Emerging Market Debt in Focus on Nigeria Debt Exclusion

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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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