EMERGING MARKET BONDS: HIGH YIELDS AND DIVERSIFICATION?

Mitchell Ratner, Rider University, Lawrenceville, New Jersey, U.S.A.
Chih-Chieh (Jason) Chiu, Rider University, Lawrenceville, New Jersey, U.S.A.

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ABSTRACT

This study examines the potential diversification benefits of adding emerging market bonds to portfolio of US stocks from July 2004 through July 2019. The results indicate that relatively higher returns can be earned by investing in local currency emerging market bonds during the full sample period. While emerging market bonds offer diversification benefits, they do not provide a hedge to portfolio risk. In times of economic/political turmoil, emerging market bonds do not afford a safe haven. The greatest hedging benefits (among bonds) are provided by investing in diversified portfolio of US bonds. To a lessor degree, hedging benefits are also achieved through investment in a diversified portfolio of international bonds from developed countries.

Keywords: *bonds, emerging markets, diversification, hedge*

1. INTRODUCTION

The benefits of diversification are best achieved by holding assets with imperfect correlation as stipulated in modern portfolio theory. Investors historically include assets that do not move in lock-step with U.S. stocks to earn a relatively higher return with lower risk. Given rising correlation among stocks globally, investors are increasingly searching for alternative assets including commodities, real estate, etc., and more complex hedging strategies using derivatives such as options, futures, and swaps.

The liberalization of many emerging market economies in the late 1980s and early 1990s results in an expansion of investor attention at that time, primarily focused on stocks. Investment in emerging market stocks is now considered mainstream even for retail investors. Emerging market bonds receive relatively less attention in the previous decades compared with stocks.

In recent years investors have turned some attention to emerging market bonds for several reasons. First, ultra-low interest rates (or even negative) in much of the developed world since 2010. Second, emerging markets have expanded their offerings in the bond world (particularly China). Third, a number of “frontier markets” have bond offerings such as Azerbaijan, Colombia, and Zambia (some of these countries offer bonds but no stocks).

Low co-movement between global stock markets is long considered the primary motivation in international investments (Solnik, 1974). Studies by Chiang et al. (2007), Fjelstad et al. (2005), and Erb et al. (1999) confirm the risk reducing properties of emerging market bonds. Early development of the emerging bond markets began with the denomination of bonds in foreign currency (such as the U.S. dollar) in order to attract investors. Locally priced emerging market bonds are sparse until the early 2000s. Burger et al. (2012) find that emerging market bonds priced in local currency are only recently available and offer U.S. investors attractive returns.

This study investigates whether U.S. investors can indeed earn both higher returns and diversification benefits from a relatively new asset class -- local currency emerging market bonds. This analysis utilizes a time-varying methodology to examine the diversification, hedging, and safe haven characteristics of emerging market bonds as an asset class. The empirical evidence indicates that emerging market bonds offer both higher returns and risk compared with developed market bonds. Further, emerging market bonds provide less diversification, no hedging benefits, and virtually no safe haven properties. U.S. investors are better served by U.S. bonds during the sample period regardless of the relatively low interest rates.