William Blair

EMERGING MARKETS DEBT

Investment Management
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Seeking to Optimize Risk-Adjusted Return Potential With Frontier Markets Debt

Opportunities have increased significantly in frontier markets debt as more countries have made a conscious effort to open their capital markets to international investors and currencies have become more fairly valued. As a result, we believe the time may be right for an allocation to frontier markets debt through a dedicated strategy. In this paper, we take a closer look at both the potential benefits a frontier debt portfolio can add to an investor's portfolio, discuss our investment process, and explain how we handle the risks inherent in this asset class.

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Portfolio Managers
Yvette Babb
Daniel Wood

The Time May Be Right

Investment opportunities in frontier markets debt have increased in recent years due to structural improvements, valuation shifts, greater diversification potential, and continued growth in hard currency frontier debt.

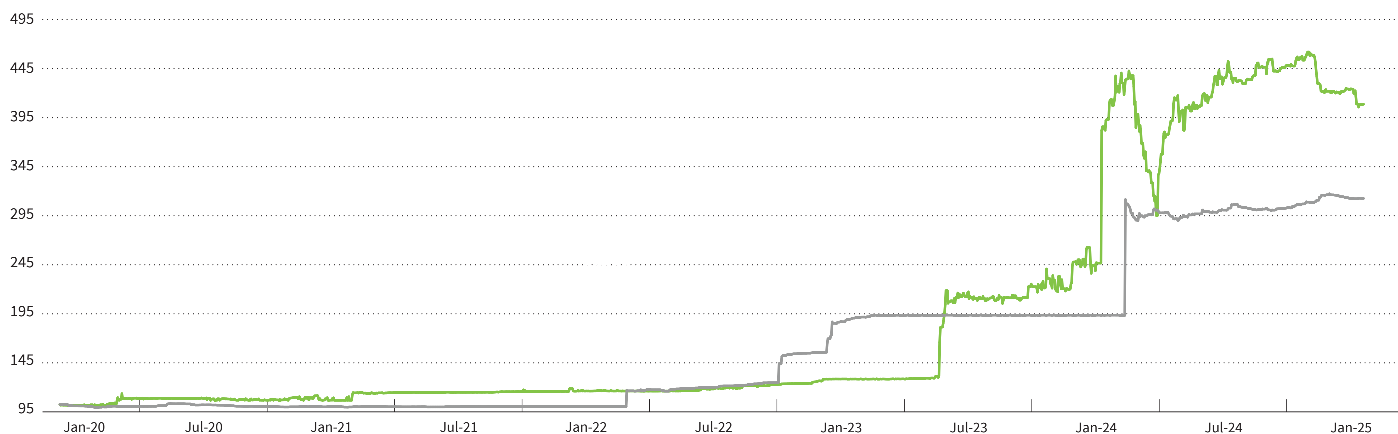
- **Structural improvements:** More frontier economies are opening their local capital markets to international investors, driven by pro-market reforms supported by multilateral development partners, reduced capital controls, and enhanced liquidity measures provided by central banks.
- **Attractive valuations:** Many frontier currencies have undergone significant devaluations, leading to what we view to be more fairly valued currencies alongside attractive interest rates. This environment allows investors to access higher-yielding assets while potentially benefiting from improved currency valuations.
- **Greater diversification potential:** Previously, emerging markets managers often allocated to frontier local markets in a concentrated manner. However, we believe the asset class has now evolved sufficiently to stand as a diversified investment category.
- **Hard currency frontier debt:** This segment of the asset class has seen a growing and diversified issuer base for more than a decade. Hard currency frontier bonds continue to offer relatively high nominal yields with valuations pointing to room for further spread compression. We are also confident that restructuring risk is likely to be low over the forecastable time frame, following successful negotiations with bondholders in recent default cases. We believe the resilience of recovery values for Eurobond investors further strengthens the case for investment.

Valuations Have Improved

In frontier countries, central banks often use the nominal exchange rate as a financial and economic policy anchor while managing borrowing costs. However, investing in bonds of countries with overvalued currencies and low carry can be risky. Over the past four years, harsh global macroeconomic conditions and policy measures supported by the International Monetary Fund (IMF) have pushed many frontier markets to abandon unsustainable currency pegs and managed exchange rates, leading to more competitively valued currencies (see exhibit 1 for the meaningful adjustment in Nigeria and Egypt). Concurrently, monetary policy tightening and sharp interest-rate hikes have strengthened the investment case for frontier markets debt.

EXHIBIT 1

Nigeria and Egypt: Select Frontier FX Adjustments



Source: Bloomberg, as of February 2025. Indexed to 100 on January 1, 2020. **Past performance is not indicative of future returns.**

Inefficiency Can Be Exploited

In frontier markets, we believe persistent lack of transparency and research coverage embeds an unwarranted risk premium in certain frontier assets. This inefficiency presents opportunities for skilled managers to capitalize on:

- **High yield per unit of duration:** Hard currency frontier bonds often provide an outsized yield relative to their risk profile.
- **High risk-adjusted carry:** Local frontier markets frequently exhibit currency forwards with risk-adjusted returns that exceed those of developed or emerging markets.
- **Underrepresentation in global benchmarks:** The relatively low international ownership of frontier assets further may further enhance these opportunities.

This phenomenon is even more pronounced in frontier markets than non-frontier emerging markets, as international ownership is minimal and access to information more difficult.

Correlations to Traditional Asset Classes Are Generally Low

Frontier market debt has historically exhibited low correlation to traditional asset classes, making it a potentially valuable diversifier. Several key factors contribute to this:

- **Absence of dedicated exchange-traded funds (ETFs):** Without ETF-driven liquidity swings, frontier markets are less prone to volatility driven by large passive flows.
- **Low international participation:** Market access challenges and a lack of a globally recognized benchmark may limit participation and in turn reduce susceptibility to global risk sentiment shifts.
- **Returns with a tendency to be driven by predominantly bottom-up factors:** Market returns tend to be primarily driven by country-specific dynamics rather than broad macroeconomic trends.

Meet the Managers

Yvette Babb

Yvette Babb is a hard and local currency portfolio manager on William Blair's EM debt team. Before joining William Blair, she was a portfolio manager on NN Investment Partners' EM debt team and the chief economist and strategist for sub-Saharan Africa at J.P. Morgan. She also held a similar role at Standard Bank in Johannesburg, South Africa. Yvette serves on the PRI's Sovereign Advisory Committee (SDAC). She received a B.Sc. in international economics and business studies from Erasmus University of Rotterdam and an M.Sc. in economics from the University of Amsterdam.

Daniel Wood

Daniel Wood is a hard and local currency portfolio manager on William Blair's EM debt team. Before joining William Blair, he was a senior portfolio manager on NN Investment Partners' EM debt team; a portfolio manager at BNP Paribas; and an analyst on the EM fixed-income team at Rexiter. Daniel began his career in 2000, holding various middle-office, marketing, and client service roles for Fidelity, Schroders, and State Street. He received a B.A., with honors, in finance and accounting, economics, and accountancy from the University of Brighton.

Optimizing Risk (continued)

In addition to not being highly correlated with other risk assets, frontier markets are generally not highly correlated with one another. Even within the same country, hard and local currency bonds often display low correlation, which can further enhance portfolio diversification.

Sponsorship Has Improved Fundamentals

Many frontier economies enjoy strong geopolitical importance and recognition of economic opportunities, attracting significant support from multilateral and bilateral institutions. A large proportion of these markets currently benefit from IMF programs and further support from development partners, which provide:

- **Low-cost financing:** Reducing fiscal strain and enhancing economic stability.
- **Economic reforms:** Encouraging market-friendly policies, including subsidy removals and privatization efforts.
- **Improved debt sustainability:** Strengthening economic fundamentals, lowering default risks, and increasing growth potential.

Such reforms are helping to improve structural potential growth across many frontier markets, putting debt levels on a more sustainable path and potentially reducing the probabilities of large drawdowns in asset prices.

Risk-Adjusted Return Potential Is Compelling

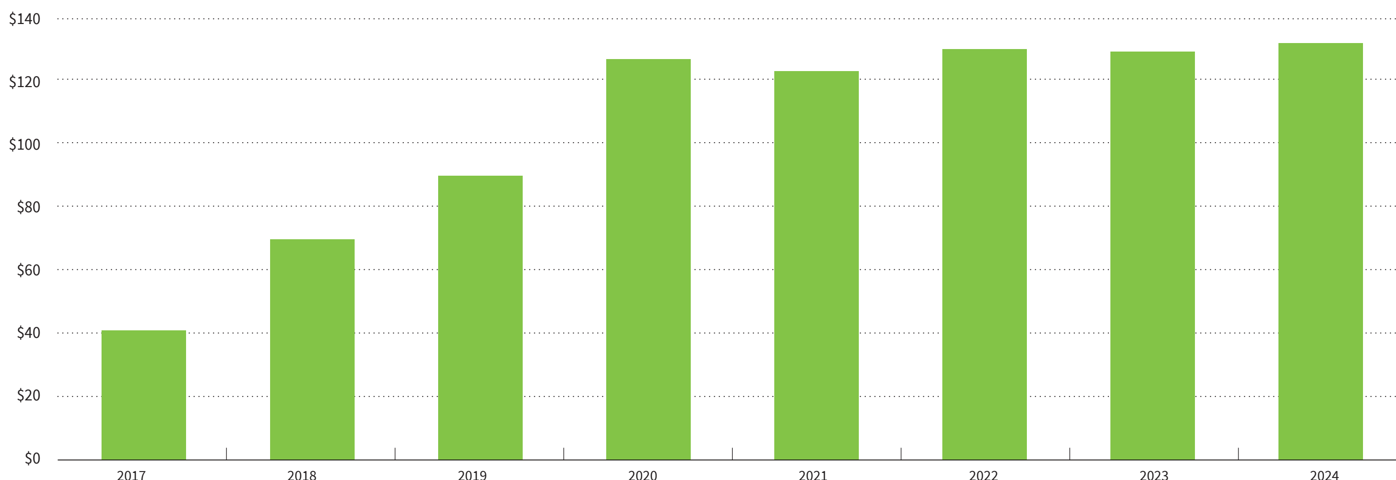
We believe the combination of excess risk premium, diversification benefits, low correlation with traditional assets, and strong institutional sponsorship makes frontier markets debt an attractive asset class. Historically, it has offered high Sharpe ratios due to:

- **Overcompensation for volatility:** High carry and risk-adjusted premiums offset perceived risks.
- **Resilient recovery rates:** Even in default scenarios, frontier markets debt has historically delivered relatively strong recovery values.
- **Active management advantage:** Experienced managers can unlock additional alpha through strategic asset allocation and rigorous risk mitigation.

We believe a high Sharpe ratio has the potential to persist given that the high carry and risk-adjusted premia overcompensate investors for volatility, default risk, and loss potential.

EXHIBIT 2

IMF Credit Outstanding to 78 Frontier Countries (in Billions)



Source: IMF, as of 2025. Shows credit outstanding under the General Resource Account (GRA), Poverty Reduction and Growth Trust (PRGT), and Resilience and Sustainability Trust (RST).

Optimizing Risk (continued)

The Importance of Active Management

We believe that navigating the complexities of frontier markets debt requires an experienced, research-driven manager who can identify opportunities, manage risks, and seek to optimize asset allocation between hard and local currency debt, which are the two broad categories of the asset class. Due to the relatively low transparency in frontier markets, we believe a rigorous bottom-up, research-driven process is necessary to identify high-value opportunities and allocate capital effectively. At the same time, a well-diversified portfolio, coupled with robust risk controls, is crucial in seeking to limit drawdowns and providing long-term resilience.

Capturing Risk-Adjusted Return Potential With William Blair's Emerging Markets Frontier Debt Strategy

That's why we introduced William Blair's Emerging Markets Frontier Debt strategy, which invests in a diversified portfolio of frontier markets debt, targeting 75% of assets in local currency debt and 25% in hard currency debt.[1]

Our approach prioritizes:

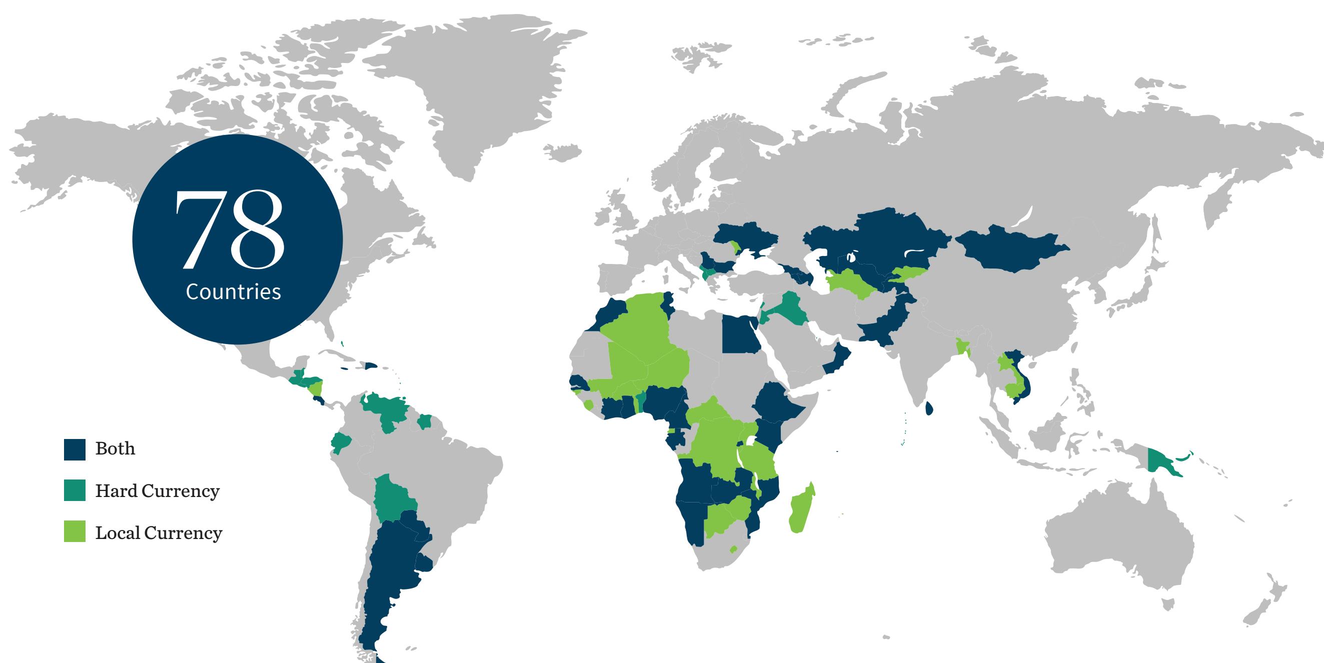
- **Diversified portfolio construction:** Seeking to limit drawdown risk through strategic asset selection.
- **Bottom-up research:** Allocating capital to what we consider the most attractive opportunities through a robust bottom-up research-oriented process.
- **Dynamic asset allocation:** Adjusting exposure to hard and local currency bonds based on evolving market conditions.

Leveraging our extensive operational expertise, we invest across 78 different frontier markets—37 accessible in both hard and local currency, 20 in local currency only, and 21 in hard currency only. This broad reach enables well-balanced exposure across Latin America, Europe, the Middle East, Africa, and Asia.

1 Approximate initial allocation. The allocation is flexible and determined by both top-down and bottom-up drivers.

EXHIBIT 3

Frontier Markets Span Geographies



Sources: Bloomberg, JPMorgan, and William Blair, as of January 31, 2025. Index and universe characteristics are provided for illustrative purposes only.

Optimizing Risk (continued)

Risk Considerations and Mitigation Strategies

While the opportunities in frontier markets debt are compelling, prudent risk management is essential. Key risks and our approach to mitigating them include:

- **Liquidity risk:** Frontier markets liquidity remains lower than that of developed and emerging markets. We address the associated risks at a market and portfolio level by placing a ceiling on the level of total assets under management, imposing country-specific allocation limits, and employing bottom-up liquidity assessments.
- **Convertibility risk:** Local market investments face repatriation risks. We mitigate this by maintaining a convertibility risk scorecard, leveraging strong custodian relationships, and diversifying investment instruments (such as global bonds, credit-linked notes, non-deliverable forwards, and supranational bonds).
- **Devaluation risk:** Pegged and managed currencies may face sudden and meaningful adjustments. We manage this risk through a bottom-up approach, identifying vulnerable currencies and diversifying exposure across multiple markets.
- **Default and restructuring risk:** While it is rare for local markets to undergo bond restructurings, the risk is significantly higher for hard currency investors. Hard currency frontier bonds carry a historical annual default rate below 1%, with recovery values averaging in the mid-50s. The recent wave of sovereign restructurings has reduced near-term risks. Our active management strategy further minimizes exposure to distressed issuers while seeking to capitalize on recovery opportunities.

Conclusion

We believe frontier markets debt is an underappreciated asset class that offers compelling risk-adjusted return potential and meaningful diversification benefits. With inefficiencies that can be exploited through active management, improving fundamentals, and robust institutional sponsorship, we believe it presents an exciting investment opportunity for today's investors. By employing a disciplined, research-intensive, and diversified approach, we believe investors can enhance returns while effectively managing risks in this dynamic market segment.

Fortunately, as portfolio managers we have various resources at our disposal to help with the complex task of balancing these different, sometimes competing objectives.

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Alpha is a measure of an investment's return in excess of the market's return, after both have been adjusted for risk. Sharpe ratio is a risk-adjusted measure calculated using standard deviation and excess return to determine reward per unit of risk.

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