December 29, 2011

GETTING YOUR FIXED-INCOME FIX WITH EMERGING MARKET BOND ETFS

Exchange traded funds that invest in U.S. Treasuries were among the top performers in 2011 as Europe's sovereign debt nightmare and economic growth jitters pushed yields on the 10-year note below 2%. Treasury ETFs benefitted from the flight to safety, but anemic bond yields are problematic for investors that focus on income.

Emerging market debt has matured over the years, becoming a viable asset class that investors can access with relative ease. Aside from higher growth rates and cleaner balance sheets, many developing economies have improved their economic, legal and regulatory systems, bringing greater stability to their markets.

Emerging market bonds, or fixed-income debt, are issued by developing countries and their domestic companies. Credit quality has vastly improved over the years, but emerging markets are seen as higher credit risks than their developed counterparts. Of course, the higher risk also comes with the potential for higher returns. While credit risk and potential defaults are large considerations when choosing bonds from the developing world, the emerging economies have dramatically reduced their debt levels to around 50% of their gross domestic product, compared to the U.S. which sits at around 100% of debt-to-GDP.

When investing in emerging market bond ETFs, it's important to determine whether they are dominated in the local currency. Some funds hedge their foreign currency exposure, so investors in these ETFs don't need to worry about whether the Brazilian real or the Indian rupee is weakening versus the dollar.

Accessing emerging market sovereign debt has traditionally been a difficult task for individuals. At one time, retail investors could only get exposure to emerging market debt through expensive mutual funds, and many brokerages required hefty minimums. However, the ETF industry launched a handful of portfolios tracking emerging market bonds, denominated in both the local currency and in U.S. dollars, some of which have already attracted hundreds of millions in assets.

Emerging Market Debt ETFs

PowerShares and BlackRock's ETF division, iShares, were the first to introduce emerging market bond funds. PowerShares Emerging Markets Sovereign Debt Portfolio (PCY) and the iShares JPMorgan USD Emerging Markets Bond Fund (EMB) both began trading in 2007. Since both funds track U.S.-denominated emerging market debt, investors should not have to worry about foreign currency risk or the direct affect movements in the forex market may have on the funds' performance.

EMB tracks the JPMorgan EMBI Global Core Index, which also follows U.S.-denominated emerging market debt. The fund has $3.5 billion in assets, an expense ratio 0.60% and yields around 5%. The ETF follows a market-value-weighted strategy, which means that the countries with the most amount of outstanding debt will have a larger weighting within the index, but it does limit weightings at 8%. Top country allocations include Mexico at 8%, Brazil at 7.9%, Russia at 7.5%, Turkey at 7.1% and the Philippines at 6.9%.

PCY attempts to reflect the DB Emerging Market USD Liquid Balanced Index, which follows liquid emerging market government bonds that are denominated in U.S. dollars. The fund has $1.4 billion in assets, an expense ratio of 0.50% and yields 5.5%. The ETF is also very well balanced among emerging market countries as it employs an equal-weight strategy. For instance, top country allocations include Columbia at 4.9%, Indonesia 4.8%, Qatar 4.6%, Turkey 4.3% and Russia 4.2%, to name a few.

WisdomTree and Van Eck also came out with their own emerging market debt ETFs in 2010. These newer ETFs follow the local currency and investors should be aware that potential foreign currency fluctuations may affect returns.

WisdomTree Emerging Markets Local Debt Fund (ELD) is an actively managed ETF that holds a basket of debt denominated in the local currencies of the emerging markets from where the bonds originate. ELD selects bonds from countries based on low debt-to-GDP, large foreign reserves, positive growth and adequate inflation levels, among others. The fund has $1.1 billion in assets, an expense ratio of 0.55% and yields 5.1%. Some of its largest country allocations include Brazil, Mexico, Indonesia and Malaysia.

The Market Vectors Emerging Markets Local Currency Bond ETF (EMLC) also tries to reflect movements in local currency bonds issued by emerging market governments. The fund has $497 million in assets, an expense ratio of 0.49% and yields 5.7%. Top country allocations include Brazil at 10%, Poland 10%, South Africa 10%, Mexico 10% and Malaysia 9.6%. The ETF caps holdings at 10% to help limit the influence any single region may have on the overall portfolio.

The iShares Emerging Markets Local Currency Bond (LEMB) is the latest addition to the asset category. LEMB tries to reflect the Barclays Capital Emerging Markets Broad Local Currency Bond Index, which is a market-value-weighted index that follows the performance of emerging market sovereign debt denominated in their local currencies. The fund has $29.2 million in assets, an expense ratio of 0.60% and provides a yield of 5.4%. Top country allocations include Korea 20.2%, Brazil 13.5%, Mexico 6.8%, Poland 5.5% and Indonesia 4.5%. LEMB leans toward emerging markets with more developed and liquid bond markets.

Investors seeking a more narrowly focused emerging market bond ETF may consider the WisdomTree Asia Local Debt Fund (ALD), which tries to reflect local debt denominated in currencies of Asia Pacific countries, excluding Japan. The fund has $396.5 million in assets, an expense ratio of 0.55% and a yield of 2.2%. Top country allocations include Thailand 11.4%, Malaysia 11.4%, Indonesia 11.2%, Australia 11% and South Korea 11%. ALD is similar to WisdomTree's Emerging Markets Local Debt ETF ELD, except it only holds bonds from Asia Pacific countries.

Investors frustrated with rock-bottom U.S. Treasury yields may find emerging market bond ETFs an attractive alternative. The investments should help provide an international diversification component to any portfolio while generating some extra income in a low-yield environment.

Full disclosure: Tom Lydon's clients hold shares of EMB.

http://www.fa-mag.com/blog/tom-lydon-blog/9515-getting-your-fixed-income-fix-with-emerging-market-bond-etfs.html