

EMERGING MARKET DEBT IN FOCUS ON NIGERIA DEBT EXCLUSION

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09/28/2015

While emerging market equities receive a lot of attention, a large amount of assets also follow emerging market local debt. J.P. Morgan estimates that approximately \$200 billion is tied to its [Government Bond Index-Emerging Markets \(GBI-EM\) Index](#) series. The countries included—or excluded—from the Index can have a major impact on performance. Case in point, Nigeria. Last week, J.P. Morgan announced that Nigeria's debt would be phased out of the GBI-EM Index Series over the next two monthly rebalances, occurring at the end of September and the end of October 2015.¹ Nigeria first appeared in the index in October 2012, when the government removed a required one-year lock-in period for foreign investment in government bonds. In January 2015, Nigeria was put on watch, as a series of administrative measures began to impede the ability of foreign investors to transact in this debt, and in June 2015 the watch was extended because of the need to monitor the transparency and liquidity of the Nigerian foreign exchange market.² Nigeria's challenges are not surprising, given the movement in oil prices. Oil represents approximately 90% of Nigeria's exports and two-thirds of the government's revenue³. Nigeria has placed restrictions on foreign exchange to stem the fall of the currency within this environment. Applying a Focus on Fundamentals Never Included Nigeria In 2010, the [WisdomTree Emerging Markets Local Debt Fund \(ELD\)](#) was introduced as an [active](#) investment approach to emerging local debt. The structured investment process of ELD runs counter to the concept of [market capitalization-weighted](#) approaches to emerging markets debt, which place the greatest weight in debt markets with the largest issuance. Instead, ELD's approach focuses on [fiscal sustainability](#) and [external vulnerability](#) indicators in order to monitor [risk](#). Political risk and [economic solvency](#) are also considered. The process allocates weight according to three tiers, where the country exposures within each respective tier are equally weighted. The portfolio is rebalanced to targeted exposures on a quarterly basis, and the currency selection and universe definition are reassessed at scheduled intervals at least annually. The result? Troubled countries like Nigeria often don't make the cut. **The August 31, 2015, Rebalance & ELD's New Target Weights Below**, we compare ELD's target weights (post-August rebalance) to that of the J.P. Morgan GBI-EM Global Diversified Index and the [J.P. Morgan GBI-EM CORE Index](#), two of the more widely followed Indexes within J.P. Morgan's GBI-EM series.

ELD Exposure Tiers versus Two GBI-EM Indexes

Market	ELD Actual Exposures as of 8/31/2015	ELD Exposure Targets After 8/31/2015 Semi-Annual Review	JP Morgan GBI-EM Global Diversified Index	JP Morgan GBI-EM CORE Index
Tier 1				
Brazil	9.53%	10.34%	10.00%	10.00%
Mexico	10.06%	10.34%	10.00%	10.00%
Poland	11.23%	10.34%	10.00%	10.00%
Tier 2				
South Korea	7.06%	6.90%	0.00%	0.00%
Colombia	5.83%	6.90%	6.02%	5.31%
Indonesia	6.54%	6.90%	9.03%	7.47%
Malaysia	9.58%	6.90%	9.47%	7.79%
Turkey	6.57%	6.90%	10.00%	8.25%
South Africa	6.79%	6.90%	10.00%	9.77%
Tier 3				
China	3.56%	3.45%	0.00%	0.00%
India	3.54%	3.45%	0.00%	0.00%
Chile	3.39%	3.45%	0.11%	3.00%
Peru	3.35%	3.45%	1.84%	3.00%
Philippines	2.46%	3.45%	0.48%	3.00%
Romania	3.75%	3.45%	2.94%	3.09%
Russia	3.73%	3.45%	4.40%	4.14%
Thailand	3.42%	3.45%	8.58%	7.15%
Excluded Markets				
Hungary	0.00%	0.00%	5.63%	5.03%
Nigeria	0.00%	0.00%	1.51%	3.00%

Sources: WisdomTree, J.P. Morgan, with data as of 8/31/15. Subject to change.

Key Notes and

Changes⁴:

- **Nigeria and Hungary Excluded from ELD:** J.P. Morgan recently decided to exclude Nigeria, but ELD never included it. As of August 31, 2015, Hungary was also included within the J.P. Morgan Indexes as a prominent, [noninvestment-grade](#) issuer. ELD’s process led to both Hungary’s and Nigeria’s exclusion in an effort to manage risk within the portfolio.
- **Biggest Changes at August Rebalance:** Malaysia was moved from a top-tier to a middle-tier exposure, representing a 3.10% reduction in targeted exposure. This change was made due to a deterioration in Malaysia’s [current account](#) and [foreign exchange reserves](#), coupled with limited confidence in any near-term reversal in either trend.
- **ELD Exposures Excluded from the J.P. Morgan Indexes:** It is noticeable that South Korea is a middle-tier exposure, but has no representation within the Indexes shown. Similarly, China and India are third-tier exposures with no representation in the J.P. Morgan Indexes. This is an important point—ELD’s active process is not tied to the actions taken by other Indexes.

Continuous Risk Monitoring while steering around Nigeria’s troubles is one benefit a structured, active approach can exhibit, in emerging markets (especially the current environment), the portfolio management process can never rest. The team is continuously evaluating country exposures according to [growth](#) and inflation indicators, [debt capacity](#), serviceability indicators, [short-term liquidity factors](#) and market-based indicators. The bottom line: Instead of following weights within an index, ELD’s structured process is actively looking to manage risk. Emerging markets have faced performance difficulties with the strength in the U.S. dollar. For those [contrarians](#) who think the U.S. dollar rally has run its course and are searching for a relatively high-yielding asset class, ELD’s fundamental approach is worthy of consideration.

¹Source: Gloria Kim et al, “Index Watch: Nigeria to be Phased Out of the GBI-EM Series,” J.P. Morgan, 9/8/15.

²Source: Gloria Kim et al, “Index Watch: Nigeria to be Phased Out of the GBI-EM Series,” J.P. Morgan, 9/8/15.

³Source: Paul Wallace, “JPMorgan to Remove Nigeria from Emerging Market Bond Indexes,” Bloomberg News, 9/8/15.

⁴Source for bullets: ELD Semi-Annual Review and Rebalancing Announcement, 9/1/15.

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DEFINITIONS

JP Morgan Government Bond Index – Emerging Markets (GBI-EM) Global Diversified : The JP Morgan GBI EM Global Diversified tracks the performance of local currency debt issued by emerging market governments, whose debt is accessible by most of the international investor base. The index incorporates a constrained market-capitalization methodology in which individual issuer exposures are capped at 10%, (with the excess distributed to smaller issuers) for greater diversification among issuing governments.

Active : Funds that attempt to outperform the market by selecting securities a portfolio manager believe to be the best.

Market Capitalization : Market cap = share prices x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.

Fiscal sustainability : Attention to measures such as government spending plans and budgets and how these relate to government revenue policies, like taxation.

External vulnerability : Attention to measures such as current account and foreign exchange reserves that could potentially lead to a greater influence of macroeconomic factors occurring outside of a market influencing that particular market.

Risk : Also standard deviation, which measures the spread of actual returns around an average return during a specific period. Higher risk indicates greater potential for returns to be farther away from this average.

Economic solvency : Attention to a more medium- to long-term perspective relating to how spending relates to revenue and the ability of programs or policies of particular importance are viewed as to their longevity.

JP Morgan GBI-EM CORE Index : A measure of the performance of the debt of emerging market governments measured in their own local currencies.

Non-investment grade debt : Sometimes referred to as “junk bonds,” these securities have a higher risk of default than investment-grade securities.

Current account : The difference between a nation’s total exports of goods, services and transfers, and its total imports of them.

Foreign exchange reserves : The total balance of foreign currency deposits and bonds held by a central bank or monetary authority.

Growth : Characterized by higher price levels relative to fundamentals, such as dividends or earnings. Price levels are higher because investors are willing to pay more due to their expectations of future improvements in these fundamentals.

Debt capacity : Attention to measures that have the potential to indicate if a market can take on additional debt without impacting the market price of existing debt to a large degree.

Short-term liquidity factors : Factors relating to the ability of a country’s government to make payments on certain projects, obligations or other expenses with current resources on hand, most notably cash.

Contrarian : Practice of seeing what the majority of market participants are focused on and attempting to look in the complete opposite direction.

