TCW

INSIGHT

VIEWPOINT

A Balanced Approach to EM Investing

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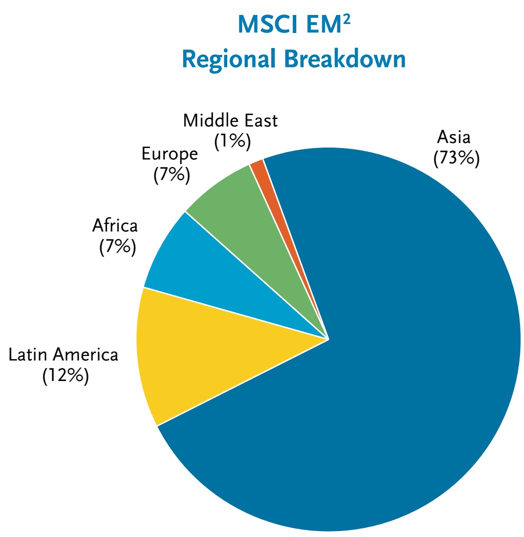
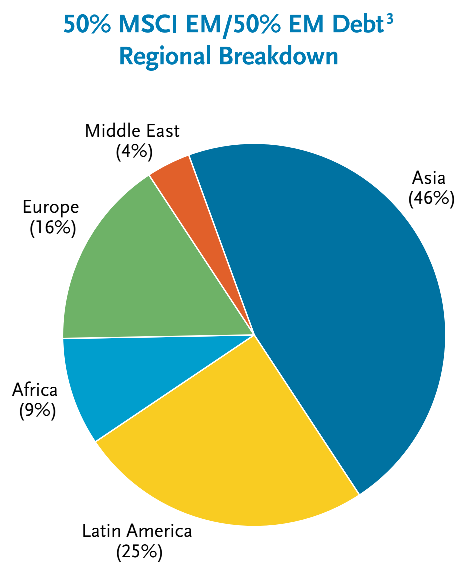
We remain constructive on the outlook for EM assets. A blended EM Equity/EM Debt Strategy is an attractive lower volatility alternative to a pure EM equity strategy, enabling investors to capture the bulk of the upside, while improving downside capture.

2017 was characterized by synchronized global growth and low inflation, both of which benefited Emerging Markets Equities. The asset class returned 37.3%[1], almost doubling the return of the MSCI World Index (Developed Markets Equities) for the second year in a row. While we don't expect Emerging Markets (EM) assets to perform at the same pace in 2018, we see scope for outperformance by EM equities relative both to developed markets equities and EM fixed income. First, not only is the growth recovery broad based across countries and sectors, but also, the spread between EM and Developed Markets (DM) growth is widening, which historically has benefited EM assets. Furthermore, we see potential for the rebound in global capex to extend the growth cycle in Developed Markets, which directly benefits EM through more supportive commodity prices and increased global trade.

While the backdrop is favorable for EM equities, both on an absolute and relative basis, some investors may want to express or add EM exposure via a more risk-controlled vehicle. One attractive way to achieve this objective would be to invest in a blended strategy that incorporates both EM equities and EM fixed income, with allocations actively managed on a real-time basis, depending on the market cycle. We see this as a lower volatility alternative to a pure EM equity strategy, enabling investors to capture the bulk of the upside, while reducing downside capture, with the debt component helping to dampen volatility and provide stable current income. In addition, incorporating EM debt improves regional diversification, reducing the concentration of Asia, and provides access to the entire capital structure for individual companies.

1 MSCI Emerging Markets Net Total Return Index

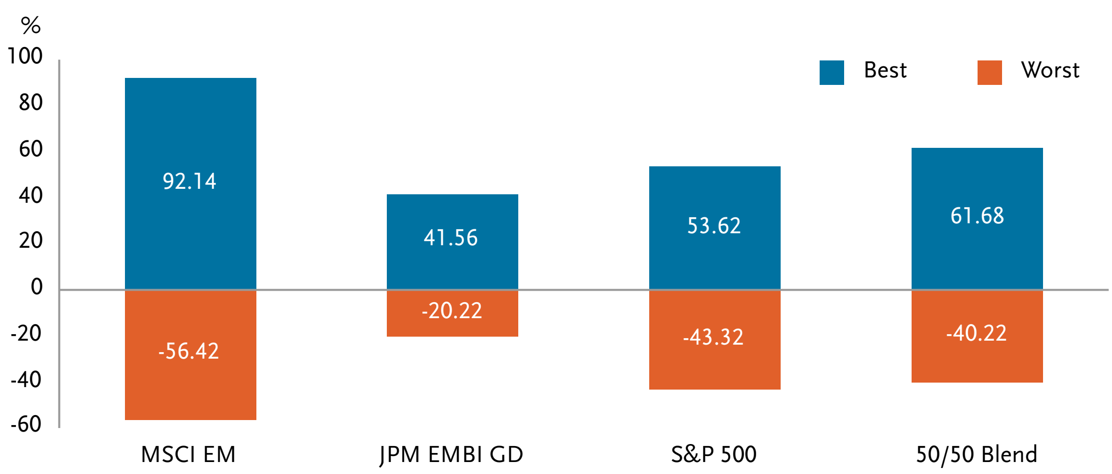




Source: TCW Portfolio Analytics, December 31, 2017
2 MSCI Emerging Markets Net Total Return Index
3 JPM EMBI Global Diversified Index

For illustrative purposes, below we present a comparison of a simple 50/50 blend ("blend") of the MSCI EM and the JP Morgan Emerging Markets Global Diversified (EMBI GD), the major dollar-denominated EM sovereign debt index, against the standalone EM equity and debt indices and the S&P. Not surprisingly, over the last 20 years, the MSCI EM posted the highest return for any single 12-month period (over 90% from 2/27/09 to 2/26/10). Both the MSCI EM and the blend performed best during periods of rising growth. During periods of falling growth, however, the debt sleeve of the blend provided return protection; the worst rolling 12-month period for EM debt was approximately -20% versus -56% for EM equity. Notably, the blend's highest and lowest 12-month rolling returns were both better than those of the S&P, which is typically a major holding in most global portfolios.

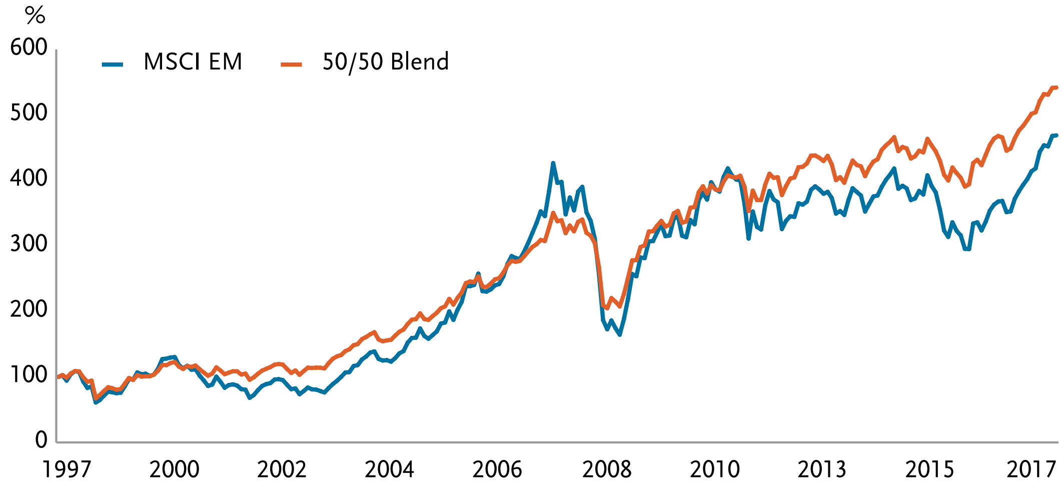
Best and Worst 12 Month Returns



Source: TCW Portfolio Analytics; Data as of November 30, 2017

Furthermore, over the past 20 years, the cumulative return on the 50/50 blend has exceeded the MSCI EM return by 88bps annualized, with a beta of 0.65. Put simply, the debt component has enhanced returns by tempering drawdowns and shortening drawdown recovery time.

Cumulative Returns



Source: TCW Portfolio Analytics; Data as of November 30, 2017

As such, Sharpe ratios are higher for the blend versus the MSCI EM over both short- and longer time periods with an up capture of 63% and a downside capture of only 66%.

Period Ending November 30, 2017		Annualized Return (%)	Sharpe Ratio	Up Capture (%)	Down Capture (%)	Beta
5 Years	50/50 Blend	4.93	0.49	68.30	69.30	0.65
	Emerging Equity	4.98	0.33	100.00	100.00	1.00
10 Years	50/50 Blend	4.85	0.30	63.40	63.90	0.64
	Emerging Equity	1.70	0.06	100.00	100.00	1.00
20 Years	50/50 Blend	8.91	0.44	63.20	65.60	0.65
	Emerging Equity	8.03	0.26	100.00	100.00	1.00

Source: TCW Portfolio Analytics

Implementation and Outlook

We believe the optimal blended strategy is one with the flexibility to actively adjust allocations between equity and debt in order to capture market upcycles while managing downside risk. At TCW, we have a long track record of managing EM blended strategies, through a limited partnership product (launched in 1987) and the TCW Emerging Markets Multi-Asset Opportunities Fund (launched in 2013). Focusing on the best ideas in the emerging and frontier equity and debt markets, the strategy allows investors to capture all stages of development in a particular country and shift capital structure positioning over time to reflect those segments with the most attractive risk-adjusted return dynamics. Generally, a strong growth environment favors the equity markets, while the debt markets provide better defensive trades in a less robust environment. Local currency debt is something of a hybrid between the two – offering stable fixed income through coupon payments and beta to growth through FX appreciation potential.

We also see this as an interesting way for investors without any exposure to EM to more easily access both the equity and debt markets through a single vehicle. Emerging markets currently represent 59% of the global economy and an estimated 77% of 2018 global growth.[4] Typically, they benefit from strong demographics, a rising middle class, and a growing local investor base. Moreover, EM has grown to represent close to 16% of global fixed income and 12% of global equities, warranting a standalone allocation to the asset class.

As for timing, we believe that the current environment of high growth and low inflation will continue to bode well for Emerging Markets in 2018. Specifically:

- The synchronous global growth story continues, which directly benefits Emerging Markets through improved trade and a stronger commodity price environment. This growth story has been broad-based, rather than concentrated in a small number of countries. The spread between EM and DM growth is likely to increase for the second year in a row, which typically leads to foreign direct investment and passive investment flows.

- Relative valuations are supportive for both EM equities and debt, when compared to developed markets. Earnings growth should continue to support EM equity markets (estimated at 11.5% for 2018 plus an expected 2.9% in dividend income) and, while EM equity valuations are in the top quintile relative to history, EM P/E ratios are well below those of the S&P and free cash flow yields are higher. We believe there is scope for P/E ratios to increase over time. As for EM debt, with average yields of 5-6% (with the potential to capture more in select markets), valuations remain attractive versus developed markets, particularly considering that close to 60% of global fixed income trades below 2%.

- Despite strong inflows last year, most investors remain underweight EM. We expect technicals to remain supportive in light of this underweight, and continue to see investor interest to add exposure to the asset class. ■

4 Based upon PPP using IMF estimates.

Author Biographies

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Mr. Prasad is a Portfolio Manager for the TCW Emerging Markets and International Equities Groups. Prior to joining TCW in 2014, Mr. Prasad was the Director and Senior Portfolio Manager for emerging markets equities at Batterymarch Financial Management. In that capacity, he managed the investment process and co-led the emerging markets team. At Batterymarch, he was also a member of the investment strategy and research leadership team, which oversaw all investment products. Before Batterymarch in 1996, he worked in strategic planning at Modi-Revlon Inc. and at J. Walter Thompson. Mr. Prasad holds an MS in Finance from Boston College, an MBA from the Indian Institute of Management, and a BA (with Honors) in Mathematics from St. Stephen's College in New Delhi, India. He is a CFA charterholder.

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Mr. Glukhov is a Co-Portfolio Manager for the TCW Emerging Markets and International Equities Groups. Prior to joining TCW in 2011, Mr. Glukhov spent over a decade in sell side equity research focusing on Internet and enterprise software, most recently as a Managing Director at Brean Murray, Carret & Co. Mr. Glukhov holds a BA in International Business from Peter the Great St. Petersburg Polytechnic University in Russia and an MBA from the University of Texas at Dallas. He is a CFA charterholder.

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Ms. Goodly is the Portfolio Specialist for the TCW Emerging Markets and International Equities Groups. In this role, she serves as the primary liaison between TCW's Emerging Markets investment team and TCW's client relations and marketing professionals and is responsible for communicating investment strategies, performance and outlook to clients. Prior to joining TCW in 2013, Ms. Goodly spent eleven years at Morgan Stanley, most recently as an EM Fixed Income institutional salesperson. At Morgan Stanley, she also served as the Asia Credit Product Manager, marketing Asian credit products globally to the firm's largest institutional clients. In addition, she spent several years working as part of Morgan Stanley's Institutional Investor-ranked U.S. Credit Strategy research team. Ms. Goodly currently serves on the board of Consano. Ms. Goodly graduated with a BA in Economics from Stanford University.