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Balcells (Aristea): This is how we manage the default risk

by Marco Capponi

Dependence on the external demand and sensitivity to the commodities: two elements that strengthen the fixed income of emerging markets, one of the asset classes that benefited most from the global bond reflation context. An interesting bet also for ***Francesc Balcells****, manager of* ***Aristea Sicav*** *Fim Gem Debt fund, a company launched by Banor Capital in 2015. The money manager has discussed this theme with MF-Milano Finanza.*

Emerging markets debt. Why is it a winning asset class to look for yield right now?

In the context of a FED staying on hold at least through 2023, EM debt is one of the few asset classes which offers attractive yields, between 4 to 8%. Moreover, very little went into EM bonds in 2020, but now the valuations in US credit are so unattractive that we expect those flows to start to rotate out of the US and into more peripheral and higher yielding asset classes like EM.

What are the main beneficiaries of a post-Covid "back to normal" life?

Countries that are highly dependent on external demand, or which are sensitive to commodity prices, should benefit from a return to normal. So the list is quite long as many EM credits meet those characteristics. Many Asian economies, for example, or countries like Egypt and Costa Rica, will be very sensitive to a return of tourism flows, while the Russias and the Perus of the world will benefit from a bounce in commodity prices.

Starting with sovereign bonds, what are the most attractive EM?

First of all the EM dollars bonds in the high-yield space, because they tend to be short duration, they are cheap on their own and relative to US high yield, and they are the most reflation-friendly portion of the market. One name we own in that space is Oman, where we can buy USD-denominated bonds with a 7% yield.

And the second opportunity?

"Frontier" names in local currency. They are smaller credits, not yet mainstream emerging market countries highly uncorrelated to global markets. For example, we have a big position in the portfolio in Egyptian T-bills, where we earn yields of 13.75

What about at a corporate level? Is it best to have HY or IG in the portfolio?

We think corporates dollar bonds in EM are a great return enhancer to EM portfolios. Here we also favor the high-yield segment of the market: high spread, cheap, and shorter duration. We tend to like corporates in the Middle East region, we are a bit more cautious on Asian corporate names, especially Chinese ones, given the constant supply in the market and some transparency issues.

How do you build your portfolio?

We need to make sure the portfolio avoids defaults at all costs and has manageable market "Beta" which reduces the drawdown risk of the fund. On the former, the best way to go about it is making sure that every position is anchored on a fundamental view of the country, with a particular emphasis on solvency and liquidity risk. On the latter, the key is to make sure that any trade we put on is always "positively convexed" (i.e., the ex-ante upside of the position is much greater than the downside.

How do you minimize risks?

Generally, a lot of the risk mitigation comes down to portfolio construction – the appropriate sizing of the position, how it fits within the existing portfolio from a correlation perspective and optimizing the position to several risk constraints. (reproduction reserved)

Francesc Balcells