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The Case for a Very Boring Emerging Market Debt Strategy

It has become fashionable to say that markets were blindsided by the February 24, 2022 Russian invasion of Ukraine. Unfortunately, the data doesn't quite support that view. Putin's widely noted essay, "On the Historical Unity of Russians and Ukrainians"¹ was published on July 12, 2021. It is fair to say that financial markets largely dismissed this essay as the nostalgic musings of an aging autocrat. In retrospect, it is odd that we largely ignored his public statement that Russia and Ukraine were one people, occupying the same historical and spiritual space.

The chart below shows the credit spread of the benchmark BBB- Russia 2047s versus the spread of the BBB Indonesia 2048s, from June 15, 2021 to February 18, 2022. (For purposes of scale, we have left out the subsequent parabolic increase in Russian yields.) We can see that the long-standing relationship between the two bonds went awry on January 13, 2022. On January 13, 2022, the world seemed to realize that Putin might be serious about recreating the Russian Empire, and the financial markets began repricing Russian risk.

A Reuters article captured the relevant mood of the day:

Poland's foreign ministers said on Thursday that Europe was at risk of plunging into war as Russia said it was not yet giving up on diplomacy but that military experts were preparing options in case tensions over Ukraine could not be defused.

In Washington, the White House said the threat of a Russian invasion of Ukraine remained high with some 100,000 Russian troops deployed and the United States would make public within 24 hours intelligence suggesting Russia might seek to invent a pretext to justify one.²

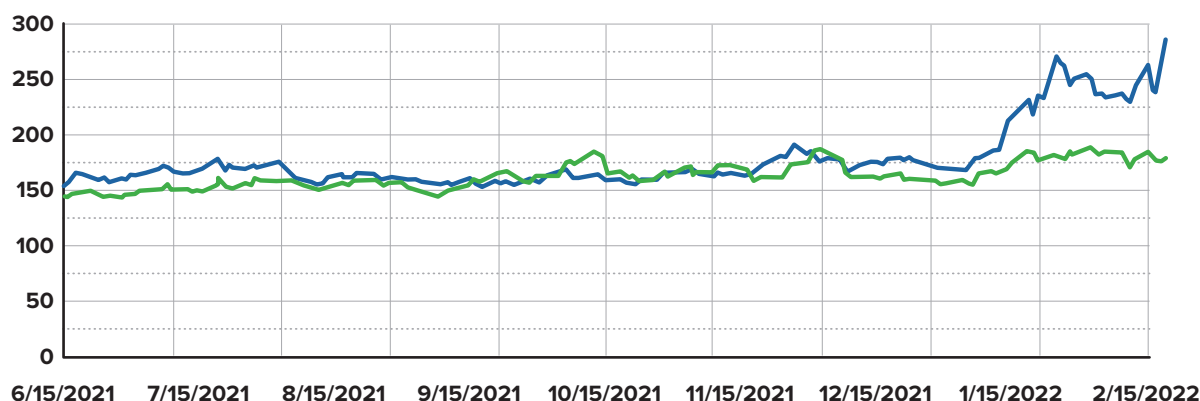


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Spread to US Treasury Benchmark

■ Russia 5^{1/4} 06/23/2047 REGS Corp ■ INDON 4.35 01/11/2048 Govt



Any investor claiming to be blindsided by a Russian invasion after January 13, 2022 should be sheepishly looking inward at their ability to incorporate new information into their investment process.

At LM Capital, we have a long-standing rule that we do not invest in countries that lack a “Rule of Law”.³ This is the reason that our accounts had no exposure to Russian issuers, on January 13, 2022, or for several prior years. The lack of institutional constraints on the actions of a near absolute ruler made Russian issuers inherently risky. We certainly were not alone in this assessment. The question for analysts and portfolio managers was: how great is the risk? Is the risk miniscule, like a large meteor? Or each year, was there a 2% chance of something very bad happening? What evil lurks in the hearts of men?

One source of information that we often use in our “Rule of Law” investment decisions is the World Justice Project’s Rule of Law Index.³ One particular interesting factor in that index is the rankings of countries according to their “Constraints on Government Power”.⁴

The World Justice Project describes this factor as measuring “the extent to which those who govern are bound by law. It comprises the means, both constitutional and institutional, by which the powers of the government and its officials and agents are limited and held accountable under the law. It also includes non-governmental checks on the government’s power, such as a free and independent press.”

When we talk about our “Rule of Law” consideration, we often use China, Russia and Turkey as examples of countries in which we don’t currently invest. These countries are led by “strongmen” who seem to govern with little regard for basic human rights. You can see in the chart below that these countries rank very near to the bottom of the Constraints on Government Power rankings.

Bloomberg Hard Currency EM by Country of Risk, with Constraints on Government Power Ranking (as of December 31, 2021)

	Constraints on Government Power Ranking	Weight	Option Adjusted Spread	Bloomberg Composite Rating
China	133/139	17.74	288.64	A-
Mexico	102/139	8.28	324.42	BBB-
United Arab Emirates	63/139	6.37	135.73	A+
Brazil	76/139	5.94	324.37	BB
Saudi Arabia	NR	5.73	131.95	A
Indonesia	98/139	5.38	191.98	BBB
Turkey	134/139	3.98	559.84	B
Qatar	NR	3.75	108.59	AA-
South Korea	25/139	3.26	60.85	A+
Chile	24/139	2.91	209.92	BBB+
India	52/139	2.82	286.48	BB+

Bloomberg Hard Currency EM by Country of Risk, with Constraints on Government Power Ranking (as of December 31, 2021) (continued)

	Constraints on Government Power Ranking	Weight	Option Adjusted Spread	Bloomberg Composite Rating
Colombia	72/139	2.47	375.52	BB+
Argentina	57/139	2.04	1,823.83	CCC-
Peru	48/139	2.01	224.42	BBB
Philippines	85/139	1.93	181.15	BBB
Israel	NR	1.86	232.18	BBB
South Africa	40/139	1.71	331.98	BB-
Panama	71/139	1.53	220.43	BBB-
Oman	NR	1.48	338.17	BB-
Malaysia	59/139	1.37	159.36	BBB+
Russia	129/139	1.36	3,256.88	BBB-
Bahrain	NR	1.20	358.54	B+
Dominican Republic	91/139	1.09	409.70	BB-
Egypt	138/139	1.07	744.36	B
Kazakhstan	NR	0.84	226.93	BBB-
Uruguay	18/139	0.77	159.51	BBB-
Kuwait	NR	0.76	170.09	A-
Nigeria	80/139	0.74	623.76	B-

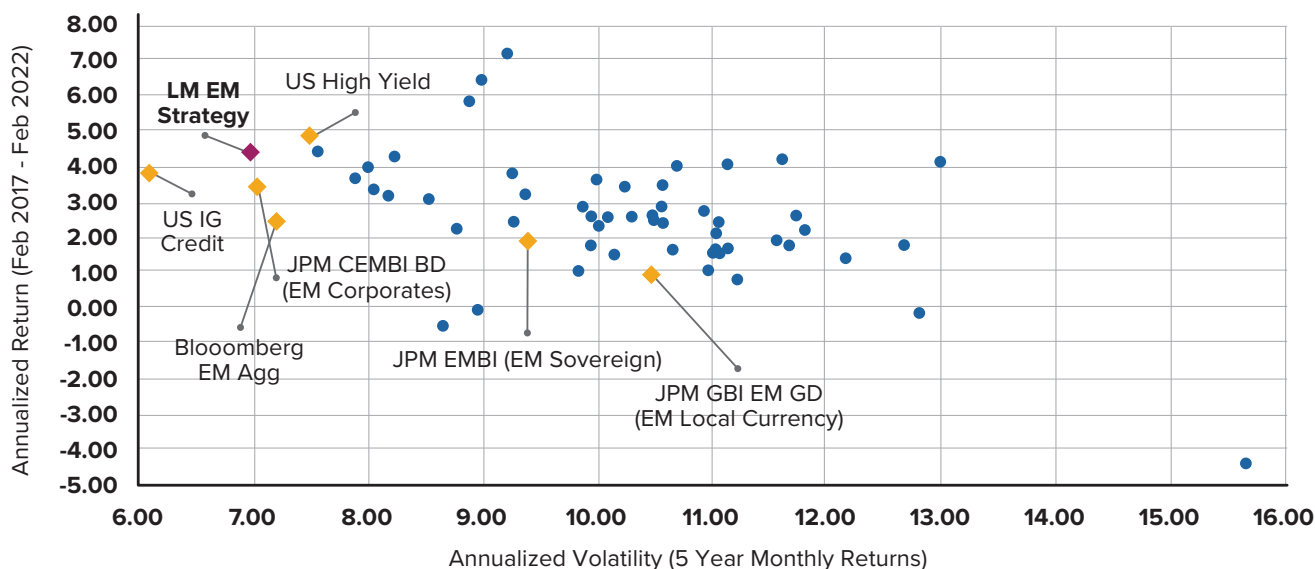
Sources: Bloomberg and World Justice Project

LM Capital looks at emerging market debt with a risk-averse approach that emphasizes principal protection. This approach leads us to higher quality sovereign and corporate issuers. We carefully consider the low probability, high-cost events to which the issuer is exposed. Our “Rule of Law” factor helps limit these low probability, high-cost events that are due to the whims of an absolute ruler.

Conclusion

LM Capital's "Rule of Law" constraint is part of an investment process that leads to excellent volatility-adjusted performance. The chart below shows that on a risk-adjusted basis, our Emerging Market Debt strategy has few peers.

EM Peer Universe (Annualized Risk vs Annualized Volatility)



Source: EMD manager universe is calculated using Bloomberg Mutual Fund data for 53 funds with 5 years of track record; Using Gross of fees returns for all Mutual funds/LM Capital. Volatility is calculated using 5 years of monthly returns (Feb 2017 – Feb 2022)

1. https://en.wikisource.org/wiki/On_the_Historical_Unity_of_Russians_and_Ukrainians
2. https://www.reuters.com/world/europe/russia-says-us-nato-talks-so-far-unsuccessful-2022-01-13/?-taid=61e0d220ed344f0001a65dbd&utm_campaign=trueAnthem:+Trending+Content&utm_medium=trueAnthem&utm_source=twitter
3. <https://www.lmcapital.com/wp-content/uploads/2019/10/LMC-EM-Debt-and-the-Rule-of-Law-191031.pdf>
4. <https://worldjusticeproject.org/sites/default/files/documents/WJP-INDEX-21.pdf>

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