Siddharth Dahiya

Episode 243: Extension Strategies in Emerging Debt

GUEST Q & A

Stewart: Welcome to another edition of the InsuranceAUM.com podcast. My name's Stewart Foley, I'll be your host. Hey, welcome back and thanks for joining us. We've got a great podcast for you today. We're going to be talking about emerging market debt, and specifically extension strategies in emerging market debt. And we're joined today by Sid Dahiya, who is the head of emerging market corporate debt at Aberdeen. Sid, thanks for taking the time. Thanks for coming to educate us today. We really appreciate you being on.

Sid: Thank you Stewart. Thanks for having me.

Stewart: We are thrilled that you're here. We've got a lot to talk about on emerging market debt. We haven't done a podcast on this asset class for a minute, and you're neck deep in it, so I can't wait to pick your brain a little bit. But before we get going too far, we'll start this one the way we always do, which is where did you grow up? What was your hometown? And what was your first job? Not the fancy one.

Sid: Great. Sure. So I was born and raised and all my education was in India. My hometown is in the north of India. Not many people would've heard of it, so I'll spare your listeners the name. But I grew up, my very early years were in a very different India to what we see today. This was the time before liberalization and reforms of 1991. I'm originally from an EM country, and I think I have first-hand seen the benefits of what changing economic policy can do, and how they can impact a large population for the positive. And what was my first job? My first job was actually, I was trained as an engineer, and my first job was in tech, in a coding job. But I wasn't very good at it. It didn't take me very long to realize that I should be changing tracks.

Stewart: So you started, you weren't mowing lawns or milking cows or anything else? You started, your first job was a lofty, that was a lofty start there. So I can appreciate that. I mean, I went down the road of, I started out as a computer science major. And I just didn't understand what the math requirement was, and so I was redirected, or redirected myself into finance. But I can appreciate the challenges of coding, especially back in the time period when you're talking about, so very cool.

Sid: That's right. Straight out of college wasn't the easiest job. But yeah, glad I changed.

Stewart: Yeah, us too. So that's what we're here to talk about today. So Aberdeen's got a really interesting history in insurance and in emerging market debt. And for those who might not be familiar, can you give us a high level overview of Aberdeen and, there's a standard life component and there's been a merger along the way and so I think it would be helpful to just kind of people understand the heritage that comes with Aberdeen.

Sid: Sure, Stewart. Yeah, absolutely. So Aberdeen was formed... In this current format, was formed in 2017 as a merger of two UK-based asset managers. The first of them was Standard Life, which is one of UK's oldest and largest life insurance companies. This was actually formed almost 200 years ago, so a very, very long heritage. The other one was Aberdeen, which actually had a very long history of investing in emerging markets, both equities as well as fixed income. I think we, Aberdeen, have been investing in EM for more than 40 years now. Really from very much from the infancy of the asset class. So yeah, so those two companies combined have a very strong heritage in insurance assets. As a firm, as far as I'm aware, we serve more than 150 insurance companies globally with more than $230 billion of AUM across a range of asset classes.

Stewart: And so today's, we're focused entirely on EMD. Can you talk a little bit about your history? I mean, my notes say that you've been in this market, in the emerging market, debt market for over 40 years. Talk a little bit about that.

Sid: Yeah. So the Aberdeen business is well known for investing in EM. We started off in the emerging market equity business because that is an older business than the fixed income world in EM. And when the fixed income world started gaining traction within EM, we were very much one of the first movers in the market. We have been doing this, like you said, for more than 40 years. We have offices across the world, many EM countries, plenty of offices in Asia, in Latin America, in Middle East. We have on-ground resources to cover these companies and countries across EM. We've looked at these countries and companies across different cycles, across different crises. So yeah, so there's a lot of in-depth knowledge about EM embedded within the business.

Stewart: And what about on the technology front? Are there any proprietary tools or things that have been developed over the years that are still being used today?

Sid: Yeah, I think that's really important when it comes to the philosophy that you have in terms of investing. And we have, as a firm, we have a very bottom-up driven philosophy. And I feel sometime, people who invest from a bottom-up basis tend to sort of diminish the importance of macro top-down factors. We are under no illusion. We don't think the macro or top down is not important. And I think in order to have a successful strategy, you need to marry the two bottom-up analyses as well as top-down analyses. And we have a couple of proprietary tools which help us do that. These tools look at different macro sensitivities, they tell us if we are overexposed or underexposed to any particular macro risk factor, et cetera. So they really help us in terms of risk management, which actually is very appealing to some of our clients where risk tolerance is very much within their mandate.

Stewart: And so, can you talk a little bit about the secular trends in EMD. And what would be helpful, I think, is to talk a little bit about the size and characteristics of that market. And we've done other podcasts on EMD, but it's been a minute. So can you just get our audience current on the situation that is out there today?

Sid: Sure, Stewart. And I'm going to be a little bit technical, so stop me if you think anything is not relevant. But just looking at some of the more secular trends within EM, the bigger picture. So what is the size of the market? And I'm talking about the EM corporate debt market here. This is the corporate debt market denominated in our currency, predominantly the US dollar. Bond stock, the total outstanding size of the market is about $2.5 trillion. How does that compare to other markets? The sovereign market in EM is $1.5 trillion, so it's much bigger than that. The US high yield market is about $1.3 trillion, so much bigger than the US high yield market. Some of the more compatible markets are your IG, with around $3.1 trillion. Munis are around almost $4 trillion. But if you look at Euro high yield, this is almost five times the size of Euro high yield market.

Stewart: That's the thing that always surprises me. Is how big this market is.

Sid: That's right.

Stewart: And when you start thinking about it's double the size of US high yield. I mean it's not quite, but it's close. And you start thinking about that, it's like, I'm just not sure that everybody, when they think about EMD, remember that part, which I think is astonishing. Every time I... I've heard people throw some numbers around about how big this market is, and it always catches my attention.

Sid: That's very right. And it does show in the technicals and the holding picture that we see across the market. So for example, across EM, almost 65% of the bonds outstanding in the EM corporate debt market are owned by EM geographies themselves. So Asian investors owning Asian bonds, Middle Eastern investors owning Middle Eastern bonds. Only about 5% of the outstanding market is actually owned by US insurance and pension funds. That's the very small percentage of the market. We think this is a secular trend, this is going to increase over time. If you look at it from the perspective of US investors, EM corporate debt accounts for around 1.6% of US IG investors balance sheet and around 2.6% of US high yield investors. So again, a very small part of their investments. We think that this is going to increase as time goes on.

Stewart: So the title of the podcast is Extension Strategies in EM Corporate Bonds. And can you go in and give us a backdrop before you go into those particular extension strategies? Which I think there are three, but help us set the stage.

Sid: Yeah, absolutely. I mean, the other things that we can talk about, which we haven't so far, are credit fundamentals. In this market, and I think this is a slightly underappreciated fact, leverage for EM companies remains below pre-pandemic levels, and it's at the best point it has been in over 10 years. EBITDA margins very consistent over the years, interest coverage around 8 to 10 times. And what is very stark is the difference of leverage of EM companies advanced compared to US companies. So if you look at the investment grade part of our universe, the average net leverage of EM company is only 0.9 times. Whereas for a US company, it's 2.7 times. So almost 3 times as levered as an EM investment grade company. And I think if you were to go a little bit deeper into this, in my view, actually, Taper Tantrum, back in 2013, 14, worked in very different ways across DM and EM. What happened to develop mark... And by DM, I mean Developing Market Companies, US companies predominantly.

What happened to US companies after Taper Tantrum is that they enjoyed excessively loose monetary policies, and increased debt, whereas EM companies realize that they get punished very severely if leverage is high. So you see a very stark contrast, a very big divergence happening in 2014. Up until 2014. Actually, you might be surprised to know that net leverage for EM and US companies was exactly the same. Fast-forward 10 years, there is a threefold difference in net leverage between US companies and EM investment-grade companies. So I think that is a very interesting fact about EM. And we see similar, not quite as stark, but similar trends in the high-yield space. The net leverage for EM companies is around 2.3 times, whereas for US is about 3.4 times.

Stewart: That's interesting. And so what about liquidity in this market? I think that's something that every insurance company has in the back of their mind, one way or the other. And given the size of the market, it seems as though it would be considerably more liquid than high-yield, but something tells me that maybe it's not. So can you talk a little bit about the liquidity in the market under normal circumstances and then what happens if there's a bump in the road, if you will?

Sid: Yeah, I think that's a very important point and something that insurance companies, as any other investor, obviously, keeps into mind when they invest in this market. And I would say liquidity in our market could be better. We have seen, over the years, liquidity worsen a little bit. Having said that, if you look at just overall numbers, and I was looking at all the bonds that are trace legible, and what's the kind of daily turnover that we see in those bonds in our market, and it's around three, three and half percent, which isn't terrible I would say, but it varies a lot. Some of the bigger issuers in the investment-grade space are a lot more liquid than a small high-yield issuers. So it's very difficult to generalize. You'd find that there are parts, pockets of our market which are a lot more liquid than an average US high yield bond. But yes, there are also parts of our market which are less liquid.

Stewart: That's helpful. I mean, I think that that comes with... If you think about it, there's a lot of what I've heard referred to as tribal knowledge. Which is you learn things over time, which is the value of experience. So it's like if you said, "Give me a chart that communicates that," it's like it's not really a chart, but you have to have the experience in that market to understand those dynamics. Is that a fair assessment or am I overstating that case?

Sid: I think it's a fair assessment. You need to know when you invest in EM, there are idiosyncrasies of investing in the EM market. Politics is an important driver of risk premium across EM and investing in EM also requires, in some instances, understanding the political nuances of each country, all the risks that accompany that country. And if you've been investing in that market for, let's say decades, you've seen a few cycles, you are probably better suited to appreciate things that can go wrong.

Stewart: Yeah. It's interesting whenever, I think about, folks talk about the political environment in EM and I'm like, "Have you looked at the DM political environment lately?" I mean our politics, it's like the wild west. So we've been teasing the extension strategies for a minute here. And so would you mind jumping off into that topic specifically and talk about the first extension strategy?

Sid: Yeah. I mean look, there's a few ways you can implement band-aids or investments for insurance clients across EM fixed income. I think the first one is the time-tested investment grade buy and hold book, which works very well across EM in particular. I'd say because of the breadth of the corporate market, the available opportunities, and the ability for us to really match liabilities with cash flows, that is something, in long-term liabilities with long-term cash flows. And the EM market offers significant duration across the investment grade portion. The other thing that's quite interesting with this market is that in general, curves in EM are steeper than comparable curves in the US market or US credit market, which is very attractive again for long-term investors. So just throwing some numbers out there, 10s, 30s in EM aggregate around, obviously it depends on the time, but around, let's say 75 basis points. Whereas in the US IG market, that's probably closer to 20 basis points.

Now this is skewed a little bit by Latin America, where the curves are a lot steeper than other parts of EM. In particular, Asian, Middle Eastern curves are less steep, but still, for investors coming to the EM market, they benefit from duration or access to duration, and fairly steep curves in fairly high quality corporates.

Stewart: Yeah. And one of the questions I guess I have is, when you're talking about a buy and hold strategy, what kind of flexibility... If I'm a hypothetical CIO, can I put a specific duration target on a separately managed account? And can I have bespoke quality hurdles and can I manage my industry exposure? Are those things that are... Or am I going to get more of a homogenous strategy?

Sid: No, absolutely not. This is the thing. With EM, we're looking at a universe of close to 1000 companies if you include everything that's in our benchmarks, and outside of it. Within 1000 companies, if you strip out the high yield part of the universe, there's still a very big chunk. More than half of our universe, actually almost 60%, is investment grade across all the various geographies of EM and across a range of industries. I mean 10 years ago, it used to be different. These days, there are a lot of industries, pretty much every industry being represented in EM fixed income, and you can construct a very diversified portfolio for whatever, 10, 12, 15 year duration, with any other requirements that you have from an industry point of view, minimum size, etc. All of those things.

Stewart: Okay, so that's super helpful. That is under the category of buy and hold. There's two more. What's the next one?

Sid: So the other one is for those investors that are able to add a bit of crossover or high yield to their portfolios. It could be a 90/10 or an 80/20 portfolio with 80, 90% IG. We could really add some really interesting high yield names, the best ideas from the high yield universe in EM. And really, you have to think of high yield or higher quality high yield in a slightly different way when it comes to EM. Now EM corporate credit is probably the only market where you can find very high quality investment grade companies punished for being in a low rated country and facing a sovereign rated ceiling. So you could have an IG balance sheet in a BB country being rated BB. So what you get in return is investing in a strong balance sheet, getting paid, high yield, which does add... If you look at empirical data, you can see that adding these kinds of companies in a small amount, 10%, 20% does improve the risk-return characteristics of a portfolio, adds diversification of all of those other benefits.

Stewart: And so does the opportunity for crossover... Is there a sweet spot in terms of how much high yield I want to sprinkle in? Does that sweet spot move as relative value moves? I mean would I say, "Hey, we can go up to 15% crossover credits," and you're going to have some discretion around whether you're at 15 or seven or nine depending upon what the relative value is between IG and high yield. Is that how you run it?

Sid: That's very right. Yes. I mean, at different points of time, you can have a different mix of the two markets, which gives you the best return outcome. But having a leeway, it generally helps to be able to move risk up or lower in the high yield space. But we are not talking about big numbers here, we are talking 10% to 15% to 20% at most can add a lot of stability, a lot more spread on the portfolios.

Stewart: All right. So extension strategies, we've covered buy and hold, we've covered crossover. And what's the last one?

Sid: The last one would be something that we've been exploring in recent times. There's different ways to look at EM. Because of the size of the EM market, we can look at some thematics in EM. So for example, we've been working with one of our clients to launch a portfolio on companies in EM that benefit from the de-globalization or nearshoring concept that we've seen in the markets in recent times. And again, within that remit, because of the breadth of the investment opportunity, we were able to construct a very well-diversified portfolio of companies. And this is diversified across geographies, across countries, across industries. But well-diversified portfolio of companies which benefit from this structural long term trend of nearshoring or de-globalization. Now, granted that these kinds of thematics are a little bit more popular on the EM equity side, but within fixed income, also you can find these opportunities.

Stewart: That's super helpful. And Sid, I've gotten a great education on emerging market corporate debt. Any final thoughts for this audience on the way out the door? I've got a couple of fun ones for you, but just to wrap up our investment discussion, what's next?

Sid: Yeah. Look, I mean we talked about how big the market is, $2.5 trillion in size. But one of the things that we did not discuss is that in this market, because of various factors, because of investors attitude towards EM over the last few years, various other events, geopolitical events, issuance has been really weak. So we have seen net negative issuance in the market for the last few years. So net financing this year is going to be around negative $140 billion, so it's a big number. What that means is that even though it's a big opportunity set, there are times, there are periods where it doesn't grow as much as you'd like it to grow, and you need to think outside the box.

Some of the things that we have been looking at, and we can focus a lot more, and it actually gels very well with the long-term nature of insurance capital, are private placements, structured transactions, pre-export finance deals, DPRs. Not necessarily private credit, but not very far from it. I would call it less liquid stuff, which gives you enough premium for the illiquidity, and if you get the credit right, which hopefully we do, it's a great source of investments for someone with long-term capital.

Stewart: That is super cool. I'm happy to know about the latest developments in this market, and I'm glad that you've been on the show to be our professor for a day if you will. So I've got a couple of fun ones for you out the door. I want to take you back to earlier in your career, when you first got out of school, or when you were... Still early days, what do you wish you would've known at that point? Or put another way, what would you tell a 21, 22, 23-year-old Sid Dahiya?

Sid: Yes, that's a good question. I think one of the things I'd say is very important to understand really early on in life is that, and it might sound very cliche, but is that attitude is everything. Very early on in life, it becomes quite apparent that people with similar abilities can end up at very different places, and luck or chance or being at the right place at the right time definitely plays its part, but it is one of the uncontrollables in life. Your attitude is very much a controllable that you can control, and the right attitudes enables you to be a good team player, fair operator, getting on with things when they don't work out, and generally helps you in life, helps you in getting ahead in life.

Stewart: That's super cool, and I agree with you. It's really interesting how it has a tremendous impact on how things go at the workplace, I think. So what about this fun one? So you could have a lunch, four people, including yourself. So you can invite anyone you want to lunch, alive or dead, up to three people. Who would it be?

Sid: Okay, that's a good one. There's a lot of people I can think of. I mean, I'm assuming that whoever it is, they're open and honest at this lunch, right?

Stewart: I think-

Sid: And you can pick their brains.

Stewart: Yeah, of course. I think it depends on who you pick, but for sure.

Sid: Yeah.

Stewart: Yeah.

Sid: I think one of the persons I have in mind, and I don't think there's a danger with them not being open and honest is Novak Djokovic.

Stewart: Oh wow, there you go.

Sid: He is very unconventional, but very successful. Arguably the greatest athlete of our generation, you could say.

Stewart: Wow.

Sid: Comes from adversity, he has a winner's mindset, he really tries in tough conditions. The crowd, very often against him over the years. He's very articulate, very thoughtful. He is not afraid to be contrarian. He's very strong on his convictions. I mean, he would make excellent company for lunch, I think.

Stewart: Absolutely. Anybody else or just him?

Sid: I think that's fine. I think he would occupy the space very well for lunch.

Stewart: I completely agree with you. What an interesting choice. That's cool. So thanks for being on, and thanks for being a professor for a day. We certainly appreciate the education on EM corporate debt today. So thanks so much.

Sid: Great. Thanks Stewart. Thanks for having me on.

Stewart: We've been joined today by Sid Dahiya, who is the head of Emerging Market Corporate Debt at Aberdeen. Please rate us, like us, and review us on Apple Podcast, Spotify, or wherever you listen to your favorite shows. My name is Stewart Foley. We'll see you next time on the InsuranceAUM.com podcast.