Deconstructing Excess Returns

in Emerging Markets Local Currency Debt

On the face of it, any return that an active manager makes in excess of the benchmark should be attractive to investors. But excess returns can come from different sources: some involve idiosyncratic skill, while others just involve taking more risk. This is particularly relevant when evaluating managers in emerging markets (EM) local currency debt.

In equity space, excess returns can come from skill in security selection, but they can also come from simply taking "geared" exposure, for example via overweights in high-beta stocks. Geared managers who outperform in rising markets tend to give up those gains in falling markets. To differentiate security selection skill from what is essentially a lucky bet on a rising market, excess returns need to be adjusted for gearing effects.

Can we apply this to EM local currency sovereign debt? The same broad principles apply, but here instead of amplified equity beta as a way to beat the benchmark, we consider managers' exposure to the three components of total return in the asset class: currency, coupon and rates (duration). We seek to understand to what extent managers are geared towards each driver in order to isolate "true" alpha.

To measure this gearing we use a standard multi-variate regression framework, regressing the three benchmark return drivers against the active manager's total return to identify the manager's specific sensitivity to each of them.

The table shows stylised results from the framework, isolating the true alpha from driver gearing for three different managers. Note how excess returns generated by the managers, from left to right, are below, in line with, and above the benchmark respectively. But once gearing to the different drivers is accounted for, the reverse is true in terms of idiosyncratic alpha.

In addition, by separately estimating the sensitivities to the drivers relative to both the benchmark and each other, this approach tells us something about the managers' particular investment styles. Manager A is in line with the market for currency and coupon risk, but more defensive on rate risk. Manager B is in line with the market on coupon risk but is taking more currency and rate risk. C is defensive on currency and rate risk and slightly aggressive on coupon risk.

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Stylised Regression Results

	Benchmark	Manager A	Manager B	Manager C
Total Return	5.00%	4.50%	5.00%	5.50%
Excess Return	0.00%	-0.50%	0.00%	0.50%
FX Beta	-1.00%	1.00	1.50	0.5
Coupon Beta	2.00%	1.00	1.00	1.10
Rates Beta	4.00%	0.70%	1.30	0.70
True Alpha	0.00%	0.50%	0.00%	-0.50%

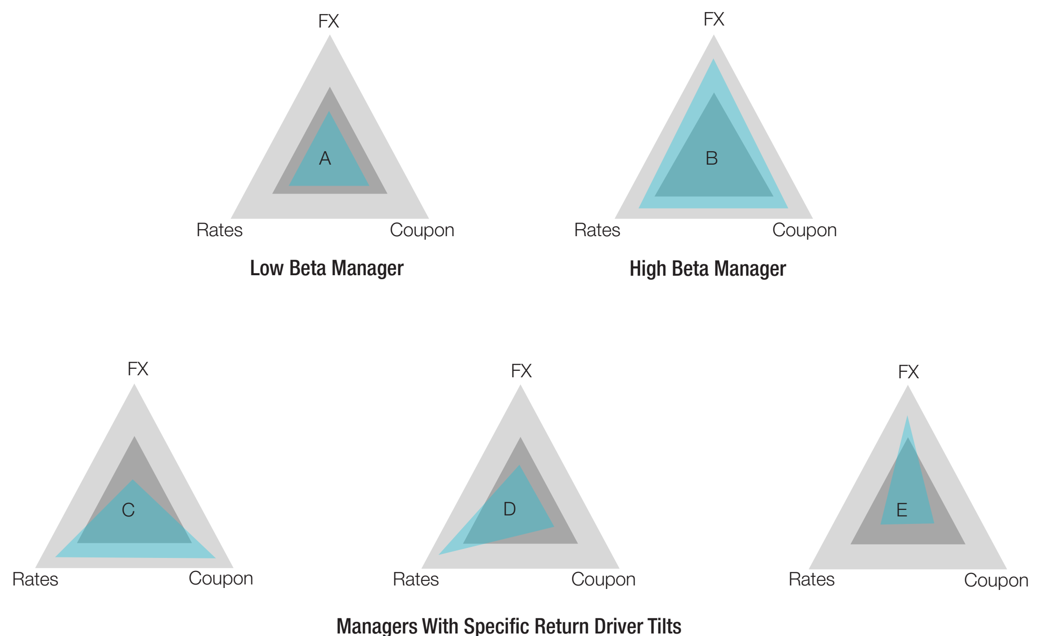
It's easy enough to illustrate this decomposition of returns in table form, but graphing the relationship is more of a challenge. In EM local currency, the existence of three market drivers means that instead of using a (single axis) bar chart we need a (three axis) triangle. The graphic illustrates this decomposition of returns, with each triangle point representing a market driver. The inner grey triangle indicates a neutral (versus the benchmark) sensitivity to the respective driver.

The below examples indicate various stylized manager sensitivities as shown by the light blue triangles.

A shows low beta (low sensitivities to all three drivers); B shows high beta (high sensitivity to all three drivers); and C,D and E are mixed-beta managers (a combination of low and high sensitivities to specific drivers).

This type of exercise not only allows for a cleaner analysis of why a manager has done well or badly in the past, but also in what environment they are likely to do well or badly in the future. A manager that has a high sensitivity to EM currency rates, for instance, will battle to beat the benchmark in an environment of US dollar strength. And, as is the case with active equity managers, understanding different manager styles allows for better blending of managers, avoiding a situation where all managers outperform or underperform at the same time.

> "With active equity managers, understanding different manager styles allows for better blending of managers, avoiding a situation where all managers outperform or underperform at the same time"



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