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PAiF
ABF Pan Asia Bond Index Fund

Asian Bond Watch

Asian Bonds: Choosing the Right Vehicle to Invest

More than 20 years have passed since the Asian financial crisis, we have seen the region's local currency bond market grow from US$304 billion in 1998 to over US$12 trillion in value today. This rapid ascent can be traced back to the programmes such as the Asia Bond Fund (ABF) initiative developed post-1997 as a collaborative effort of the central banks in the Asia Pacific region to develop the local bond markets. One of the goals of these efforts is to curtail reliance on overseas funding capital and tap into the region's wealth as a way of insulating it from future economic shocks.

Of course, any government efforts would have been futile if investors had failed to participate, but the region's favourable growth characteristics, a reduction in credit risk (as well evident in the upgrades of a number of Asian countries' sovereign credit ratings over the past years), the prospect of relatively higher yields and the benefits of portfolio diversification have worked in tandem with the coordinated policies and have contributed to a boom of the local bond markets.

Direct investments, managed funds and ETFs

Having decided to include an allocation to local currency bonds, investors are faced with a choice – should I invest in individual bonds or opt for a collective vehicle, such as a managed fund or an exchange-traded fund (ETF)?

If an investor has access to comprehensive and timely bond market research, direct investments would appear attractive as the investor can hand pick the bonds that best complement to his or her existing portfolio or those that he or she has the highest convictions in.

However, this process takes time and requires a lot of skills and effort researching individual bonds. So it's not surprising that many investors, big and small, turn to external managers who have the capability and resources to identify individual bond opportunities and monitor the markets closely, such as changes in interest rates and currency movements and how these factors will impact bond performance.

Active managers struggle to outperform

In the past, adopting an active management approach was perceived to be the best way to invest in emerging markets debts (EMD), including Asian bonds, based on the assumptions that EMD is an inefficient market and there are some obvious "weak" segments of the universe that could be avoided by active management.

The reality is, however, very different. The majority of active managers fail to outperform their benchmarks over the longer term.

We have carried out a comprehensive study on active managers in the Morningstar database tracking two flagship EMD indices: JPM GBI-EM Global Diversified Index (GBI-EM) for local currency and JPM EMBI Global Diversified Index (EMBI) for hard currency.

According to our study, in the hard currency sovereign universe, 50% of active managers underperform their benchmarks in 1-year period, and more of them – 57% and 83% respectively – failed to outperform over 3 and 5 years[1]. Outperforming the benchmark seems to be even more challenging for active managers in the local currency universe, with 80%, 83% and 87% of active managers failing to outperform their benchmarks in 1, 3 and 5 years[1].

There is also the semblance of a correlation between market underperformance and active manager underperformance. This is especially the case in the local currency universe where it often appears that the worse the performance of the index, the higher the percentage of active managers who underperform.

The inherently "high-octane" and volatile nature of the EMD sector is likely to be one of the key causes of active manager underperformance. Returns are often misaligned with fundamentals, as they are driven by investor sentiment and political risk, which are harder to predict and often lead to binary outcomes.

Indexing on the rise

Indeed, to this day most of the assets in the Asian local currency fixed income space remain in managed funds. But as we mentioned at the beginning of this article, the markets now offer much greater liquidity and diversity. More cost-efficient and transparent index approaches, in particular ETFs, are increasingly being seen as highly effective and are gaining popularity among investors.

ETFs offer a number of potential benefits to Asian fixed income investors. Because of their index tracking structure, ETFs are generally cheaper to run than managed funds. This may, in turn, positively influence the fund's overall return.

Trading like stocks on stock exchanges also allow quick and easy access to Asian local currency bonds, saving the hassles to deal with many local bond market account opening and tax matters, as well as the hassles to execute bonds and foreign exchanges with different market hours and settlement practices.

ETFs can appeal to investors who wish to play an active role in the management of their money. Its liquidity access via primary and secondary markets and the flexibility in trading facilitate tactical and strategic asset allocation decision.

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[1] Source: Morningstar. The universe is generated by selecting the 30 largest live funds as of 31 May 2018.

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