Emerging Market Local Currency Debt

Exposure to Emerging Market Debt with potentially higher returns

2014
The Oriental Pearl TV Tower in Bangkok.
At US$ 22,983, Shanghai’s GDP per person is as high as Saudi Arabia’s. (Source: The Economist), 2013
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Emerging Markets – why are they attractive?
We believe Emerging Markets (EM) present some of the world’s most dynamic growth and investment opportunities. The rationale behind investing in EMs can be summarised by 3Ds: Debt Dynamics, Disinflation and Demographics.

• Debt Dynamics: supported by stronger fiscal fundamentals (i.e. strong corporate/sovereign balance sheets and good senior management) than developed markets, we believe EMs have better prepared withstand the market turbulences of recent years. Debt levels in EMs are on average one third of those in developed markets, where unprecedented fiscal and debt deterioration has taken place with little optimism that the current outlook will improve any time soon.

• Disinflation: high inflation in the emerging economies has previously deterred investors from seriously considering local currency investments. Political reforms have led to central bank independence and looking ahead we believe inflation will be more cyclical rather than structural. Most EMs have now successfully battled inflation although we would acknowledge this might be a risk in the future and therefore believe policy responses will be important to address investor concerns.

• Demographics: growing, youthful populations and burgeoning workforces are enhancing earnings and spending power, driving domestic growth and lessening dependence on the developed world.

Emerging Market local currency debt – the attractions
• Stabilizing economies have allowed EM governments to raise more and more of their financing through issuing debt in local currency, which helps reduce their vulnerability to external shocks.
• In our opinion, opportunities in EM bonds cannot be fully explored without exposure to local currency debt. The majority of non-G10 sovereign debt is currently denominated in local currency. Therefore, if an investor only allocates to external debt, they will have limited exposure to returns from a number of EMs.
• As EMs have improved, debt denominated in U.S. dollars has also come to be regarded as lower risk and, as a result, a potentially lower return investment. Local currency debt is an attractive asset class as there is a higher potential return from higher yields than in the case of dollar-denominated debt, and from currency appreciation.
• EM sovereign debt has robust credit quality with a significant proportion of bonds in the JP Morgan GBI-EM local currency index rated investment grade (Figure 13 pg 11).

Emerging Market local currency debt – understanding the risks (for a complete discussion of the risks involved, please see page 13)
• Credit risk: the risk that an issuer will fail to make principal and interest payments when due. Issuers with higher credit risk typically offer higher yields for this added risk. Conversely, issuers with lower credit risk typically offer lower yields. Generally, government securities are considered to be the safest in terms of credit risk, while corporate debt, especially those with poorer credit ratings, have the highest credit risk. Changes in the financial condition of an issuer, changes in economic and political conditions in general, or changes in economic and political conditions specific to an issuer, are all factors that may have an adverse impact on a issuer’s credit quality and security values.
• Currency risk: the risk that the currency in which the debt is issued is overvalued relative to the investor’s currency and therefore the value of investment will decrease as a result of currency depreciation.
• Interest rate risk: the risk of interest rates increase due to fundamental or technical factors (e.g. policy mistakes).

Emerging Market local currency debt – Aberdeen Asset Management’s strengths
• Long history of investing in both the EM debt and equity markets – up to a quarter of Aberdeen’s total AUM is invested in EMs.2
• Well-resourced, stable and highly experienced team with a strong track record of investing in EM debt across a number of market cycles.
• We conduct fundamental top-down and bottom-up credit analysis providing comprehensive coverage of all factors relevant to the asset class.
• We rely on proprietary research to provide a deeper insight into the countries and companies in which we invest.
• Extensive primary coverage of issuers. We research over 60 countries and have over 250 meetings with senior policy makers each year.3
• Expertise is also drawn from our Asian fixed income and our global EM equity teams.

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1 G10 refers to the Group of Ten, a group of ten nations that have agreed to participate in the General Arrangements to Borrow (GAB) as established in 1962.
2 Aberdeen Asset Management PLC as at September 30, 2013
3 Ibid
Introduction

Over the last decade many investors globally have become more and more comfortable with the structural improvement in Emerging Markets, which now have a stronger growth outlook and often much better public balance sheets. Equity markets and external bond markets have historically been the investment vehicles of choice, but now local Emerging Market bonds have been added to this list. Strengthening economic and political fundamentals have helped Emerging Market countries to increase local currency debt issuance and supported their efforts to further deepen the bond market and lengthen maturities. Many investors worldwide are now willing and able to capitalize on the structural growth trend of developing economies through these local bond markets. They can also diversify from developed bond markets whose outlooks are far less positive.

Figure 1 – Global growth forecast

Source: International Monetary Fund, World Economic Outlook Database, April 2013
For illustrative purposes only.
Forecasts are offered as opinion and are not reflective of potential performance, are not guaranteed and actual events or results may differ materially.

\(^4\) JP Morgan, January 2013
Emerging Market Debt

We believe EMs present some of the world’s most dynamic growth opportunities. Growth rates of over 5% across the emerging world contrast sharply with those estimated for developed countries. Abundant natural resources, favorable demographics and structural credit improvements combined with fiscal and corporate reform have led to improving economic fundamentals (e.g. balance sheets) in the developing world. Growth in developed markets on the other hand is expected to remain relatively subdued for an extended period of time despite substantial monetary and fiscal easing following the significant financial dislocation in late 2008.

**Figure 2 – Emerging market and developing economies real Gross Domestic Product (GDP) growth outpaces the rest of the world (%)**

EM economies were also adversely affected by the global financial crisis but rebounded relatively quickly. For the most part, they did not have large government and private debt overhangs and were underpinned by ample macroeconomic stimulus, as well as external and domestic demand. EMs already account for a large majority of world population and 40% of World GDP. We still however believe this is likely to expand considerably in the years to come. In this paper, we look at the growth in the EM local currency bond market, why this market is becoming increasingly attractive as a standalone asset class and the risks that might be associated with this type of investment.

**Emerging Markets**

Emerging Market economies are defined by the International Finance Corporation (IFC) as economies with a low to middle per capita income. These economies largely span developing countries in three regions - Asia, Latin America, and CEEMEA (Central Eastern Europe, Middle East and Africa). Emerging economies today are generally characterized by favorable demographics, a strong financial footing and lower levels of debt than their Western counterparts.

**Hard currency debt**

Debt denominated usually in U.S. dollars.

**Local currency debt**

Debt denominated in the country’s local currency.

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4 Citi, March 2011.

5 Forecasts are offered as opinion and are not reflective of potential performance. Forecasts are not guaranteed and actual events or results may differ materially.
The attractions of Emerging Markets

As outlined in the executive summary, the rationale behind investing in the EMs can be summarized by 3Ds: Debt Dynamics, Disinflation and Demographics.

- **Debt Dynamics:** Debt levels in EMs are considerably lower than in developed economies, where unprecedented fiscal deterioration took place in recent years and in some cases unsustainable debt levels will remain a drag on growth in the near future. Government debt levels of developed and emerging economies have demonstrated divergent trends and yet global investors are generally underweight EM debt according to studies by the International Monetary Fund (IMF) and other institutions.

Furthermore, as can be seen in figure 3, developed world debt has been rising for many years meaning there is a debt overhang, something that limits fiscal flexibility, lowers growth potential and increases investor risk.

![Figure 3 – Total gross public sector debt](source: International Monetary Fund, World Economic Outlook Database, April 2013 Forecasts are offered as opinion and are not reflective of potential performance, are not guaranteed and actual events or results may differ materially.)

![Figure 4 – General Government Debt (% GDP) vs Government Balance (%GDP)](source: Aberdeen Asset Management, April 2013 G7 is the group consisting of the finance ministers of the U.S., UK, France, Italy, Japan, Canada and Germany. CEEMA - Central & Eastern Europe, Middle East and Africa. Eurozone refers to the group of nations that have adopted the euro as common currency and legal tender.)
• **Disinflation**: High inflation in the emerging economies in the 1980s and 90s has previously deterred investors from seriously considering local currency investments. In the past, EM central banks, influenced by political considerations, often found it difficult to contain inflation. Political reforms have led to central bank independence and most EMs have now successfully battled inflation. Many of the countries, such as Mexico, Colombia and Brazil, are explicit inflation targeters and have had considerable success remaining in their inflation bands. This has resulted in the stabilization of inflation with largely consistent and appropriate policy interest rate changes which has led to increased credibility among investors. It has also enabled governments to extend the maturity of bonds issued in local currency due to both local and foreign investor appetite.

Figure 5

**Inflation trends – Asia (%)**

Source: Aberdeen Asset Management, 31 August 2013

For illustrative purposes only. Forecasts are offered as opinion and are not reflective of potential performance, are not guaranteed and actual events or results may differ materially.

• **Demographics**: Currently, over 25% of Japan’s population and over 14% of American, UK and Eurozone citizens are over the age of 65 and these figures are likely to increase over time, limiting economic growth. In contrast, in the majority of EM economies the proportion of retirement age population is still in single-digits. Growing, youthful populations and burgeoning workforces are enhancing earnings and spending power, driving domestic growth and lessening dependence on the developed world.

Figure 6

**Inflation trends – Latin America (%)**

Source: Aberdeen Asset Management, 31 August 2013

For illustrative purposes only. Forecasts are offered as opinion and are not reflective of potential performance, are not guaranteed and actual events or results may differ materially.

With respect to Figures 5, 6 and 7 we have chosen these countries as a sound representation of the three regions presented. These country choices do not represent holdings or positioning and are not necessarily the best performing countries in those regions.

6 Bloomberg, July 2013

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Figure 9 – Middle class populations are expanding rapidly in the developing world

Middle class household definition: USD10 to USD100 in purchasing power parity per capita per day
Source: The Emerging Middle Class in Developing Countries, Homi Kharas, January 2010
For illustrative purposes only. Projections are offered as opinion and are not guaranteed. Actual events or results may differ materially.
The attractions of Emerging Market local currency debt

Emerging Market equities and external debt have been on many investors’ radars for some time already. So why is now the right time to look at local currency debt?

Income and capital appreciation potential

As EMs have improved, debt denominated in U.S. dollars has also come to be regarded as lower risk and, as a result, a potentially lower return investment. Local currency debt can offer higher potential return from both higher yields relative to dollar-denominated debt and nominal currency appreciation.

In August 2013 the JP Morgan EMBI global diversified index which is comprised of hard currency denominated debt provided a running yield of 6.2%. In comparison the JP Morgan GBI-EM global diversified index which comprises of local currency denominated debt offered a 6.9% yield.

Figure 10 – Local yields looking even more appealing (%)

<table>
<thead>
<tr>
<th>Year</th>
<th>EM Local Currency (BBB+)</th>
<th>EM Corporates (BBB)</th>
<th>EM Hard Currency (BBB-)</th>
<th>US 10yr (AA+)</th>
<th>Germany 10yr (AAA)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td>4.0</td>
<td>5.0</td>
<td>4.0</td>
<td>2.0</td>
<td>3.0</td>
</tr>
<tr>
<td>2004</td>
<td>5.0</td>
<td>6.0</td>
<td>5.0</td>
<td>3.0</td>
<td>4.0</td>
</tr>
<tr>
<td>2005</td>
<td>6.0</td>
<td>7.0</td>
<td>6.0</td>
<td>4.0</td>
<td>5.0</td>
</tr>
<tr>
<td>2006</td>
<td>7.0</td>
<td>8.0</td>
<td>7.0</td>
<td>5.0</td>
<td>6.0</td>
</tr>
<tr>
<td>2007</td>
<td>8.0</td>
<td>9.0</td>
<td>8.0</td>
<td>6.0</td>
<td>7.0</td>
</tr>
<tr>
<td>2008</td>
<td>9.0</td>
<td>10.0</td>
<td>9.0</td>
<td>7.0</td>
<td>8.0</td>
</tr>
<tr>
<td>2009</td>
<td>10.0</td>
<td>11.0</td>
<td>10.0</td>
<td>8.0</td>
<td>9.0</td>
</tr>
<tr>
<td>2010</td>
<td>11.0</td>
<td>12.0</td>
<td>11.0</td>
<td>9.0</td>
<td>10.0</td>
</tr>
<tr>
<td>2011</td>
<td>12.0</td>
<td>13.0</td>
<td>12.0</td>
<td>10.0</td>
<td>11.0</td>
</tr>
<tr>
<td>2012</td>
<td>13.0</td>
<td>14.0</td>
<td>13.0</td>
<td>11.0</td>
<td>12.0</td>
</tr>
<tr>
<td>2013</td>
<td>14.0</td>
<td>15.0</td>
<td>14.0</td>
<td>12.0</td>
<td>13.0</td>
</tr>
</tbody>
</table>

EM Local currency index: JPM GBI-EM GD, EM Hard currency index: JPM EMBI GD, EM Corporate index: JPM CEMBI BD
Source: J.P. Morgan, S&P, Bloomberg, 31 August 2013
PAST PERFORMANCE IS NOT AN INDICATION OF FUTURE RESULTS. The debt securities referenced in above share many similarities but also have important differences. The information below provides additional information regarding the characteristics for these securities. Treasury bonds are debt securities issued by the US government with a maturity of more than 10 years. Treasury Bonds are backed by the full faith and credit of the US government. This ‘guarantee’ does not apply to corporate bonds. An emerging market corporate bond is a bond issue by a foreign corporation and bonds of this type generally have a maturity date of least one year after their issue date. Hard currency bonds are foreign debt securities issued in US dollar terms and, thus, US investors do not need to convert to the foreign currencies when these types of bonds are purchased. The result is that there is no impact from currency risk in addition to the typical volatility associated with emerging market bonds. Local currency bonds are foreign debt securities that are denominated in local currencies rather than U.S. dollars. As result, the investor will now see the value of their investment affected by currency fluctuations in addition to the price movement of the underlying bond. Corporate bonds (local or hard) generally have a higher risk of default when compared to government bonds. This risk depends on the particular corporation issuing the bond, the current market conditions and the governments to which the bond issuer is being compared and the rating of the company. Corporate bond holders are compensated for this risk by receiving a higher yield than government backed bonds. The difference in yield reflects the higher probability of default, the expected loss in the event of default, and may also reflect liquidity and other risk features.

Size of the market

Stabilizing economies have allowed emerging governments to raise more and more of their funds through issuing debt in local currency which helps reduce their vulnerability to external shocks. The continuing evolution and development of emerging market economies is expected to drive growth in the local currency debt space as their primary source of financing.

Importantly, we believe opportunities in EM bonds cannot be fully explored without exposure to local currency debt. Today, over 80% of non-G10 sovereign debt is denominated in local currency, an increase from 76% in 2005 and 60% in 2000. Therefore, if an investor only allocates to external debt, they will have limited exposure to returns from a number of EMs.

Figure 11: Size of EM local currency bond market significantly larger than EM hard currency bond market

<table>
<thead>
<tr>
<th>Relative size of markets</th>
<th>US$bn</th>
</tr>
</thead>
<tbody>
<tr>
<td>EM Sovereign hard currency</td>
<td>2</td>
</tr>
<tr>
<td>EM Sovereign local currency</td>
<td>6</td>
</tr>
</tbody>
</table>

Source: J.P. Morgan, Aberdeen Asset Management, 30 April 2013
For illustrative purposes only.

The capitalization of the JP Morgan GBI-EM local currency bond index is in fact significantly smaller than the amount of bonds outstanding. This is because for bonds to be included in the index, they must be regularly traded, fixed-rate, domestic currency government bonds and international investors should be able to readily access them. As a result only 18 countries, including Brazil, Mexico and South Africa are currently included in the broadest version of the JP Morgan local currency index, as opposed to 60 countries in the JP Morgan hard currency index which does not have the same requirement.

In terms of J.P. Morgan EM indices, local currency debt now comprises 53% of the market capitalization.

7 J.P. Morgan, Aberdeen Asset Management, 30 April 2013
Robust credit quality

In our view, robust credit quality is one of the most widely underappreciated characteristics of EM bonds. A significant portion of the Emerging sovereign debt indices (JP Morgan GBI-EM Global Diversified Index and JP Morgan EMBI Global Diversified Index) are rated investment grade.

EMERGING MARKET LOCAL CURRENCY BONDS – REGIONAL CHARACTERISTICS

Emerging Europe: Considerable divergence across the region with Russia being a key exporter of oil and gas while Turkey is a major importer. This often leads to different problems as commodity prices fluctuate. Hungarian and Polish bond markets for the most part trade more closely with the core European bond markets where there is a large dedicated investor base.

Latin America: A region of large natural resources; from metals in Peru to the agricultural products of Argentina and the newly found oil fields in Colombia and Brazil. High real rates still offer investors good return potential.

Asia: China is the driving force of the region, with huge potential growth and pressure for the currency to appreciate. Malaysia and Thailand are the most developed Asian economies in the local currency index and are key exporting countries with relatively low yields but attractive balance of payments. Indonesia on the other hand is a more domestic-oriented growth story with long-term credit fundamentals steadily improving.

Africa: South Africa and Egypt are the relatively high yield African sovereign bond issuers. South Africa, a key metals exporter, benefits from an improved balance of payments and offers attractive real yields to investors.
Diverse investor base

We believe the EM local currency bond market has become appropriate for a wider range of investors due to its size, liquidity and dedicated research platforms.

Historically local banks dominated local currency markets but the institutional investor base has been growing, both domestically and abroad, providing impetus for further development of the local currency bond market. Institutional investors have started perceiving local markets not only as a potential alternative to traditional fixed income exposure, but also to capitalise on the secular growth story.

Foreign participation has been increasing over the past decade. While foreign participation declined in late-2008 due to investors’ risk aversion, foreign demand for local currency bonds has returned quickly, and in many cases is at new highs.

Offshore holdings of local currency debt are increasing

In the past decade, there have been very few sovereign defaults in the emerging world, and only one of those countries – Argentina – was investment-grade rated a year earlier. In fact, the average annual default rate in the EM hard currency index has been just 1.49% since December 1990. Countries that defaulted in local currency were low-rated countries, like the Dominican Republic, Cameroon, Grenada and Jamaica.

We believe EMs have responded well to the stress test of the global financial crisis, with only two defaults having occurred in 2008, Ecuador and Seychelles. The former default was arguably an example of a lack of willingness to service its debt rather than ability to pay, with the new Ecuadorian government considering this as “illegitimate” debt issued by the previous regime. Currently, countries which are at risk of debt restructuring represent less than 2% of the JP Morgan GBI-EM index.8

Improving liquidity

Liquidity has significantly improved in recent years due to both higher issuance and increased domestic and international investor interest. Bid/offer spreads are generally narrower for local currency denominated bonds relative to hard currency denominated bonds highlighting the increasing breadth of the local currency debt universe. This is further evidenced by the fact the EM local debt market capitalisation is now more than triple the size of EM hard currency debt.

8 Source: JP Morgan, April 2014.

Source: Bank of Thailand, August 2013
For illustrative purposes only.
The risks associated with investing in Emerging Markets

The risks associated with investing in EM Debt will to an extent depend on the type of investment chosen. While all investors in EM debt securities are exposed to credit and interest rates risk, currency risk is specific to investments denominated in local currency.

Investing involves risk, including possible loss of principal. Fixed income securities are subject to certain risks including, but not limited to: interest rate (changes in interest rates may cause a decline in the market value of an investment), credit (changes in the financial condition of the issuer, borrower, counterparty, or underlying collateral), prepayment (debt issuers may repay or refinance their loans or obligations earlier than anticipated), and extension (principal repayments may not occur as quickly as anticipated, causing the expected maturity of a security to increase). Foreign securities are more volatile, harder to price and less liquid than U.S. securities. They are subject to different accounting and regulatory standards. These risks are enhanced in Emerging Markets countries.

**Credit risk**
The risk that an issuer will fail to make principal and interest payments when due. Issuers with higher credit risk typically offer higher yields for this added risk. Conversely, issuers with lower credit risk typically offer lower yields. Generally, government securities are considered to be the safest in terms of credit risk, while corporate debt, especially those with poorer credit ratings, have the highest credit risk. Changes in the financial condition of an issuer, changes in economic and political conditions in general, or changes in economic and political conditions specific to an issuer, are all factors that may have an adverse impact on an issuer’s credit quality and security values.

**Interest rate risk**
The risk of interest rates increasing due to fundamental or technical factors (e.g. policy mistakes).

**Currency risk**
The risk that the currency in which the debt is issued is overvalued relative to the investor’s currency and the value of investment will decrease as a result of currency depreciation.

**Liquidity Risk**
Investments may be made in certain securities that subsequently become difficult to sell because of reduced liquidity which would have an adverse impact on market price. Reduced liquidity for such securities may be driven by a specific economic or market event, such as the deterioration in the creditworthiness of an issuer.

**Corporate bond risk considerations**
EM corporate bondholders face the same issues of transparency and corporate governance as EM equity investors, albeit in a different part of the capital structure. Corporate bonds are often issued by private family-held companies which may have complicated and opaque company structures. There may also be issues with the quality and timeliness of financial disclosures. Information can often only be gleaned from contacts within the local markets and from repeated management meetings and site visits. Other risks include market liquidity which, whilst improving, is thinner than developed market bonds. In this environment, it is critical to carry out comprehensive research into the corporate bond and the market in which it operates.

**Fundamental risks**

**Structural risks**
In the unfortunate event of a company defaulting on its debt, priority access to cash flow is crucial in determining the default and recovery scenarios, which in turn drives the relative valuation of a bond. It comes down to the exact position of the debt in the company structure – largely called structural issues and subordination risks. Companies in emerging countries are often built up in a haphazard manner, or with various subsidiaries for tax and legal planning purposes. It is in our view, important to know the entity from which the bonds are issued, the seniority of the bond, and map that to how cash flows between different entities of the same company. It pays to thoroughly research the company as well as the bond, firstly to ensure the company is what it says it is and has the necessary financial stability and management to be well-run, profitable and to grow. Secondly, it is important to ensure the characteristics of the bond are sound and they fit well with the existing portfolio.

**Transparency and Corporate governance**
Companies are increasingly aware of reputational risks, motivated by their continuous need to access international capital markets. Dialogue between investors and companies has started to improve in EMs, though significant distinctions can be seen between different countries with differing corporate governance cultures.

Whereas financial information in developed markets can be found in a comparable manner between companies of the same industries, EM companies, if publicly listed, often report according to their local Generally Accepted Accounting Practices.

Accounting standards in EMs still somewhat lag those of developed economies and so company reports require careful and in-depth analysis of primary data to differentiate and understand the true cash position and operating results of companies. The trend is to transition towards the International Financial Reporting Standards (IFRS), which will ease future ‘apples-to-apples’ comparisons.

**ONE WAY TO MITIGATE THESE RISKS IS TO DO GROUND WORK**
Visiting the country to meet management, to see the operations, and to ‘kick the tires’ is important.

Bond covenants also help to mitigate the risks of lack of transparency and corporate governance by legally limiting companies in capital raising decisions and from taking excessive operational risks. Some issues even have cash account management agreements embedded within the bond structure, directing the company’s use of cash. Other bonds have additional security attached which allow specific protections on assets that can be detached solely to repay the bonds in an event of default. It is important to thoroughly analyse the bond and identify these covenants before investing.
IMPORTANT INFORMATION
PAST PERFORMANCE IS NOT AN INDICATION OF FUTURE RESULTS

JP Morgan Corporate Emerging Markets Bond Index (CEMBI) is a market capitalization weighted index consisting of U.S. -denominated emerging markets corporate bonds. It is a liquid global corporate benchmark representing Asia, Latin America, Europe and the Middle East/Africa.

JP Morgan GBI-EM Global Diversified is a comprehensive global local emerging markets index that consists of regularly traded, liquid fixed 0-rate, domestic currency government bonds.

The JP Morgan EMBI Global Diversified is a uniquely weighted index that tracks total returns for U.S. dollar-denominated Brady bonds, Eurobonds, traded loans, and local market debt instruments issued by sovereign and quasi-sovereign entities.

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Treasury Bonds are backed by the full faith and credit of the US government. This ‘guarantee’ does not apply to corporate bonds. An emerging market corporate bond is a bond issue by a foreign corporation and bonds of this type generally have a maturity date of at least one year after their issue date. Hard currency bonds are foreign debt securities issued in US dollar terms and, thus, US investors do not need to convert to the foreign currencies when these types of bonds are purchased. The result is that there is no impact from currency risk in addition to the typical volatility associated with emerging market bonds. Local currency bonds are foreign debt securities that are denominated in local currencies rather than U.S. dollars. As result, the investor will now see the value of their investment affected by currency fluctuations in addition to the price movement of the underlying bond.

Corporate bonds (local or hard) generally have a higher risk of default when compared to government bonds. This risk depends on the particular corporation issuing the bond, the current market conditions and the governments to which the bond issuer is being compared and the rating of the company. Corporate bond holders are compensated for this risk by receiving a higher yield than government backed bonds. The difference in yield reflects the higher probability of default, the expected loss in the event of default, and may also reflect liquidity and other risk features.

Foreign securities are more volatile, harder to price and less liquid than U.S. securities. They are subject to different accounting and regulatory standards, and political and economic risks. These risks may be enhanced in emerging markets countries.

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