**Introduction**

Conventional wisdom is unlikely to support a passive approach in Emerging Market Debt, due to the perception that the asset class is prone to inefficiencies that active managers can exploit. If that is true, why are managers unable to consistently outperform the passive exchange traded fund (ETF)?

Upon further inspection it appears most emerging market managers seek to attain outperformance by adding risk, and therefore yield, to their underlying portfolios. Most active managers operate in emerging market sovereign debt, this removes individual security selection, replacing it with country selection. Country selection can be inconsistent relative to security selection as willingness to pay is more abstract and may be more difficult to predict than ability to pay.

**Success Rates for Active Managers**

The research method examined ranked performance of the iShares JPM USD Emerging Markets Bond ETF (EMB), over rolling 1-, 3-, and 5-year time horizons since its inception in 2008. The table below shows the batting average (the number of periods of outperformance) of each corresponding group over their respective rolling period.

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Metric</th>
<th>1 Year</th>
<th>3 Year</th>
<th>5 Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Emerging Market Bond</td>
<td>Percent of Periods that more than 25% of Managers Outperformed</td>
<td>69%</td>
<td>79%</td>
<td>77%</td>
</tr>
<tr>
<td></td>
<td>Percent of Periods that more than 50% of Managers Outperformed</td>
<td>52%</td>
<td>53%</td>
<td>31%</td>
</tr>
<tr>
<td></td>
<td>Percent of Periods that more than 50% of Manager Outperformed (Risk Adjusted)</td>
<td>50%</td>
<td>41%</td>
<td>23%</td>
</tr>
</tbody>
</table>

This table provides us with the following insights:
- The ETF made it into the top quartile of the peer group about 20-30% of the sample period, leading us to believe the active management can still add value to some degree.
- The ETF placed in the top half of the peer group 50-70% of the sample and fared better over longer periods.
- The ETF found itself in the top quartile of risk-adjusted returns over longer periods and outperformed most peers on a risk-adjusted basis in nearly all periods. This last line reinforces our belief that active managers are only adding risk in the space and hoping that over time that risk is rewarded.

To frame this, consider another asset class that demonstrated similar metrics in the table below.

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Metric</th>
<th>1 Year</th>
<th>3 Year</th>
<th>5 Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Large Cap Value</td>
<td>Percent of Periods that more than 25% of Managers Outperformed</td>
<td>89%</td>
<td>76%</td>
<td>77%</td>
</tr>
<tr>
<td></td>
<td>Percent of Periods that more than 50% of Managers Outperformed</td>
<td>35%</td>
<td>39%</td>
<td>30%</td>
</tr>
<tr>
<td></td>
<td>Percent of Periods that more than 50% of Manager Outperformed (Risk Adjusted)</td>
<td>41%</td>
<td>32%</td>
<td>17%</td>
</tr>
</tbody>
</table>

Though top quartile managers fared better in the short term, every other metric tested within the same ranges setup for the broader study.
Data Breakdown

Another way to visualize the data above is charted below as rolling ranked performance over the 3- and 5-year period. The ETF spends a lot of time below the red line (outperforming the peer average), to be precise the ETF beat the average peer 47% of the time on the 3-year and 69% of the time on the 5-year rolling period.

Figure 1: Rolling Ranked Returns for EMB

![Graph showing rolling ranked returns for EMB between 3/1/2011 and 3/1/2019.](Source: Factset)

The risk-adjusted returns support the aforementioned theory, with the ETF finishing below the red line 59% of the time on the 3-year and 77% of the time on 5-year rolling periods.

Figure 2: Rolling Risk-Adjusted Returns for EMB

![Graph showing rolling risk-adjusted returns for EMB between 3/1/2011 and 3/1/2019.](Source: Factset)

Ranked Performance vs. Absolute Performance

From the data presented earlier, it is inferred that the ETF is typically more defensive than the peer group. This can be demonstrated through the positive relationship between rank and absolute returns, and this translates to absolute returns increasing as the ETF performance rank rises (meaning the ETF underperforms on the upside). The inverse is also true, as absolute performance suffers the ETF climbs into the top ranks of the peer group (the ETF outperforms on the downside).
The relationship of absolute returns to return rank are exhibited in the charts below.

Figure 3: Ranked Return Relative to Absolute Return (3Y)

Figure 4: Ranked Return Relative to Absolute Return (5Y)

Source: Factset
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