FINISTERRE UNCONSTRAINED EMERGING MARKETS FIXED INCOME FUND

A new way to invest in EMD—beyond the hard and local currency paradigm

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Principal Finisterre, an investment team within Principal Asset Management, was founded in London in 2002 to focus solely on the active, unconstrained management of EMD strategies.

FOURTH QUARTER 2022

Our objective is to deliver more resilient and predictable returns from an EMD allocation, aiming at **maximising income and upside capture while minimising downside capture and volatility throughout the EMD asset price cycle.**

EMD is rightly seen as a key provider of potentially higher yield and diversification for a global asset portfolio, while hopefully offering some legitimate upside potential as these countries mature over time.

Using our unique approach, we aim to deliver the income and return opportunities available across the entire EMD universe in a risk-managed way, such that EMD can become a resilient core allocation in your portfolio.

Legacy approach is inefficient

Traditionally, EMD allocation has been characterised by benchmarked exposures. Most of the global EMD mutual fund assets remain benchmarked to either hard currency sovereign, corporate credits, or local currency bond indices.[1] This often leads to an inconclusive debate as to how and when to allocate among the three sub-asset classes to achieve the most optimal results. Benchmarked fund managers typically just follow their benchmarks up and down, trying to slightly outperform along the way as market Beta is imposed by the benchmark.

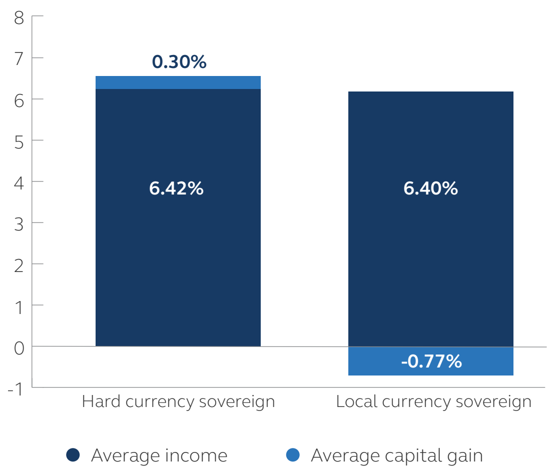
A benchmarked approach is also of very limited use in exploiting the potential of an increasingly differentiated universe where dispersion across countries, sectors, and issuers returns become the rule. Managers tend to fret over the idea of striding too far from their benchmarks, preventing them from avoiding a deteriorating story (e.g. Argentina in August 2019 and Turkey in April 2018).

[1]Source: Principal Global Investors.

Indices also hide a wide dispersion of situations and returns, linked to the differences in which EM countries need to address changing parameters in the global business cycle. Examples of this are lower Chinese and commodity demand, technological disruption, and changing globalisation patterns. We believe these have translated into a broad range trading environment for EMD indices, with a lot of return dispersion along the way.

These broad benchmark categories tend to be a bit artificial. There are several corporate index members that are state-owned companies or banks. Likewise, a local currency benchmarked fund is not an optimal strategic holding (in aggregate) given its excessive foreign exchange (FX) volatility and poor Sharpe ratio over five, ten, or 15-years, one can still identify low-volatility, long-term income opportunities in local currency markets (e.g. Peruvian government bonds).

Average annual income vs. capital gain return since 2003[2]



Source: Principal Finisterre, JP Morgan. As of 31 December 2022.

Income accounts for bulk of EMD performance

Another important aspect of investing in EMD is income. Looking at index returns over the mid-to long-term, income has on average accounted for about 100% of both local and external EM debt returns.

Contrary to popular belief, EMD is not a Beta-driven asset class. Unless portfolio exposure was actively managed across all the different market cycles, pure price moves have actually resulted in more volatility and lower long-term returns over the past 15 years.

EMD investing 2.0

These observations, together with the well-understood concern from many investors to limit volatility and the impact of market crises, have led us to a new way of investing in EMD.

Our approach is one that:

- is completely index agnostic and truly unconstrained.
- is grounded on income as the core component of portfolio returns, complemented with tactical capital gains from market timing with liquid "beta" assets and alpha generation from more idiosyncratic, assets, or relative-value strategies.

Our approach comprises processes that:

- enable the portfolio to risk and de-risk quickly thanks to a careful management of liquidity risk.
- build on our innovative process to dynamically manage the portfolio appropriately through different market cycles.

[2] Hard currency sovereign bonds is represented by the JP Morgan Emerging Market Bond Index Global Diversified, local sovereign currency bonds is represented by the JP Morgan Government Bond Index - Emerging Markets.

Technicals (risk and liquidity) as important as Fundamentals

The Finisterre Unconstrained Emerging Markets Fixed Income Fund portfolio construction process starts with the premise that an EMD portfolio's "technical" risk profile is key in explaining its behaviour during periods of market stress—often more important than its "fundamental" risk profile. The logic of our portfolio construction process rests on the notion that, across all EMD sub-asset classes, each instrument in our investment universe is either "cash-like", an "income" generator, an "alpha" provider, or a high market sensitivity "beta" asset.

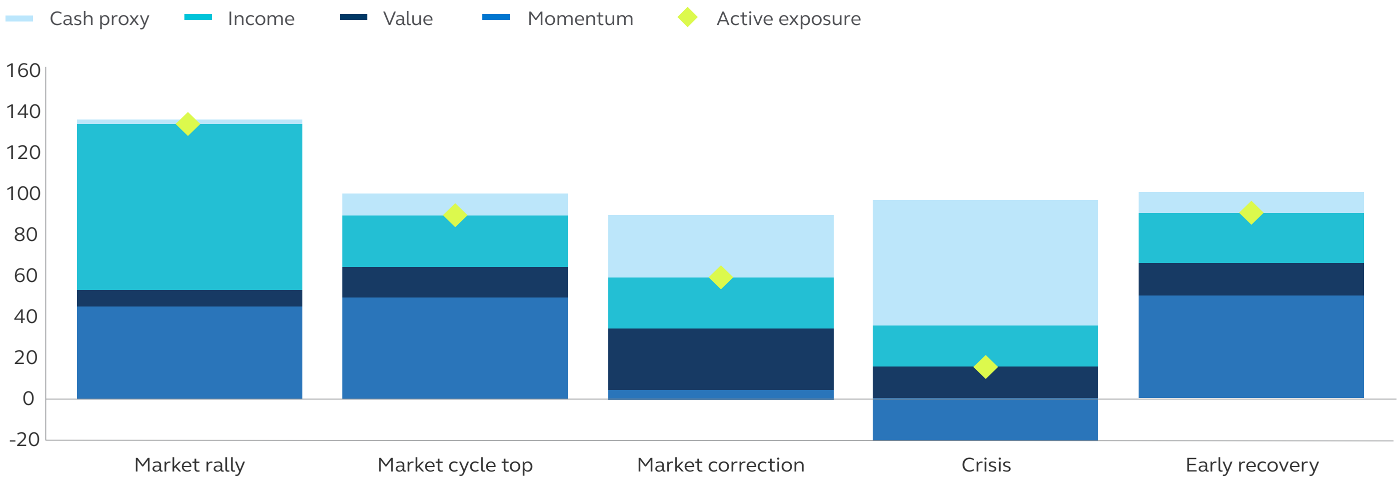
Performance driver	Cash	Income		Alpha	Beta
Risk bucket	**Cash proxy**	**Low volatility**	**Carry and rolldown**	**Value**	**Momentum**
Asset type	Defensive, short-dated EM sovereign and corporate credits Very-low-volatility local money market instruments	Bonds from U.S. dollar sovereign or corporate issuers Low-volatility currency with some income	EM shorter-duration bonds with more credit risk High carry to volatility currencies	Value and event-driven credit opportunities Cross-country credit default swaps, rates, and foreign exchange relative value	Liquid long-duration bonds High-beta currencies High market sensitivity and high liquidity
Used as	Cash proxy in times of market stress	Low-volatility anchor to portfolio performance	High carry anchor to portfolio performance	Non-directional/ value addition to portfolio performance	Capital gain contributor to portfolio performance
Examples	• U.S. T-bills • BGARIA 2% 03/22 EUR • BANCO 3.875% 02/22 USD • Abu Dhabi Govt 2.5% 11/22 USD • Korea T-bills	• CGB 3.77% 12/18/24 CNY • EQPTRC Corp 5.00% 05/25 USD • CWCLN 7.5% 10/26 USD • MGS 3.733% 06/15/28 MYR	• IVYCST 5.25% 03/30 EUR • MRFGBZ 7.00% 03/24 USD • INDOGB 7.00% 05/15/27 IDR • UKRAIN 7.75% 09/23 USD	• SRILAN 6.85% 03/11/25 • TLWLN 6.25% 15/04/22 (USD) • EGYTB 0 13/10/20 EGP • PLN SWAP 2Y (REC) vs 10Y (PAY) • Long RUB / Short ZAR	• ISRAEL 3.875% 03/07/2050 (USD) • NIGERIA 7.625 28/11/2047 (USD) • PETBRA 6.75% 03/06/50 • RFLB 7.25% 10/05/2034 (RUB) • PLN Forward

The above is based upon the current opinions of Principal Finisterre. There is no guarantee that such portfolio construction will be followed and the actual portfolio may be significantly different than shown here. All expressions of opinion and predictions are subject to change without notice. Any reference to a specific investment or security does not constitute a recommendation to buy, sell or hold such investment or security, and is provided for illustrative purposes. All portfolio construction targets are measured at the time of investment unless otherwise noted. While Principal Finisterre generally expects to adhere to the investment parameters described herein during normal market conditions, such parameters are targets and not investment restrictions. Source: Principal Finisterre.

Match portfolio to market cycles

We believe that each stage of the EMD asset price cycle presents different environments in terms of liquidity, volatility, fundamental risks and market trends, for each of which there should exist an adequate response in terms of portfolio positioning around our four performance drivers: Cash, Income, Alpha, and Beta.

Cash proxy/income/value/momentum



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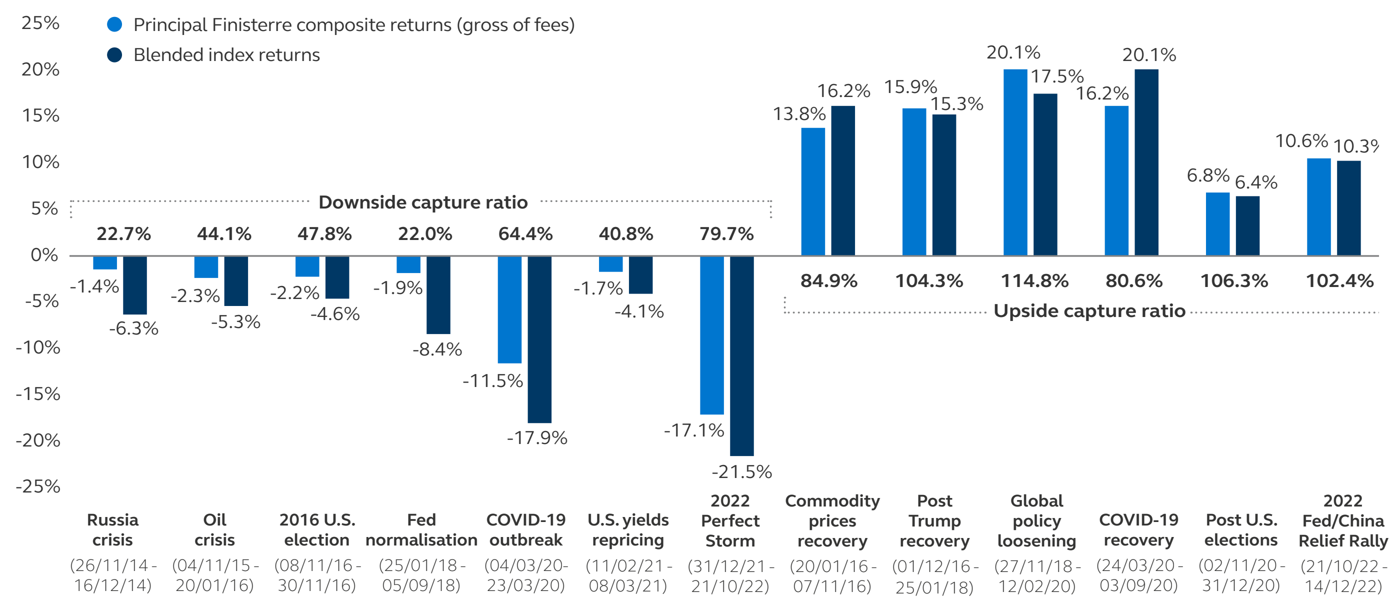
EMD investing that works

Success of the strategy is attributable to the repeatable process the team has in assessing both macro and micro factors. The strategy has been able to deliver on its objective – capturing most of the upside with much lower downside participation.



Source: Principal Finisterre. Chart reflects gross of fees performance of the Finisterre Emerging Market Total Return Composite. For illustrative purposes only. Past performance does not guarantee future return. Please see Important Information section for additional details. The Blended Index is the JP Morgan EM Equal Weight Total Return Index which is currently 33.3% CEMBI Broad Diversified, 33.3% EMBI Global Diversified, and 33.3% GBI-EM Global Diversified, gross of withholdings taxes, rebased monthly. The benchmark was changed retroactively on 30 April 2017 back to 1 June 2013. This change is due to the fact that the current benchmark more accurately reflects the current investment strategy. Additional information concerning this is available on request.

CASE STUDY:

Market cycle assessment, buckets in action

Rally

GLOBAL POLICY LOOSENING – 2019

As we ended a tumultuous 2018, 2019 was characterised by lower volatility and consistent positive returns, on the back of renewed global policy loosening, and despite key hurdles such as the U.S.-China Trade War, Argentinian elections, and Ecuadorian protests. We chose to reengage through the income route first, retaining a focus on alpha and relative-value opportunities, while progressively increasing our positive exposure to momentum assets, although remaining very liquid and tactical. At the end of a challenging year, we broadly felt that EM debt assets were trading around their low cyclical point.

Crisis

COVID-19 – 2020

The rally which had persisted through 2019 to the start of 2020 was then followed, in March, by what is now known as one of the three worst market meltdowns in the past 100 years. The COVID-19 outbreak led us to become more tactical in terms of portfolio structure. On 23 March 2020, we increased our exposure to the cash proxy bucket to 36%, up from 10% at the end of January. We started reducing our exposure to the momentum bucket by selling out of EM high beta currencies (MXN, KRW) in January. We also set up and actively traded several liquid portfolio hedging strategies.

Early recovery

SUMMER 2020

We then started engaging into high quality new issues first and then looking for selected value trades. We then increased our exposure to the Momentum bucket in order to fully participate to the recovery of the index. During the summer, we then decided to reduce the beta risk bucket while retaining exposure to steady income-generating assets, and increasingly adding to idiosyncratic stories, at a time where we turn less sanguine about overall market momentum.

Correction

SEPTEMBER 2020

September marked the first month of negative risk asset performance since the COVID-19 induced meltdown in March. As for positioning, we shifted the portfolio slightly heading towards the presidential elections in the U.S. We have reduced momentum-related positioning and focused the book on alpha and value-oriented positions that should be less sensitive to the broader macro environment and U.S. election jitters. Likewise, we remain focused on income generation stories such as strong balance sheet, short-duration corporate credit, and steep local rates curves in large, diversified EM economies.

The commentary is provided by and represents the views and opinions of Principal Finisterre, an investment management team within Principal Global Investors.

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