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THREE REASONS TO CONSIDER DEDICATED EMERGING MARKET DEBT EXPOSURE

Catherine LeGraw and Ben Inker | February 2025

Some allocators may focus their search efforts on corporate credit segments or simply a portfolio that can opportunistically trade across fixed income sectors. We encourage investors to consider including a dedicated allocation to emerging market debt (hard currency) because we believe:

1. **Emerging market debt may offer excellent long-term beta return**
2. **Emerging market debt may offer strong alpha potential**
3. **Many investors are underallocated to the asset class currently**

Beta Exposure: Excess Credit Returns & Diversification

Emerging market debt is an asset class that has delivered strong credit returns for the risk underwritten, and the credit cycle is differentiated from corporate or consumer cycles.

Historically, emerging market debt has offered an average credit spread¹ of **370 bps over duration-matched Treasuries** to bear the risk of sovereign default. Sovereigns rarely default² and almost always offer decent recovery values (because sovereigns need to access the credit markets again, in contrast to corporations who can simply disappear). The asset class has offered not only a lower annual default rate, but also a diversifying pattern of defaults relative to corporate or consumer defaults, which follow the U.S. business cycle.³ While emerging market debt investors will likely suffer mark-to-market losses from spread-widening in tough economic environments, that temporary pain is inherently different from the permanent impairment of a default.

Over the past 30 years, emerging market bonds have delivered **8.6% annualized return** compared to 5.1% from emerging market equities and 7.0% for U.S. corporate high yield – this is an asset class that deserves space in a diversified portfolio.

1

Spread is duration weighted using J.P. Morgan EMBI Global Diversified Index as a proxy for emerging market debt. Applying this weighting methodology reduces the impact of sovereign and quasi-sovereign issues in default on the overall index spread.

2

Average annual emerging market sovereign defaults are less than 2% with an average recovery of roughly 40%, according to Moody's data.

3

For more on this point, please see [The What-Why-When-How Guide to Owning Emerging Debt \(2024\)](#).

30-YEAR ANNUALIZED RETURNS IN USD (1994-2024)

MSCI Emerging Markets	5.1%
Bloomberg U.S. Corporate High Yield	7.0%
J.P. Morgan EMBI Global Diversified	8.6%

Alpha Opportunity: Consistent Active Outperformance

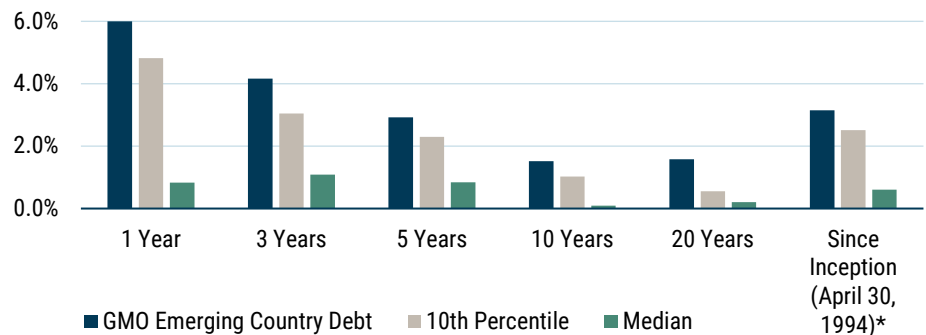
Emerging market debt is an inefficient asset class with high breadth and complexity spanning:

- countries (GMO allocates to over 85 countries),
- individual bond issues (some with unique terms), and
- sovereign debt, as well as sovereign-controlled corporate debt (e.g., state-owned utility or oil companies).

Index construction favors liquidity, not return maximization. As a result, **competent active management has historically been well rewarded**. The median manager has offered consistent excess returns, and a top manager can significantly distance themselves from the rest.

EMERGING COUNTRY DEBT (HARD CURRENCY) ALPHA

Annualized Excess Returns (Net) vs. J.P. Morgan EMBI Global Diversified Index



	1-Year	3-Year	5-Year	10-Year	20-Year	ITD
GMO Emerging Country Debt	6.03%	4.17%	2.92%	1.52%	1.58%	3.15%
10th Percentile	4.83%	3.05%	2.30%	1.03%	0.56%	2.52%
Median	0.84%	1.09%	0.85%	0.10%	0.21%	0.61%

As of 12/31/2024 | Source: eVestment

*It's worth noting that there are few managers with 30-year track records. As such, data since inception is based on just 4 observations. The number of observations in subsequent periods were: 27 (20-Year), 61 (10-Year), 77 (5-Year), 84 (3-Year), and 92 (1-Year).

Insufficient Exposure: Investors Underallocate to EM Debt

Despite the solid realized long-term returns and diversification properties of emerging market debt, we suspect that many investors may have little to no exposure to this asset class. Of the fixed income strategies listed in the eVestment database, only 4.2% of strategy AUM have emerging market debt in the benchmark.⁴ For flexible mandates that have the ability to hold emerging market debt, the average allocation for the 20 largest strategies was 7.6% as of December 31, 2024.⁵

We believe a dedicated active manager with emerging market debt expertise is necessary to fully capture the alpha potential of this asset class. Many flexible credit strategies that tactically allocate to this space are primarily accessing beta exposure.

Emerging market debt is not without its risks as detailed above; however, investors have historically been paid a handsome spread to underwrite the risk of sovereign default. In addition to the beta return, we believe emerging market debt provides consistent, strong reward for capable active management. In our view, the only way to fully capitalize on both the beta and the alpha opportunity is through a dedicated, active emerging market debt mandate.

4

As of December 31, 2024.

5

Source: eVestment, GMO.



Catherine LeGraw

Ms. LeGraw is a member of GMO's Asset Allocation team and a partner of the firm.

Prior to joining GMO in

2013, she worked as a director at BlackRock. Previously, Ms. LeGraw was an analyst at Bear, Stearns & Co. She received her BA and her BS in Economics from the University of Pennsylvania. She is a CFA charterholder.



Ben Inker

Mr. Inker is Co-Head of GMO's Asset Allocation team and a portfolio manager for the team's products. Mr. Inker is a

member of the GMO Board of Directors and a partner of the firm. He joined GMO in 1992 following the completion of his bachelor's degree in Economics from Yale University. In his years at GMO, Mr. Inker has served as an analyst for the Quantitative Equity and Asset Allocation teams, as a portfolio manager of several equity and asset allocation portfolios, as Co-Head of International Quantitative Equities, and as CIO of Quantitative Developed Equities. He is a CFA charterholder.

Disclaimer

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ANNUALIZED RETURNS AS OF 12/31/2024 (NET, USD)

	<i>Inception</i>	<i>1-Year</i>	<i>3-Year</i>	<i>5-Year</i>	<i>10-Year</i>	<i>ITD</i>
GMO Emerging Country Debt Composite*	4/30/1994	12.57%	3.26%	3.04%	4.65%	11.67%
J.P. Morgan EMBI Global Diversified +		6.54%	-0.91%	0.19%	3.00%	8.19%

*Returns for one of the accounts in the composite are based on estimated market values for the period from and including October 2008 through February 2009.

Performance data quoted represents past performance and is not predictive of future performance.

Net returns are presented after the deduction of a model advisory fee and incentive fee if applicable. These returns include transaction costs, commissions and withholding taxes on foreign income and capital gains and include the reinvestment of dividends and other income, as applicable. Fees paid by accounts within the composite may be higher or lower than the model fees used. GMO LLC claims compliance with the Global Investment Performance Standards (GIPS®). A Global Investment Performance Standards (GIPS®) Composite Report is available on GMO.com by clicking the GIPS® Composite Report link in the documents section of the strategy page. GIPS® is a registered trademark owned by CFA Institute. CFA Institute does not endorse or promote this organization, nor does it warrant the accuracy or quality of the content contained herein. Actual fees are disclosed in Part 2 of GMO's Form ADV and are also available in each strategy's Composite Report.