

Global High Yield Investing

Considering Opportunities and Risks in Emerging Markets

We believe the best way to create value in active global high yield management is to incorporate as broad a credit universe as possible, making all the flavors of emerging markets debt (EMD) integral to a successful global high yield strategy. A capable manager with the flexibility to seek and concentrate investment in high-conviction value opportunities should be able to find value in EMD at some point in a credit cycle, but importantly not at all times. Therefore, we believe both dedicated EMD managers and those with largely dedicated, but small exposures, like core plus fixed income strategies, will be challenged to earn the significant amounts of alpha available to managers capable of integrating EMD into an unconstrained, top-down valuation framework alongside the broad universe of higher-yielding credit allocations globally. Ultimately, we believe EMD fundamentals are differentiated enough from traditional credit sectors that, at times, correlations will be sufficiently low relative to those traditional credit sectors, allowing EMD to be a meaningful investment tool for a globally aware credit manager.

Figure 1 illustrates that top-quartile and top-decile global high yield managers are successfully capturing asset allocation benefits as EMD and other higher-yielding segments outlooks wax and wane in relative value. We also believe, depending on the environment, that finding value may be easier to achieve between similar sectors rather than between securities in the same sector. Perhaps this consideration helps fixed investors understand why active managers rarely earn enough alpha to cover management fees in narrow segments like emerging markets or domestic-only high yield.

In the early to mid-2000s, emerging market debt (EMD) began to hit every institutional investor's radar. By that time, EMD began to

Figure 1 Top Globalized, Unconstrained Managers Achieve More Alpha



Note: As of 3/31/15; Top 25%, top 5% vs. median, GHY, vs. U.S. HY and EMD
 Source: eVestment data

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Past performance is no guarantee of future results.

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For Institutional Investors Only

string together attractive returns while ballooning local currency issuance (see **Figure 2**) suggested institutional scalability in EMD was achievable. Making the story all the more accessible, emerging markets (EMs) offered a compelling structural improvement story: most EM central banks focused on accumulating foreign-exchange reserves to enhance macro stability in the wake of the late 1990s Asian financial crisis, EM economic growth hastened from the depressed levels of the 1990s as urbanization and infrastructure projects delivered easily executable growth, and many investors felt EM currencies would benefit from the deterioration of the U.S. dollar's reserve-currency market share.

Daily news stories, even outside of financial media, detailed China's meteoric economic rise and the commodity/growth nexus (see **Figure 3**, **Figure 4**) unfolding across EMs. **Figure 3** shows the strong relative growth in EM countries that placed the EM corporate and sovereign segment in a natural position to increase debt issuance. Finally, easy G3 monetary policy during much of the 2000s fanned EM investment fervor by accelerating foreign investment inflows seeking better yields. All the pieces were in place in the 2000s for an EMD investment boom.

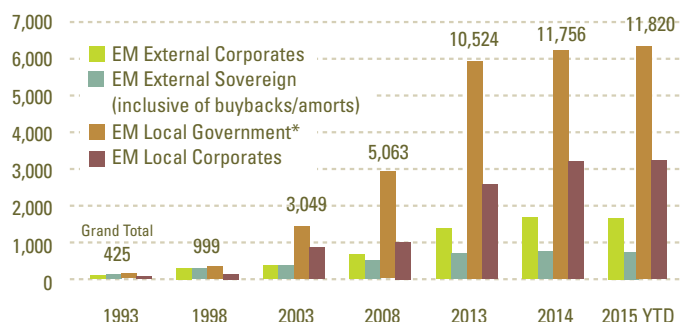
Ten years later in 2015, however, EMD is out of favor again — just as it was after the crises of the 1990s. So how should an investor approach the potential opportunity in EMD? Should EMD be considered a strategic allocation to which money remains allocated no matter the outlook for the sector? Should EMD stand alone as a passive or active allocation in your portfolio—or can your EMD exposures provide more benefit as a tool for your global high yield manager to use tactically? As we show in this paper, we believe the best opportunities from EMD will accrue to investors capable of incorporating EMD exposure as a part of a globally flexible, unconstrained, and benchmark-agnostic global high yield strategy.

EMD: STAND-ALONE ASSET CLASS OR INTEGRAL SEGMENT FOR GLOBAL HIGH YIELD

When investors began to incorporate EMD into strategic allocations in the 2000s, they initially saw a great opportunity to create a well-defined asset class from EMD. EMD did not move exactly like hard-currency corporate high yield, yet that was EMD's closest higher-yielding cousin. Most investors did not think of EMD as an integral portion of the global high yield universe, despite the obvious overlap. Investors either accessed EMD as a stand-alone asset class from what were new, just-launched strategies, or investors accessed EMD through a core-plus manager or U.S. high yield manager that treated it as a strategic bolt-on. With only 5% or 10% exposure to EMD, managers treating the segment as a bolt-on could produce mediocre returns in EMD and still not impact overall returns substantially.

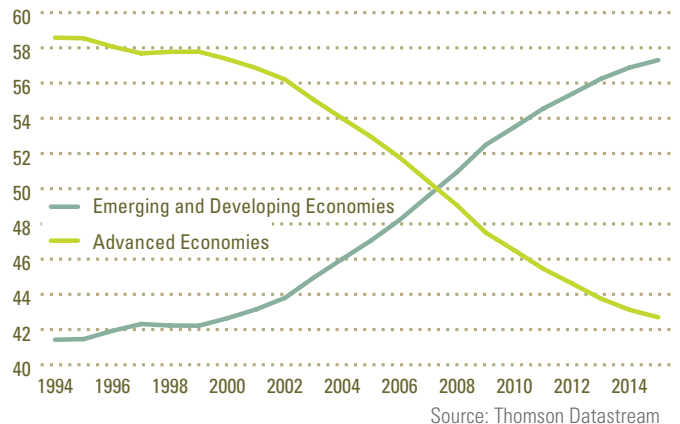
In our view, both approaches to gaining EMD exposure fail in capturing the significant amount of alpha potentially earned by integrating EMD into an unconstrained global high yield strategy, one that can tactically move into, out of, and within EMD by judging the sector's outlook relative to

Figure 2 Emerging Markets Debt Has Reached Meaningful Volume
 \$Billions; As of March 24, 2015



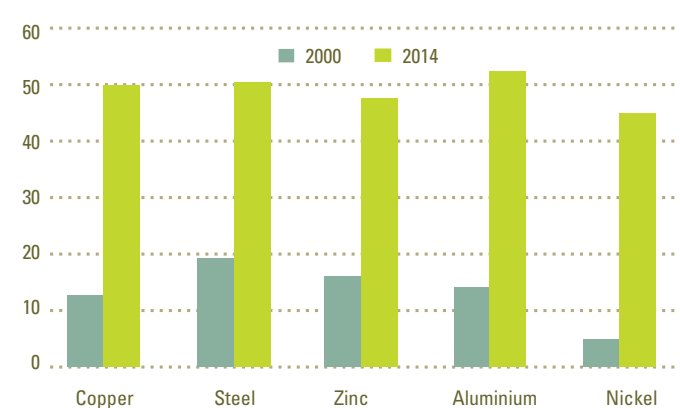
*Data prior to August 30, 2013, from BIS.
 Source: BIS and J.P. Morgan estimates

Figure 3 Emerging Markets Leap Past Developed Markets in Growth
 Share of Global GDP (%) at Purchasing Power Parity



Source: Thomson Datastream

Figure 4 China's Share of Global Commodity Consumption (%)



Source: Capital Economics, Thomson Datastream

other fixed income opportunities ranging across different sectors, currencies, credit ratings, and regions. **Figure 1** shows that successful global high yield managers—from top quartile to top decile in their manager universes—with broad flexibility to invest across credit sectors, currencies, and regions, have the ability to generate much more alpha than EM or even U.S. high yield managers.

We believe that top-quartile and top-decile managers are successfully capturing asset allocation benefits as EMD and other higher-yielding segments outlooks wax and wane in relative value. We also believe, depending on the environment, that finding value can be easier to achieve between similar sectors rather than between securities in the same sector. Fixed income investors rarely get enough alpha to pay for management fees in actively managed, narrow fixed income segments like EM or U.S. high yield.

Domestically oriented managers who added EMD assets within core fixed income mandates in the mid-2000s typically treated EMD as a dedicated strategic allocation. Not only do we believe that treating EMD like a dedicated strategic allocation a bad idea, but we warn that many of the core plus managers taking this approach only have experience investing in domestic fixed income markets. EMD naturally requires a strong grasp of global market dynamics and requires a top-down, global macroeconomic skill set to manage effectively.

Conversely, investors seeking a dedicated EMD solution, either hard currency, local, or combined, may get a manager with a more globalized skill set, but the investor will likely lack the capabilities to weigh EMD valuations against other higher-yielding segments globally. For that reason, we believe that EMD is best used as part of a global high yield strategy. It is our view that EMD, now 24% of the Bank of America Merrill Lynch Global High Yield index, is too important, too large, and too differentiated to not use as a tool in a global high yield strategy (see **Figure 5**).

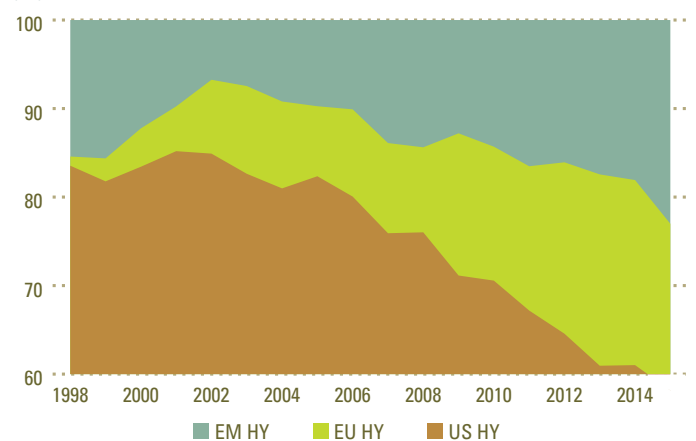
We believe institutional investors lose a significant amount of information and flexibility by not delegating the responsibility of asset allocation to a professional manager when a natural linkage exists between closely related asset classes. We also believe that allowing a single manager to manage across higher-yielding fixed income may become a crucial benefit in the event of another serious systemic crisis like the most recent in 2008.

That crisis taught investors that correlations across seemingly disparate asset classes can move toward one when investors desire diversification most. Asset classes that once looked

different can start to look like they are being driven by similar factors. Facing significant underperformance in the context of a severe market dislocation, institutional investors may question the efficacy of having different managers invest in stand-alone but similar higher-yielding segments: similar risk exposures across different managers can't be managed effectively in tandem and, more practically, switching individual managers could take many months, if not a full year.

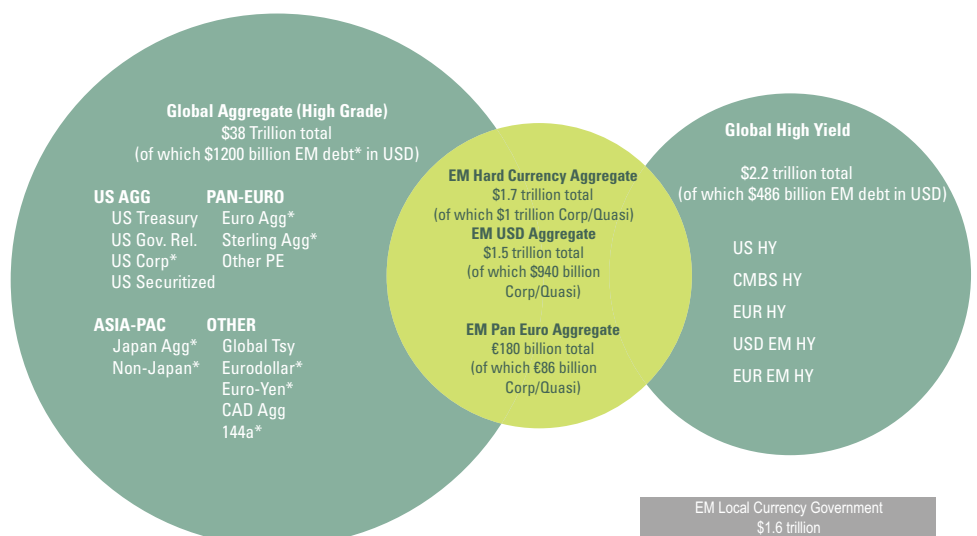
We believe the natural evolution of EMD investing will combine EMD with global high yield. The best opportunities from EMD will accrue to investors capable of incorporating EM exposure as a part of a globally flexible, unconstrained, and benchmark-agnostic global high yield strategy. Moreover, we

Figure 5 Emerging Market Debt Represents around 24% of the BAML Global High Yield Universe (%)



Source: Bank of America Merrill Lynch

Figure 6 Size and Landscape of Index-Eligible Credit with Regard to EM/non-EM split (%)



*Global Agg Index includes EM hard currency and local currency bonds.
 Source: Barclays Research

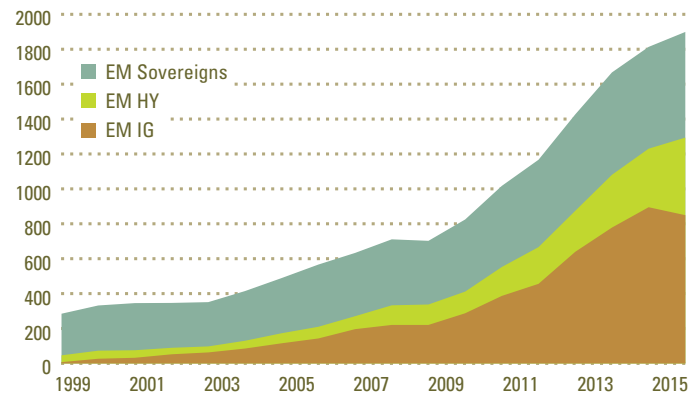
believe global high yield managers with a top-down, global macro insight advantage provide an especially natural fit for combining EMD and global high yield. Such managers likely are best positioned to execute a relative valuation methodology that can seek to tactically concentrate investment in higher-yielding securities globally where valuations and fundamentals are most appealing.

SLOWING ECONOMIC GROWTH IN EM, BUT ISSUANCE REMAINS ROBUST

EM may be structurally slowing, but the financialization of emerging economies continues unabated. **Figures 6** (on previous page) show the size of the EMD market is quite large today. And as shown in **Figure 7**, the EM hard currency corporate market is growing most quickly: sovereign EM issuance remains robust after many years of consistent growth before 2011, but the corporate EM segment offers the most explosive issuance growth today.

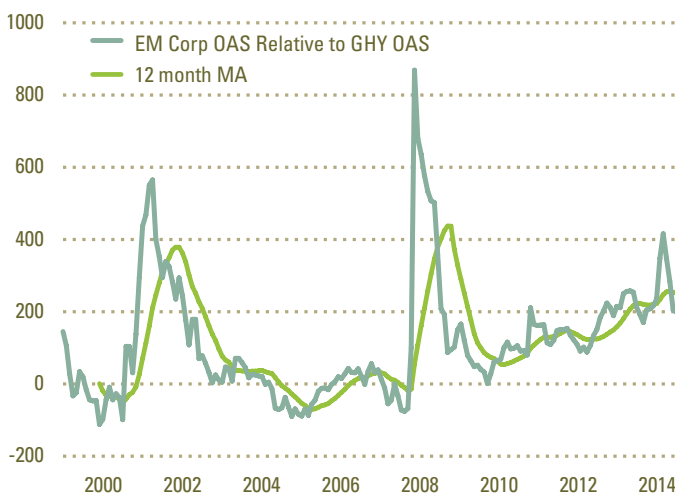
Since much of the depreciation in EMD recently has occurred on the currency side, and therefore has affected local currency issues more than hard currency issues, EMD credit spreads in either hard currency or local currency issuance do not yet look appealing relative to traditional corporate high yield from developed countries (see **Figures 8 and 9**). While emerging markets credit may not yet be an appealing tactical opportunity, the day may be near when valuations and fundamentals look attractive against the remainder of the global high yield universe. When that day arrives, EMD offers a broad universe in which to find opportunity, given its size, differentiation, and diversification across countries, geographies, and industries. Although valuations are starting to look attractive relative to history, we are concerned with the increasing amounts of leverage and declining interest coverage ratios (as shown in **Figures 10 and 11** on next page). **Figure 12**, next page, shows the amount of hard currency EM credits downgraded from investment grade is getting larger relative to the amount upgraded. We believe this downgrade cycle has a longer time to run, but the growing amount of fallen angels ultimately will become a positive for global high yield managers seeking opportunity from deterioration in EMD fundamentals.

Figure 7 Hard Currency Emerging Markets Debt (\$Billions)



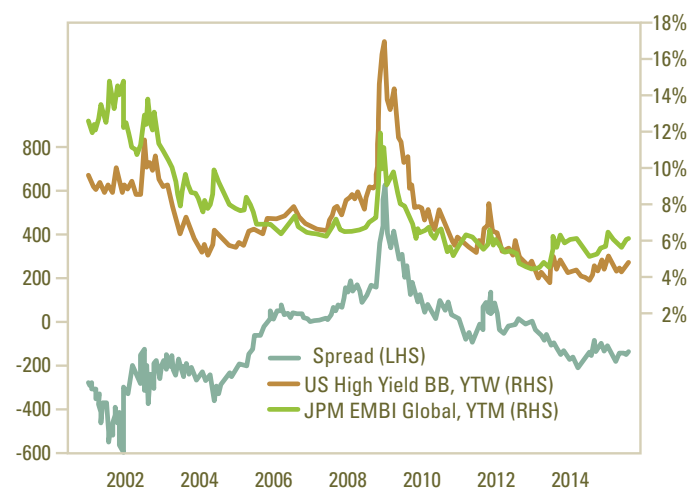
Source: Bank of America Merrill Lynch

Figure 8 EM Spreads Still Close to Global High Yield Spreads



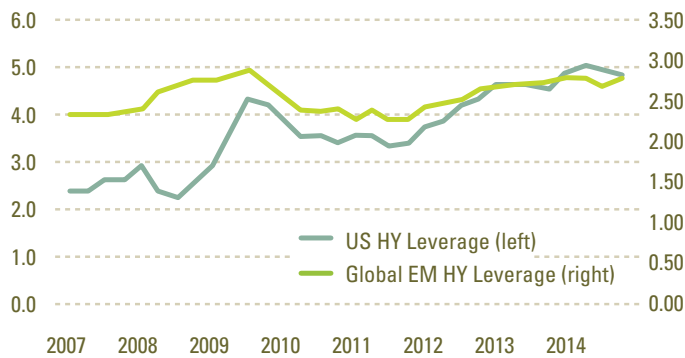
Source: Bank of America Merrill Lynch

Figure 9 EM vs. U.S. HY Spreads Haven't Increased Significantly, Yet



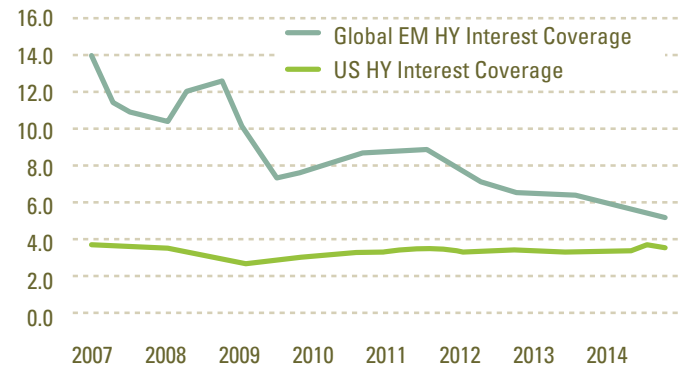
Source: J.P. Morgan and Bank of America Merrill Lynch

Figure 10 Leverage Ratios for EM and U.S. HY Companies



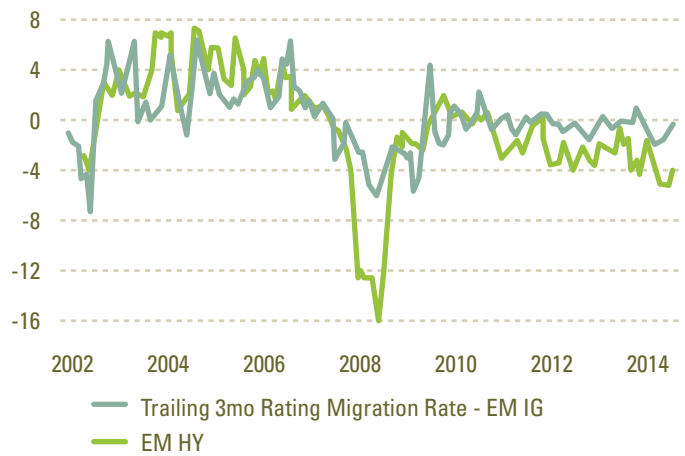
Source: Bank of America Merrill Lynch

Figure 11 Interest Coverage Ratio for EM and U.S. HY Companies



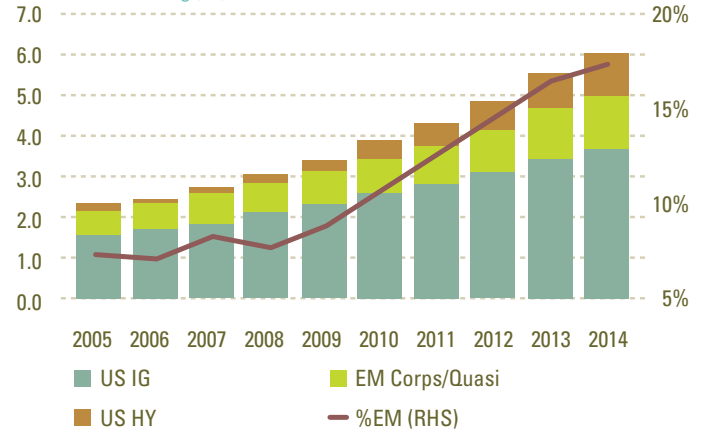
Source: Bank of America Merrill Lynch

Figure 12 EM Credit Downgrade to Upgrade Ratio



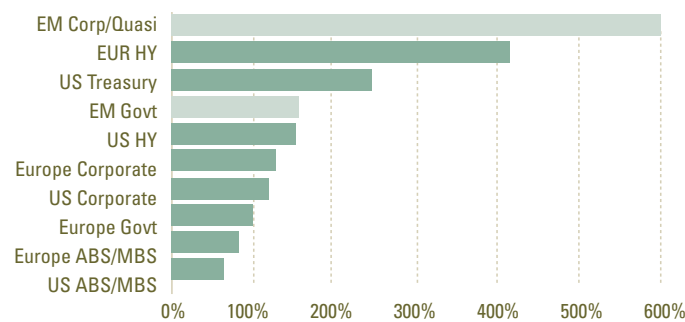
Source: Bank of America Merrill Lynch

Figure 13 EM USD Corp/Quasi Represents 18% of USD Corps
 USD trn outstanding (%)



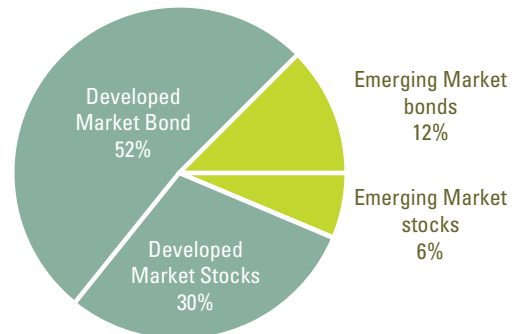
Note: Based on Barclays indices
 Source: Barclays Research

Figure 14 EM Corporates, Extraordinary Growth
 Asset class growth over the last 10 years



Source: Barclays Research

Figure 15 EM is 18% of Global Markets, but 40% of Global GDP



Source: Bloomberg, MSCI, BIS, Barclays Research

EM corporate issuance is not only growing as a portion of the high yield universe, but also as a portion of the broader dollar-denominated credit universe, including the investment-grade universe. **Figure 13** shows that, as of the end of 2014, total U.S. dollar-denominated EM corporate and quasi-sovereign issuance represented 18% of the U.S. corporate (investment-grade and high yield universe) market, growing from less than 10% in 2009. **Figure 14** shows EM hard currency corporate issuance increased more than six-fold during the past decade.

Extraordinary growth in issuance sometimes can be a harbinger of market bubbles, however, we believe that the high yield EMD sector will receive structural support from investors looking to continue globalizing portfolios in search of better yields. **Figure 15** (on previous page) shows that investors have yet to globalize to a level that might be suggested by relative issuance sizes. Relative issuance size is not always a great investment guide, but in the case of EMD, we believe certain investor groups are just not utilizing EMD as much as they will in the coming future, providing an impending structural support to EMD once valuations, our global outlook, and fundamentals justify investment.

A broader opportunity set is only helpful, however, if the new assets offer periods of sufficiently low correlations to traditional higher-yielding sectors. **Figure 16** shows rolling one-year correlations between the Bank of America Global High Yield Index and various EM segments analyzed in this paper. The chart also shows that correlations are typically elevated enough to reasonably consider EMD segments to be an integral piece of the global high yield asset class. As EMD grows as a portion of global high yield indices, correlations are likely to continue growing during benign, non-stress periods for EMD or global high yield. Importantly, however, correlations tend to drop during challenging periods for either EMD or global high yield. That dynamic should allow a successful active manager to derive significant amounts of alpha from an asset allocation perspective, just as we showed earlier in **Figure 1**.

We believe the best way to create value in active global high yield management is to incorporate as broad a credit universe as possible, making all the flavors of EMD integral to a successful global high yield strategy. A capable manager with the flexibility to seek and concentrate investment in high-conviction value opportunities should be able to find value in EMD at some point in a credit cycle, but importantly not at all times. We believe both dedicated EMD managers and those with largely dedicated but small exposures, like core plus fixed income strategies, will be challenged to earn the significant amounts of alpha available to managers capable of integrating EMD into a top-down value framework with the broad universe of higher-yielding credit allocations globally. Ultimately, we believe EMD fundamentals are differentiated enough from traditional sectors that, at times, correlations will be sufficiently low relative to those traditional credit sectors, allowing EMD to be a meaningful investment tool for a globally aware credit manager.

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Figure 16 One-Year Correlations to BAML Global HY Index

