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Implementation Insight

Emerging Market Debt: Extracting Potential Amidst Complexity

Contents

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Why read on?

Few asset classes divide investor opinion quite like Emerging Market (EM) Debt. For some, it is a long-standing allocation: since the market's institutionalisation in the early 2000s, many institutional portfolios have included some degree of exposure, often viewed as a source of diversification and incremental yield.

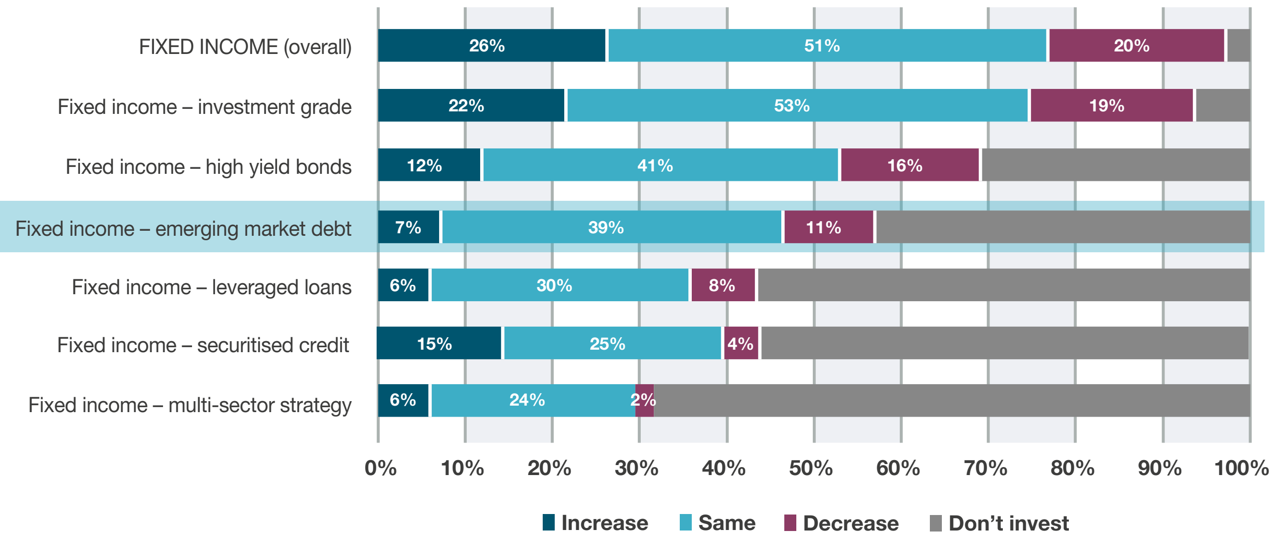
For others, however, the asset class remains on the periphery—seen as volatile, complex, and challenging to justify within strategic asset allocation frameworks.

Today, the profound macroeconomic shifts reshaping global capital markets—including the changing role of the US and the US Dollar in the geopolitical and economic world order—are prompting investors to re-examine their approach to the asset class, whether this stems from an impetus to re-evaluate the overall size of the allocation or the types of strategies used to provide exposure.

This report aims to support institutional investors in making informed, implementation-oriented decisions on EM Debt exposure. We begin by exploring the breadth and depth of the investment universe and evaluating not only its merits but also its challenges.

We then consider the value of active management, with emphasis on Blended EM Debt strategies, which integrate both hard and local currency instruments, from sovereign and corporate issuers. These strategies offer the broadest opportunity set and, in theory, the greatest flexibility to harness multiple alpha levers. Our analysis draws on historical portfolio allocation data to identify how and how far asset managers have used these levers in practice. We also address a series of practical implementation questions that investors may face when constructing or revisiting their EM Debt allocations, including benchmark design, mandate structuring, and FX hedging policy.

FIGURE 1: INVESTOR INTENTIONS FOR FIXED INCOME ALLOCATIONS OVER THE NEXT 18 MONTHS



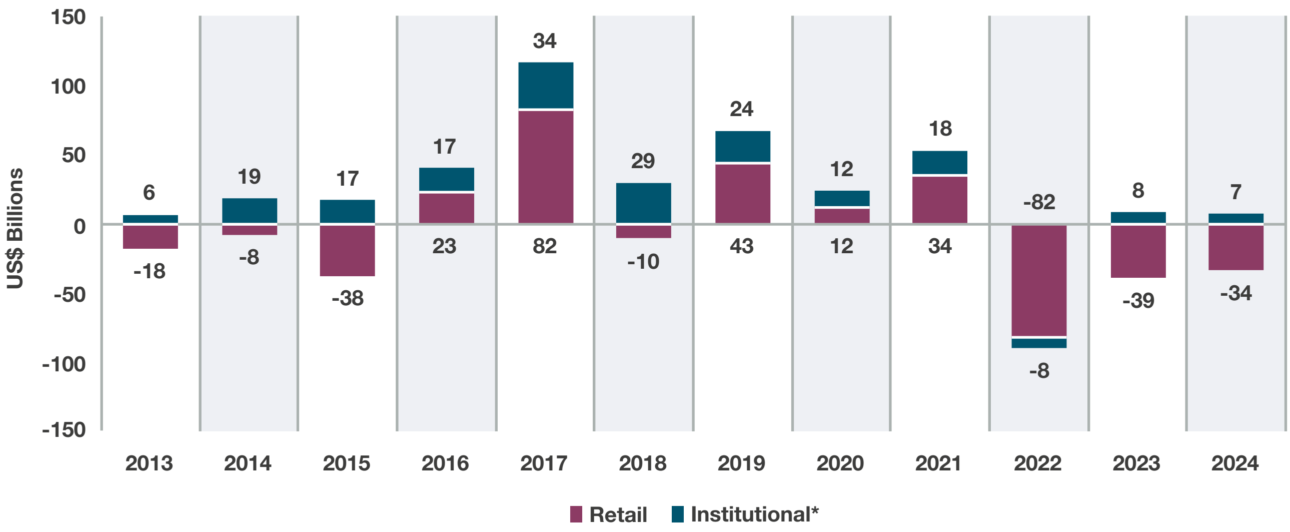
Source: bfinance Global Asset Owner Survey, November 2024

Emerging Market Debt: the great divide

The most recent Global Asset Owner Survey revealed that 57% of respondents held exposure to Emerging Market Debt (figure 1). Of those, 80% indicated plans to either maintain or increase their allocations over the following 18 months.

Asset flow data adds further insight. Although net outflows from EM Debt (both hard and local currency) were recorded in each of 2022, 2023 and 2024—reversing six prior years of inflows—these redemptions were largely driven by retail investors. As figure 2 demonstrates, institutional investors remained committed to the asset class, with allocations even increasing through 2023 and 2024.

FIGURE 2: ANNUAL EM DEBT FLOWS (RETAIL AND INSTITUTIONAL)



*Source: J.P. Morgan. *Calculated quarterly from the J.P. Morgan EM Client Survey, which polls around 200 institutional investors managing over $1.4trn in EM bond and currency assets.*

Why do institutional investors remain committed?

Yield advantage

EM Debt offers a compelling yield relative to developed market bonds. As a risk asset within the fixed income universe, it provides access to higher-yielding opportunities—yet with relatively high credit quality, on average.

EM Hard Currency Sovereign Debt spans over 80 countries across the credit rating spectrum, with approximately 50% of issuers (by market value) rated ‘investment grade’ (figure 3).

EM Corporate Debt offers a slightly stronger credit quality profile, with around 60% rated investment grade. The Local Currency EM Debt market, focused on larger emerging economies, now boasts investment grade exposure of ~80%, boosted by the inclusion of China and India in major indices in 2020 and 2024, respectively.

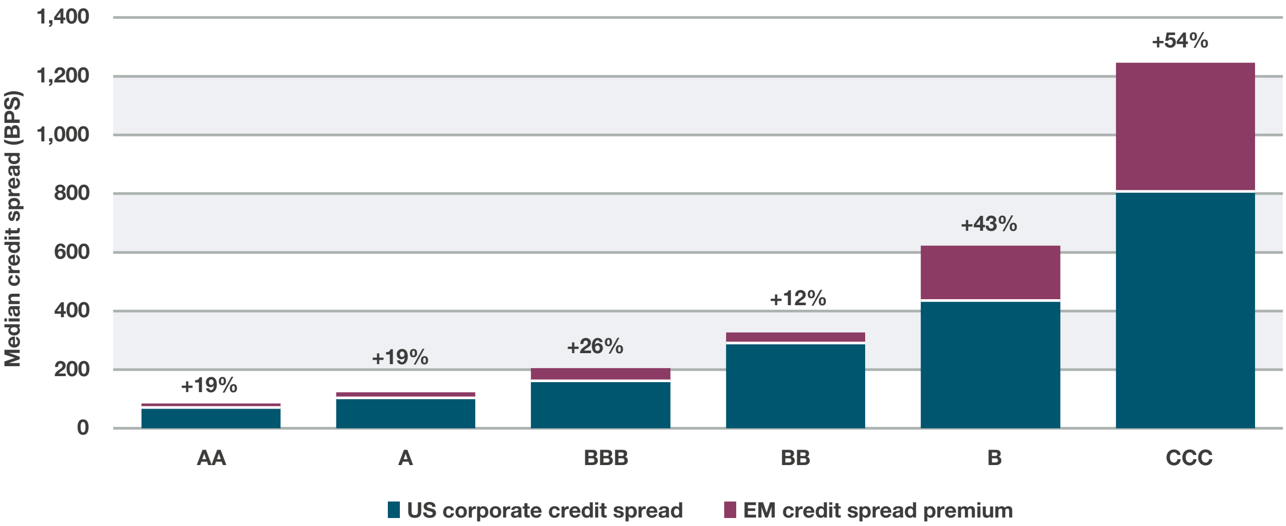
FIGURE 3: EMERGING MARKET DEBT KEY CHARACTERISTICS

Bond markets	Emerging market (sovereign) hard currency	Emerging market corporate	Emerging market (sovereign) local currency	Global Government	Global Corporate Investment Grade	Global Corporate High Yield
Market size (billion)	US$ 1,300+	US$ 1,200+	US$ 4,800+	US$ 35,000+	US$ 13,000+	US$ 1,800+
# issuers	160+	750+	20+	30+	1,800+	1,500+
# countries	80+	60+	20+	30+	30+	30+
Interest rate duration	6.5 years	4 years	5 years	7.5 years	6 years	3.5 years
% investment grade	50%	60%	80%	100%	100%	0%
% US dollar	100%	100%	0%	35%	65%	75%
% corporate	0%	100%	0%	0%	100%	100%
% top 20 countries	65%	80%	100%	95%	95%	99%

Source: JP Morgan, Bloomberg. Indicative characteristics of representative market indices as of end-December 2024

These characteristics are particularly attractive to investors required to comply with risk-based capital rules—such as insurance companies—who are able to find yield at relatively low capital charges via EM Debt. EM Hard Currency bonds typically trade at higher spreads than developed market corporate bonds of comparable credit rating (figure 4), particularly on issuers of lower credit quality (B and CCC). The spread differential reflects a combination of liquidity and complexity premia. EM Debt is not covered as well by wall street analysts, still relatively ignored by mainstream investors, and less traded. Restructuring processes in case of defaults are uncertain and require specific expertise, involving negotiation with sovereign issuers and less tangible assets.

FIGURE 4: MEDIAN CREDIT SPREADS BY RATING CATEGORY OVER 15 YEARS – US CORPORATE BONDS VS EM DEBT



Source: Bloomberg. Data to end December 2024.

FIGURE 5: CORRELATION OF EMERGING MARKET DEBT TO GLOBAL FIXED INCOME MARKETS

	J.P. Morgan CEMBI Broad Diversified	J.P. Morgan EMBI Global Diversified	J.P. Morgan GBI-EM Global Diversified (USD Unhedged)	J.P. Morgan GBI-EM Global Diversified (USD Hedged)
Bloomberg Global Corporate HY (USD Hedged)	0.87	0.82	0.71	0.57
Bloomberg Global Corporate IG (USD Hedged)	0.80	0.82	0.59	0.72
Bloomberg Global Treasury (USD Hedged)	0.37	0.48	0.27	0.60

Source: bfinance. Based on monthly returns from January 2005 to December 2024.

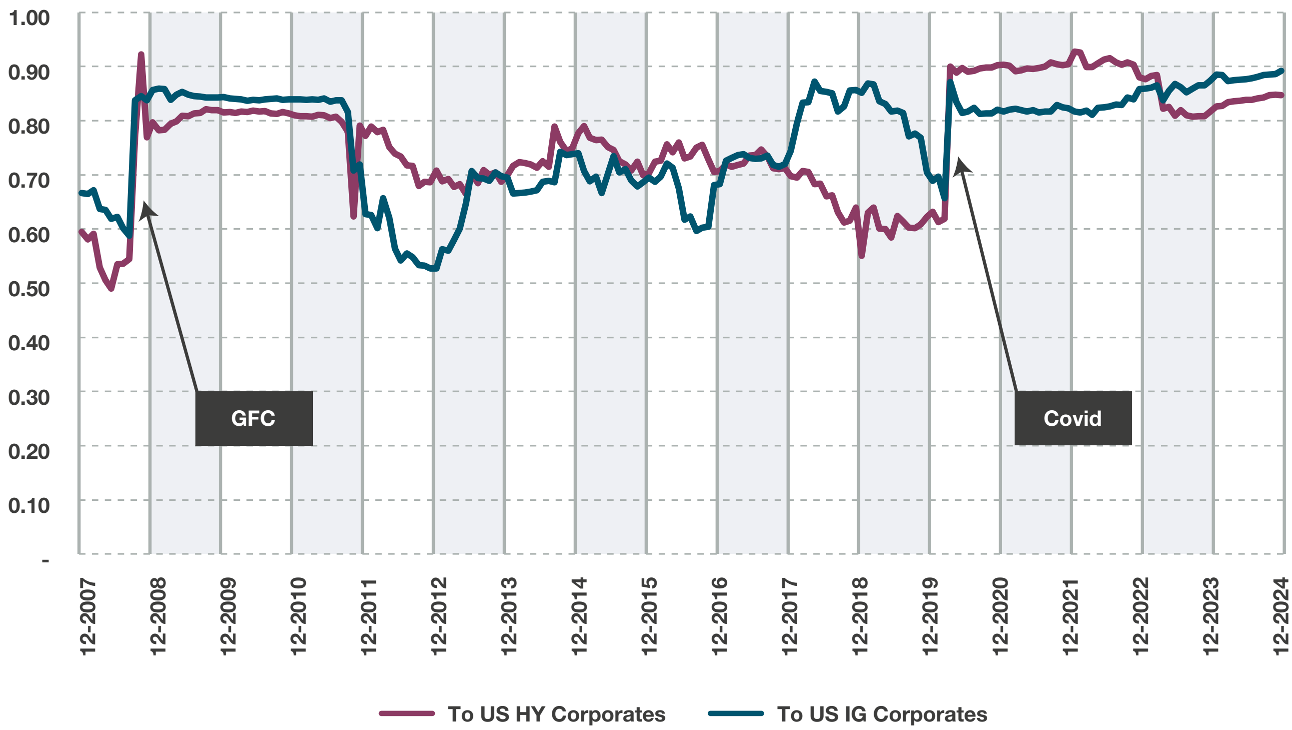
Diversification benefits

EM Debt also presents clear diversification advantages. EM Debt is less than perfectly correlated to developed market credit (figure 5), offering risk dispersion benefits when integrated into global fixed income portfolios.

This is especially true of frontier market exposures, where local factors—such as political shifts, commodity reliance, and idiosyncratic monetary policy—introduce economic drivers that are decoupled from global trends.

That said, diversification is not without limits. During episodes of global financial stress, EM Debt correlations with risk assets tend to spike temporarily (figure 6). Still, over longer horizons, the asset class has historically delivered diversification benefits—particularly when used as a strategic (rather than tactical) allocation.

FIGURE 6: ROLLING 3-YEAR CORRELATION OF EMERGING MARKET HARD CURRENCY DEBT



Source: bfinance. Based on monthly returns from January 2005 to December 2024.

Potential for alpha

The heterogeneity of the EM universe—including sovereigns, quasi-sovereigns, and corporates across credit ratings and currencies—provides fertile ground for active management. Market inefficiencies persist: liquidity is uneven, sell-side coverage is inconsistent, and transparency is often limited. In this context, active managers with strong research capabilities can identify mis-pricings before the market does and add meaningful value.

Our Global Asset Owner Survey reinforces this view: over 60% of asset owners reported being either "very satisfied" or "quite satisfied" with their EM Debt managers. Performance data (figure 7) supports this sentiment. Over the ten years to 2024:

- **Hard Currency EM Debt:** 68% of managers outperformed their benchmarks, with median outperformance of 0.36% (net of fees).
- **Local Currency EM Debt:** 72% outperformed, with a median of 0.48%.
- **Blended EM Debt:** 77% outperformed, delivering the highest median excess return of 0.59%, and demonstrating the greatest consistency (43% outperformed in at least 7 of the past 10 years).

FIGURE 7: ACTIVE MANAGER PERFORMANCE VERSUS RELEVANT BENCHMARKS

	EM Hard Currency (USD) Sovereign Debt strategies	EM Corporate Debt strategies	EM Local Currency Sovereign Debt strategies	EM Blended Debt strategies
Total managers	62	43	43	44
Total outperformers	42	24	31	34
% outperformers	68%	56%	72%	77%
Average outperformance - Top quartile	1.55%	0.44%	0.83%	1.13%
Average outperformance - Median	0.36%	0.08%	0.48%	0.59%
Average outperformance - Bottom quartile	-0.81%	-0.49%	-0.04%	0.19%
Outperformed in 5 out of 10 years	82%	67%	70%	89%
Outperformed in 6 out of 10 years	53%	47%	65%	68%
Outperformed in 7 out of 10 years	27%	23%	33%	43%

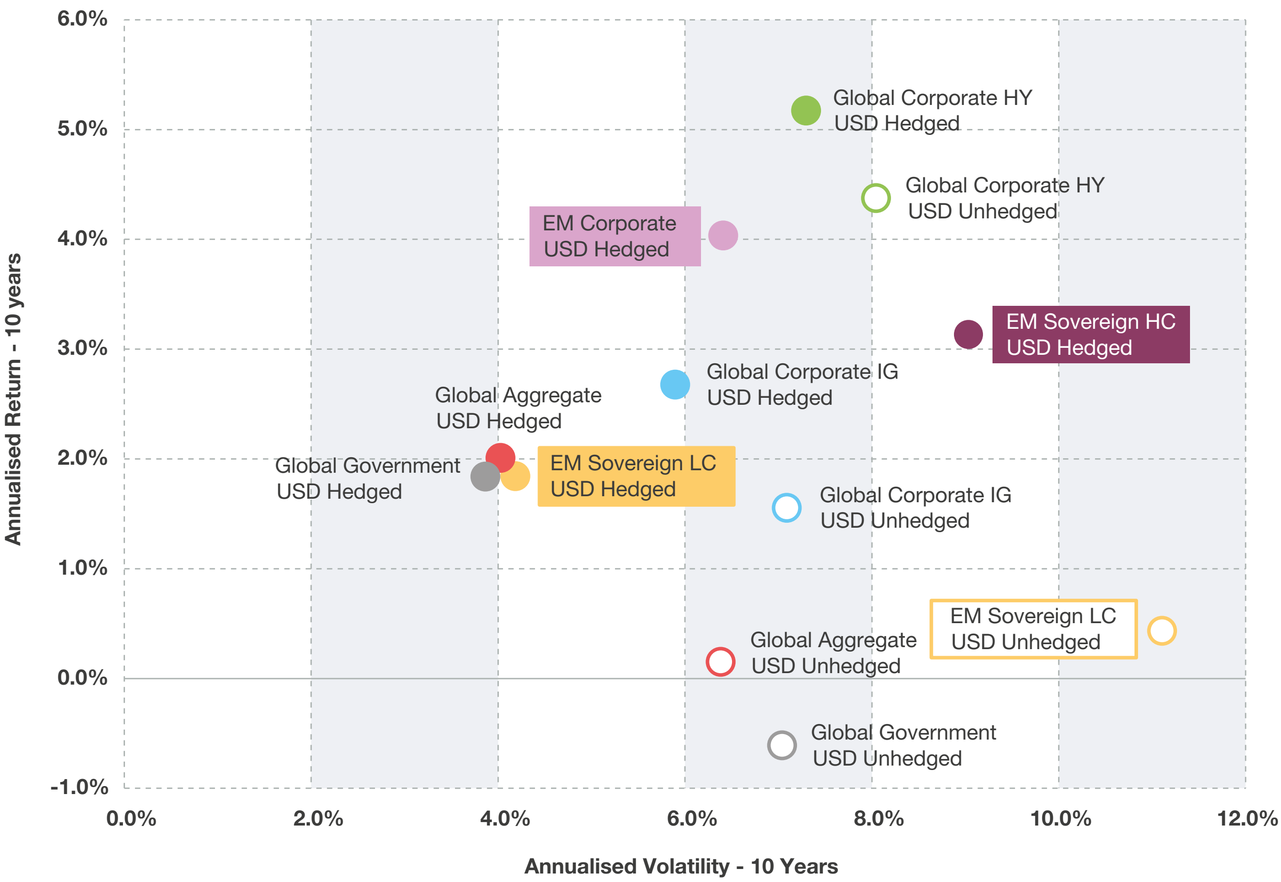
Source: bfinance. The analysis only considers managers with 10 years of returns, from 2015 to 2024. Returns in USD, net of management fees. Benchmarks used: JPM EMBI Global Diversified for EM HC Sovereign Debt; JPM CEMBI Broad Diversified for EM Corporate Debt; JPM GBI-EM Global Diversified (Unhedged) for EM LC Sovereign Debt; EM Blended Debt strategies compared to the most relevant mix of the JPM EMBI Global Diversified and JPM GBI-EM Global Diversified indices.

Understanding investor scepticism

Despite these strengths, 43% of respondents to our survey still reported no exposure to EM Debt. One might ask why the asset class remains underutilised? For some investors, the answer lies in the role that fixed income is expected to play. EM Debt's volatility may appear incompatible with the function of fixed income as a capital-preserving, income-generating anchor. This perception may deter those unwilling to accept equity-like risk in their bond portfolio.

This hesitation is not without basis. Over the past decade, EM Hard Currency Sovereign Debt delivered returns marginally higher than developed market investment grade corporates but suffered in comparison to high yield corporate bonds with clearly lower returns and greater volatility (figure 8). EM Corporate Debt fared better, delivering returns consistent with its investment grade-biased profile and lower interest rate sensitivity, which proved advantageous during the inflationary shock of 2022.

FIGURE 8: RETURN AND RISK FOR EMD AND NON-EMD INDICES



Source: Bloomberg, J.P. Morgan. Based on monthly returns to end December 2024, in US Dollar hedged (full circles) and unhedged (empty circles).

Local Currency EM Debt, by contrast, underwhelmed. Over ten years, it delivered minimal returns in USD terms while exhibiting the highest volatility among global fixed income sectors. Several factors contributed to this underperformance:

- EM GDP growth trailed expectations.
- Geopolitical instability and reform setbacks hampered several key emerging markets.
- The US economy outperformed, supporting the US dollar and compressing spreads in domestic credit markets.

Crucially, the prolonged bull run in the US dollar proved especially detrimental to Local Currency EM Debt, where currency risk is a major source of return and remains mainly unhedged. However, figure 8 illustrates that this was not unique to Local Currency EM Debt: all global bond assets performed poorly and exhibited higher volatility when left unhedged against the US Dollar.

With currency exposure hedged, Local Currency EM Debt performance has been broadly in line with other global government bonds.

Looking ahead, with renewed focus on reducing the US trade deficit and evolving global trade alignments, investors are re-evaluating the structure of their global fixed income portfolio. A sustained weakening of the US dollar could materially improve the outlook for Local Currency EM Debt, potentially reversing the narrative of the past decade.

Alpha generation - Blended EM Debt strategies in focus

Active EM Debt managers have delivered meaningful and consistent outperformance over the past decade.

However, investors must scrutinise the underlying drivers of this outperformance with care. What has truly driven relative returns? Which alpha levers are managers actively using in practice—and are they using them effectively? For investors selecting EM Debt managers, a clear understanding of which levers are being deployed—and how they align with specific objectives and market conditions—is critical.

Below, in figure 9, we set out the principal levers that can be employed within EM Debt portfolios. In practice, however, the relevance of each lever varies considerably—between managers and over time. Recent years have been a particularly fertile ground for evaluating manager skill, with sharp shifts in risk appetite, monetary policies, and correlations between local and hard currency markets. These dynamics offer valuable insight into which managers have successfully adapted—and which have not.

FIGURE 9: POTENTIAL 'ALPHA LEVERS' IN EMERGING MARKET DEBT

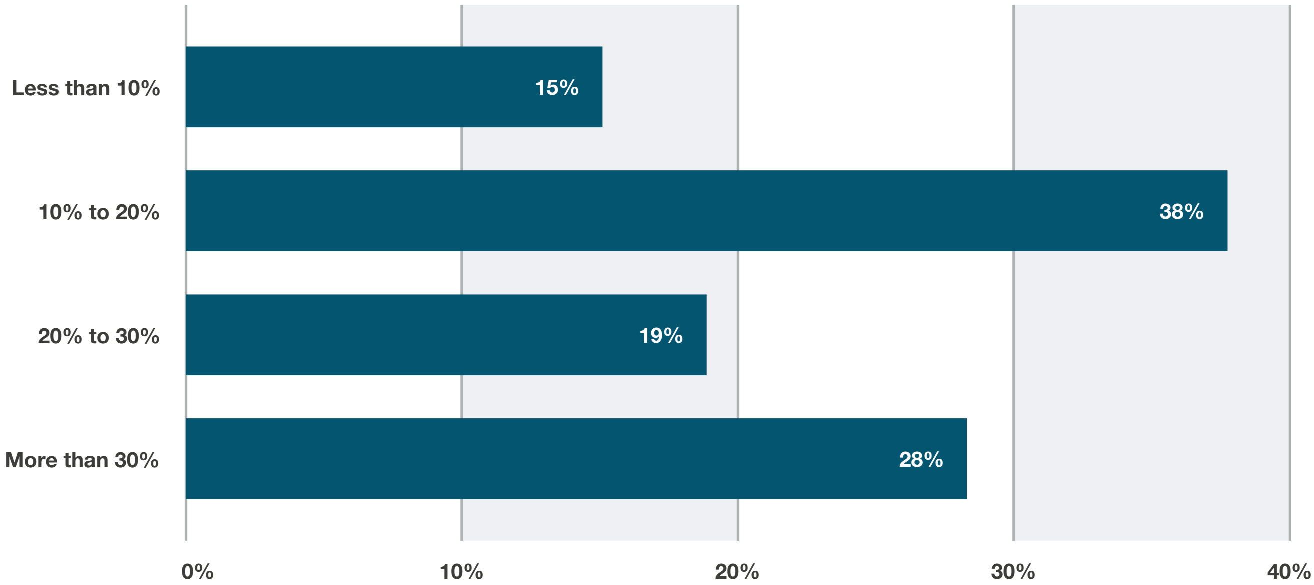
POTENTIAL ALPHA 'LEVERS'	THE NARRATIVE	THE REALITY
Hard vs. local currency allocation	Allocating tactically between local currency and hard currency EM debt based on anticipated shifts, for example, in interest rate and currency (e.g. USD) markets.	Which levers are active managers actually using in practice? Is there evidence that these levers are used effectively?
Country selection	Setting overweight/underweight positions to countries based on growth potential, fiscal discipline, external vulnerabilities, political stability, liquidity concerns.	
Duration and yield curve positioning	Adjusting the positioning on the US Dollar yield curve (hard) or on the yield curves of individual EM countries (local) to benefit from changes in interest rate expectations.	
Credit risk management	Adjusting exposure across the credit rating spectrum (e.g. high yield vs investment grade) based on expected shifts in the global risk sentiment	
Security selection	Identifying and overweighting mispriced bonds, especially those with near-term performance catalysts (e.g., rating upgrades).	
Corporate vs. sovereign/ quasi sovereign	Allocating to corporate and/or quasi-sovereign issuers, for example, to benefit from spread pick-up compared to sovereign bonds of the same country.	
Currency selection	Overweight (underweight) EM currencies that are expected to appreciate (depreciate) versus the strategy's base currency. Identifying cheaper (hard) currencies to fund local currency positions.	
Relative value	Finding arbitrage opportunities between similar instruments, e.g., differences in bond spreads, yield curves, currency pairs.	

To assess the use of these levers, it is analytically helpful to focus on Blended EM Debt. These strategies—spanning both local and hard currency exposures and often including both corporate and sovereign debt—are theoretically capable of employing the full spectrum of alpha levers. (Note: The rise of the 'Blended EMD' strategy group was discussed in a 2018 paper: Emerging Market Debt: to Blend or Not to Blend?)

More fundamentally, the subject of 'hard versus local' exposure is also a particularly interesting one in current market conditions. Local currency market performance over the past decade has not been enticing—but this has been heavily influenced by macroeconomic trends driving a strengthening USD (as discussed), and those dynamics have now shifted.

Alpha source 1: hard vs. local currency allocation

FIGURE 10: VARIATION BETWEEN HIGHEST AND LOWEST LOCAL CURRENCY EXPOSURE OVER 4 YEARS



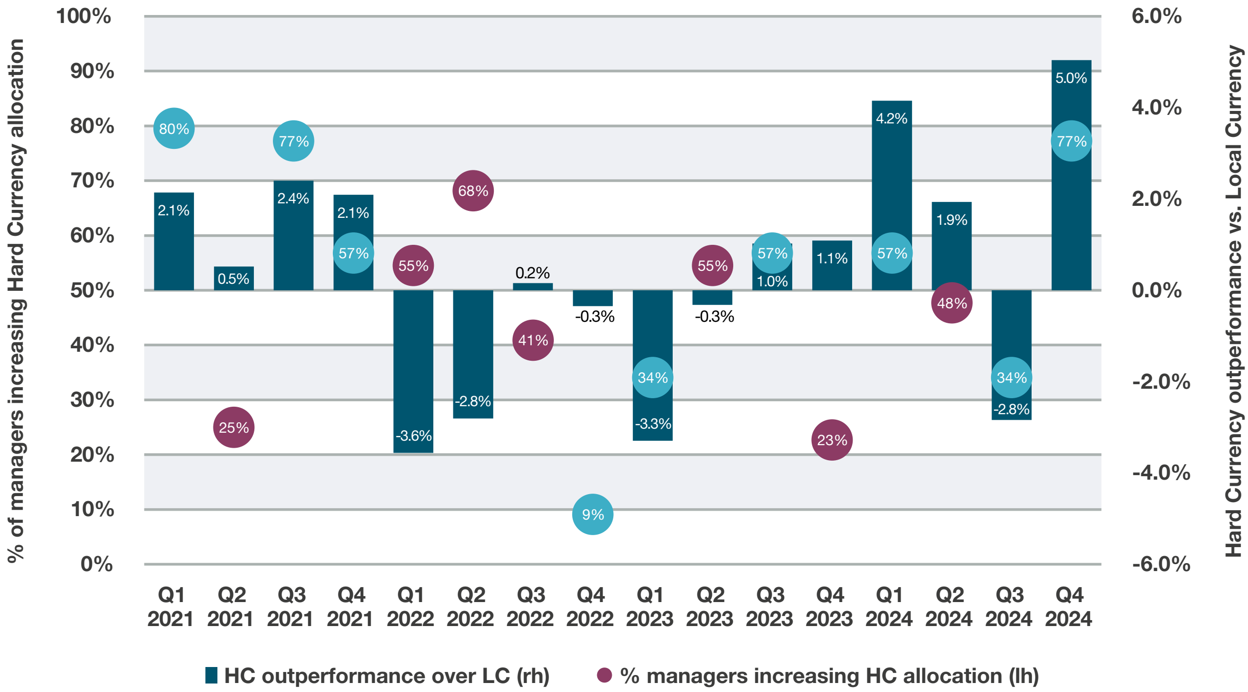
Source: bfinance, based on Blended EM Debt strategies publishing quarterly currency allocations on eVestment from end Q1 2021 to end Q4 2024 (53 strategies).

To what extent do Blended EM Debt strategies actively manage allocations between local and hard currency assets—and is this positioning alpha-generative? The answer varies significantly across managers.
Our analysis of 53 strategies over a four-year period to end-2024 shows that:

- The median local currency exposure was approximately 40%.
- 53% of managers adjusted local vs. hard currency exposure by less than 20% over four years (figure 10).
- Only 28% demonstrated a highly tactical approach, varying exposure by more than 30%.

Beyond allocation changes, investors can also assess whether managers are adding value through the timing of these changes. Figure 11, on the following page, shows that a majority of managers made the right allocation changes in 9 out of 16 quarters, i.e., increasing hard currency exposure when hard currency bonds outperformed local currency bonds, and vice versa.

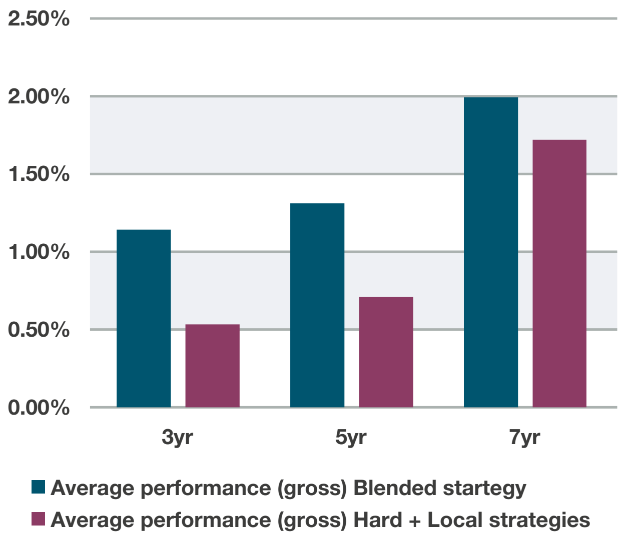
FIGURE 11: QUARTERLY CHANGE IN HARD CURRENCY ALLOCATION VS QUARTERLY OUTPERFORMANCE OF HARD CURRENCY OVER LOCAL CURRENCY



Source: bfinance, based on Blended EM Debt strategies publishing currency allocations on eVestment from end Q1 2021 to end Q4 2024 (53 strategies). Quarterly returns for J.P. Morgan EMBI Global Diversified (HC) and J.P. Morgan GBI-EM Global Diversified (LC)

Further evidence comes from a subset of 36 managers offering standalone Hard and Local Currency products alongside a Blended strategy. For 65% of these managers, the Blended strategy outperformed a fixed-weight composite of the standalone products over three, five, and seven years (figure 12), indicating that tactical allocation decisions added value.

FIGURE 12: RETURNS OF BLENDED EMD STRATEGY VERSUS COMPOSITE OF HARD AND LOCAL STRATEGIES (GROSS OF FEES, FOR COMPARATIVE PURPOSES ONLY)



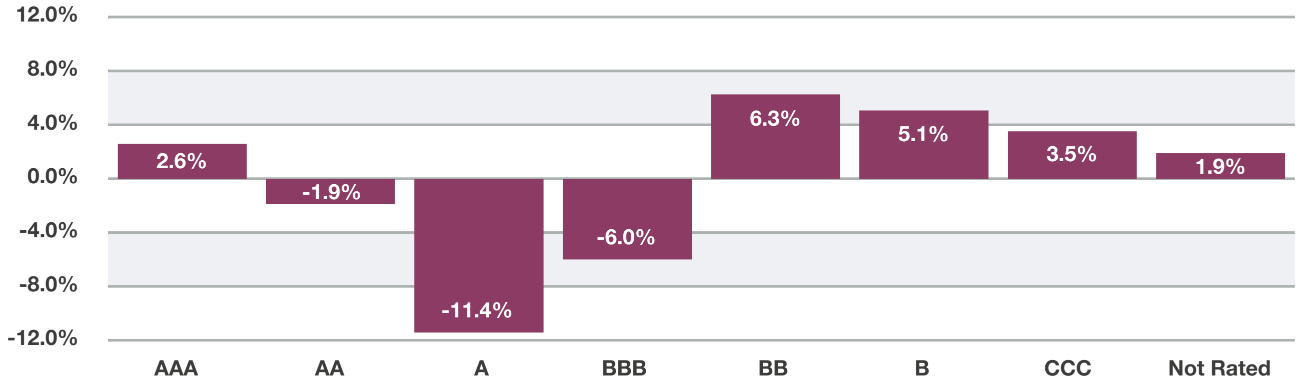
Source: bfinance, eVestment. Based on peer group of 36 managers. Returns are gross of management fees; not representative of actual returns and shown for comparative purposes only.

Alpha source 2: credit risk management

Another key lever is credit quality management—adjusting the allocation across credit rating segments (e.g., high yield and investment grade) .

Across Blended EM Debt strategies, managers typically exhibit a tilt toward lower-rated credits. Over the past four years, the average allocation to sub-investment grade bonds was 43%, versus 37% in a representative 50:50 hard/local currency benchmark (figure 13). This suggests a deliberate effort to capture the yield premium and spread compression potential associated with higher-risk issuers.

FIGURE 13: AVERAGE POSITIONING VERSUS BENCHMARK BY CREDIT RATING



Source: bfinance, based on Blended EM Debt strategies publishing credit rating allocations on eVestment from end Q1 2021 to end Q4 2024 (44 strategies). Each strategy compared against their respective benchmarks.

Yet such positioning is not without risk. Shifts in global sentiment can materially impact outcomes. Figure 14 examines strategy performance across risk-on (months when high yield outperforms investment grade) and risk-off (months when investment grade outperforms high yield) environments:

- In risk-on environments, the median strategy outperformed in 71% of instances.
- In risk-off environments, the success ratio dropped to around 38% for the median strategy.
- While only 7% of managers outperformed in both environments, 57% delivered sufficient outperformance in risk-on periods to offset underperformance during risk-off periods—supporting their value creation over a full cycle.

FIGURE 14: OUTPERFORMANCE IN RISK-ON AND RISK-OFF ENVIRONMENTS

	RISK OFF (IG outperforms HY)				RISK ON (HY outperforms IG)			
	# months > benchmark	Total # months	Success ratio	Avg. monthly excess return	# months > benchmark	Total # months	Success ratio	Avg. monthly excess return
Quartile 1	16	48	33%	-0.32%	46	72	64%	0.16%
Median	18	48	38%	-0.24%	51	72	71%	0.25%
Quartile 3	21	48	44%	-0.12%	53	72	73%	0.36%

Source: bfinance, eVestment. Based on Blended EM Debt strategies with 10 years of track record to end-December 2024 (44 strategies). Returns in USD, net of fees.

Alpha source 3: country selection

Finally, country selection remains a powerful—if nuanced—source of alpha. EM economies differ markedly in their political, fiscal, and economic characteristics. There is wide dispersion in returns between countries (and currencies), offering abundant opportunities for alpha generation through bottom-up analysis.

Figure 15 illustrates the impact: over the ten years to 2024, the difference in average monthly returns between the top and bottom decile countries exceeded 4.5% in both hard and local currency markets. This dispersion underlines the importance of granular, country-by-country positioning.

Country selection tends to be heavily emphasised by asset managers. Speaking broadly, we note that EM Debt managers across strategy types do lean heavily on bottom-up analysis when shaping portfolios. Yet, in examining this subject, it is important to consider the potential resilience of a manager's process going forward, including the balance between so-called **bottom-up and top-down** considerations within country-level analysis and overall strategic portfolio positioning. This is a particularly sensitive consideration in view of ongoing macroeconomic regime shift.

FIGURE 15: AVERAGE MONTHLY RETURNS OF TOP-DECILE AND BOTTOM-DECILE COUNTRIES OVER 10 YEARS

	Top decile countries	Bottom decile countries	Difference
EM Hard Currency	2.92%	-1.99%	4.91%
EM Local Currency (unhedged)	2.49%	-2.26%	4.75%

Source: bfinance, based on monthly returns for JPM EMBI Global Diversified and JPM GBI-EM Global Diversified, in USD, to end-December 2024

Practical considerations for implementation

The broad and complex EM Debt investment universe offers a wide array of customisation options—but also requires important decisions at the point of implementation.

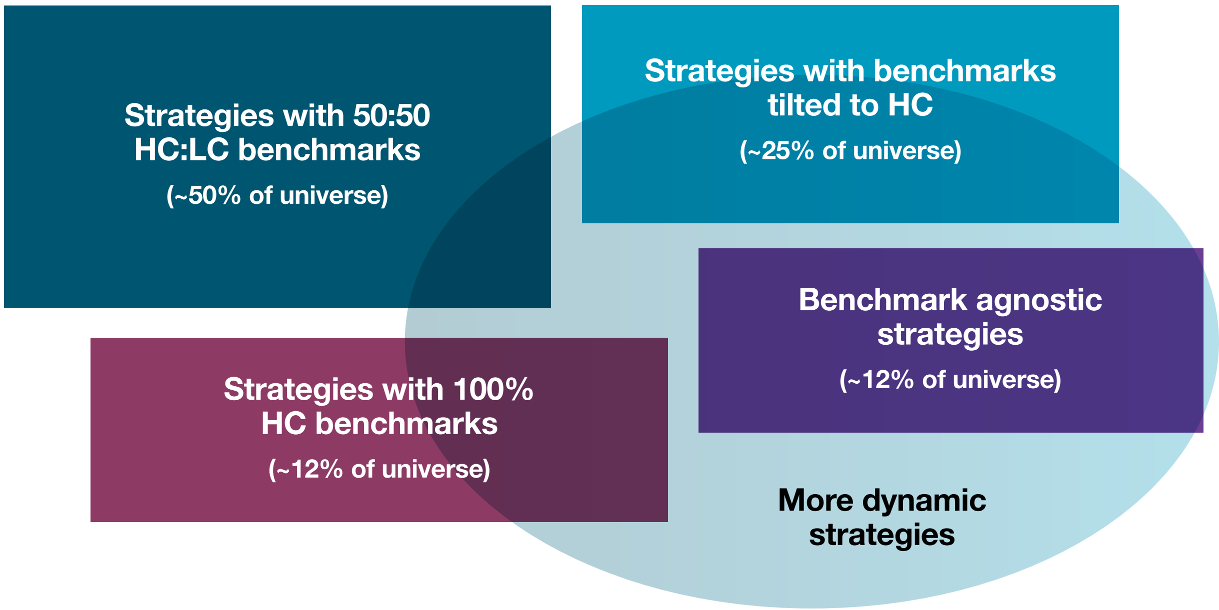
The choice of strategy, benchmark, and hedging approach can have material consequences for outcomes, for non-USD-based investors especially.

Strategy and benchmark selection

Blended EM Debt strategies differ substantially with respect to both the local currency exposure of their benchmarks and the extent of active deviations versus those benchmarks. While most strategies seek to capture value through credit, country, and security selection, some do so with minimal deviation from benchmark weights, while others pursue a more dynamic approach.

Benchmarks are a useful starting point in the effort of categorising the strategies on offer. From the universe of Blended EM Debt strategies referenced on eVestment, we found that nearly half use a 50:50 Hard Currency (HC):Local Currency (LC) benchmark, more than 25% use a benchmark tilted to HC (somewhere between 60% and 80%), and the rest either use a pure HC (100%) benchmark or are said to be benchmark agnostic.

FIGURE 16: BLENDED EMD MANAGERS TAKE DIFFERENT APPROACHES TO HC:LC EXPOSURE



Source: bfinance, based on 74 strategies in eVestment's Global Emerging Mkts Fixed Income - Blended Currency universe as of end-December 2024 (44 strategies). Returns in USD, net of fees.

Key groupings include:

1) 50:50 HC:LC: These strategies are typically benchmark-aware, with positions sized relative to benchmark weights and low tracking error. Commonly benchmarked to J.P. Morgan's indices EMBI Global Diversified (HC) and GBI-EM Global Diversified (LC).

2) Tilted to HC: May be benchmark-aware or more active. The HC tilt may be adopted to obtain equal contribution to risk from the HC and LC components (risk parity). The higher HC allocation may also be due to the inclusion of EM corporates via the J.P. Morgan CEMBI Broad Diversified which exclusively includes USD-denominated bonds. The J.P. Morgan Emerging Markets Blend Index (JEMB)—which equally weights HC sovereign, LC sovereign, and corporate debt—has gained popularity among Blended EM Debt managers.

3) 100% HC: Start from a pure HC neutral position and take tactical LC or EM corporate exposures as off-benchmark bets. LC positioning tends to be via episodic directional exposures (e.g., when FX appreciation catalysts are identified) or through a book of 'market-neutral' pair trades (i.e. long one EM currency and short another). Typically benchmarked to the EMBI Global Diversified, these strategies may have higher tracking error.

4) Benchmark agnostic: Often labelled 'total return', these strategies have no default allocation to LC and portfolios are not constructed against a benchmark (though in practice they may indicate a benchmark for performance comparison). While they tend to have a broader investment universe, these strategies are sometimes wrongly called 'unconstrained'. They do have constraints, but those are internal concentration limits rather than benchmark-based constraints. These strategies tend to be among the most dynamic and opportunistic in the Blended EM Debt space.

Index providers:

- While all major fixed income index providers, such as Bloomberg and ICE BofA, offer emerging market debt indices, **J.P. Morgan is still the overwhelmingly dominant player.** A vast majority of EM Debt strategies use one (or a combination) of their EM Debt indices.
- **'Diversified' indices** – With large global powerhouses (China, India) alongside sometimes very small countries (e.g. Benin, Maldives), traditional index construction rules following market capitalisation were yielding highly concentrated EMD indices. J.P. Morgan remedied this by launching 'Diversified' versions of their indices, which effectively caps each issuer to 10% of the index's market value. The resulting index diversification was welcome by portfolio managers and contributed to the broad adoption of J.P Morgan's suite of EMD indices.

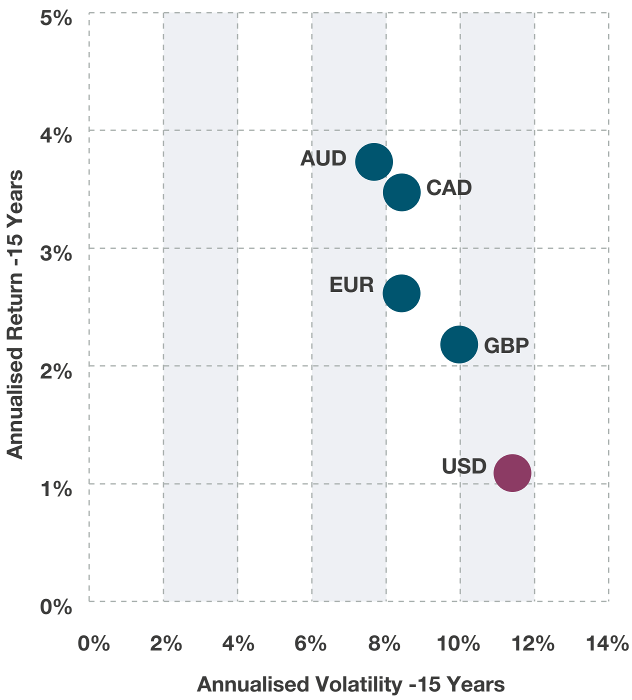
Optimal blend of Hard and Local Currency

EM Debt returns are typically reported in USD. However, this USD-centric lens can obscure the realities faced by non-USD investors. In practice, the optimal balance between HC and LC exposures in an EMD strategy can vary significantly depending on an investor's home currency and its correlation with EM currencies.

Over the past decade, the strength of the USD has been a dominant macroeconomic theme. As illustrated in figure 8, this prolonged appreciation exerted a significant drag on the performance of unhedged LC EM Debt for dollar-based investors. But a closer look at returns through the lens of other base currencies paints a notably different picture.

For instance, Australian investors—whose home currency exhibits greater correlation with commodity-linked EM currencies—experienced a much smoother ride. These investors saw from LC EM Debt roughly a third less volatility and more than triple the annualised return of their USD-based peers. Similarly, Canadian and euro-based investors benefited from both lower volatility (by approximately 25%) and more than double the return. UK-based investors also experienced enhanced outcomes, with a 13% reduction in volatility and a twofold increase in return compared to USD investors (figure 17).

FIGURE 17: LOCAL CURRENCY EM DEBT RISK AND RETURN IN VARIOUS CURRENCIES (UNHEDGED)



Source: bfinance, based on monthly returns to end-March 2025 for the J.P. Morgan GBI-EM Global Diversified.

These differences in risk-return outcomes naturally translate into different strategic allocations. When we assess the blend of HC and LC exposure that would have maximised risk-adjusted returns (i.e. Sharpe ratio), stark variations emerge, as highlighted in figure 18. For USD-based investors, the optimal approach was to maintain a 100% allocation to HC. In contrast, Australian investors would have achieved the highest Sharpe ratio with a 100% LC allocation. Euro and Canadian investors saw their optimal results with a blend that included approximately 35% exposure to LC EM Debt.

This analysis underscores a vital point: the strategic design of Blended EM Debt mandates should reflect the investor's home currency and its relationship to EM currencies. A benchmark or allocation model optimised for USD-based investors may not be appropriate—or efficient—for investors operating from other currency regions. Yet, this consideration is often overlooked in favour of standardised templates or off-the-shelf products.

FIGURE 18: OPTIMAL HARD AND LOCAL CURRENCY ALLOCATIONS FOR VARIOUS BASE CURRENCIES OVER 15 YEARS

	USD	AUD	EUR	GBP	CAD
LC allocation	0%	100%	37%	0%	35%
HC allocation	100%	0%	63%	100%	65%
Annualized Return	4.45%	3.79%	2.82%	3.76%	3.86%
Annualized Volatility	8.39%	7.68%	7.70%	8.47%	7.67%
Sharpe Ratio	0.53	0.49	0.37	0.44	0.50

Source: bfinance, based on monthly returns to end-March 2025 for the J.P. Morgan EMBI Global Diversified (hedged to the respective currencies) and J.P. Morgan GBI-EM Global Diversified (unhedged).

To hedge or not to hedge

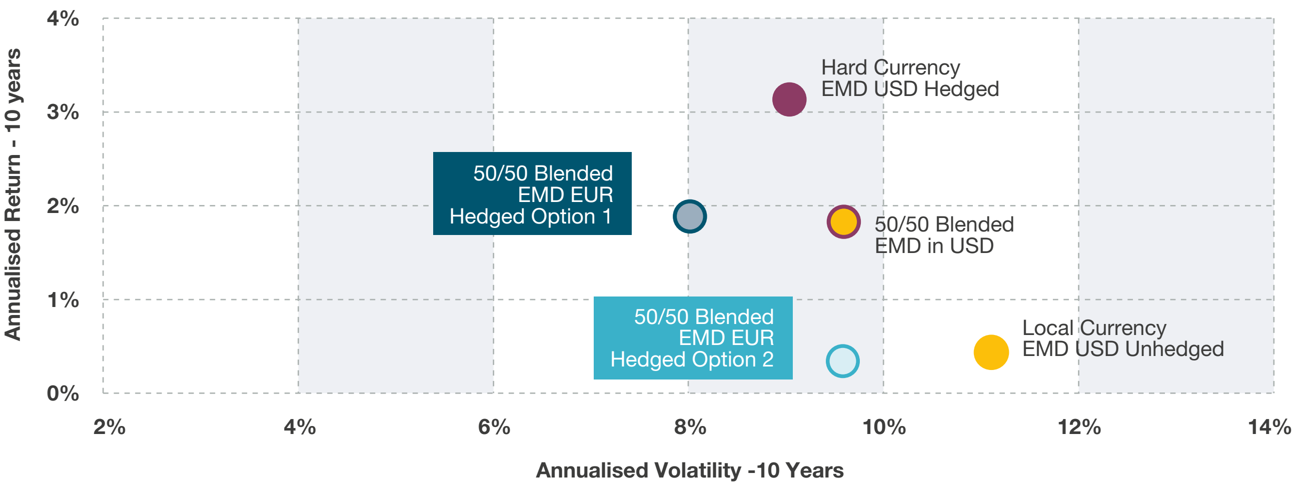
Alongside the question of optimal currency mix lies another key implementation decision for non-USD investors: how to manage the USD risk. While most Blended EM Debt strategies leave local currency exposure unhedged (either systematically or with tactical oversight), there is no universally adopted approach for hedging the residual USD exposure into other base currencies (for the sake of simplicity, we are taking here the perspective of a EUR investors, although findings are valid for any non-USD investor).

Two common approaches dominate the market:

- **Option 1** – Local currency assets are converted to EUR at the spot foreign exchange rate. Only hard currency (USD) assets in the portfolio are hedged to EUR.
- **Option 2** – Local currency assets are converted to USD at the spot foreign exchange rate. The whole portfolio is hedged to EUR.

Although both approaches may be labelled "EUR hedged", their economic impacts diverge significantly. Over the 10 years to end-2024, option 2 delivered 1.5 percentage points more volatility and 1.5 percentage points less annualised return than option 1 for a EUR-based investor. The reason is simple: option 2 essentially locked in the volatility of EM local currencies versus the US Dollar, negating any correlation benefits between EUR and EM currencies, and thus eroded the returns earned by a EUR investor.

FIGURE 19: RISK AND RETURN OF VARIOUS "EUR HEDGED" OPTIONS



Source: bfinance, based on monthly returns to end December 2024 for the J.P. Morgan EMBI Global Diversified (HC) and J.P. Morgan GBI-EM Global Diversified (LC).

It is important for non-US Dollar investors to pay close attention to the hedging approach at the time of implementing a new Blended EMD mandate or investing in a Blended EMD fund. In the case of a mandate, the choice of the blended benchmark and the treatment of currency risk in each leg of the benchmark should be addressed with the manager and anchored in the investment management agreement. In the case of a fund investment, understanding the hedging approach applied at fund and/or share class level should be a key selection criteria.

Scrutiny is particularly advised as option 2 is operationally less onerous for asset managers and is more likely to be the default solution they offer, although it may not necessarily be beneficial to the end investor.

The choice of the right option comes down to the view on the future strength of the USD. Should the USD keep on strengthening versus other global currencies (EM included), option 1 would remain the most optimal from a risk-adjusted return viewpoint. Option 2 could become a valid alternative if the long-term USD appreciation durably reverses. Finally, investors with a currency overlay may decide not to hedge the USD risk at all and leave it for their overlay manager to manage.

Key takeaways

Emerging Market Debt (EMD) is often overlooked, misunderstood, or met with caution. Yet, despite the volatility, institutional investors have remained committed to the asset class, even during periods of outflows driven by retail investors.

The asset class presents compelling structural advantages. These include a spread premium over developed market credit of equivalent rating, and meaningful diversification benefits within global fixed income portfolios.

With its unique breadth and complexity, EMD offers rich alpha potential for active managers. Among the different strategy types, Blended EMD strategies stand out for their strong and consistent alpha generation.

Investors must give careful thought to implementation mechanics, which can materially shape investment outcomes. The optimal mix of Hard and Local Currency exposure is highly dependent on the investor's base currency. Likewise, the chosen hedging approach can significantly affect returns—particularly for non-USD-based investors.

Appendix

APPENDIX 1: ACTIVE MANAGER OUTPERFORMANCE OVER CALENDAR YEARS (2015 TO 2024)

EM Debt Hard Currency	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	Average	% years outperformed
Total managers	62	62	62	62	62	62	62	62	62	62	62	
Total outperformers	16	48	42	14	30	46	15	41	45	54	42	
% Outperformers	26%	77%	68%	23%	48%	74%	24%	66%	73%	87%	68%	
Outperformance - Top quartile	0.03%	3.53%	2.13%	-0.27%	0.63%	2.26%	-0.02%	2.30%	2.40%	2.54%	1.55%	70%
Outperformance - Median	-1.40%	1.77%	0.58%	-1.27%	-0.05%	1.18%	-0.52%	0.97%	1.08%	1.27%	0.36%	60%
Outperformance - Bottom quartile	-3.28%	0.09%	-0.31%	-1.96%	-0.90%	-0.03%	-1.11%	-0.98%	-0.24%	0.59%	-0.81%	50%
Outperformed in 5 of 10 years												82%
Outperformed in 6 of 10 years												53%
Outperformed in 7 of 10 years												27%

EM Debt Corporate	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	Average	% years outperformed
Total managers	43	43	43	43	43	43	43	43	43	43	43	
Total outperformers	7	27	33	14	31	24	13	21	18	31	24	
% Outperformers	16%	63%	77%	33%	72%	56%	30%	49%	42%	72%	56%	
Outperformance - Top quartile	-0.70%	2.23%	2.84%	0.50%	1.60%	1.62%	0.27%	1.50%	0.43%	1.80%	0.44%	60%
Outperformance - Median	-1.75%	0.87%	1.65%	-0.86%	0.71%	0.40%	-0.70%	-0.07%	-0.12%	0.79%	0.08%	50%
Outperformance - Bottom quartile	-1.84%	-6.81%	0.18%	-2.11%	-0.18%	-1.12%	-1.31%	-0.74%	-1.39%	-0.19%	-0.49%	40%
Outperformed in 5 of 10 years												67%
Outperformed in 6 of 10 years												47%
Outperformed in 7 of 10 years												23%

EM Debt Local Currency	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	Average	% years outperformed
Total managers	43	43	43	43	43	43	43	43	43	43	43	
Total outperformers	21	24	27	7	23	28	26	40	38	6	31	
% Outperformers	49%	56%	63%	16%	53%	65%	60%	93%	88%	14%	72%	
Outperformance - Top quartile	1.19%	2.30%	1.68%	-0.68%	0.95%	1.80%	1.32%	3.51%	2.83%	-0.56%	0.83%	70%
Outperformance - Median	-0.01%	0.35%	0.55%	-1.31%	0.40%	0.45%	0.62%	1.70%	1.90%	-1.24%	0.48%	60%
Outperformance - Bottom quartile	-0.97%	-0.96%	-0.28%	-2.06%	-1.11%	-0.11%	-0.42%	0.90%	1.12%	-2.05%	-0.04%	40%
Outperformed in 5 of 10 years												70%
Outperformed in 6 of 10 years												65%
Outperformed in 7 of 10 years												33%

EM Blended Debt	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	Average	% years outperformed
Total managers	44	44	44	44	44	44	44	44	44	44	44	
Total outperformers	20	27	32	16	22	32	24	34	38	33	34	
% Outperformers	45%	61%	73%	36%	50%	73%	55%	77%	86%	75%	77%	
Outperformance - Top quartile	2.05%	2.60%	1.93%	0.46%	1.36%	2.98%	1.61%	3.04%	2.44%	2.93%	1.13%	70%
Outperformance - Median	-0.26%	1.32%	1.23%	-1.41%	0.08%	1.85%	0.29%	2.01%	1.02%	1.22%	0.59%	60%
Outperformance - Bottom quartile	-1.51%	-0.54%	-0.07%	-2.24%	-1.46%	-0.08%	-0.92%	0.33%	0.30%	-0.04%	0.19%	50%
Outperformed in 5 of 10 years												89%
Outperformed in 6 of 10 years												68%
Outperformed in 7 of 10 years												43%

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