



Overcoming the challenges of investing in Asian bond markets

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In our global investor survey on Asian fixed income, respondents highlighted corporate governance and liquidity as their key concerns for investing in Asian bond markets. While studies indicate that Asia's corporate governance standards and bond market liquidity have improved over the years, we believe idiosyncrasies in each market still provide room for active managers to add alpha.

2021 has been a challenging year for Asian bonds as the delta variant delayed the economic reopening in many Asian countries, resulting in patchy recoveries. Rising bond defaults in China also caused significant volatility in the Asian bond market.

This did not seem to temper the appetite of investors for Asian bonds. More than half of all respondents in a global [survey](#) that we conducted from July to September 2021 indicated that they were looking to increase their exposure in Asian bonds over the next 12 to 24 months.

In a world where the amount of negative-yielding bonds has risen since its low in March 2020, Asia's

higher bond yields remain compelling. 73% of all survey respondents agreed that Asian bonds offer higher risk-adjusted returns than their developed market peers.

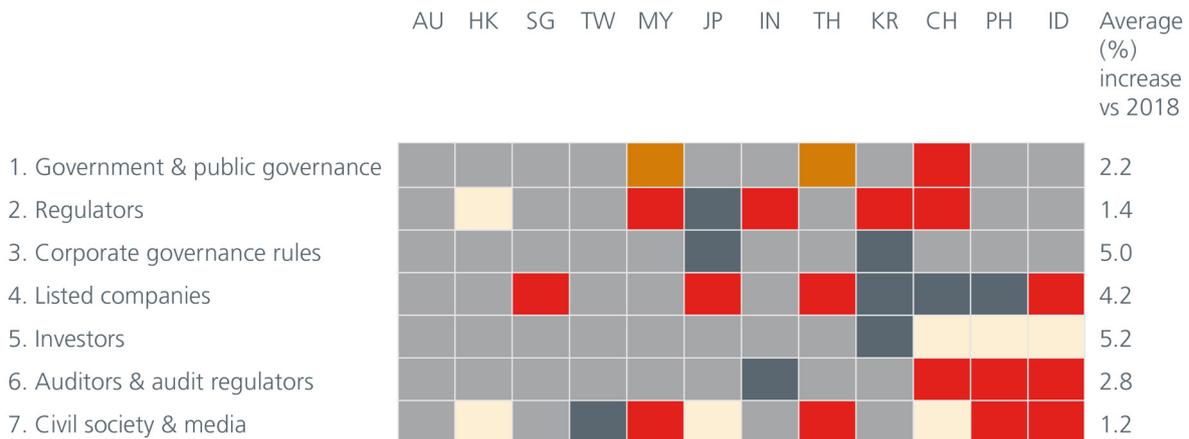
BETTER GOVERNED

This is not to say that there are no challenges when investing in Asian bonds. 42% of all respondents in the survey highlighted corporate governance issues as their top concern when investing in Asian bond markets.

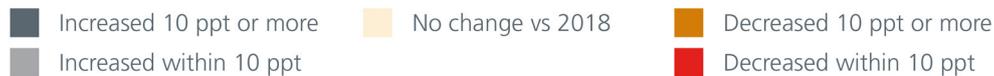
Despite the impression of limited progress, Asia's corporate governance standards, according to CG Watch¹ have largely strengthened since 2018. While government and public governance measures may have deteriorated in Thailand and Malaysia given the political challenges there, the following improvements have been observed in the rest of Asia:

- ▶ Better standards for sustainability reporting
- ▶ Updated corporate governance codes
- ▶ New or revised stewardship codes
- ▶ Tighter definitions for independent directors

Fig. 1: Heat map of corporate governance metrics (2020 vs 2018)



Note: Markets ordered from left to right in terms of their ranking.



Source: ACGA

- › Stronger enforcement tools
- › More sophisticated and transparent audit regulations.

However, the wide range of scores for the different corporate governance metrics suggests that significant divergence exists between the top (Australia) and bottom ranked (Indonesia) markets, as well as within the region. See Fig. 2. Given the idiosyncrasies in each market, it is imperative for Asian bond investors to know their markets and credits well and to be dynamic in their analysis.

RISING LIQUIDITY

In our global survey, liquidity came in second in the list of key concerns for Asian bond investors. The Asian bond market has grown significantly over the years. The current market capitalisation of the Asian bond market (USD and local currency) stands

at USD22 trillion, around 18% of the global bond market. Since 2006, Asia's local currency and foreign currency bond markets have grown at a compound annual growth rate (CAGR) of 15% p.a. and 13% p.a. respectively². That said, some markets within the region are less liquid than others.

Bid-ask spread is one of the measures we can use to assess bond market liquidity. The average bid-ask spread for on-the-run local currency government bonds in Emerging Asia has fallen substantially from 7.2 bp in 2010 to 2.8 bp in 2019. See Fig. 3. Even if we were to compare these figures against 2020's average bid-ask spread (which would have been impacted by the COVID-19 pandemic), the region still shows significant improvement.

There is however a wide divergence amongst the individual markets. The more developed government bond markets, such as Korea and China, have

Source: ²In terms of market capitalisation.

Fig. 2: Assessment of corporate governance metrics (2020)

(%)	AU	CH	HK	IN	ID	JP	KR	MY	PH	SG	TW	TH	Regional average
1. Government & public governance	68	29	65	45	31	60	60	32	28	60	68	35	48
2. Regulators	65	52	69	53	24	62	53	53	27	63	66	51	53
- Funding, capacity, reform	62	42	62	51	31	58	45	53	27	56	62	47	50
- Enforcement	68	64	76	56	16	66	62	54	26	70	70	56	57
3. Corporate governance rules	82	63	75	69	35	58	56	77	45	75	66	76	65
4. Listed companies	79	51	59	65	38	44	48	66	55	60	63	60	57
5. Investors	66	18	34	44	19	60	44	43	21	39	38	38	39
6. Auditors & audit regulators	86	43	81	54	59	77	70	86	60	81	76	76	71
7. Civil society & media	80	22	60	78	38	62	36	44	36	64	62	49	53
Total	74.7	43.0	63.5	58.2	33.6	59.3	52.9	59.5	39.0	63.2	62.2	56.6	55

Source: ACGA

bid-ask spreads of 0.4 bp and 1.1 bp respectively, while spreads for the Vietnam government bond market are wider at 5.5 bp³. The liquidity of China's government bond market has improved following its inclusion in the Bloomberg Barclays Global Aggregate Index in April 2019.

Liquidity in the region's local currency corporate bond market has also improved over the years, although bid-ask spreads are wider than in the government bond market. This is largely because pension funds, insurers and financial institutions tend to be the largest investors in the local currency corporate bond market and have long holding periods.

Fig. 3. shows that the average bid-ask spread in local currency corporate bond markets in the region fell from 23.7 bp in 2010 to 11.6 bp in 2019. Investment grade and government-related issues typically

enjoy higher liquidity. Liquidity conditions differed significantly too across countries with Korea having the narrowest bid-ask spread at 1.2 bp and Vietnam having the largest (70 bp).

Transaction size is another measure that investors use to gauge liquidity. Bigger transaction sizes reflect the presence of large investors, although the amount of issuance and monetary policies are also contributing factors. On average, the transaction size of local currency government and corporate bond markets in the region have increased over the years. In the local currency corporate bond market, China and Korea enjoy larger average transaction sizes of USD8.6 m and USD8.4 m respectively, while transaction sizes are smaller in Indonesia (USD0.8 m) and Philippines (USD0.3 m).

Qualitative factors can affect a bond market's liquidity. According to the Annual Bond Market

Source: ³For local currency government bond markets.

Fig. 3: Quantitative liquidity measures

Emerging Asia	2010	2015	2019	2020
Local currency government bond markets				
Bid-ask spreads* (bp)	7.2	5.0	2.8	2.8
Transaction size (USD m)	6.9	4.0	15.0	NA
Local currency corporate bond markets				
Bid-ask spreads (bp)	23.7	11.8	11.6	18.0
Transaction size (USD m)	3.9	3.7	10.5	3.2

Note: Emerging East Asia comprises the People's Republic of China; Hong Kong, China; Indonesia; S Korea; Malaysia; Philippines; Singapore; Thailand and Vietnam.

Source: AsianBondsOnline Annual Bond Market Liquidity Survey 2010, 2015, 2019, 2020. *For on the run government bonds.

Liquidity Survey conducted by AsianBondsOnline, Emerging Asian local currency government bond markets score well in terms of settlement and custodial processes, but need to work at making more hedging options available for investors. Again, we see that each market has its own dynamics – Thailand for example scores better than Singapore in investor diversity but underperforms Vietnam when it comes to tax treatment. See Fig. 4.

OPPORTUNITIES TO ADD ALPHA

Asia's corporate governance standards have improved over the years, and we expect the increased emphasis on Environment, Social and Governance (ESG) to effect more meaningful changes in corporate governance frameworks across the region. We also expect initiatives such as the Asian Bond Fund (ABF) project and Asian Bond Markets Initiative (ABMI) to help enhance Asian bond market liquidity going forward.

The diversity of Asian bond markets presents significant room for active managers to add alpha. Active and dynamic credit analysis is key in investing in such markets. When corporate governance failures occur, the loss in bond capital values often materialise long before the actual credit rating downgrade or default.

While Asia's bond markets see different levels of liquidity, an active manager with scale can potentially improve trading efficiencies and enjoy stronger issuer engagement, which can add to returns. At times, size can also facilitate better primary deal allocation. In Asian markets and cultures, where human relationships are highly important, having local investment teams on the ground can go a long way.

Fig. 4: Assessment of structural factors in local currency government bond markets

	Emerging Asia	China	HK	Indo	S. Kor	Mal	Phil	Sing	Thai	Viet
Diversity of investors	2.9	3.2	2.3	2.7	3.6	2.9	2.8	2.9	3.3	2.0
Market access	3.3	3.2	3.7	3.6	3.6	3.2	2.6	3.9	3.3	2.3
FX regulations	3.1	3.0	4.0	3.2	3.7	2.8	2.7	3.5	2.8	2.4
Transaction funding	2.9	3.0	3.0	2.8	3.7	3.1	2.6	3.0	2.3	2.6
Tax treatment	3.0	2.8	3.7	2.6	3.1	3.4	2.1	3.9	2.5	3.3
Settlement & custody	3.7	3.6	4.0	3.5	4.0	3.6	3.4	4.0	4.0	3.2
Hedging mechanisms	2.6	2.2	2.7	2.3	3.4	2.8	1.9	2.9	2.8	2.3
Transparency	3.4	3.4	3.3	3.1	3.9	3.8	3.4	3.9	3.2	2.9

FX = foreign exchange.

Note: Emerging East Asia comprises the People's Republic of China; Hong Kong, China; Indonesia; S Korea; Malaysia; Philippines; Singapore; Thailand and Vietnam.

Source: AsianBondsOnline 2019 Annual Bond Market Liquidity Survey. Respondents have been asked to score these factors on a scale from 1 to 5. Scores above have been highlighted in grey.

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