

# Spotlight

Whilst many investors recognise the opportunities in Asian equity markets, they continue to overlook the 'search for yield' theme, where a better understanding of, and an appropriate allocation to, Asian debt is required.

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## Asian Debt Hard Currency

Future proofing your portfolio through Asian debt exposure



Joel Kim, CFA, is Head of the Asian Debt team and is based in Hong Kong.

Joel has 13 years of experience, and since joining ING Investment Management Asia Pacific in 1997, he has been responsible for the emerging markets debt assets in the Asian region.

Watching the rise of the Asian tiger has become more fascinating, particularly post the global financial crisis, where many developed markets continue to struggle in a macroeconomic and fiscal sense. Yet, whilst many investors recognise the opportunities in Asian equity markets, they continue to overlook the 'search for yield' theme, where a better understanding of, and an appropriate allocation to, Asian debt is required.

In constructing any portfolio, the journey into a successful future starts with an accurate assessment of the facts. It is our strong belief that future proofing your portfolio can be achieved by gaining exposure to Asian debt, particularly where fundamentals are solid, valuations are attractive and where the asset class will continue to grow as Asia matures.

Hard currency (HC) Asian debt provides investors with exposure to the credit risks of Asian issuers, determined by the USD risk-free debt (US treasuries), plus a credit spread. Investing in local currency (LC) Asian debt provides two additional exposures, namely debt positioning through the region's interest rates curves, as well as Asian currencies. In this article, we provide fundamental reasons for positioning into Asian debt, a sub-set of emerging markets debt, and present evidence to show that a separate allocation into Asian bonds makes sense from a strategic point of view.

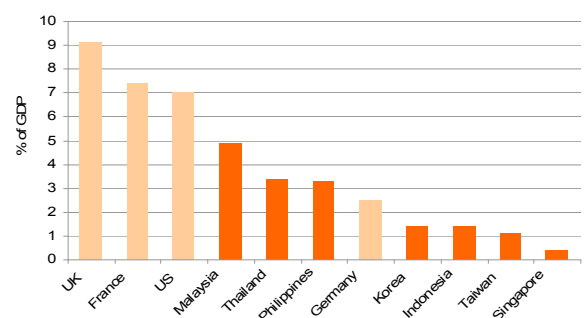
### Let's explore the rationale for Asian debt

Asia asks: What crisis? Solid debt fundamentals persist

In many ways, Asia is now more structurally sound than its European and US counterparts. Asia ex-

Japan is a net creditor to the world and has sustainable fiscal dynamics, especially when compared to the developed countries. Budget deficits are also at much lower levels. The region's structural current account surplus, in stark contrast with many developed and emerging economies, underpins macro stability. Asia is also less leveraged, with corporate leverage multiples low compared to the US and Europe, especially for high yield issuers. In addition, domestic credit conditions in the region are supportive, which means loan-to deposit ratios are low by international standards. Asian banks have ample liquidity and hence have limited reliance on wholesale funding, which makes them less vulnerable in crisis periods, that is when money market liquidity dries up, as was the case during the credit crunch. The ability and willingness of Asian banks to lend creates a favourable credit environment. Asset quality in the region is stable due to supportive economic conditions, and Tier 1 capital ratios range from almost 9% to more than 14%, implying that the Basel III bank capital adequacy standards should not have an adverse impact on Asian countries.

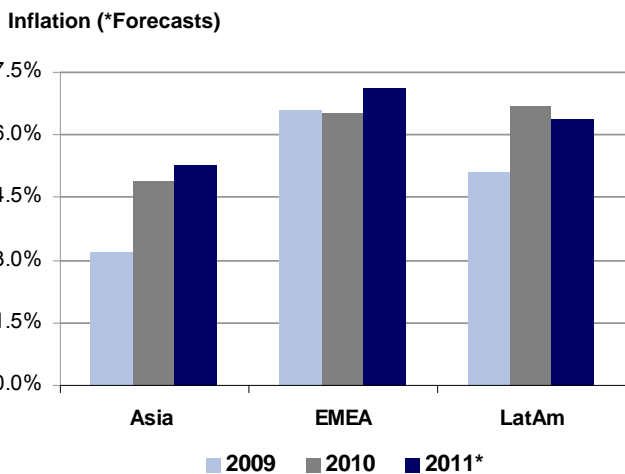
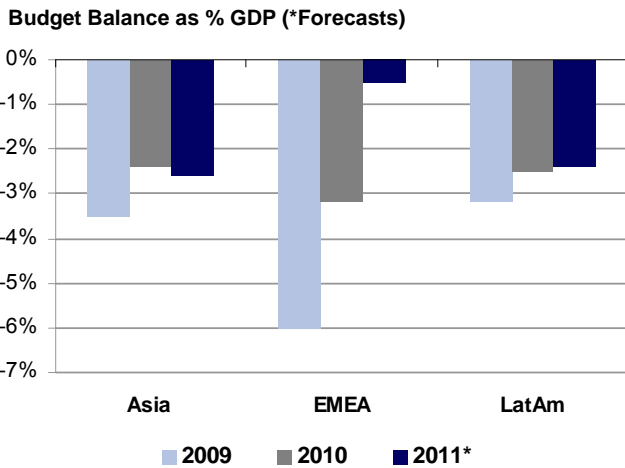
Figure 1: Superior debt fundamentals



Source: EIU 2010 forecasts, as of 30 September 2010

Asian macro fundamentals are also sound when compared with other emerging markets in Europe, the Middle East, Africa and Latin America. As evident in Figure 2 below, the region generally enjoys superior fiscal dynamics.

**Figure 2: Asia vs. other emerging markets: better fiscal dynamics, lower inflation**



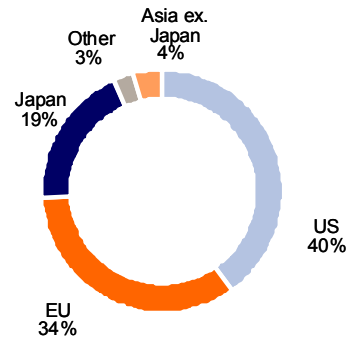
Source: Credit Suisse (EM Quarterly, March 2011)  
 Aggregates for regions are weighted by 2010 nominal GDP (\$bn) figures. Asia doesn't include Japan

**Looking forward, this growing asset class will be difficult to ignore**

The share of Asia-ex Japan within the Barclays Global Aggregate Bond Index (“BGABI”) is just 4%. We believe this is much too low, considering the demographic profile of the region and the expected above par, sustainable growth in the Asian economies in the longer term. Investors wanting to gain exposure to Asian bonds through the BGABI would, in our view, be inadequate. A separate allocation to Asian bonds would make sense from both a strategic and tactical point of view and would be especially logical for Asian investors, who hold higher proportions of their assets in Asian investments.

**Figure 3: Asian bonds are under-represented globally**

**Barclays Global Aggregate Bond Index**



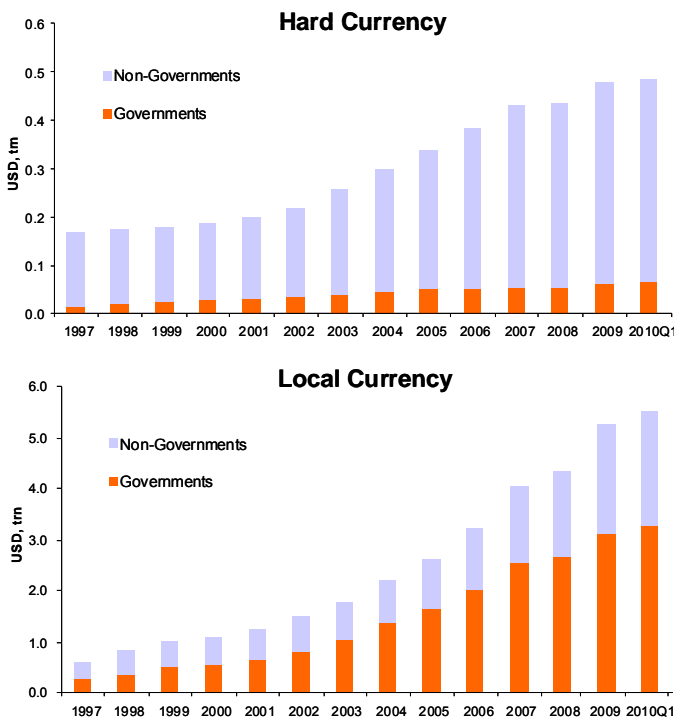
Source: BIS Quarterly Review, September 2010

The region’s HC USD corporate bond market has shown higher rates of growth than the government sector, as many countries reduced their fiscal stimulus packages and some central banks have also slowed their bond sales. As evident in Figure 4, Asia’s HC bond markets are increasingly dominated by corporates, since the region’s governments tend to focus on the LC debt markets for their funding requirements.

The LC corporate credit market continues to grow, but it is still relatively immature by comparison. The HC debt markets therefore still play an important role in Asia, in view of the relatively undeveloped LC corporate credit markets. In addition, the superior liquidity when compared with the LC corporate segment is a further positive, implying that HC credit is more appropriately priced.

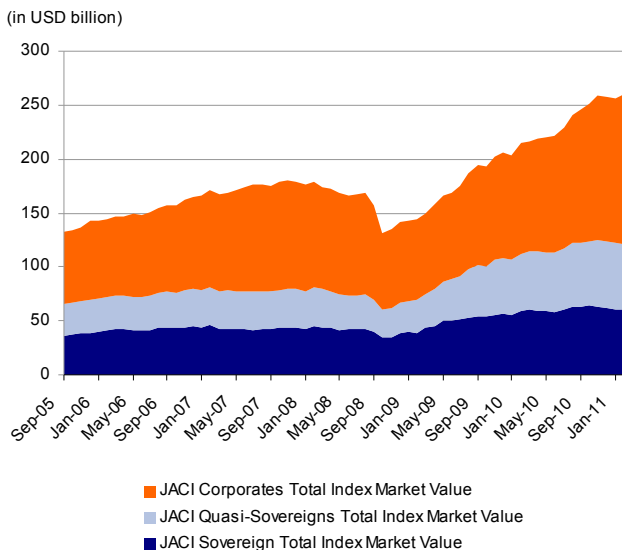
The HC corporate bond segment remains a fast-growing asset class, which has more than doubled in the past 5 years and more than quadrupled in the past decade, to more than USD 134 billion at the end of 2010. The number of investment grade and high yield issuers is still small, with 147 included within the sub-index of the JP Morgan Asia Credit Index. Whilst the high yield segment is also small at USD 35 billion at the end of last year, the growth within this sub-asset class has matched corporate credit in the past 10 years and is expected to continue to increase at a rapid pace in 2011.

**Figure 4: Growth in Asian bond markets**



Source: BIS Quarterly Review, September 2010

**Figure 5: Asia's USD corporate bond market is growing rapidly versus local credit**

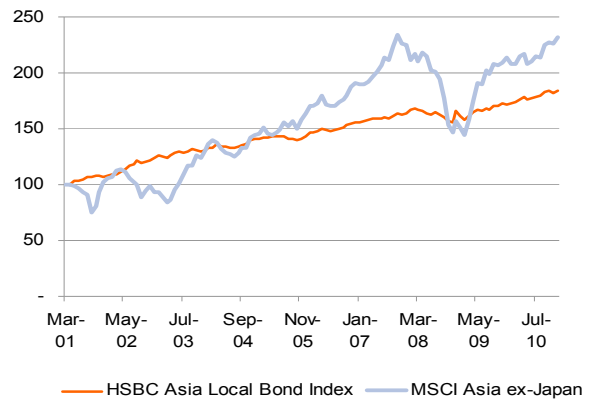
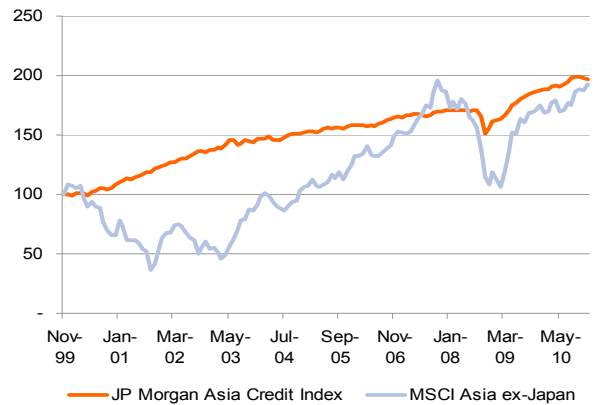


Source: JP Morgan Asia Credit Index (JACI) - Sovereign, JP Morgan Asia Credit Index (JACI) - Quasi Sovereign, JP Morgan Asia Credit Index (JACI) - Corporates. Data as of 28 February 2011

**Risk-return characteristics are favourable**

Historically, Asian bonds have provided investors with attractive risk-adjusted returns. Figure 6 shows that HC Asian debt has not only performed better than Asian equities since November 1999, it has been much less volatile. Returns in HC Asian bonds have been driven by improving credit fundamentals and lower credit risks. Meanwhile, abundant liquidity, appreciating currencies, credible monetary policy and stronger fundamentals lowered risk premiums, resulting in a tightening in spreads in local yield curves in the region, which boosted LC Asian bond returns.

**Figure 6: Attractive risk adjusted returns**



Source: Bloomberg, HSBC, JP Morgan, data expressed as of 31 December 2010

On a 5-year annualized basis, whilst Asian equities have performed better than Asian bonds, the volatility of the latter is only a fraction of that for Asian equities. During this period, Asian bonds have provided higher returns than global bonds, with slightly higher volatility. When compared with global high yield and emerging markets, the returns for Asian bonds were similar, but with substantially lower volatility. It is worth noting, however, that individual country performances within the region tend to vary substantially, highlighting the importance of active management, that is, the ability to exploit inefficiencies in the market, using a disciplined investment process as well as adhering to stringent risk management processes.

**Figure 7: Attractive risk return profile (5-yr annualized)**

Asset Category	Return (%)	Risk (%)	Return per Risk
Asian USD Bonds	7.67	9.26	0.83
Asian LC Bonds	8.10	7.37	1.10
US Treasuries	5.60	5.13	1.09
US IG Corp	6.05	7.35	0.82
US High Yield	8.91	13.65	0.65
Global HY (Non-Fin)	8.16	12.78	0.64
Global EMD (HC)	8.37	10.64	0.79
European Govt Bonds	5.82	12.76	0.46
Japanese Govt Bonds	10.00	11.50	0.87
Global Bonds	6.66	6.78	0.98
Global Equities	2.99	19.39	0.15
Asian Equities	12.75	26.60	0.48

Source: Bloomberg, as of December 31, 2010

### Putting all your eggs in one basket? The benefits of diversification prevail

Correlations for both HC and LC bonds in relation to other asset classes are relatively low, thereby offering significant diversification benefits (Figure 8). Whilst correlations have risen in the past few years as globalization has taken hold, the relatively lower correlations of Asian LC bonds with other asset classes reflect the strong influence of regional and country specific factors, the differences in credit quality among Asian countries, exchange rate policies in the region, the incomplete integration of domestic debt markets into global capital markets and the relatively low degree of involvement of foreign investors.

**Figure 8: Asian bonds – low correlation with other asset classes**

Asset Category	Asian Bonds	USD Bonds	Asian LC Bonds
Asian USD Bonds	1.00		
Asian LC Bonds	0.54		1.00
US Treasuries	0.23		0.23
US IG Corp	0.84		0.57
US High Yield	0.73		0.56
European Govt Bonds	0.56		0.70
Japanese Govt Bonds	-0.10		0.22
Global EMD (HC)	0.96		0.63
Global EMD (Local)	0.62		0.74
GBI EM	0.71		0.82
Global Bonds (hedged)	0.54		0.42
Global Bonds (unhedged)	0.58		0.70
Asian Equities	0.76		0.51
Global Equities	0.62		0.66

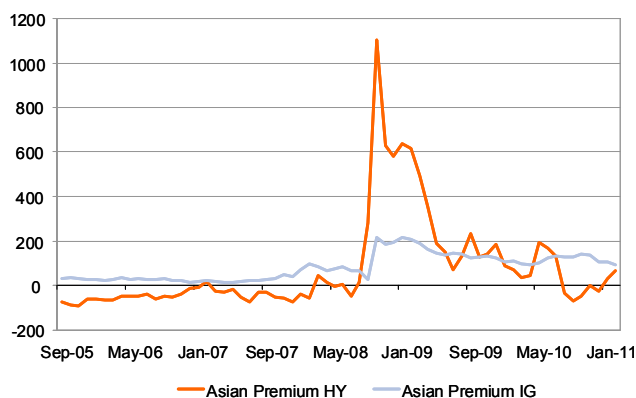
Source: JPMorgan, HSBC, Barclays  
Based on annualized USD monthly returns for 5 years as of 31 December 2010

The low representation of Asian bonds within both global bond and emerging market bond strategies lead us to the conclusion that a separate allocation to the Asian region makes strategic sense for both international and Asian investors. Apart from being complementary to existing global emerging markets debt exposure, a separate Asian allocation would also be easier to manage tactically.

### Valuations are attractive on the back of solid fundamentals

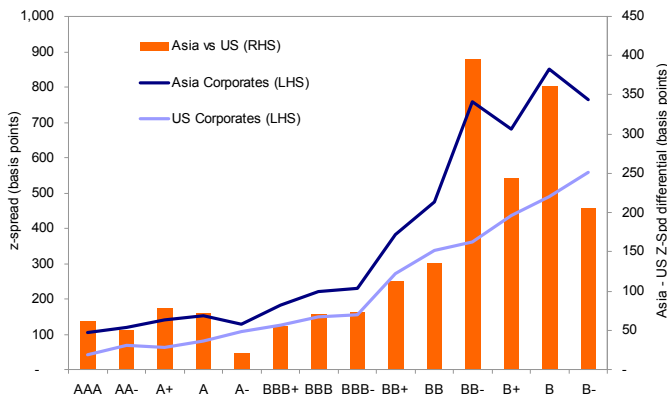
Within the corporate and sovereign segments in the region, implied default rates are very low, with minimal defaults expected, especially within the Asian investment grade bond universe. Rating actions have been positive and spreads have narrowed considerably from the peaks seen at the height of the global financial crisis. Positive rating actions in Asia are expected to continue, and there is a possibility of a convergence in sovereign credit ratings between developed and emerging markets, as those in the former fall (1). The historical trend of Asia's premium over US spreads (Figure 9) suggests that relative valuations are solid at these levels and that there is scope for Asian spreads to narrow.

**Figure 9: Asia's premium over US spreads - trend**



Source: UBS & Bloomberg. Data as of 28 February 2011  
Note: Asia IG Corp premium based on spread over treasuries differential between JP Morgan Asia Credit Index (JACI) - Corporates Inv Grade and JP Morgan US Liquid Index (JULI). Asia HY Corp premium based on spread-to-worst differential JP Morgan Asia Credit Index (JACI) - Corporates Inv Grade and JP Morgan Domestic HY. Data as of 28 February 2011

**Figure 10: Z-spread Asian corporates vs. US corporates (ex-financials)**



Source: INGIM calculations based on JP Morgan Asia Credit Index (JACI), JP Morgan US Liquid Index (JULI), Barclays US HY Corporate index. Data as of 28 March 2011

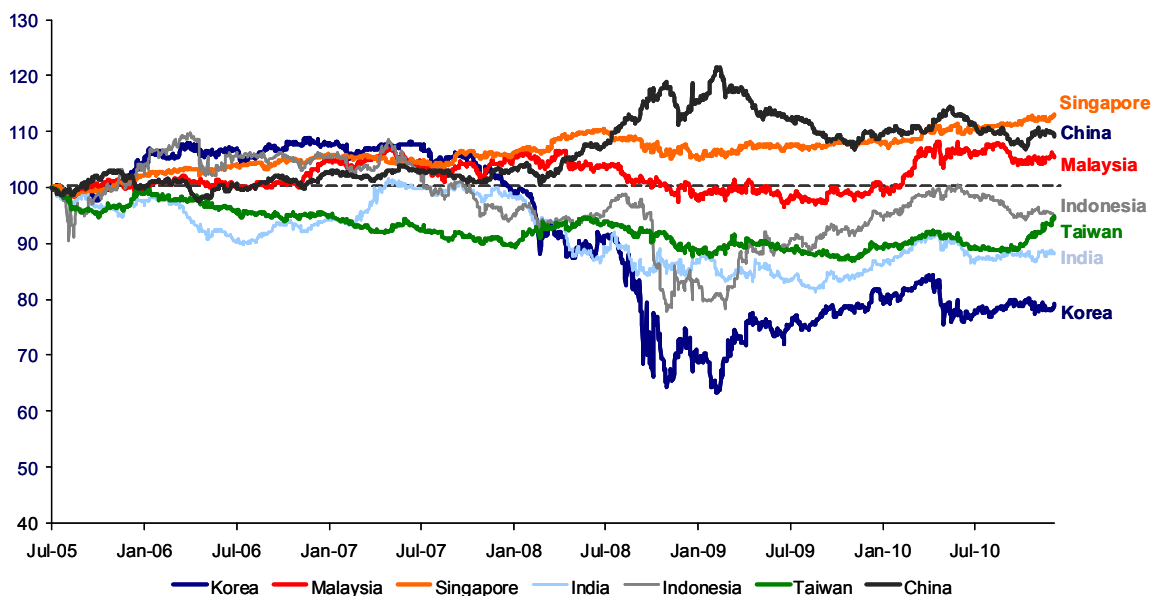
Note: bonds issued by Sovereign/Quasi-sovereigns issuers and by financial institutions have been excluded from average z-spread calculations. Z-spread calculations based on bid pricing.

Figure 10 shows the z-spreads of Asian corporates over their US counterparts. We believe there is room for compression in spreads in 2011 on the back of strong fundamentals for the corporate sector, as well as yield differentials, suggesting potential outperformance in Asian corporate debt when compared with US treasuries.

Despite their solid fundamentals, Asian currency valuations remain attractive. Whilst inflationary pressures are generally on the rise in Asia, with food prices behind higher headline inflation numbers, core inflation remains largely stable. Nevertheless, further policy tightening is likely to be required in certain countries to limit second round effects of inflation and to manage inflation expectations. We expect currency appreciation to be used as a further tightening tool. Our view is that the Asian markets have already priced in further expected interest rate tightening, of an average of 75 basis points to the end of 2011.

**Figure 11: Asian FX valuations remain attractive**

**Asian FX (NEERs) Nominal Effective Exchange Rates**



Source: Bloomberg, data as of 31 December 2010

**How may investors best access Asian debt investments?**

Asian debt is no longer a new asset class. Notwithstanding its continuous evolution, market inefficiencies exist, which can be identified and exploited using a disciplined investment process. We believe that an active investment management style can result in superior and consistent returns, at an acceptable level of risk, over the long term. Five key factors are essential for successful investment into Asian debt including:

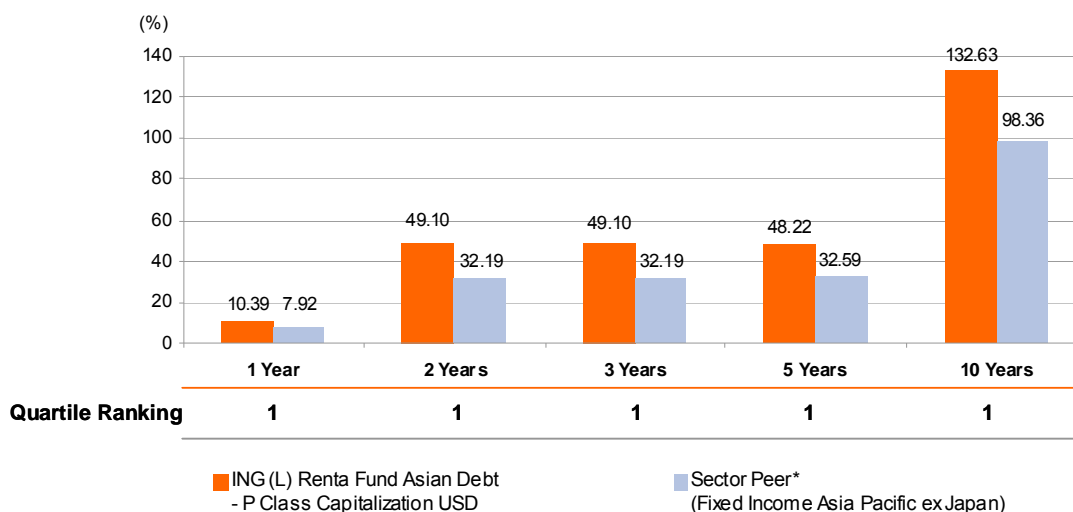
- Experience and a proven track record in managing Asian debt investments;
- Proven ability to add value from various alpha sources within this asset class;
- Local presence, coupled with strong links to successful global investment teams for global market input;
- A structured and disciplined investment process; and
- Strong risk management and credit analysis skills

## ING's Asian debt capability is virtually unrivalled in the industry

ING Investment Management has extensive experience in managing Asian debt in both HC and LC since 1996 and 1998, respectively. Our capability, both in terms of experience and coverage, is virtually unrivalled in the industry. Our actively managed flagship pan-Asian bond fund, **ING (L) Renta Fund Asian Debt (the "Fund")** has the investment mandate to invest in both HC and LC Asian bonds. Up to 1/3 of the Fund can be invested in bonds denominated in LC. With a 10-year Morningstar rating of \*\*\*\*\* and an Overall Morningstar Rating of \*\*\*\*\*, the Fund has been awarded the Best Fund over Ten Years Bond Asia Pacific by Lipper Fund Awards Hong Kong and Singapore 2010. ING Investment Management is also the winner of Benchmark 100 Fund of the Year Awards 2010 (Best in Class Fund for the Asia Bond Category) and AsianInvestor 2010 Investment Performance Awards - Asia Fixed Income Category. In terms of peer ranking, the Fund is consistently ranked within the top quartile within the Morningstar universe over one, two, three, five and ten years.

ING Investment Management has an extensive presence in 10 Asian countries, where we have more than 240 investment professionals covering the region. The Asian Debt team consists of nine investment professionals, with six members based in Hong Kong and three in Singapore. The investment team boasts an average of ten years of fixed income experience and has in-depth knowledge of the Asian debt markets due to our strong local presence in the Asian region. Led by our Head of Asian Debt, two of our portfolio managers focus on LC sovereign risk and active FX management (interest rates as well as currency overlays), while another covers the HC sovereign bond market. Our fifth portfolio manager focuses on corporate debt and is supported by four credit analysts. The investment team is further supported by our fixed income teams based in China, India, Korea, Malaysia, Taiwan and Thailand.

**Figure 12: ING (L) Renta Fund Asian Debt generates alpha from various sources, including a tightening in credit spreads, interest rates positioning and appreciating currencies**



Source: Morningstar, NAV to NAV in USD with dividend reinvested. All data are expressed as of 31 March 2011.

\*Sector Peer: Peers are funds in the "Asian Bond" sector and are Offshore and International Funds. Performance of sector peer is determined based on the average return of the funds in the peer sector.

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## Disclaimer

The ING (L) Renta Fund Asian Debt is a sub-fund under ING (L) Renta Fund, a variable capital investment company established in Luxembourg, and is recognized under Section 287 of the Securities and Futures Act, Chapter 289 of Singapore Act ("Act"). ING (L) Renta Fund is the responsible person as defined under the Act and has appointed ING Investment Management Asia Pacific (Singapore) Ltd as its corporate representative in connection with the offer of Shares in the Fund.

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