

THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

Look Beyond Traditional Emerging Markets for More Diversification



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SECTOR — GENERAL INVESTING

Mr. Cirami: Artisan Partners is an asset management firm, and the way that we are organized is into different investment teams that operate fairly autonomously. So, I work in the EMSights Capital Group, which is a team that started three years ago that focuses on primarily emerging market investing on the fixed income side. Artisan Partners has a number of different teams that operate in different segments that are completely independent from me.

TWST: Great. Maybe we can talk about emerging markets.

Mr. Cirami: Emerging markets has been a very dynamic and interesting space. I think that there's probably a number of elements worth highlighting.

In terms of how things have gone from a capital markets perspective on the fixed income side, emerging markets has generally performed along with broader risk assets. So, when risk assets are doing well, that's usually the environment where emerging markets has done well when you look at it from an asset class perspective.

We've been in the midst of a good run for risk assets, and broadly speaking, the emerging markets has done well with that.

But I would say maybe part of the more interesting aspects of emerging markets is that it is a very broad universe with differentiated assets within it. And so, within the asset class, you have seen a fair amount of dispersions, and some places haven't done so well, and other areas of the market have done even better than the averages.

So, broadly speaking, the wind has been at the back of emerging markets for quite a while at this point, but there is a lot of dispersion within the asset class.

TWST: One of the strategies I understand you manage is emerging markets debt opportunities. Maybe you want to get into that?

Mr. Cirami: Artisan's Emerging Market Debt Opportunities Strategy (EMDO) is our attempt to put together a portfolio that showcases the best of what emerging markets has on offer.

So, I mentioned how there's a differentiated set of assets within EM, and to expand upon that within the emerging market debt space, you have local assets. These are assets that are denominated in local currencies from different countries. You could think about Mexican pesos, South African rand, Hungarian forints, and so on and so forth.

Then you have external debt, which is largely denominated in U.S. dollars, and this can be issued by sovereigns or corporates.

And so, our EMDO strategy is really designed to go find the best among this broad set of opportunities. So, we are very picky and choosy in where we would like to invest, and often we're looking far beyond the standard fare in emerging markets that tend to dominate people's thinking.

When you hear emerging markets, you might think of China, India, Brazil, Mexico, South Africa. But there's this very long tail of emerging market countries that also fall into the category, and it's places that maybe are not as much top of mind. Uganda, Zambia, Papua New Guinea, Mongolia, maybe Uruguay, are some of the examples of these types of countries.

Our EMDO strategy canvases all of these countries looking for unique situations that offer assets that we think will be able to perform whether the broader markets are doing well or in a more challenging environment. So, that's really what our EMDO strategy is all about.

TWST: I understand you also have a global unconstrained strategy? Can you tell me about that?

Mr. Cirami: I'll say a word about the Artisan Global Unconstrained Strategy (GLUN).

This strategy, in some similar ways to the EMDO strategy, is also looking to exploit this broad universe and really seize the best opportunities in the emerging market debt space. But we even have further latitude here where we'll invest in developed markets as well. Not to the same extent as we will invest in emerging markets, but it just further opens up that universe. We also have the flexibility to invest long and short.

We're really looking, one, for the best opportunities on either side of the market. So, to take advantage of opportunities where maybe assets are overpriced or a particular situation is set to deteriorate. But I would say, secondly, being able to short assets provides us an opportunity to hedge out risk and create more balanced portfolios that can potentially withstand volatile markets or markets that are experiencing a meaningful selloff, let's say.

And maybe the final thing to say about this strategy is that since it's a long/short strategy, we don't necessarily have a traditional index that we're trying to beat. What we're trying to accomplish is three objectives. The first is to deliver incremental returns over the risk-free rate.

“There's this great misperception that emerging markets sits at some unique point of the risk spectrum that is different and distinct from other parts of the fixed income market or the equity markets.”

The second is to make sure that we're getting generous compensation for the risks that we're taking. So, I think about the Sharpe ratio of our portfolio.

And then the third piece is to make sure that we have low betas and low correlations to traditional risk factors. And I think about those as the things that people already have exposure to in their asset allocation mix. So, you could think about the equity market, maybe U.S. high yield, U.S. Treasuries.

And so, if we could put those three objectives together, I think we have a very compelling portfolio for individuals.

TWST: When people talk about emerging markets, sometimes there's a concern that risk is an issue. What advice would you give investors about that topic, especially in emerging markets?

Mr. Cirami: There's this great misperception that emerging markets sits at some unique point of the risk spectrum that is different and distinct from other parts of the fixed income market or the equity markets.

I think some of this is born from the headlines that we see in newspapers that might not have anything to do with financial markets, but just negative stories that might come out of certain emerging market countries.

I also think some of this misperception is born out of how the indices are created, and people who might have a window into the asset class through these indices perceive the risks as being larger than they are.

We have obviously all seen the type of volatility that the U.S. Treasury market can bring to investors over the last few years. And so, there's perhaps changing perceptions about risk and which segments of the market are risky and which aren't.

When people think about the asset class, to my comment earlier, they tend to think about China, Brazil, Mexico, maybe Colombia, South Africa, a few other countries would fall in there. Often these assets are among the most volatile within the emerging market space, and they also occupy some of the heaviest weightings in the index.

And furthermore, the volatility around these assets is in a large part driven by global risk appetite or capital flows that are coming into and out of emerging markets. And so, what I'm highlighting here is that the correlations of the moves up and down across the set of countries is often quite high.

When you expand out that universe to the 100 or so emerging market countries that an investor can actually look through for investments, what you find is less market beta and more idiosyncratic country risk.

And to me, that's quite exciting. It means that you get better diversification. So, if the risks in country A, B, C, and D are all idiosyncratic from each other, there's a lower chance that negative outcomes are all going to materialize at the same time. So, you get real diversification.

And it also means to me that doing research and investment analysis and bringing meaningful research and investment analysis into your process can then give you a leg up to eliminate the idiosyncratic risk that you're just not getting good compensation for. So, what that means in practice is avoiding investing in a particular country if you think it's going in the wrong direction.

I always try to hammer home the point that emerging markets have a lot to offer. We don't believe it's as risky as the perception is out there. And there's some really clear underlying reasons why that's the case.

TWST: And you mentioned diversification. Do some investors just assume because they're going into emerging markets it's going to be diversified or do you have to really search for that?

Mr. Cirami: I don't want to say you have to search for diversification in an onerous type of way. But I wouldn't just assume that if you step into an emerging market investment, say it's a mutual fund or an ETF or something of that nature, that you're going to get the diversification that you want.

While you might perceive diversification at a high level through the differentiation of the names that you might see in the holdings, there could be a very singular risk, or maybe a few common risk factors, across these countries that's driving performance.

And so, I mentioned these big EM countries, they trade as a monolith in some sense. So, capital that flows into EM during various points in the cycle is allocated to a very narrow set of countries. Those assets perform well. But there's always that period where things reverse and capital leaves. And then all those assets might underperform.

And the reason why money is moving in and the reason why money is leaving, might have nothing to do with emerging markets. It could have to do with Fed policy.

So, we're speaking today when the Fed held a rate decision and cut 50 basis points. There's going to be a bid for some of those highest volatility EM assets as a result of that. And that's not a great characteristic. It's something that people need to be very mindful of.

Another way this plays out could be the price of commodities. Many emerging market countries are commodity exporters. Oil's kind of the top of the pyramid there. And when oil's moving high or moving up in price, you'll see emerging market countries tend to do well and receive more capital. But the flip side of that also holds true.

So, you need to be a little bit more assertive. It's not particularly onerous, but more assertive to make sure that you're investing in emerging markets in a manner that does bring true diversification.

And the reason why I'm harping on this, perhaps, is because I think it's really important for the asset class that one has good diversification. And it's available, which is not always true in different asset classes where you get pairwise correlations that are just really high across the individual constituents within a segment of the market.

You know, in emerging market countries, you really do have a whole world at your disposal. There's very different characteristics in countries from A to B and B to C, different parts of the world, different set of commodities or a different set of industries that drive how a country performs.

You can get real diversification. You just have to make sure that you do it. Unfortunately, there's many in the asset class that don't make sure that they have this diversification. And the way that the benchmarks are constructed, I think they fail in this regard.

TWST: And did you want to highlight a country or two that might be of interest to investors — ones that you're following?

Mr. Cirami: Yes. One country that comes to mind, and it touches on a number of points that I think I've already made, is the Bahamas. Here's a country that by many standards, but not every standard, is an emerging market country, but doesn't even reside in the indices that most people look at. So, it's an asset that is a little bit, I guess, underexplored or under-researched by that nature.

And what we find attractive and interesting in the Bahamas is that the country's going through a fiscal reform program that is bringing the budget deficit to lower and more sustainable levels.

Like every country, COVID was a massive shock that hurt fiscal balances. And the Bahamas, being a tourism-led economy, was particularly hurt back during the global lockdowns of travel and the like. Around the same time, the Bahamas also experienced a devastating hurricane, which also put stresses on the finances. So, it's coming out of that dual shock right now.

The Bahamas has been reducing the budget deficit. The economy is doing very well as tourism has rebounded massively in the country — and pretty much everywhere that you have a tourism industry has seen a massive post-COVID pickup.

But nevertheless, the assets that we find particularly attractive is their sovereign debt, which starts to trade at distressed levels and is still trading at what we feel is generous compensation for the risks that the country faces today.

And I think it's a bit underappreciated how much the country's government has moved to improve its finances and make the fiscal more resilient to future shocks. So, that's one place that really stands out to us that we find quite attractive.

TWST: Some people who might have been invested in China are also looking at some of the other smaller Asian countries, like Vietnam or some of the other nearby nations. Are you following any of those and what might investors want to know about those?

Mr. Cirami: There's a lot of interesting dynamics in Asia as people are looking to diversify their supply chains and preparing for more tense relationships between the U.S. and China. This has been an opportunity, I'd say, for other countries in the region to attract FDI — foreign direct investment — and the like.

For us on the fixed income side, I think it's less of an opportunity than it might be for people in the equity space that can look at specific companies that are really benefiting from this trend.

And to expand upon that just for another moment, we find that although Asia has big capital markets, and there's certainly fixed income debt, it is on the wealthier end of the spectrum for fixed income sovereign investing. And as a consequence of that, in practice the financial market opportunities in the sovereign dollar space in Asia is just fewer than other parts of the world.

So, you mentioned Vietnam as an example. They have very limited external debt and it trades with yields that are not too dissimilar from U.S. Treasuries, quite frankly.

TWST: And anything we haven't talked about you care to bring up?

Mr. Cirami: Maybe another dynamic worth mentioning is in the high yield space for sovereign debt.

Similar to the U.S. where you have a high yield market and an investment grade — IG — market, when we say emerging markets, that term is used to describe all the countries that are really not developed. And some of those countries are IG in credit rating and some of those countries are high yield. Where we're broadly finding the best opportunities is in the high yield space.

We've seen multiple bouts of selloffs in the high yield sovereign space. And when those episodes happen, usually spreads widen across countries that maybe don't have fundamentals that warrant spread widening. It can be described as like the babies being thrown out with the bathwater.

And we've just recently gone through an episode of this over the summer in August where we've just seen spread widening through that segment of the market, which is providing opportunities for investors in the EM debt space.

Another dynamic at play here, which I think is exciting, is there are a number of countries during COVID and post-COVID that got into financial trouble and needed to restructure their debt. And we've gone through, in some cases, multi-year periods of negotiations with creditors.

And we're starting to see the tail end of these discussions and countries coming back into the fold of the debt universe — getting their restructurings done and having cleaner balance sheets and current and performing debt.

Suriname completed a restructuring about a year ago. Zambia a handful of months ago. Ukraine sort of preemptively restructured their debt. Hopefully we're in the final moments of a debt restructuring in Ghana as well. So, in some sense, this is breathing new life and new opportunities into the asset class as these things get dealt with.

TWST: Thank you. (ES)

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