TCW

INSIGHT

VIEWPOINT

A Balanced Approach to EM Investing

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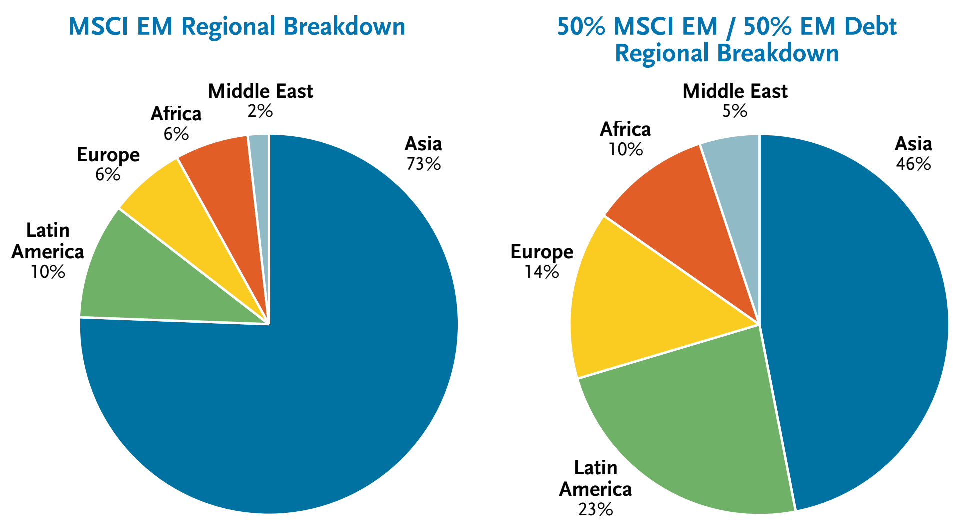
A blended EM Equity/EM Debt strategy is an attractive lower volatility alternative to a pure EM equity strategy, enabling investors to capture the bulk of the upside, while improving downside capture. Such a strategy enhances portfolio diversification, by providing exposure to a broader opportunity set, and allows investors to take advantage of the overall and country-specific economic cycles.

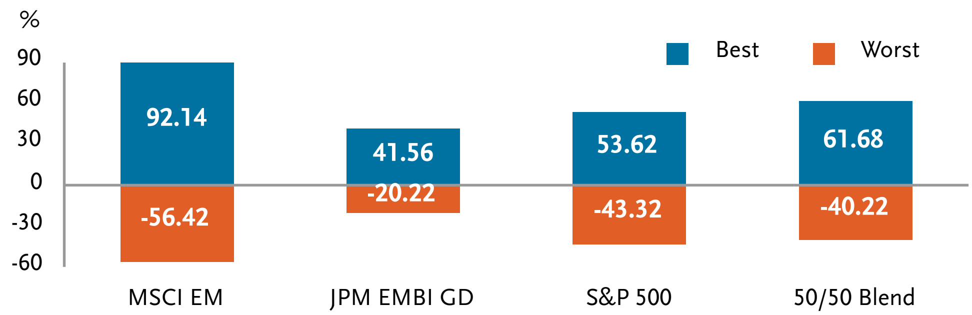
Emerging Markets (EM) equities have provided investors with years of significant upside, but risk-adjusted returns have underperformed other major global asset classes. One attractive way to access EM equity upside, while managing drawdown risk, is to invest in a blended strategy that incorporates both 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 potentially 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 can help to improve regional diversification, reducing the concentration of Asia and increasing the number of investible countries from 24 to approximately 80, and providing access to the entire capital structure for individual companies.



Source: TCW Portfolio Analytics, February 28, 2019

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 twelve month period (over 90%). 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.

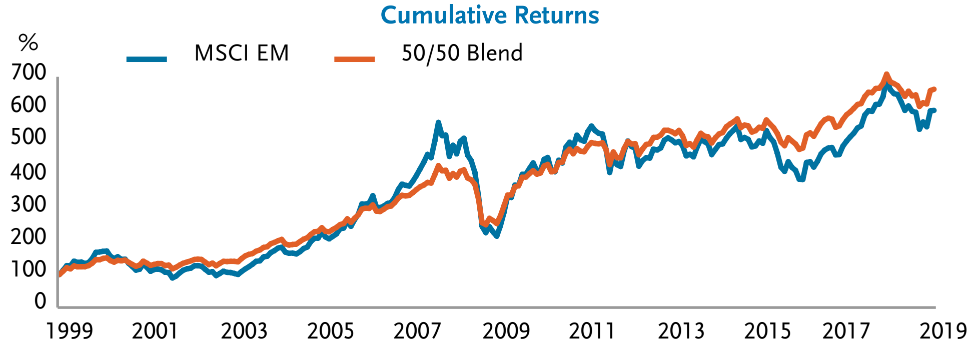
Best and Worst 12 Month Returns



Source: TCW Portfolio Analytics; Data as of February 28, 2019

Furthermore, over the past 20 years, the cumulative return on the 50/50 blend has exceeded the MSCI EM return by 46 basis points annualized, with a beta of 0.62. Put simply, the debt component has enhanced returns by tempering drawdowns and shortening drawdown recovery time.

Cumulative Returns



Source: TCW Portfolio Analytics; Data from February 28, 1999 - February 28, 2019

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 62% and a downside capture of only 63%.

Period Ending February 28, 2019		Annualized Return	Sharpe Ratio	Up Capture	Down Capture	Beta
5 Years	50/50 Blend	5.16%	0.46	65.53%	64.53%	0.63
	MSCI EM	4.52%	0.25	100.00%	100.00%	1.00
10 Years	50/50 Blend	10.02%	0.79	63.16%	61.55%	0.63
	MSCI EM	10.70%	0.54	100.00%	100.00%	1.00
20 Years	50/50 Blend	**9.81%**	0.57	62.10%	62.69%	0.62
	MSCI EM	**9.35%**	0.35	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 the TCW Worldwide Opportunities Strategy (launched 1987) and the TCW Emerging Markets Multi-Asset Opportunities Fund (launched 2013). Focusing on the best ideas in the emerging and frontier equity and debt markets, the strategy allows investors to potentially 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. Asset allocation decisions between equity and debt are driven by our views on economic growth, valuations and technicals. Generally, a strong growth environment, as well as a widening EM/DM growth differential, favors the equity markets, while the debt markets provide better defensive trades in 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 close to 60% of the global economy and an estimated 70.6% of 2019 global growth[1] and benefit from strong demographics, a rising middle class, and a growing local investor base. Moreover, EM has grown to represent approximately 20% of global fixed income and over 25% of global equities, warranting a standalone allocation to the asset class.

We would be pleased to discuss this in more detail with you. ■

1 Source: IMF World Economic Outlook as of October 2018

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. 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 and is an Ambassador for Girls Who Invest. Ms. Goodly graduated with a BA in Economics from Stanford University.

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GLOSSARY OF TERMS

Basis Point – One hundredth of one percent, used chiefly in expressing differences of interest rates. **Beta** – The sensitivity of a stock (portfolio) to the market (benchmark) in the capital asset pricing model. It is comprised of the volatility of a stock and its correlation with the market (benchmark). **Capital Ratio** – The ratio of a bank's capital to its risk. **Capital Structure** – A capital structure is a mix of a company's long-term debt, specific short term debt, common equity and preferred equity. The capital structure is how a firm finances its overall operations and growth by using different sources of funds. **Defensive** – Stock that provides a constant dividend and stable earnings regardless of the state of the overall stock market. **Drawdown** – A decline in an investment or fund. **Emerging Market (EM)** – A country that has some characteristics of a developed market but is not a developed market. This includes countries that may be developed markets in the future or were in the past. **FX Foreign Exchanges** – The exchange of one currency for another, or the conversion of one currency into another currency. **Frontier Markets** – Frontier markets are countries with investable stock markets that are less established than those in the emerging markets. **JP Morgan EMBI Global Diversified Index (EMBI GD)** – A market capitalization-weighted total return index of U.S. dollar and other currency denominated Brady bonds, loans, Eurobonds and local market debt instruments traded in emerging markets. **MSCI** – An investment research firm that provides indices, portfolio risk and performance analytics and governance tools to institutional investors and hedge funds. **Risk-Adjusted Return** – Refines an investment's return by measuring how much risk is involved in producing that return, which is generally expressed as a number or rating. **Rolling Returns** – The annualized average return for a period ending with the listed year. Rolling returns are useful for examining the behavior of returns for holding periods similar to those actually experienced by investors. **Sharpe Ratio** – A risk-adjusted measure calculated as the ratio of excess return to standard deviation. The Sharpe ratio determines reward per unit of risk. The higher the Sharpe ratio, the better the historical risk-adjusted performance. **Technicals** – Analyzing statistics generated by market activity, such as past prices and volume. **Valuations** – The process of determining the current worth of an asset or company. There are many techniques that can be used to determine value, some are subjective and others are objective. **Volatility** – A measure of the risk of price moves for a security calculated from the standard deviation of day-to-day logarithmic historical price changes.

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