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**EMERGING MARKET CORPORATE BONDS - MOVING CENTRE STAGE  
JULY 2011**

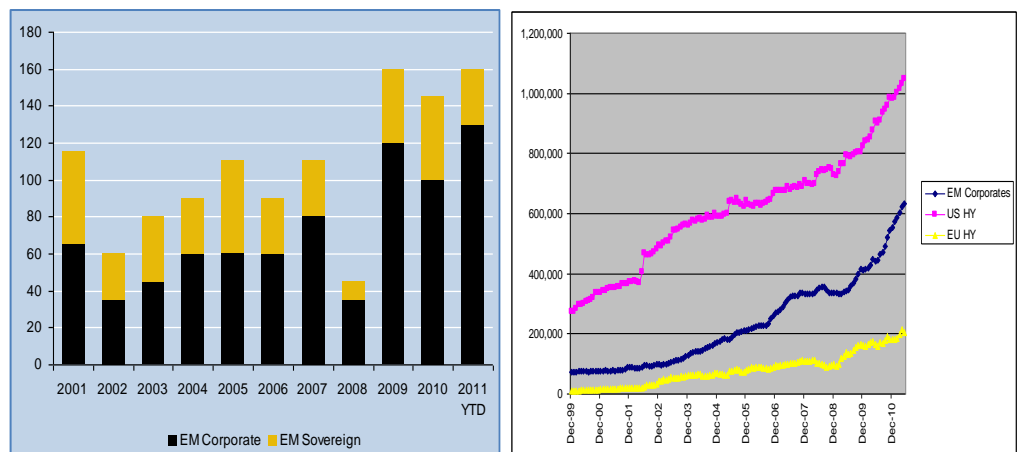
The impressive investment story in emerging markets has continued to develop in recent years. These countries are characterised by high growth, favourable demographics, manageable fiscal positions and low debt levels, in stark contrast to the challenges facing developed economies. Credit fundamentals in emerging markets have never been stronger, which is increasingly being recognised by credit rating agencies and investors alike.

These positive fundamentals provide a supportive backdrop for emerging market (EM) corporate credit, reducing the country risk premium and consequently the cost of debt capital for corporate issuers. At the same time, EM companies benefit from an abundance of growth opportunities as their domestic economies develop apace. Increasing wealth in EM countries and the rise of the consumer presents businesses with the opportunity to grow quickly and profitably, a prospect that is increasingly difficult in the developed world. Many companies have taken advantage of the debt markets to fund their expansion plans, spurring the rapid development of EM corporate bonds as an asset class.

**A growing, liquid market**

Strong EM government balance sheets have reduced the need for external financing and consequently EM sovereign debt in US dollars is a shrinking asset class. It is therefore unsurprising that in each of the last ten years EM external corporate issuance has surpassed that of external sovereign debt. Since the financial crisis of 2007-2009 issuance has soared as the credit crunch created a lending vacuum in emerging markets. The trend has continued, and so far in 2011 EM companies have issued in excess of \$125bn in new debt. The development of the asset class has been rapid - as at the end of May 2011 the EM corporate debt market was more than three times the size of Europe's high yield market and 60% of the size of the one in the US.

**New Issuance**



Source: Bar chart - IMF International Financial Statistics, National Statistics Offices, Credit Suisse  
Line graph - BAML, THREADNEEDLE, External debt only

The launch of a market index for the asset class, the CEMBI Diversified in November 2007, opened the door for a dedicated EM corporate bond investor base, although it only accounts for around \$20bn of assets under management so far. Over time we expect the asset class to move into the mainstream and form a key component of the global high yield market. At the same time, the market has become increasingly diversified in terms of both countries and sectors as shown in the tables below. (Constituents of the CEMBI Diversified).

Country	Market cap (%)
Hong Kong	8.64
Russia	8.37
Brazil	7.68
Mexico	7.56
South Korea	6.31
China	6.14
India	5.60
United Arab Emirates	5.30
Qatar	4.23
Singapore	4.18

Sectors	Market cap (%)
Banks	28.15
Basic Materials	15.80
Industrials	10.89
Oil & Gas	10.05
Telecommunications	8.88
Other Financials	7.76
Utilities (Non-Collateralised)	6.74
Consumer Services	3.58
Securitised and Collateralised	3.56
Consumer Goods	2.44

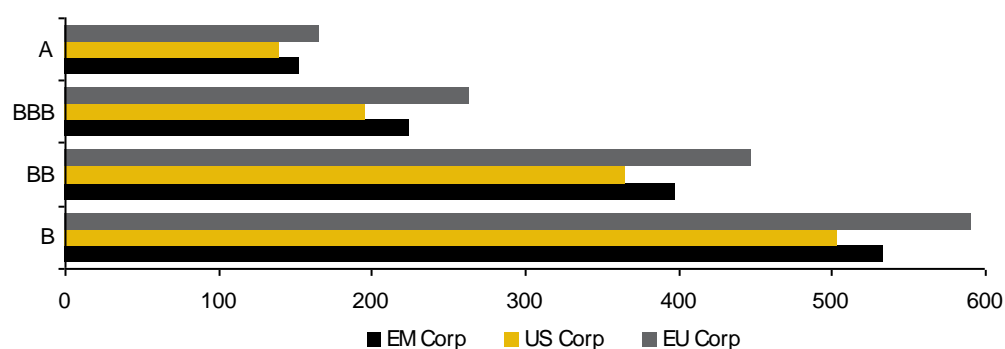
Source: JP Morgan

### Opportunities for strong risk-adjusted returns

The speed of the market's development has taken many investors by surprise and coverage of the asset class is still limited. This results in inefficiencies which can be exploited by experienced and well-informed investment managers. Furthermore, measured in terms of return per unit of risk, EM corporate bonds have historically delivered some of the most efficient portfolios among asset classes.

Despite strong recent performance, EM corporate bonds continue to look attractively valued in spread terms relative to credit in both the US and Europe. We believe this represents a mispricing of risk, and therefore a good investment opportunity, given the positive macro-economic background, strong EM company fundamentals and historically comparable default rates with companies in developed markets.

### EM corporates offer value across spectrum



Source: BAML

### **How can investors capitalise on this opportunity?**

The growth of the asset class offers tremendous opportunities for investors. However, attempting to mirror the CEMBI is not the way to fully exploit the potential of the asset class. Over 70% of the CEMBI Diversified is composed of investment grade issues, which are dominated by large EM companies that are growing in significance on the world stage and whose merits are already widely known. The benchmark yield is reflective of this. An index-like portfolio is therefore not likely to deliver the yield one might hope for from the asset class.

Instead, investors in search of return, and in particular yield, in emerging market corporate bonds must be discriminating. At Threadneedle, we believe that traditional asset-class and geographical parameters have broken down and that adopting a rigid definition of an asset class does not capture the true potential available to investors. For example, consider Standard Chartered Bank, a UK-listed financial-services company that generates 70% of its profits from emerging markets. The risk to the company is not in the UK, but in Asia and Africa where it does most of its business. Therefore, in our approach we extend our EM corporate investment universe across fixed income sectors, such as quasi sovereign bonds, where issuers like Venezuelan state oil company PDVSA display an attractive risk/return profile, including a 16% yield. We also seek to benefit from positive country fundamentals where a corporate bond market does not yet exist, such as in Lebanon and Jordan. The result is a more representative set of opportunities across emerging market corporate credit assets and a portfolio that has the potential for high capital returns and an attractive yield.

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