Research Report
Fixed Income

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Asian Fixed Income

Graduating from Emerging-Market School

ABF Pan Asia Bond Index Fund 15TH ANNIVERSARY | STATE STREET GLOBAL ADVISORS SPDR®

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Important Risk Disclosure for ABF Pan Asia Bond Index Fund:

- ABF Pan Asia Bond Index Fund ("PAIF") is an exchange traded bond fund which seeks to provide investment returns that corresponds closely to the total return of the Markit iBoxx ABF Pan-Asia Index ("Index"), before fees and expenses, and its return may deviate from that of the Index.
- PAIF primarily invests in local currency government and quasi-government bonds in eight Asian markets, comprising of China, Hong Kong, Indonesia, Korea, Malaysia, Philippines, Singapore and Thailand.
- Investment involves risks, including risks of exposure to bonds in both developed and emerging Asia markets. Investors may lose part or all of their investments.
- PAIF is not "actively managed" and will not try to "beat" the market it tracks.
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Executive Summary

Asian bonds may still be a pupil in the broader emerging market (EM) asset class, but they are far from a monolithic entity. While some markets, such as China and Indonesia, are often referred to as EM, others like Korea, Hong Kong and Singapore are commonly considered developed markets (DM). Asian fixed income, as an asset class, therefore possesses both EM and DM characteristics. And in many ways, it has already pulled ahead of many of its contemporaries and looks to soon graduate from EM school.

In this whitepaper, we will take a retrospective look at the Asian bond markets — specifically the local-currency (LC) space — exploring how it has matured into a class of its own to become a new global core. We will also look towards the future and make a case for why we believe Asian LC fixed income remains a valuable addition to a portfolio, even amid uncertainty around the global COVID-19 pandemic and geopolitical tensions.

In the final section, we will look into why index funds might be an appropriate investment vehicle for gaining exposure to the Asian fixed income universe.

Asian Fixed Income — A 15-Year Retrospective

Asian LC bond markets have mature into an asset class that is giving rise to new opportunities.

In historical terms, 15 years is not an especially long time. But for the Asian LC bond markets, that has been sufficient for them to develop and mature into an asset class that is giving rise to new opportunities — and increasingly drawing attention from investors.

There are several aspects to this development, from specific bond market growth initiatives and an increase in issuance to deeper liquidity and growing foreign investor participation. In the following sections, we will take an in-depth look at these various aspects and elaborate on why LC bonds will continue to play a pivotal role in Asian economies moving forward.

Continued LC Bond Market Development Initiatives and Reforms

The 1998 Asian financial crisis sparked a massive devaluation of Asian currencies, with many plunging by 30–40%. This exposed the danger of taking on short-term foreign-currency debt while relying on long-term LC-generating assets for repayment — a currency and a maturity mismatch.

Although the 1998 crisis was the catalyst for the creation of active LC bond markets in the region, it was not until the 2008 global financial crisis that the sector began its rapid growth. Cognisant of the danger of using excessive foreign-currency debt, Asian governments turned instead to LC bond markets to finance stimulus packages for combating the economic downturn. And as global liquidity began to run dry, local corporates also resorted to this market.

While the 2008 global financial crisis caused temporary disruptions and capital outflows in LC bond markets, investor confidence swiftly returned, strengthened by enduring macro fundamentals amid a worldwide backdrop of fiscal stimulus and monetary easing.

This confidence was also aided by the variety of market-reform initiatives already undertaken by the region's policymakers. Some critical measures included:

- The start of the Asian Bond Market Initiative (ABMI) by ASEAN+3 in 2002 to strengthen financial stability via the LC bond markets
- The launch of the Asian Bond Fund 1 (ABF1) in 2003 by the Executives Meeting of East Asia and the Pacific (EMEAP). This initiative pooled USD1 billion of international reserves from eight central banks to invest in the USD-denominated sovereign and quasi-sovereign debt of those same eight countries

- An extension of ABF1 — named ABF2 — in 2005, this time with USD2 billion invested in LC bonds of the eight countries

- The signing of a New ABMI Roadmap in 2008 by ASEAN+3 ministers and the establishment of various task forces to address specific LC bond market issues

Reform initiatives continued even after the global financial crisis had passed, including:

- The establishment of the Asian Bond Market Forum (ABMF) in 2010 to encourage the standardisation of market practices and harmonisation of regulations to facilitate cross-border bond transactions

- The creation of the Credit Guarantee and Investment Facility (CGIF) — operational since 2012 — to provide credit enhancement for corporate-bond issuances

- The development and release of implementation guidelines for the ASEAN+3 Multicurrency Bond Issuance Framework (AMBIF) in 2015 to standardise bond issuances and investment processes

On top of these regional initiatives, the respective governments and their central banks also became more transparent in courting investors — for instance, announcing shifts in monetary policies proactively and timely. Central banks have been viewed as mostly independent, and the political climate has remained relatively stable, particularly when compared to their non-Asian EM counterparts.

Increase in Issuance

When ABF2 was launched 15 years ago, the Asian LC bond space was a fraction of the size it is today. Since then, its growth has been exponential. In China, the market went from USD 617 billion at the end of 2004 to over USD 12 trillion by December 2019.[1]

While other markets have not matched the levels of growth seen in China, their figures are still impressive.

Figure 1
Market Sizes of Key Asian LC Bond Markets

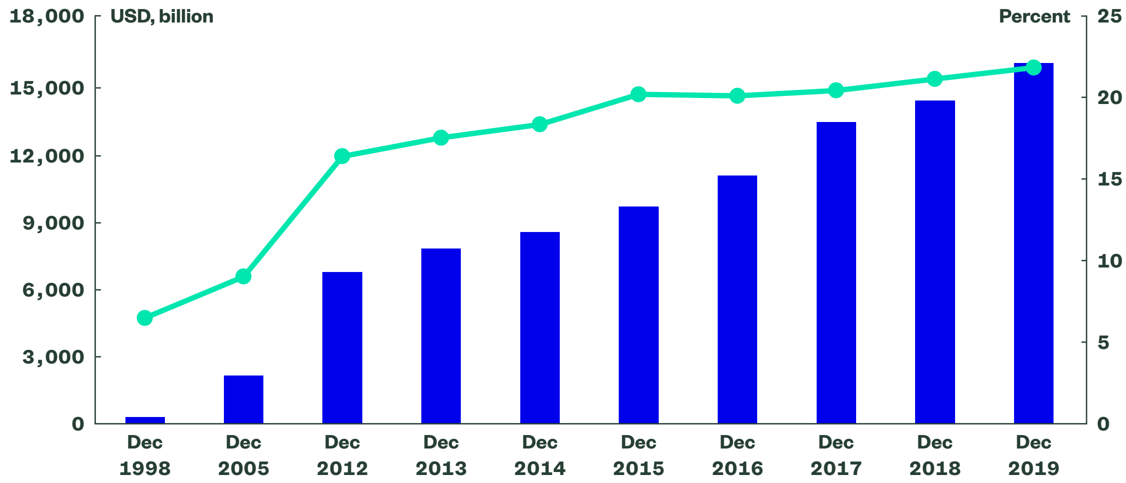
Market	2005 (USD)	2019 (USD)
China	617 billion	12.1 trillion
Hong Kong	78 billion	291 billion
Korea	657 billion	2.1 trillion
Malaysia	97 billion	363 billion
Singapore	80 billion	340 billion
Indonesia	61 billion	239 billion
Philippines	36 billion	131 billion
Thailand	67 billion	446 billion

Source: Asian Bonds Online Data Portal.

The overall Asian local currency bond markets continue to expand, with assets growing eight-fold from approximately USD 2 trillion at the end of 2005 to USD 16 trillion in December 2019.[2]

Figure 2
Asian Local Currency Bonds Markets Issuance Growth

Pan-Asian Bond Markets (LHS)
Pan-Asian GDP as % of World Total (RHS)



Source: Bloomberg, Asian Development Bank, International Monetary Fund, World Economic Outlook Database, as of December 2019. Government, central bank and corporate bonds. Includes China, Hong Kong, Indonesia, Korea, Malaysia, Philippines, Singapore, and Thailand.

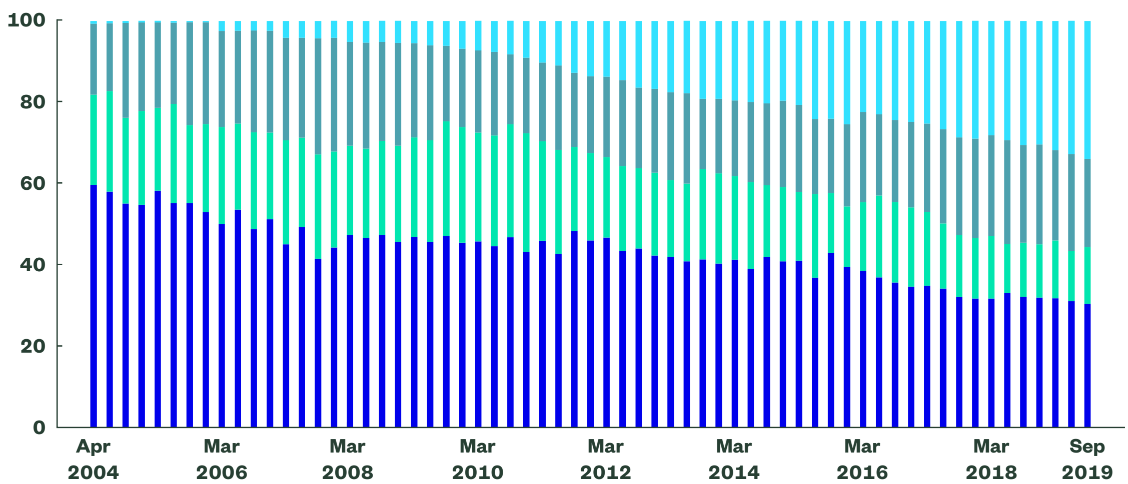
Extended Duration

In earlier years, shorter-term bonds dominated issuances. However, governments began ramping up their issuance of longer-dated bonds to meet the rising need for longer duration investment assets. They also increased benchmark sizes.

At the end of 2004, for example, government securities with maturities of over ten years comprised 5.2% of all issuance in the Philippines; by end-2019 it stood at 36.0%.[1] In Korea, such long-dated bonds increased from just 0.4% of all issuance to 33.9% as at September 2019.[1] Malaysia, Singapore and Thailand also recorded significant increases in their bond tenures.

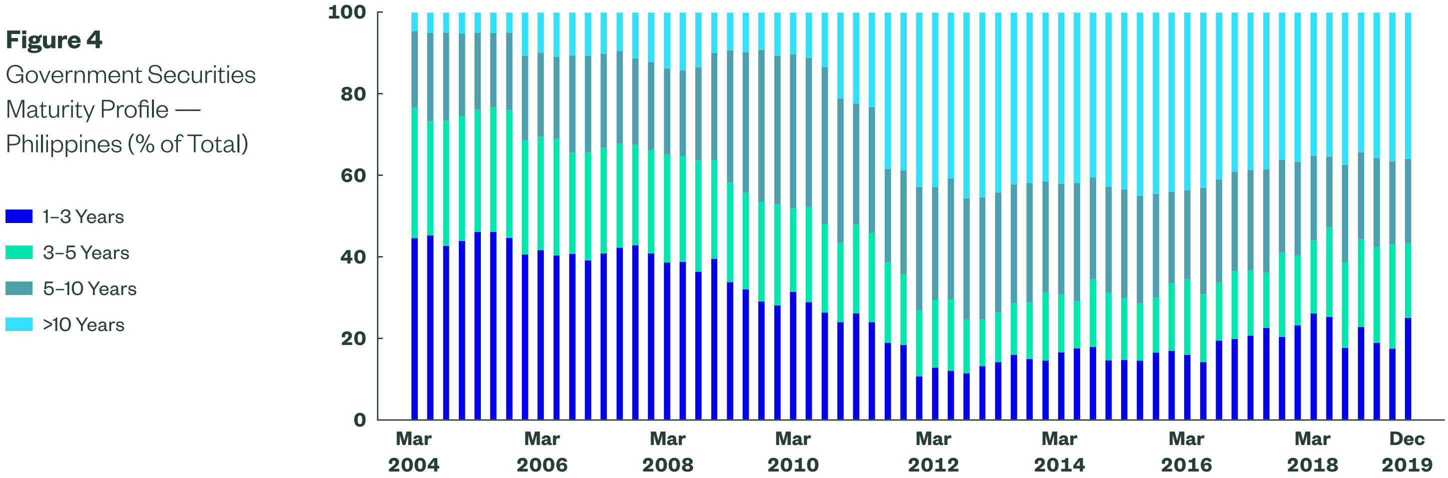
Figure 3
Government Securities Maturity Profile — Korea (% of Total)

1–3 Years
3–5 Years
5–10 Years
>10 Years



Source: Asian Bonds Online Data Portal, quarterly data from April 2004 to September 2019. Government bonds include treasury bonds, central bank bonds, and state-owned agencies. End-of-period exchange rates are from Bloomberg.

Figure 4
Government Securities Maturity Profile — Philippines (% of Total)



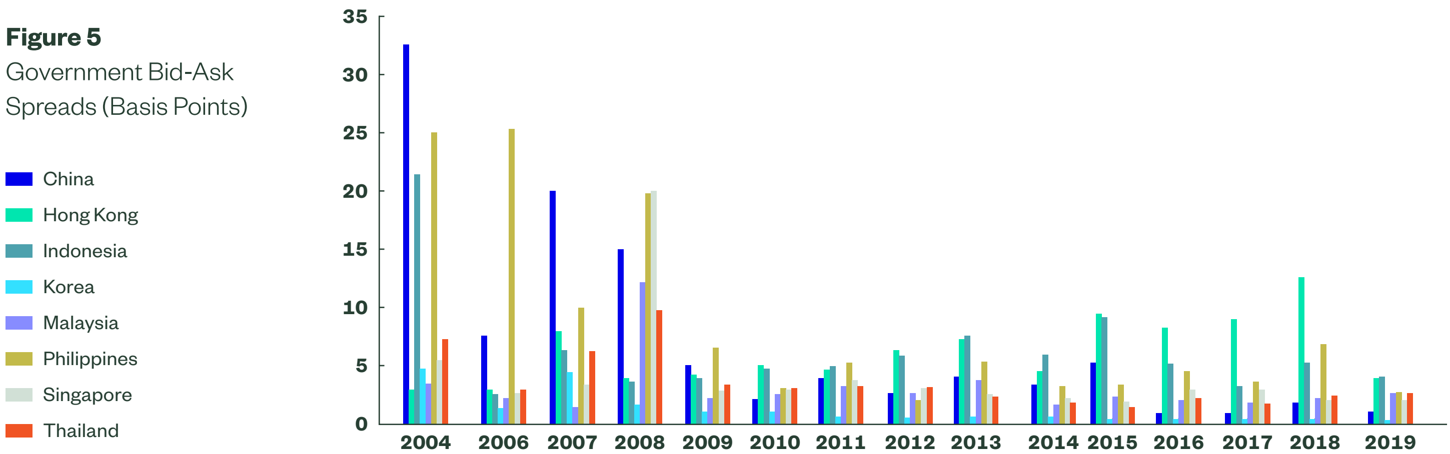
Source: Asian Bonds Online Data Portal, quarterly data from March 2004 to December 2019. Government bonds include central government bonds only. End-of-period exchange rates are from Bloomberg.

Deepened Liquidity

From a liquidity perspective, there have also been substantial improvements. Trading volumes have risen across the board. China saw activity surge from USD 341 billion in 2004 to USD13.9 trillion for just the first three quarters of 2019.[1] In Indonesia, it increased almost ten-fold from 2004 to 2019.[1] And although the expansion in other economies was more modest, it was still apparent.

This was also reflected in the narrowing of bid-ask spreads. Admittedly, the difference was far starker in select markets — China's spreads narrowed from 32.5 basis points (bps) in 2004 to 1.1 bps in 2019, Indonesia's from 21.4 bps to 4.1 bps, and the Philippines' from 25.0 bps to 2.8 bps.[1] Tightening was consistent across the entire Asian LC bond landscape.

Figure 5
Government Bid-Ask Spreads (Basis Points)



Source: Asian Bonds Online Local Currency Bond Market Liquidity Survey (2005 data is not available).

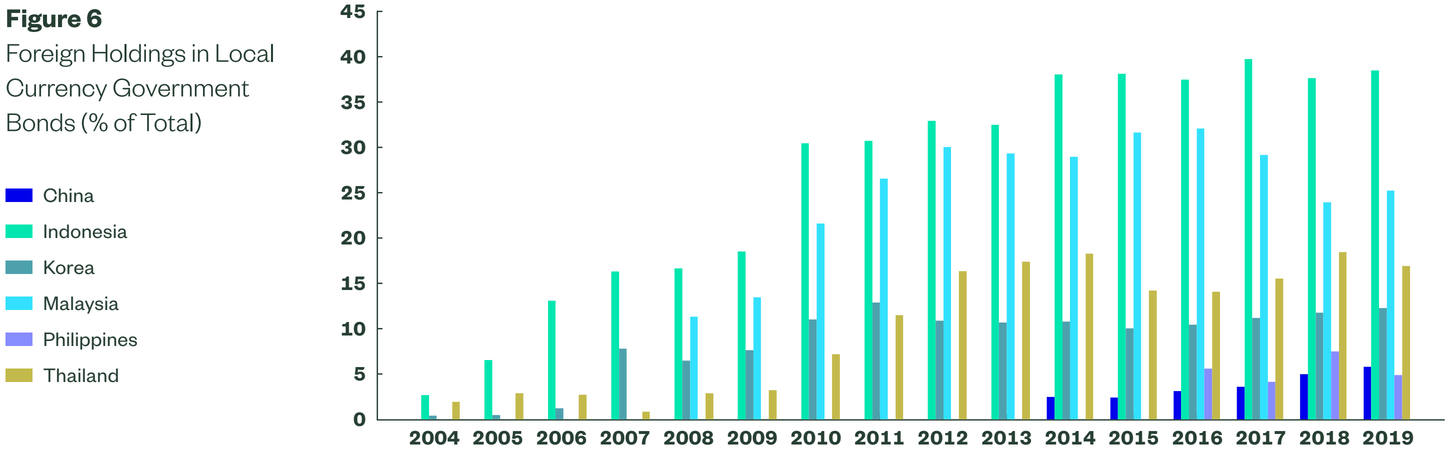
Growing Foreign Investors' Participation

All these developments have led to an increase in foreign investors' participation in the Asian LC bond space.

Apart from China — which saw foreign ownership of LC government bonds more than double from 2.5% at end-2014 to 5.8% at end-2019[1] — other Asian countries saw exponential rises in external-ownership rates.

In Indonesia, for instance, the percentage climbed from 2.7% at end-2004 to 38.6% at end-2019.[1] Over the same period, Korea saw an increase from 0.4% to 12.3% and Thailand from 2.0% to 17.0%.[1]

Figure 6
Foreign Holdings in Local Currency Government Bonds (% of Total)



Source: Asian Bonds Online Data Portal.

Looking Ahead — The Continued Importance of the LC Bond Market

Although the COVID-19 pandemic and the heightened geopolitical tensions raise the spectre of a global recession, it is unlikely to derail the long-term growth of the Asian LC bond market. Apart from the fact that Asian governments will continue to tap the LC bond space for funding to support the growth of individual countries, there are several other reasons why LC issuances will only become more critical:

- Strong macro fundamentals and more dynamic economic growth in Asian economies will likely create significant financing needs for private-sector fixed investment
- The LC bond market can help meet the rising demand for infrastructure investments
- Rising incomes and wealth levels throughout the region will necessitate further investment opportunities, and LC bonds can serve as a potential investment avenue
- LC bonds are also significant vehicles for local institutional investors, such as pension funds
- International corporations continue to establish offices and factories in Asia and will tap the market for their regional funding needs

Asian LC Government Bonds — The Case for Portfolio Inclusion

There are several good reasons why Asian LC government bonds deserve an inclusion — or even an increase in allocation — in most investors' portfolios for both the short and long term.

With the COVID-19 pandemic causing an increase in uncertainty and sparking a 'flight to safety', global investors are understandably wary about shouldering additional credit risk from so-called EMs. This is despite the contrast between the potential yield pickup available in the EM space and the lack of return — especially in the DM world — amid a persistent 'lower for longer' yield environment.

This is where the divergences between Asian LC government and corporate bonds come to the fore, especially from a credit risk perspective. While many investors may shy away from such perceived riskier credits in these times, there are several good reasons why Asian LC government bonds deserve an inclusion — or even an increase in allocation — in most investors' portfolios for both the short and long term.

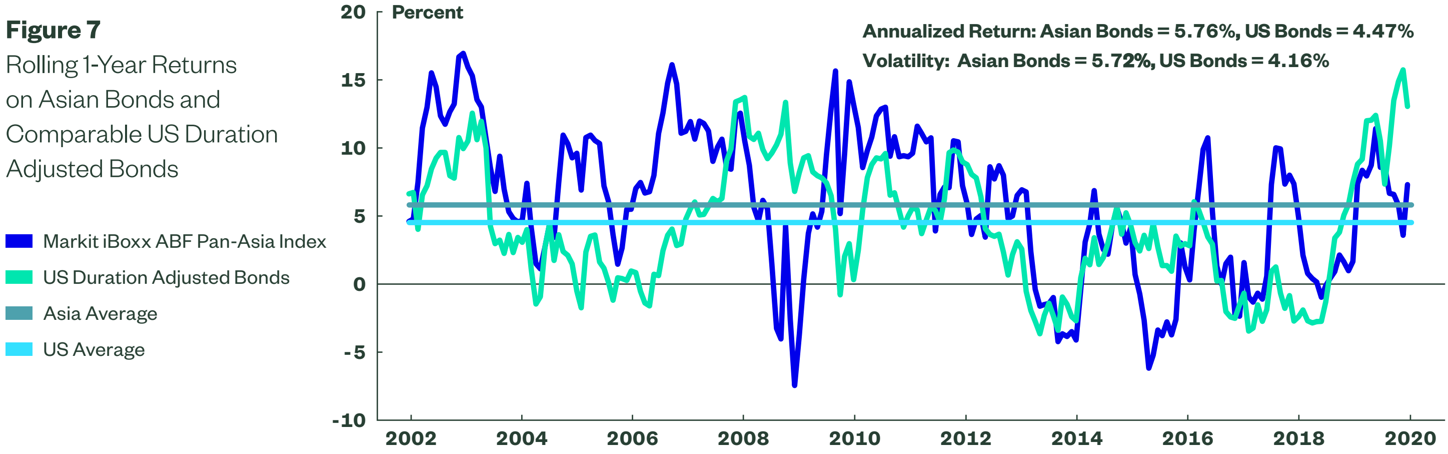
Favourable Risk-Return Profile

Although the pandemic has undoubtedly hit the corporate credit space, the government and quasi-government sides have been able to prevent their fundamentals from significantly weakening. It is true that though governments will have to come up with additional funding for stimulus packages and supplementary budgets, many have alternative means of financing such packages — meaning they do not have to rely on the bond markets exclusively.

As such, the macro fundamentals of many Asian governments remain robust, and they will likely continue to be a growth driver as the global economy recovers. Investors, therefore, have an opportunity to obtain a good yield pickup without taking on excessive risk.

In fact, Asian bonds have historically demonstrated a risk-return profile that is proportional to that of US Treasuries. This contrasts with many other non-Asian EM governments, where the step-up in potential return may not be fully justified when compared to the additional risk taken.

Figure 7
Rolling 1-Year Returns on Asian Bonds and Comparable US Duration Adjusted Bonds



Source: FTSE Government Bond Indices, Markit iBoxx ABF Pan-Asia Index and State Street Global Advisors; index data from January 2001 to May 2020. Index returns reflect capital gains and losses, income, and the reinvestment of dividends. Past performance is no guarantee of future results. It is not possible to invest directly in an index. Index performance does not reflect charges and expenses associated with the fund or brokerage commissions associated with buying and selling a fund. Index performance is not meant to represent that of any particular fund.

Figure 8
Asian Local Currency Bonds Present Attractive Overall Returns with Moderate Volatility

For the period Jan 2010 to Mar 2020	Asian Local Currency Bonds	US Treasuries	European Government Bonds	Emerging Market Equities	US Equities	Asia ex-Japan Equities
Annualised Return (%)	3.40	3.78	1.88	1.04	10.53	4.58
Annual Standard Deviation (%)	5.42	3.65	9.35	17.68	13.24	16.79
Sharpe Ratio	0.49	0.83	0.12	0.02	0.74	0.23
Beta to S&P 500 Index	0.18	-0.14	0.30	1.01	1.00	0.93

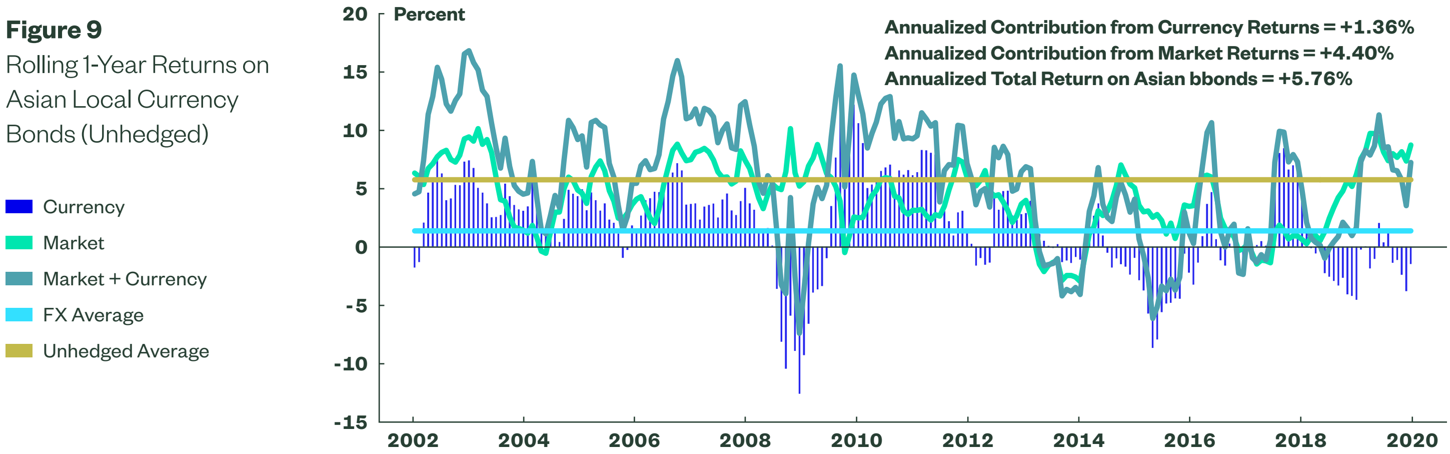
Source: Calculated by State Street Global Advisors with data from Markit, JP Morgan, FTSE Russell and Bloomberg for 1 January 2010 to 31 March 2020 period. Indices used (from left to right): Markit iBoxx ABF Pan-Asia Index, FTSE USBIG Treasury Index, JP Morgan GBI-EMU Index, MSCI EM, S&P 500 and MSCI AC Far East ex Japan. Note: Returns are in US dollar terms, total return unhedged. Risk free rate used for Sharpe Ratio calculations is based on the JP Morgan 1-month LIBOR Index returns. Characteristics are as of the date indicated, are subject to change, and should not be relied upon as current thereafter. Index returns reflect capital gains and losses, income and the reinvestment of dividends. Past performance is no guarantee of future results. It is not possible to invest directly in an index. Index performance does not reflect charges and expenses associated with the fund or brokerage commissions associated with buying and selling a fund. Index performance is not meant to represent that of any particular fund.

Potential for Additional Yield via Local Currency Appreciation

There is a persistent stereotype when it comes to EM LC bonds that most of the historical gains were derived from local-currency appreciation. This might have led to some investors staying away, fearing currency volatility.

However, the data shows otherwise. Our analysis reveals that for Asian LC bonds, currency appreciation only accounted for about a third of total returns.

Figure 9
Rolling 1-Year Returns on Asian Local Currency Bonds (Unhedged)



Source: Markit iBoxx ABF Pan-Asia Index as of May 2020 (index data from January 2001). Index returns reflect capital gains and losses, income, and the reinvestment of dividends. Past performance is no guarantee of future results. It is not possible to invest directly in an index. Index performance does not reflect charges and expenses associated with the fund or brokerage commissions associated with buying and selling a fund. Index performance is not meant to represent that of any particular fund.

The remainder — and majority — of the returns were the result of the economies' growth potential and macro fundamentals.

Nonetheless, we do expect currency appreciation to continue to be an important source of potential returns moving forward. Current US-dollar strength has depressed currency gains in Asian LC bonds, but over the medium to long term, there is a good chance of a rebound. In the meantime, dollar strength presents attractive entry opportunities for Asian LC bonds.

A 'Back to Basics' Diversified Portfolio Construction Strategy

The markets' heightened uncertainty will likely persist for some time. In such a situation, it makes sense for investors to take a defensive 'back to basics' approach to portfolio construction. This does not entail a universal 'flight to safety', but instead focuses on creating a well-diversified portfolio that offers an optimal risk-return profile.

In the increasingly interconnected world, correlations between Asian LC bonds and other major asset classes have inevitably risen. Still, they remain low enough to allow such assets to add valuable diversification benefits to investors' portfolios.

Figure 10
Correlations between Asian Local Currency Bonds and Other Major Asset Classes over a 10-year Period

	World Government Bonds	World Government & Corporate Bonds	Emerging Market Local Currency Bonds	Emerging Market Hard Currency Bonds	Global High Yield Bonds
Local Currency Asian Bonds	0.495	0.538	0.715	0.631	0.565

Source: Bloomberg, data from 16 June 2010 to 16 June 2020. World Government Bond is represented by FTSE WGBI unhedged in USD. World Government & Corporate Bonds is represented by FTSE WBIG unhedged in USD. Emerging Market Local Currency Bonds is represented by JP Morgan GBI EM Global unhedged in USD. Emerging Market Hard Currency Bonds is represented by JP Morgan EMBI in USD. Global High Yield Bonds is represented by Bloomberg Barclays Global High Yield unhedged in USD. Local Currency Asian Bonds is represented by Markit iBoxx ABF Pan Asia Index Unhedged in USD.

Investing in Asian LC Bonds — The Pan Asia Bond Index Fund (PAIF)

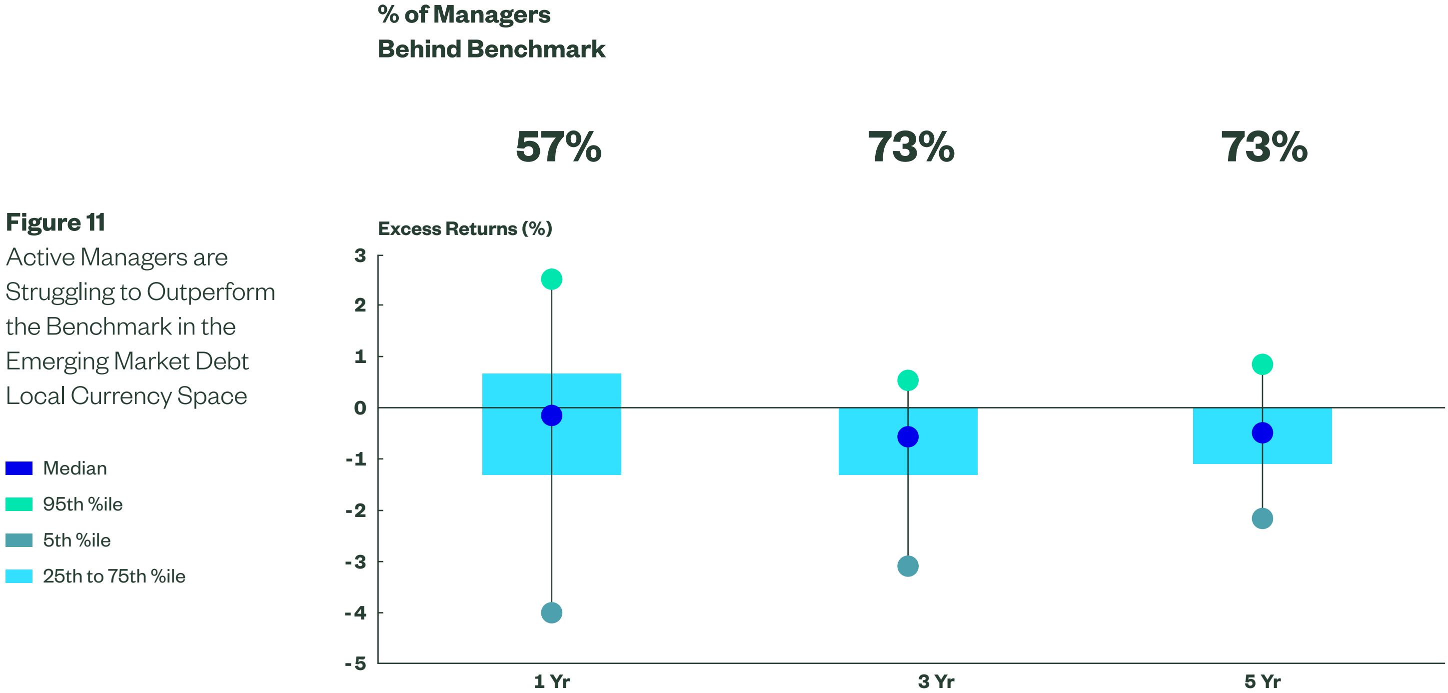
Index funds could be an optimal alternative for gaining exposure to Asian LC bonds.

Investors looking to gain or increase their exposure to the Asian LC bond space run into a challenge — selecting an appropriate investment vehicle that gives them the desired exposure while also balancing multiple credit risk factors.

One common way to achieve this is by investing through an actively managed fund. There is a belief that EMs are less efficient, therefore active strategies must be the optimal way forward.

Yet, the evidence tells a different story. Even in so-called less efficient EMs, most active managers underperform their benchmarks. According to Morningstar, as at end-2019, 57% of the 30 largest EM LC debt funds benchmarked to the JPM GBI-EM Global Diversified Index underperformed the index over the past year.[3] This 'active underperformance' phenomenon is even more apparent over a longer horizon, with 73% of them underperforming over a three-year and five-year period.[3]

Figure 11
Active Managers are Struggling to Outperform the Benchmark in the Emerging Market Debt Local Currency Space



Source: Morningstar, as of December 2019. 30 largest funds in the Morningstar's emerging market local currency debt category benchmarked to the JPM GBI-EM Global Diversified Index.

Even discounting the effects of higher fees, risks within EMs can be asymmetric and concentrated, making it extremely difficult to outperform benchmarks.

The data thus suggests that index funds could be an optimal alternative for gaining exposure to Asian LC bonds. However, index investing — while increasingly popular — is not without its challenges.

The challenge when using index funds is determining the appropriate construction of the index. For instance, simply taking a market-capitalisation-weighted approach to allocation will result in substantial biases towards the most indebted countries. An expansion of a local bond market is not necessarily a positive thing, as it may be caused by a cash-strapped government desperate for funding. As such, an index that is heavily tilted toward market capitalisations might result in disproportionate exposure to fiscally challenged countries.

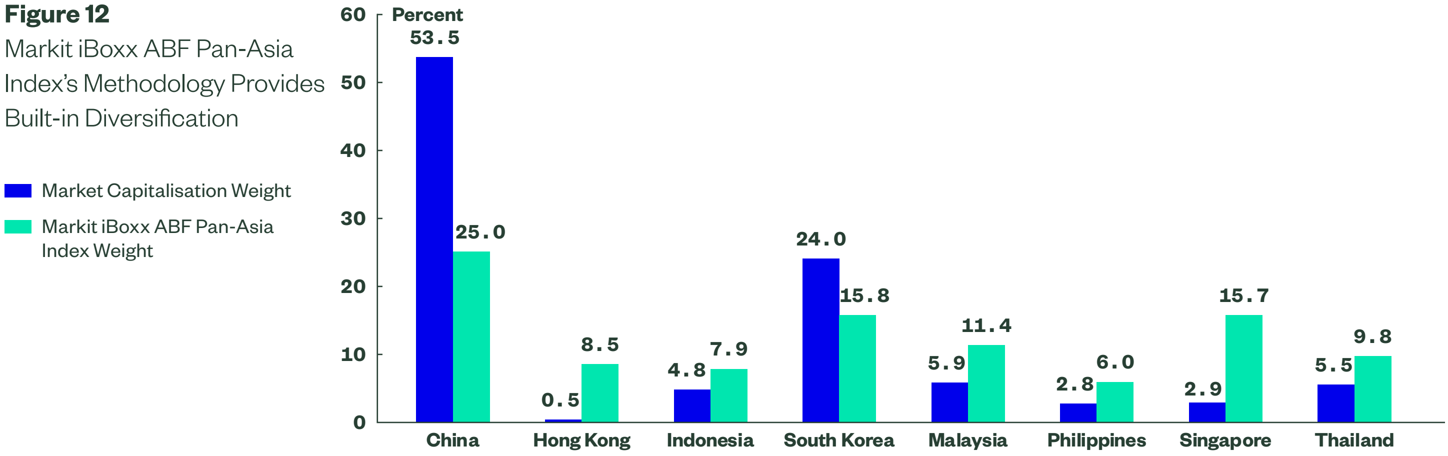
Intelligent Indexing

To avoid the problems associated with that kind of simplistic indexing, PAIF's benchmark, the Markit iBoxx ABF Pan Asia Index, adopts an intelligent indexing approach — probably one of the earliest "smart beta" examples. Security selection is executed using a weighted method considering the following three factors[4]:

- 20% allocated to market capitalisation (local bond market size)
- 20% to sovereign credit rating
- 60% to the GEMLOC Investability Indicator

Developed by the World Bank, the GEMLOC Investability Indicator is a transparent and objective methodology that offers detailed insight into a bond's liquidity and accessibility to foreign investors. It is computed based on factors such as turnover, bid-ask spreads, benchmark yield curve, and bond-pricing data.

Figure 12
Markit iBoxx ABF Pan-Asia Index's Methodology Provides Built-in Diversification



Source: Markit, iBoxx Asian Annual Index Review 2019 (31 December 2019), index weight as of 31 October 2019. Market capitalization weight shown in the chart is calculated based on government bond market size. Weights are as of the date indicated, are subject to change, and should not be relied upon as current thereafter. Diversification does not ensure a gain or a guarantee against a loss.

The Role of PAIF in the Development of the Asian LC Bond Markets

PAIF invests in debt obligations denominated in Asian currencies issued or guaranteed by the government, quasi-government organisations or supranational financial institutions in China, Hong Kong, Indonesia, South Korea, Malaysia, Philippines, Singapore and Thailand. These are the same eight economies represented in ABF2, and the PAIF is a crucial part of the EMEAP's initiative to develop local bond markets.

In line with this objective, the fund has started participating in securities lending from June 2018 to deepen secondary market liquidity. This move places the PAIF on par with funds tracking DM indices, and is a milestone in the continued maturity of the Asian LC bond space. Further, the fund also expects to generate income from the programme, which could be used to offset costs and potentially enhance returns.

A Convenient Entry Point into the Asian LC Bond Space

For investors looking for a convenient entry point into the LC bond space, the PAIF — the first and currently largest Asian fixed income ETF in the region[5] — provides instant exposure to eight major Asian bond markets via a single investment. In addition, investors can enjoy all the benefits an ETF offers, such as transparency, cost-efficiency, and higher liquidity, stemming from the capability to trade in both the primary and secondary market.

Please visit **abf-paif.com*** for the fund details or contact us for more information.

* This website has not been reviewed by the SFC.

Contributor

Kheng Siang Ng, CFA
Asia Pacific Head of Fixed Income

Endnotes

1 Source: Asian Bonds Online Data Portal.

2 Source: Bloomberg, Asian Development Bank, International Monetary Fund, World Economic Outlook Database, as of December 2019. Government, central bank and corporate bonds. Includes China, Hong Kong, Indonesia, Korea, Malaysia, Philippines, Singapore and Thailand.

3 Source: Morningstar, as of December 2019. 30 largest funds in the Morningstar's emerging market local currency debt category benchmarked to the JPM GBI-EM Global Diversified Index.

4 Before 31 October 2012, 2 factors — Overall liquidity and Market functionality — were considered.

5 Source: Bloomberg, as of 31 May 2020.

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Invest as Stewards We help our portfolio companies see that what is fair for people and sustain-able for the planet can deliver long-term performance. As fiduciaries, we believe good stewardship is good investing.

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^ This figure is presented as of March 31, 2020 and includes approximately $51.62 billion of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated.

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