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Executive summary

Emerging Markets – why are they attractive?

We believe Emerging Markets (EM) present some of the world’s most dynamic growth and investment opportunities. The rationale behind investing in EMs can be summarised by 3Ds: Debt Dynamics, Disinflation and Demographics.

- **Debt Dynamics**: supported by stronger fundamentals than developed markets, EMs have been able to better withstand the market turbulences of recent years. Debt levels in EMs are on average one third of those in developed markets, where unprecedented fiscal and debt deterioration has taken place with little optimism that the current outlook will improve any time soon.

- **Disinflation**: high inflation in the emerging economies has previously deterred investors from seriously considering local currency investments. Political reforms have led to central bank independence and looking ahead we believe inflation will be more cyclical rather than structural. Most EMs have now successfully battled inflation although we would acknowledge this might be a risk in the future and therefore believe policy responses will be important to address investor concerns.

- **Demographics**: growing, youthful populations and burgeoning workforces are enhancing earnings and spending power, driving domestic growth and lessening dependence on the developed world.

EM debt – why now?

- **EM hard currency sovereign debt** has shown a steady improvement in credit quality with a growing proportion of bonds in the investment grade range. Most countries are no longer net issuers of external debt, thus we believe the supply and demand dynamics should remain supportive for hard currency bonds in the coming years.

- **Stabilising economies** have allowed EM governments to raise more and more of their financing through issuing debt in local currency, which helps reduce their vulnerability to external shocks. Credit quality is higher than hard currency debt given the ability to issue bonds in their respective home currencies.

- **In our opinion**, opportunities in EM bonds cannot be fully explored without exposure to local currency debt. The majority of non-G101 sovereign debt is currently denominated in local currency. We believe return prospects are even more attractive than hard currency debt, but with likely higher volatility based on the performance of EM currencies over the past few years.

- **As EM sovereign balance sheets have improved**, debt denominated in US dollars has also come to be regarded as lower risk and, as a result, a potentially lower return investment. We believe local currency debt is an attractive asset class as there is a higher potential return from both higher yields than in the case of dollar-denominated debt, and from currency appreciation.

EM corporate debt – why now?

- In our opinion the EM corporate bond market has become an appropriate destination for a wider range of investors due to its size, liquidity and improving transparency.

- **Total outstanding EM corporate debt is currently estimated at over US $974 billion.**

- **Over the past seven years**, corporate bond issuance has been over US$1 trillion\(^\text{a}\) more than double the level of sovereign bond issuance. We expect this trend to continue, providing a good entry point to the asset class.

- **The majority of EM corporate debt stock is investment grade.** Furthermore, bigger issuance sizes and a more dedicated investor base have improved market liquidity.

- **Many EM countries are likely to see continued corporate bond issuance** in the foreseeable future as domestic and international investment interest increases.

EM Debt – a ‘blended approach’

- Our blended approach invests in hard currency, local currency, corporate bond and currencies against a hard currency benchmark.

- **We have been managing the blended strategy** for over a decade, building a strong and established track record.

- **Well resourced team** with skill set necessary to select hard currency, local currency and corporate investment opportunities.

- **Blended approach** offers diversified sources of alpha.

EM debt – Aberdeen Asset Management’s strengths

- **Long history of investing in both the EM debt and equity markets**.

- **Well resourced, stable and highly experienced team** with a robust track record of investing in EM debt across a number of market cycles.

- **We conduct fundamental top-down and bottom-up credit analysis** providing comprehensive coverage of all factors relevant to the asset class.

- **We rely on proprietary research** to provide a deeper insight into the countries and companies in which we invest.

- **Extensive primary coverage of issuers.** We research over 50 countries and have over 250 meetings with senior policy makers each year.

- **Expertise is also drawn from our Asian fixed income and our global EM equity teams.**

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\(^1\) C10 refers to the Group of 10, a group of industrialized nations that participate in the General Agreements to Borrow.

\(^a\) Source: JP Morgan, August 2012
Emerging Market Debt
An Introduction

As emerging economies expand, governments and companies alike are looking to domestic and international capital markets to finance growth. This buoyant market segment presents skilled fixed income managers with potential opportunities to identify and benefit from improving companies and countries.

Figure 1 – Global growth forecast

Source: IMF staff estimates for 2012, % per annum, IMF, World Economic Outlook database, April 2012
For illustrative purposes only
Forecasts are offered as opinion and are not reflective of potential performance, are not guaranteed and actual events or results may differ materially.
Emerging Market Debt

A strengthening asset class

Over the last decade, the EM debt universe has undergone rapid growth and is becoming more attractive to a wide range of investors. The key drivers behind this are:

Improving credit quality

Many EM countries have implemented sound fiscal and monetary policies over the past decade. This has resulted in a structural improvement in creditworthiness and has served to considerably reduce the historically high volatility of the asset class. As at March 2013, approximately 58% of the JP Morgan EM Bond Index was investment grade debt; this compares with just 30% of the index in 2002. The combination of rising credit quality and fundamental improvements in EM countries has attracted new investors to the asset class, which in turn has boosted liquidity.

Positive outlook

EM long-term growth expectations are supported by solid fundamentals that include positive demographics, economic reform, improving governance and increasing industrialisation. We believe that rock-bottom interest rates will prompt fixed rate investors to seek alternative sources of potential return and given the still sound credit fundamentals of the asset class, EM debt should continue to benefit as risk appetite increases. EM debt should also find support as global investors reduce their structural underweights to the asset class.

Investment opportunities

There are a number of ways that investors can access EM debt. Historically, the main way to invest in EM bonds was through sovereign debt issued in US dollars (Hard Currency). However, stabilising economies have allowed EM governments to raise more and more of their financing through issuing debt in local currency, which helps to reduce their vulnerability to external shocks. EM hard currency debt and EM local currency debt are two distinct asset classes. The two feature different credit quality and regional compositions and respond to different drivers of return. EM local currency debt has explicit exposure to currency and interest rate dynamics, and more recently, the former has been highly correlated to the European sovereign debt crisis. The emergence of the local investor has also played a role in the development of local markets, which in turn has resulted in improved liquidity positions. In addition, the inclusion of local markets such as Mexico in 2010 and South Africa in 2012 into global bond indices has broadened the investor base in local markets. By contrast, hard currency EM debt is ultimately a ‘spread product’, meaning it is compared to the yields on other comparable sovereign debt instruments. In this yield environment we believe EM debt offers an attractive pickup of around 300 basis points US Treasuries.

In recent years, EM corporate debt has also developed into a standalone asset class. Previously the asset class was viewed only as a specialist source of returns for investors seeking ‘risky’ alpha. Now, dedicated financial infrastructure, such as investable market indices, dedicated research and the rapid growth in market capitalisation from increasing issuance has brought this burgeoning asset class into the spotlight.

Significant diversification benefits*

EM debt, both hard and local currency, offers low correlation to developed markets and EM equities, suggesting that it has a valuable role to play in portfolio diversification, particularly for portfolios that already have significant stock allocations.

Source: Morgan Stanley, March 2013. For illustrative purposes only.

LHS - left-hand side; RHS - right-hand side.

Standard & Poor’s credit ratings are expressed as letter grades that range from “AAA” to “D” to communicate the agency’s opinion of relative level of credit risk. Ratings from ‘AA’ to ‘CCC’ may be modified by the addition of a plus (+) or minus (−) sign to show relative standing within the major rating categories. The investment grade category is a rating from AAA to BBB-.

Emerging Markets

Emerging Market economies are defined by the International Finance Corporation (IFC) as economies with a low to middle per capita income. These economies largely span developing countries in three regions, Asia, Latin America, and CEEMEA (Central Eastern Europe, Middle East and Africa). Emerging economies today are generally characterised by favourable demographics, a strong financial footing and lower levels of debt than their Western counterparts.

Hard currency debt

Debt denominated usually in US dollars.

Local currency debt

Debt denominated in the country’s local currency.

Emerging Market corporate bonds are bonds issued from countries in Emerging Market regions.

*Diversification does not ensure a profit or protect against a loss in a declining market.
Emerging Market Debt

The 3Ds

As outlined in the executive summary, the rationale behind investing in the EMs can be summarised by 3Ds: Debt Dynamics, Disinflation and Demographics.

- **Debt Dynamics**: Supported by stronger fundamentals than developed markets, EMs have been able to better withstand the market turbulences of recent years. Debt levels in EMs are considerably lower than in developed economies, where unprecedented fiscal deterioration took place in recent years and in some cases unsustainable debt levels will remain a drag on growth in the near future. Government debt levels of developed and emerging economies have demonstrated divergent trends and yet global investors are generally underweight EM debt according to studies by the International Monetary Fund (IMF) and other institutions.

Also, as can be seen in figure 3, developed world debt has been rising for many years meaning there is a debt overhang, something that limits fiscal flexibility, lowers growth potential and increases investor risk.

![Figure 3 – Total gross public sector debt](source)

![Figure 4 – General Government Debt (% GDP) vs Government Balance (%GDP)](source)

Source: IMF, World Economic Outlook database, April 2012
For illustrative purposes only
• **Disinflation:** High inflation in the emerging economies in the 1980s and 90s has previously deterred investors from seriously considering local currency investments. In the past, EM central banks, influenced by political considerations, often found it difficult to contain inflation. Political reforms have led to central bank independence and most EMs have now successfully battled inflation. Many of the countries, such as Mexico, Colombia and Brazil, are explicit inflation targeters and have had considerable success remaining in their inflation bands. This has resulted in the stabilisation of inflation with largely consistent and appropriate policy interest rate changes which has led to increased credibility among investors. It has also enabled governments to extend the maturity of bonds issued in local currency due to both local and foreign investor appetite.

**Figure 5 – Inflation trends across EMs**

**Inflation trends – Asia**

- Thailand
- Malaysia
- Indonesia

**Figure 6 – Inflation trends – Latin America**

- Brazil
- Colombia
- Peru
- Mexico

**Figure 7 – Inflation trends – Emerging Europe**

- Turkey
- Poland
- Hungary

**Figure 8 – Demographics: major EM countries vs the developed economies**

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<tbody>
<tr>
<td>China</td>
<td>1355.693</td>
<td>17.1</td>
<td>73.3</td>
<td>9.6</td>
</tr>
<tr>
<td>India</td>
<td>1236.345</td>
<td>28.5</td>
<td>65.7</td>
<td>5.8</td>
</tr>
<tr>
<td>Brazil</td>
<td>210.174</td>
<td>25.4</td>
<td>67.3</td>
<td>7.3</td>
</tr>
<tr>
<td>Turkey</td>
<td>81.619</td>
<td>25.5</td>
<td>67.8</td>
<td>6.7</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>63.743</td>
<td>17.3</td>
<td>65.2</td>
<td>17.5</td>
</tr>
<tr>
<td>Eurozone</td>
<td>402.792</td>
<td>15.8</td>
<td>66.8</td>
<td>17.5</td>
</tr>
<tr>
<td>United States</td>
<td>322.423</td>
<td>20.1</td>
<td>65.8</td>
<td>14.1</td>
</tr>
<tr>
<td>Japan</td>
<td>125.223</td>
<td>12.5</td>
<td>62.0</td>
<td>25.4</td>
</tr>
</tbody>
</table>

Source: Bloomberg, December 2012

For illustrative purposes only
Figure 9 – Middle class populations are expanding rapidly in the developing world

Middle class household definition: USD10 to USD100 in purchasing power parity per capita per day
Source: The Emerging Middle Class in Developing Countries, Homi Kharas, January 2010
For illustrative purposes only.
Projections are offered as opinion and are not guaranteed. Actual events or results may differ materially.
EM sovereign hard currency debt has become an endangered species of sorts as the majority of the largest issuers are no longer issuing external bonds on a net basis. Nearly the entire stock of Brady bonds, which peaked at US$150 billion in 1994, was retired in 2006 as policymakers embraced liability management strategies, shifting the bulk of their debt financing to their respective local markets. This proved to be more than a symbolic move away from the volatile past of EMs, as it also coincided with a period of marked improvement in sovereign credit ratings. Indeed, the sharp decline in external debt levels and significant rise in foreign exchange reserves over the past decade has greatly reduced the credit risk of investment grade hard currency sovereign debt, which has become a flight to quality trade amid the on-going European sovereign debt crisis.

While we are not advocating investors should put most of their eggs in an EM investment grade portfolio with 10-year yields on Brazilian and Mexican bonds well below 3%, credit risk is relatively low. In contrast, investors are taking on significant credit risk by holding investment grade sovereigns such as Spain and Italy, which unsurprisingly trade at implied sub-investment grade levels with considerable downside risk.

Going back to the start of the Brady bond days in 1993, the investment grade portion of the index was only 2%, underscoring the risky nature of the asset class. The steady improvement in credit quality over the past several decades has pushed the investment grade portion of the index to over 60%. Over the course of time, the index has grown in terms of the issuers, with a total of 56 sovereigns currently in the JP Morgan EMBI Global Diversified index. More recently, Frontier Market issuers such as Ghana, Gabon, Nigeria and Senegal have joined the index, while Ivory Coast re-entered the index in 2010 after restructuring its defaulted Brady bonds. We have benefitted by taking overweight positions in the Frontier Market sovereigns, along with some of the less frequent issuers such as the Dominican Republic, El Salvador, Guatemala, Iraq and Pakistan. One common link between these names is that the sell-side research coverage tends to be fairly lean, thus providing opportunities for fund managers with the skill set necessary to conduct the research in order to exploit undervalued opportunities. We would acknowledge that at times there are liquidity risks when investing in some of the smaller countries, and therefore would limit the size of our absolute and relative positions accordingly.

In terms of valuations, we have opined that the yield on the investment grade sovereigns in the index is not exactly compelling at 3.6%, unless one is looking to complement their ‘traditional’ government bond portfolio that holds a great portion in lower yielding bonds. In contrast, the yield on the sub-investment grade sovereigns is 6.8%, reflecting the higher credit risk in countries such as Argentina and Venezuela, while the overall index yield is just below 5%. The argument for investing in hard currency debt is even stronger when one looks at it in spread terms, which is effectively a measurement of default risk, and more appropriate than Credit Default Swaps (CDS) since most investors are not active participants in the CDS market. At a spread of around 300 basis points over US Treasuries, we believe investors are getting attractively compensated for the low default risk in the asset class.
The attractions of Emerging Market local currency debt

We believe EM hard currency debt has been on investors’ radars for some time already. So why is now the right time to look at local currency debt?

Size of the market

A key constituent of an EM bond portfolio

Importantly, opportunities in EM bonds cannot be fully explored without exposure to local currency debt. In 2010, 85% of non-G10 sovereign debt was denominated in local currency, an increase from 76% in 2005 and 60% in 2000. Therefore, if an investor only allocates to external debt, they will have limited exposure to returns from a number of EMs.

Figure 12 – GBI-EM Broad (local currency), EMBI GD (hard currency), CEMBI Broad (corporate bonds)

<table>
<thead>
<tr>
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<th>GBI-EM Broad</th>
<th>EMBI GD</th>
<th>CEMBI Broad</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market Cap (bn)</td>
<td>$1,576</td>
<td>$331</td>
<td>$651</td>
</tr>
<tr>
<td>Percentage</td>
<td>62%</td>
<td>13%</td>
<td>25%</td>
</tr>
</tbody>
</table>

Source: Market capitalisation of indices, J.P. Morgan, 31 March 2013

For illustrative purposes only.

Higher total returns

Multiple sources of return

As EMs have evolved, debt denominated in US dollars has come to be regarded as lower risk. Local currency debt can offer a higher potential return from both higher yields relative to dollar-denominated debt, and the potential of currency appreciation.

Liquidity

Declining yields signal a more efficient market

Liquidity has also significantly improved due to both higher issuance and increased interest on the part of investors both domestically and internationally. Bid/offer spreads are generally narrower for local currency denominated bonds relative to hard currency denominated bonds highlighting the increasing breadth of the local currency debt universe. This is further evidenced by the fact the EM local debt market capitalisation is now more than triple the size of EM external debt.

Developing asset class

EMs are increasingly using local currency debt to raise capital and have benefited from declining risk premiums. More recently, local rates markets have been behaving like G7 rates markets, with yields falling in countries such as Mexico, Brazil and South Africa due to concerns about the global risk environment and growth outlook.

Investor base

Diverse number of investor types

In our opinion EM local currency bonds are becoming appropriate to a wider range of investors due to their size, liquidity and dedicated research platforms. Historically, local banks dominated local currency bond space, but the institutional investor base has been growing both domestically and overseas providing impetus for further development of the local currency bond market. As an example, foreign participation in local bond markets in Indonesia increased from 15 to 30% over the past three years, while non-residential holdings of local Mexican bonds increased from 15 to 35% of total bonds outstanding over the past six years.
The attractions of Emerging Market corporate debt

As with developed market corporate bonds, EM corporate bonds are publicly traded debt instruments issued by companies that wish to raise capital through both public and private markets. Corporate bonds can offer investors a potentially higher yield in compensation for the fact that corporations are, in aggregate, more likely to default on their debt than governments.

There has always been a compelling story for EM corporates due to the much greater capacity for growth and development of the relevant markets and demographics. So why should EM corporate bonds be considered attractive now?

Growth of the market
The size of the market has increased significantly
The EM corporate bond market is almost US$1 trillion in size and has grown by over 170% over the last 3 years with corporate issuance far outstripping sovereign issuance in recent years.

Figure 14 – EM corporate issuance exceeds sovereign

![Graph showing EM corporate issuance exceeding sovereign issuance](image)

Source: JP Morgan, 31 January 2013
For illustrative purposes only
Forecasts are offered as opinion and are not reflective of potential performance, are not guaranteed and actual events or results may differ materially.

Credit rating
More than two-thirds of the bonds are investment grade
Some 72% of EM corporate debt stock is investment grade - that is rated BBB- or above. The highest ratings tend to be dominated by Asian companies.

Diversity of universe
Variety of investments by region, quality and sector
The EM corporate bond market is well diversified providing investors with interesting opportunities across the board (see figure 15). New issuance has increased diversity not only in regional but also in quality and sector terms. Currently, there are over 405 issuers in the EM corporate bond index.

The breakdown of issuers among EM companies is fairly evenly distributed across regions apart from Emerging Europe. This imbalance has appeared as companies in Central and Eastern Europe have been traditionally more reliant for funding on bank lending rather than capital markets, leading to less corporate bond issuers in this region. However, as European banks withdraw from the global markets and bank lending becomes more difficult to obtain, we are likely to observe a significant increase in issuers from the region.

Level of defaults
Default rates have been low
2009 was the year of particularly high default rates. Even then, the default rate for high yield EM corporate bonds was 6.1% (of which approximately 3/4 came from the Kazakhstan banking sector), compared with 9.5% for global corporate bonds and 11.2% for US high yield corporate bonds. Outside of the Kazakhstan banking sector, 2009 default rates were very low. Over the past 12 months default rates decreased to less than 1%, below the world average and that for US companies. This goes someway to disprove the previously held perception that this asset class is more risky than other areas of the world. The developed world has experienced unprecedented turmoil in recent years but the fact that EM companies have been relatively unscathed is testament to the quality and stronger fundamentals in the asset class.

Fundamentals
Relative to US corporate bonds
In our view, EM corporates are characterised by stronger fundamentals than their counterparts in developed markets. To take one example, in figure 16, the characteristics of a Ukrainian and a US company within the steel sector are compared. The Ukrainian steel producer Metinvest has a worse credit rating than its US counterpart AK Steel Corporation, despite enjoying significantly better financial metrics.

One reason for this is that the credit rating agencies still give an ‘EM risk premium’ to EM companies in their ratings. Furthermore, many companies continue to be capped by their sovereign ceiling. So for the same credit ratings, selectively, you often get better fundamentals in emerging markets than in developed markets.
It is true that investors are concerned about the potential for currency devaluation in the Ukraine due to the challenging political environment and the need for structural reform. However, the majority of the Metinvest’s revenues are generated in US dollars, and we believe that its high operating margins and low debt levels far outweigh any perceived sovereign risks.

The Ukrainian steel sector is just one of the many interesting opportunities we are finding in the EM corporate bond sector.

**Figure 16 – Significantly better fundamentals in EM steel producers**

<table>
<thead>
<tr>
<th></th>
<th>AK Steel Corporation</th>
<th>Metinvest</th>
</tr>
</thead>
<tbody>
<tr>
<td>Country</td>
<td>US</td>
<td>Ukraine</td>
</tr>
<tr>
<td>Sector</td>
<td>Steel</td>
<td>Steel</td>
</tr>
<tr>
<td>Credit rating</td>
<td>B1</td>
<td>B3</td>
</tr>
<tr>
<td>Quality of cash generation¹</td>
<td>0.5</td>
<td>20.0</td>
</tr>
<tr>
<td>Ability to pay interest⁸</td>
<td>1.7</td>
<td>9.2</td>
</tr>
<tr>
<td>Debt burden</td>
<td>8.9</td>
<td>1.3</td>
</tr>
<tr>
<td>Yield of representative 10 year bond⁰</td>
<td>6.0</td>
<td>7.8</td>
</tr>
</tbody>
</table>

Source: BofA Merrill Lynch Global Research, Bloomberg, Moody’s, 31 March 2013
For illustrative purposes only

**Investment grade**

After the increase during the 2008/09 financial crisis, spreads on bonds returned to the range at which they historically traded. EM investment grade companies are generally in better shape than their US peers and there is more diversification across the regions allowing investors to gain access to the key growth markets of Brazil, Russia, India and China (BRIC).

**High yield**

Compared to US high yield, EM high yield corporate bonds are still trading with a greater risk premium. Even on a like-for-like basis, we believe EM high yield bonds have a more compelling yield. They offer potentially better diversification across regions and have a lower default risk, making them more attractive.

**Corporate balance sheets**

Fundamentals have been very positive

In the previous section we noted that a Ukrainian steel producer boasts better fundamental characteristics than its US peer. It should be pointed out that this trend is not restricted to specific sectors but EM companies on the whole have been strengthening their balance sheets and capital positions. Leverage ratios of EM companies both in the investment grade and high yield sectors have been improving and compare favourably with their US peers.

**Figure 17 – Investment grade companies leverage trends: EM vs US**

**The investor base has broadened**

There is now a wider spectrum of investors

There has been a shift away from the regional investors that previously dominated the market to an increase in the number of investors that recognise EM corporate bonds as a fully fledged asset class. At the beginning of 2010, dedicated corporate funds totalled just US$7 billion and this has quickly increased over five times to US$47 billion as at January 2013E. Long-term investor interest in all three EM regions – Asia, Latin America, and CEEMEA – has helped to improve the market and made it a more stable place to be invested. Given the growth of the asset class, and the structural changes such as the increased breadth and depth of the asset class, liquidity, growing understanding of its relative fundamental strength and attractive valuations, we have seen a growing interest in EM corporate bonds. We expect fund flows to be one of the strongest in this subset of the asset class for the next five years⁷.

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¹ Operating income/revenues (%)
² EBITDA interest coverage (x)
³ Debt/EBITDA (x)
⁰ Yield-to-worst (%) as of March 2013
⁷ Source: JP Morgan, January 2013

Forecasts are offered as opinion and are not reflective of potential performance, are not guaranteed and actual events or results may differ materially.
Emerging Markets – the risks involved

The risks associated with investing in EM Debt will to an extent depend on the type of investment chosen. While all investors in EM debt securities are exposed to credit and interest rates risk, currency risk is specific to investments denominated in local currency.

Credit risk
Sovereign default risk is expected to remain low in the coming years, reflecting the improved fiscal and debt trends in the developing world. Such trends are supported by robust external reserves, positive terms of trade, and generally speaking, reduced political risk.

Interest rate risk
The risk of interest rates increasing due to fundamental or technical factors (e.g. policy mistakes).

Currency risk
The risk that the currency in which the debt is issued is overvalued relative to the investor’s currency and the value of investment will decrease as a result of currency depreciation.

Liquidity Risk
Investments may be made in certain securities that subsequently become difficult to sell because of reduced liquidity which would have an adverse impact on market price. Reduced liquidity for such securities may be driven by a specific economic or market event, such as the deterioration in the creditworthiness of an issuer.

Corporate bond risk considerations
EM corporate bondholders face the same issues of transparency and corporate governance as EM equity investors, albeit in a different part of the capital structure. Corporate bonds are often issued by private familyheld companies which may have complicated and opaque company structures. There may also be issues with the quality and timeliness of financial disclosures. Information can often only be gleaned from contacts within the local markets and from repeated management meetings and site visits. Other risks include market liquidity which, whilst improving, is thinner than developed market bonds. In this environment, it is critical to carry out comprehensive research into the corporate bond and the market in which it operates. At Aberdeen we have a highly experienced team and we carry out fundamental research and due diligence before we include a corporate bond in our portfolios.

Fundamental risks
Structural risks
In the unfortunate event of a company defaulting on its debt, priority access to cash flow is crucial in determining the default and recovery scenarios, which in turn drives the relative valuation of a bond. It comes down to the exact position of the debt in the company structure – largely called structural issues and subordination risks. Companies in emerging countries are often built up in a haphazard manner, or with various subsidiaries for tax and legal planning purposes. It is important to know the entity from which the bonds are issued, the seniority of the bond, and map that to how cash flows between different entities of the same company. It pays to thoroughly research the company as well as the bond, firstly to ensure the company is what it says it is and has the necessary financial stability and management to be well run, profitable and to grow. Secondly, it is important to ensure the characteristics of the bond are sound and they fit well with the existing portfolio.

Transparency and Corporate governance
Companies are increasingly aware of reputational risks, motivated by their continuous need to access international capital markets. Dialogue between investors and companies has started to improve in EMs, though significant distinctions can be seen between different countries with differing corporate governance cultures.

Whereas financial information in developed markets can be found in a comparable manner between companies of the same industries, EM companies, if publicly listed, often report according to their local GAAP standards.

Accounting standards in EMs still somewhat lag those of developed economies and so company reports require careful and in-depth analysis of primary data to differentiate and understand the true cash position and operating results of companies. The trend is to transition towards the International Financial Reporting Standards (IFRS), which will ease future ‘apples-to-apples’ comparisons.

ONE WAY TO MITIGATE THESE RISKS IS TO DO GROUND WORK
Visiting the country to meet management, to see the operations, and to ‘kick the tires’ is important. We do this at Aberdeen. We never invest in a company without first meeting management and carrying out full due diligence.

Bond covenants also help to mitigate the risks of lack of transparency and corporate governance by legally limiting companies in capital raising decisions and from taking excessive operational risks. Some issues even have cash account management agreements embedded within the bond structure, directing the company’s use of cash. Other bonds have additional security attached which allow specific protections on assets that can be detached solely to repay the bonds in an event of default. It is important to thoroughly analyse the bond and identify these covenants before investing.
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