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Emerging Markets Debt

Serbia's new inclusion in Index highlights benefits of investing outside indexes

Emerging Markets Debt Team
Eaton Vance Management

Boston - The Eaton Vance emerging markets debt team has long held that issuers outside the common EM benchmarks are a tremendous source of opportunity for managers willing to devote the time, resources and expertise required for such investments.

The announcement on February 10 by JP Morgan that Serbia will be added to its Government Bond Index - Emerging Markets (GBI-EM) underscores why the outside-the-benchmark approach is so valuable. When Serbia officially moves to the local-currency benchmark in June, its 0.33% weight in the GBI-EM could attract as much as $800 million in foreign investment to the three eligible Serbian issues, according to JP Morgan. That's a huge increase in demand, and potentially in the price of the bonds.

Rushing in with the crowd to buy bonds simply because they are now part of a benchmark highlights what we believe is one of the major flaws with index-based strategies. Investment decisions are, by definition, reactive, arbitrary and untethered to fundamental value.

In contrast, the EM debt team first invested in Serbian debt more than a decade ago, as a result of proprietary country-level macroeconomic and political research. While this approach is time- and labor-intensive, we believe it is the best process for identifying potential success stories.

In Serbia, we saw a former communist country committed to the hard transition to democracy and a market-based economy, with concrete reforms such as:

- Closing or privatization of failing state-owned enterprises.
- Restructuring and downsizing of large public utilities.
- Reducing the size of the public sector workforce.
- Reform of the banking sector, including a reduction of nonperforming loans.

When we first bought Serbian bonds, the yield was around 15%; today, it is about 2.6%. Serbia has taken steps to boost liquidity of its debt to qualify for inclusion in the GBI-EM, and may indeed be an attractive holding relative to other Index issuers, based on pricing and fundamentals. But much of Serbia's potential is now "priced in" its bonds.

Bottom line: Serbia's progress over the last decade illustrates the potential for alpha in the EM debt sector for those willing to invest the time and effort to go beyond the narrow universes of common indexes.

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