend

> "The classification of "emerging markets" probably doesn't properly reflect the risk that many investors are taking in combination with some other parts of their portfolios."

with higher exposure to lower growth developed markets," explains Nick Hoar of Neuberger Berman.

"We believe direct exposure to locally-driven emerging markets equities can be a core part of a client's capital appreciation equity allocation," he adds.

MORE RISK THAN EXPECTED

Despite the optimism in relation to opportunities, however, if looking at client portfolios more holistically, the classification of "emerging markets" probably doesn't properly reflect the risk that many investors are taking in combination with some other parts of their portfolios.

For example, says Tony Edwards at Robeco, investors need to analyse some of the US or European stocks they hold where these companies are big investors in emerging markets themselves.

"A developed market fund might already have much emerging market exposure," he explains. "I think there needs to be a lot more caution applied to emerging market exposure generally," adds Edwards.

Just adding an emerging market allocation might be adding more risk without necessarily increasing the overall return potential.

Nick Hoar
Neuberger Berman

"Direct exposure to locally-driven emerging markets equities can be a core part of a client's capital appreciation equity allocation"

ADDRESSING MISCONCEPTIONS

At the same time, given some of the common mistakes and misconceptions which exist in relation to emerging markets, it is vital for relationship managers and investment advisers to (re)educate clients.

While valuations in some emerging markets stocks look cheap on the surface – for instance from a price/earnings ratio perspective – many portfolio managers evaluate from the context of the earnings quality, management track record, and the country macro outlook, explains Charles Chui of Falcon Private Bank.

That includes focusing on politics, GDP, external debt, inflation outlook, market liquidity and currency risk.

In addition, adds Hoar, many investors believe the MSCI Indices to be representative of the local emerging markets economies.

"However, this is not always the case," says Hoar.

"For example, Brazil's stock market has 54% commodities exposure, while private consumption makes up 63% of the local economy." ■

Tony Edwards
Robeco

"I think there needs to be a lot more caution applied to emerging market exposure generally"

Co-published article

BUYING TIME FOR EMERGING MARKET CURRENCIES

Less-pronounced investor concerns over the evolution of the Eurozone crisis, the US recovery and, eventually, the global outlook have contributed to spurring a recent emerging market currency rally. But how sustainable is this for key Asian markets, asks Cristian Maggio of TD Securities.

While the strongest recent emerging market currency performances on average have been recorded in Europe, euphoria has extended to Asia, as well.

The decisions that crucially changed sentiment remain major market drivers in the short run.

The European Central Bank's (ECB's) September announcement of the Outright Monetary Transactions (a sovereign bond purchase programme to contain spreads) was followed by a favourable ruling from the German Constitutional Court on the activation of the ESM/EFSF.

Finally, the Bank of Japan (BoJ) extended its bond buying programme and the US Federal Reserve announced a third round of quantitative easing (QE3) in the form of an open-ended commitment to purchase mortgage-backed securities, to lower the cost of mortgage loans, to fuel the recovery in the housing sector, and also to underpin inflation.

ASSESSING THE IMPACT

While the joint impact of these events is positive for risk assets, none of them introduces material solutions to the weakness of developed markets. They rather buy time, hoping that the real economic trends will get fixed in the meantime.

In Asia, in particular, China's deceleration to the edge of a hard landing requires looser monetary policy and a stronger US recovery to put the growth metrics back on track.

The QE3 effect will only partially contribute to resolve these issues.

Against this backdrop, the QE3 impact for Asian currencies could be less pronounced than in Latin America or EMEA. Likewise, the risk of commodity price reflation may restrain central banks' capacity to ease rates, making the slowdown longer or larger.

ALL EYES ON INDIA

This is the case for India, where the rupee is still suffering from weak fundamentals. Numerous hindrances that require time to fix continue to constrain the currency potential.

In particular, the rupee remains vulnerable to idiosyncratic risks (mostly of a political nature) and a "too tight for too long" monetary policy.

In fact, USD/INR historically correlates better with the performance of the stock market than it does with the local bond dynamics.

By averting a hard landing and enhancing the business environment, lower repo rates would boost equities and underpin the rupee.

But excessively-high inflation, still beyond the Reserve Bank of India's (RBI's) comfort zone, reduces the possibility to ease monetary policy.

Moreover, the government's commendable intentions to curb fuel subsidies may translate to additional inflationary pressures, while producing negligible effects on the state budget.

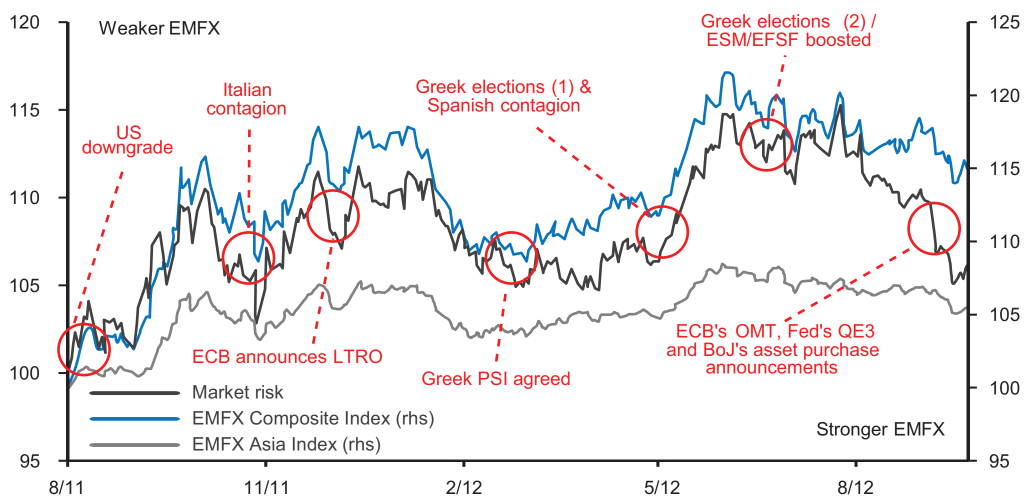
And besides the efficacy of spending cuts, the government's commitment to implement the recently-announced reforms (privatising state-owned assets, lifting the ban on foreign investment in airlines, and allowing foreign investment in the multi-brand retailers) must stand the test of time, as it did make similar announcements in the past, backing away from the good intentions immediately after.

As soon as the Pavlovian reaction to the hangover of QE3 and reform announcements fades, given that the risk of a downgrade to junk is still material, markets may add pressure on the rupee again. However, as a lot depends on the public initiative, USD/INR may fall substantially below the 50 handle if the Singh administration finally delivers on their promises.

Helping the normalisation process, on a total return basis, the rupee is already very attractive given that its interest returns (just below 9% in 12 months) is one of the highest within the emerging markets FX space.

Contributing to a possible extension of the rally over 2013, the government planned to introduce a hefty 15% tax

Asian FX generally less volatile during episodes of risk aversion



Source: TD Securities, Bloomberg

> The QE3 impact for Asian currencies could be less pronounced than in Latin America or EMEA. Likewise, the risk of commodity price reflation may restrain central banks' capacity to ease rates, making the slowdown longer or larger.

break on interest payments to non-resident bond/loan lenders meeting specific criteria.

The announcement helped the rupee outperform all other emerging market currencies in September, and could continue supporting inflows for the coming quarters.

RISKS IN INDONESIA

The macro-economic backdrop in Indonesia is discernibly different, whereby fundamentals continue to exhibit a remarkable resilience to downturns. However, local rates and the rupiah are also exposed to policy risks and market sentiment.

The S&P's decision to affirm Indonesia's BB+ rating in April, not following in Moody's and Fitch's footsteps of an upgrade to investment grade, has somewhat validated these concerns and increased the rupiah's vulnerability since then.

Capital flight is now more balanced, but market-unfriendly decisions from lawmakers could reignite outflows, while Indonesia's weakest spot is now the widening current account deficit.

We recognise that the rupiah has not traded in line with its fundamentals since May 2012, but better sentiment should finally help the IDR to recover as we move into 2013.

With the global prospects likely improving next year, and Bank Indonesia drifting progressively more hawkish on rising inflation, USD/IDR should fall below 9,500.

POTENTIAL CORRELATION ISSUES IN MALAYSIA

Finally, the impact of sentiment is emblematic on the ringgit.

The Malaysian unit has received formidable support throughout the June to September 2012 period, but failed to live up to its "emerging market safe haven" role when risk appetite turned for the worst in May.

The country is fundamentally sound, which explains the strong relative performance, but also suffers from a strong correlation to China and crude oil prices.

The former is still a hindrance as long as Chinese growth doesn't turn around, while the latter should support better currency valuations in the wake of QE3.

Overall, the outlook for the MYR remains positive, but a return to stronger global growth in 2013 is likely to shift investors away from defensive emerging markets currencies and progressively back into high betas with distressed valuations.

In the midst of this rebalancing, the ringgit is likely to post positive gains, though it may underperform some of the currencies backed by more opaque policies and fundamentals. ■

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Source: Bloomberg. Include all public International AUD Eurobond and Kangaroo issuance, from 1 January to 15 September 2012.

Q&A

USING THE CHINA LINK TO CREATE A FUNDS NICHE

King Lun Au, chief executive officer of Bank of China Asset Management, says the firm is taking advantage of the appetite for RMB product – and access to China generally – by creating a differentiated offering with a regional and global reach.

What is an example of the types of funds which you sell?

We have launched three private placement funds specifically for the high net worth segment of Bank of China (Hong Kong) Group (BOCHK).

The BOCHK RMB High Yield Bond Fund, in particular, is ranked by Bloomberg as the best-performing offshore RMB Bond Fund globally year-to-date. We have managed to protect the downside through proactive risk management during market downturns and also to generate alpha during rising markets.

Adopting the same investment philosophy, we launched our first retail fund in an exclusive partnership with the World Bank in Hong Kong in July 2012. The BOCHK-World Bank Emerging Markets Bond Fund is the world's first China-centric global bond fund with investments in AAA-rated bonds issued by the World Bank and denominated in local currencies of both emerging markets and commodity countries.

What is the attraction of RMB bond funds generally?

The internationalisation of RMB is rapidly gaining pace, with RMB being gradually recognised as a major currency for trade and wealth storage. The demand for RMB fixed income as a new investment asset class is expected to increase significantly in the near future, especially from overseas investors.

Investors are interested in RMB bonds because of the appreciation potential of RMB and the attractive yields. China has been adopting a more prudent monetary policy than most developed countries.

As a result, the RMB is back by a strong economy and will continue to strengthen as it becomes more widely-acceptable for trade and investment.

The nascent offshore RMB bond market has grown to US$60 billion in just over two years.

It has taken the Asian USD bond market 20 years to reach its present size of US$360 billion.

How will opportunities to invest in China, and vice versa, continue to evolve?

The Chinese economy is shifting from being investment and export dependent to more consumption-led. The Chinese equity markets have been pricing in the impact of this economic transition. Value investors who have a three- to five-year time horizon should find the markets now trading at attractive levels.

China is accelerating the opening of its capital markets as evidenced by the quickening pace of QFII (with the inclusion of private equity) and RQFII quota approvals.

These are positive developments and good news to investors in the long run.

So how else do you differentiate your offering compared with so many mainland fund managers looking more internationally?

This comes down to our investment philosophy and approach. Myself and my colleagues have managed hedge funds or proprietary trading before, which taught us a lot about risk management and capital preservation.

So we now apply the same mindset and approach to managing long-only assets with the motto of "benchmark aware but not benchmark driven".

By way of illustration, our sovereign risk analysis model gave out early warning signals on several European countries in March 2010. Having evaluated the Euro debt issue in details, we took a calculated deviation from benchmark and gradually increased our exposures to cash and US Treasuries (with currency hedging) for our two RMB bond funds, in correct anticipation of a flight to quality.

This proxy hedging was an effective insurance policy which enabled us to protect our portfolios from the drastic market corrections in RMB and Asian bonds in September and October 2010. Our two RMB bond funds have been outperforming the peer group consistently since inception.

What are the opportunities for fixed income investors in China?

I believe RMB fixed income offers a very compelling investment story. The internationalisation of RMB is rapidly gaining pace. Japan and China started direct currency trading in June this year. Taiwan signed an RMB clearing agreement China in August. Singapore is keen to follow suit. London is seeking to become the first RMB clearing centre in Europe.

With these exciting developments, RMB is fast-becoming a major currency for trade and wealth storage. The demand for RMB fixed income is getting more global.

On the supply side, we already have multinationals and quasi-sovereigns issuing offshore RMB bonds in Hong Kong. There will be more issuance overseas, especially in other offshore RMB clearing centres over time and this will lead to a global offshore RMB fixed income market.

King Lun Au

Bank of China Asset Management

With the onshore fixed income market being more accessible through QFII and RQFII, RMB fixed income will soon be recognised as a new asset class.

What approach do you take when trying to sell China to investors outside of Asia?

Instead of setting up a UCITS fund umbrella for passporting in Europe and Asia, we prefer to partner with a local distributor for our core capabilities on an exclusive basis in each country or region.

We believe a strategic partnership will bring many mutual benefits to both parties, such as alignment of interest and co-branding.

Further, we can focus on portfolio management and also rely on our local partners for marketing and client servicing on the ground.

Co-published article

UNDERSTANDING CREDIT CONDITIONS IN CHINA

Credit conditions in China warrant special attention in light of the country's considerable size and systemic importance to the global economy, says Andrew Clark of Thomson Reuters.

The property and credit markets in China represent potential vulnerabilities in an environment of decelerating – albeit still good – growth.

In part because of administrative measures intended to prevent or deflate property bubbles, house prices in most Chinese cities have been moving downward since 2008 and appear to have recently bottomed (see chart, page 40).

Housing affordability is still stretched, and while most market participants are saying that price declines have ended or bottomed, some analysts are concerned that housing prices may resume their decline.

If prices have bottomed, pressure will be taken off property developers, local governments relying on land sales for revenue, and other exposed sectors (see charts, page 39).

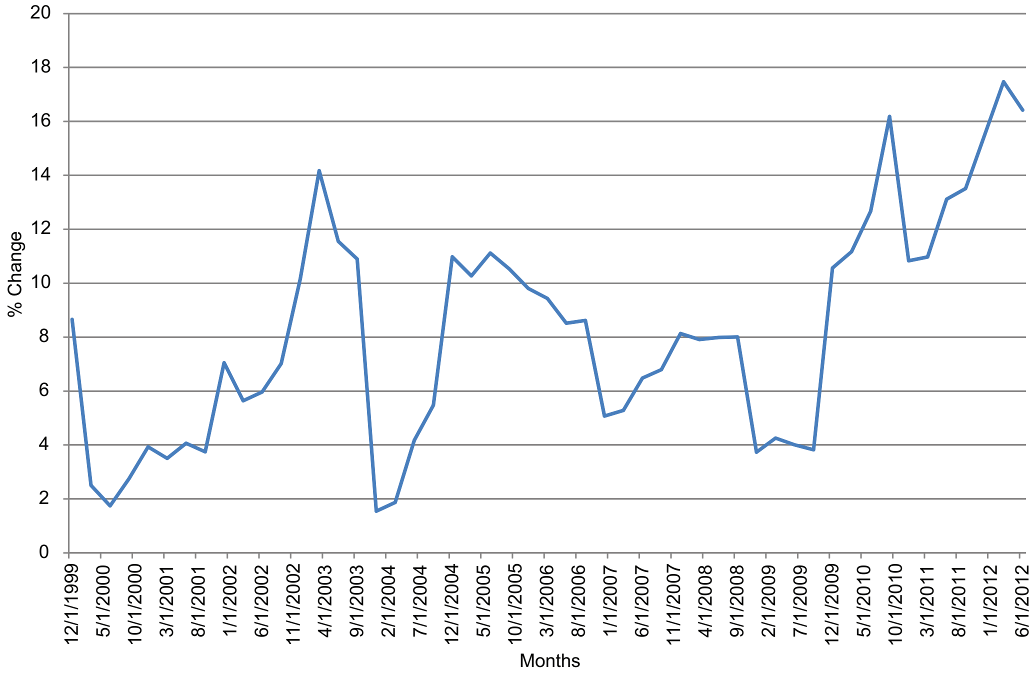
With real estate investment accounting for 13% of economic output and about 20% of bank loans, if housing prices resume their decline the sector could have a strong negative effect on the quality of bank assets.

THE CREDIT CYCLE IN CHINA

China is already at an advanced stage of the credit cycle. As a consequence of stimulus measures adopted in response to the global credit crisis, overall credit in China – according to the IMF – grew at an average annual rate of more than 25% from 2009 to 2011, bringing the overall credit-to-GDP ratio above 150%.

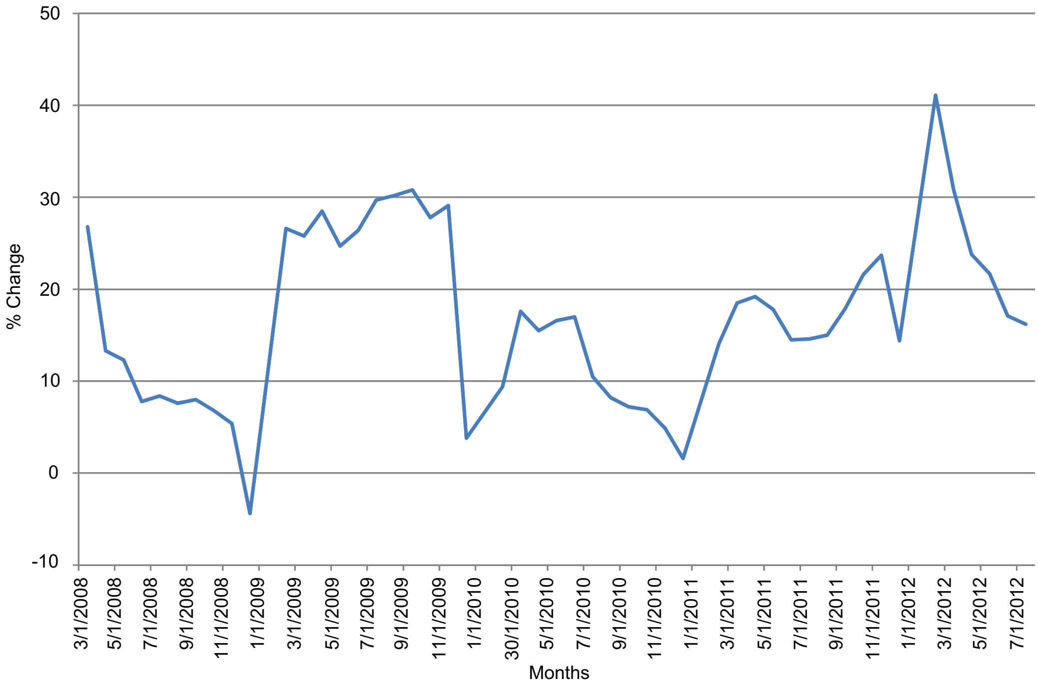
According to Christopher Woods of CLSA: "The latest China credit data is far from disastrous. But it also does not end growing concerns about a credit trap. Thus, new lending totaled RMB704 billion in August, or RMB6.1 trillion in the first eight months of this year, which means 76% of the annual target based on the assumed RMB8

Figure 1: Year-to-Year Change (%) in Real Estate Employment, 1999-2012



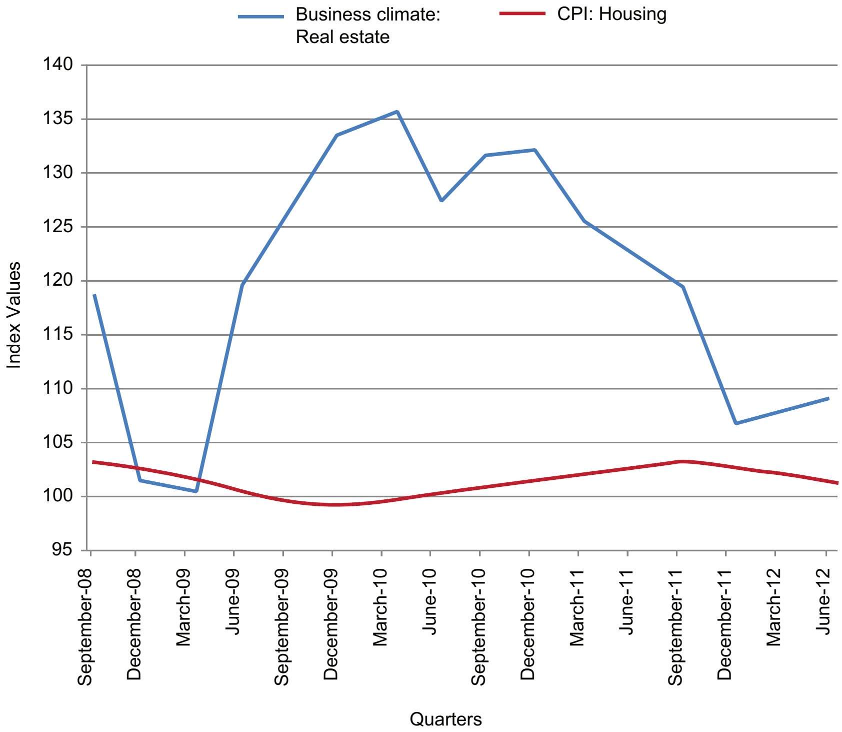
Source: Thomson Reuters

Figure 2: Year-to-Year Change (%) in Number of Houses Completed, 2008-2012



Source: Thomson Reuters

Figure 3: Business Surveys and CPI Values for Housing, 2008–2012



Source: Thomson Reuters

trillion credit quota. Still the interesting, and concerning, point remains the substantial amount of loans accounted for by short-term lending and bill financing. Thus new short-term loans and bill financing totaled RMB398 billion in August and RMB3.88 trillion year-to-date, accounting for 57% of total new lending in August and 64% year-to-date, compared with 50% in 2011 and only 20% in 2010."

Another concern with China's credit recovery is evidence of capacity constraints in the banking system.

While loan growth has been increasing, it appears to be hampered by a lack of liquidity.

For instance, weak deposit growth across the system, high loan-deposit ratios outside the major banks, and binding regulatory loan-deposit ratio-requirements plus high reserve ratio requirements are soaking up liquidity.

Stress tests by the Chinese authorities (conducted in the context of the recent Financial Sector Assessment Program with the IMF and World Bank) suggest that, in a tail-risk scenario with weak growth and plunging house prices, nonperforming loan rates could rise to as high as 8%.

While China has the resources to recapitalise domestic banks facing difficulties, incipient problems with credit quality would likely deter authorities from repeating the 2008 to 2009 strategy of domestic credit expansion.

RISKS LOOMING

The chief risk we see to credit conditions in China is a lack of follow-through in terms of improving credit conditions. Current monetary policy appears to be in favour of loosening and credit demand appears to be in be real, but the recovery of credit conditions ultimately rests on the system's ability to sustain lending.

Any evidence to the contrary would be a challenge to the positive views some analysts are taking.

We agree with Morgan Stanley and other firms that credit conditions have been improving and that China's muted growth recovery could mean further policy easing.

Several investment firms, including Morgan Stanley and Nomura, have written that if the current positive monetary conditions continue and China credits see supportive technicals and attractive valuations, China credits will become – or are already – the best opportunity in Asian credit markets today.

Investors should be cautious, however. Given the continued systemic risk in the global financial system, for example the issues in the Eurozone, they may want to seriously consider only high-quality credits – and possibly high-quality property credits – as potential investment vehicles. ■

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