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Taking a Total Return Approach to Emerging Market Debt

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A Q&A with Tina Vandersteel | July 2026

Emerging market debt (EMD) is a broad, diverse, and often inefficient opportunity set. Investors can access it through benchmark-relative strategies tied to hard or local currency indices, or through an approach that seeks to maximize total return using a defined cash-plus objective. For investors with the governance flexibility to prioritize explicit portfolio outcomes, a total return framework can at times offer better value and diversification properties than benchmark-relative strategies. We sat down with Tina Vandersteel, GMO's Head of Emerging Country Debt, to explore how to think about the trade-offs of benchmark-relative and total return EMD strategies, the current opportunity set across credit, rates, and currencies, and how a benchmark-agnostic approach may be especially attractive in today's environment.

Q&A

Q. "Tina, GMO's Emerging Country Debt team has now been running active strategies for more than 30 years. After that history, you are now expanding your implementation offerings to introduce a Total Return strategy in a mutual fund format. What objective in today's fixed income landscape is a total return strategy designed to achieve for investors?"

For some investors, benchmark-relative investing doesn't suit, as the benchmarks in question may have characteristics or volatility that don't fit well in their portfolios. Instead, they may prefer outcome-based investing, which is the objective of a total return strategy. As with Total Return strategies in general, ours will target a cash-relative outcome. From a portfolio management perspective, this is nothing new; it's simply a natural extension of what we have been doing for decades – using the full breadth of the opportunity set seeking to deliver alpha relative to a client's benchmark or total return relative to cash.

One of the longstanding challenges with benchmark-relative fixed income investing is that investors often inherit the benchmark's characteristics (duration, yield, credit quality, and currency exposure), whether or not those are the exposures they actually want, and whether or not the benchmarks are well valued at the time. In emerging market debt, that challenge can be even more pronounced because the main benchmarks can drift in duration over time, offer limited control over credit quality, and represent only part of the broader investable universe. As for valuation¹, the benchmarks, at times, are too poorly valued to achieve a particular investment outcome.

A total return approach gives us a different starting point. Rather than anchoring the portfolio to benchmark composition, we begin with the return objective, in this case SOFR + 3%, and build the portfolio around the opportunities we believe can deliver that outcome. That should signal three things to investors: it implies a focus on higher-yielding/higher-return potential issues and strategies (for example, a 3% spread is consistent with the long-term spread history of U.S. corporate high yield); it suggests a lower duration (SOFR is a floating overnight rate, so duration is essentially zero); and finally it allows us to utilize our currency

and interest-rate alpha overlay programs instead of requiring the investor to make top-down timing decisions between benchmark-relative sleeves (more common in 'blended benchmark' relative investing).

Q. "What are your perspectives on EMD valuations right now, and what are the most significant risks or opportunities you think the market is still mispricing?"

The dollar is currently quite rich relative to EM currencies, and local currency interest rates are at levels that offer high total return potential even before any currency appreciation is realized. In our view, the combination of cheap currencies and high rates has priced more local currency markets to deliver SOFR + 3% than has been true in decades.

By contrast, aggregate sovereign, quasi-sovereign, and corporate credit spreads appear narrow relative to the broader opportunity set. However, we continue to find attractive issues both from within the benchmarks and beyond that we believe satisfy a SOFR + 3% objective with favorable risk/reward characteristics.

Q. "What exposures do you expect to be most important for a total return strategy in this environment (carry, FX, duration, credit, liquidity)? What do you most want to own, and what would you explicitly try to avoid?"

Our Total Return strategy has two broad building blocks: a funded asset portion, which buys bonds and loans/private instruments, selected from a subset of the available universe that will satisfy a SOFR + 3% objective; and two derivatives-based components that are effectively portable alpha overlays, one from FX and one from rates.

With respect to factor exposures such as carry, we do not expect exposure to shift opportunistically. Rather, carry is an element in both our FX and rates models, but it's not the only one. We incorporate a model with a suite of mostly fundamental factors whose betas have historically remained fairly stable over time.

Regarding overall duration, we expect the portfolio to include a mix of hard and local currency durations, likely in the 3-4-year range, depending on market conditions and implementation during strategy launch.

Finally, in terms of credit quality, the SOFR + 3% hurdle could potentially influence the opportunity set to BB-rated and below; however, should investment-grade markets suddenly satisfy our hurdle on a total return basis, these could become attractive candidates for inclusion.

Q. "How does a SOFR + 3% objective change your positioning? Put another way – what changes in your approach are you able to make because you're not anchored to benchmarks like the other EMD strategies you manage?"

The central difference is that portfolio construction begins with the return hurdle rather than with benchmark composition. Credit quality, duration, and currency exposures are therefore anchored to expected return and valuation, not to the characteristics of a single benchmark or benchmark blend.

In practice, that means a universe that satisfies SOFR + 3% is *smaller* than that of a benchmark not restricted by credit quality or otherwise. Often, the highest-quality issuers (think: China, Saudi Arabia, etc.) with single- or double-A ratings are able to issue the most debt, driving benchmark quality higher and spreads well below SOFR + 3%. They can also issue at much longer tenors, thereby increasing duration. Outside of market panics/wars/etc., it's rare to see issuers like this in a total return strategy.

Investing for a cash-plus hurdle is not something new for us. For example, we currently run a SOFR + 6% strategy for a client. It's the same fundamental idea scaled for a different return objective, although higher return targets will typically imply a narrower opportunity set, greater concentration, and higher risk.

Q. "In a turbulent market environment, which tools in your toolkit do you expect to matter most for the Total Return strategy (shorting/hedges, FX instruments, rates hedges, credit hedges)? Can you give an example of how you expect to use them to manage downside?"

Emerging markets are rarely static, and periods of turbulence are normal. The tools we expect to use are the same as those used in our benchmark-relative strategies: security selection, bond over/underweights, credit protection, and carefully considered, risk-managed currency and interest-rate overlay programs.

Given that we will be focused on the riskier end of the credit spectrum (issues with at least 3% spreads much of the time), one can expect that the riskier the credit, the more we'll be focused on downside protection. Unlike our benchmark-relative strategies, which allow us to underweight certain bonds in favor of others, a total return setting may require shorting bonds and/or purchasing credit protection. Our currency programs already include pretty tight limits on single currency positions as well as overall USD positioning.

Q. "How dynamic do you expect the allocation between hard vs. local to be? Historically, how have you seen relative attractiveness change over time?"

We will build the Total Return strategy using instruments that satisfy the SOFR + 3% objective. As a result, hard currency versus local currency exposure is not set as a top-down allocation target. Instead, those exposures emerge from the bottom up based on where the most attractive opportunities are found across credit, rates, and currencies. This differs from our blended benchmark-relative strategy, which we adjust over time based on the relative benchmark's attractiveness, as estimated and published in our Quarterly Valuation Update publication.

We also plan to use our currency and local currency interest rate absolute return programs, which are largely USD/duration-neutral; as such, there's no target allocation to EMFX or EM rates but rather a series of cross-sectional positions. At select times, we may lean into or away from the 'beta' of local currency (either FX and/or rates) when exceptionally well valued, although these episodes are fairly rare.



Tina Vandersteel

Ms. Vandersteel is the Head of GMO's Emerging Country Debt team and the lead portfolio manager

for the team's products. Ms. Vandersteel is a partner of the firm. In her role as portfolio manager, she focuses on security selection and portfolio construction. Prior to joining GMO in 2004, she worked at J.P. Morgan in fixed income research developing quantitative arbitrage strategies for emerging debt and high yield bonds. She began her career at Morgan Guaranty Trust, attending Morgan Finance Program #18, before establishing her career in emerging debt. Ms. Vandersteel earned her bachelor's degree in Economics from Washington & Lee University. She is a CFA charterholder.

Disclaimer

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Q. "Where does this strategy fit best in a client portfolio today, within the Credit/Fixed Income sleeve of a portfolio, or as a diversifier?"

The first question is whether a total return approach aligns with the investor's governance framework, benchmarking philosophy, and portfolio objectives. If the priority is to remain closely aligned with peers or with a policy benchmark, a benchmark-relative EMD strategy may be the more natural fit. If, however, the objective is to pursue a defined return target with greater flexibility over duration, currency, credit quality, and hedging tools, a total return approach may be more appropriate.

In practice, the strategy may fit in different ways. For some investors, it may serve as a benchmark-agnostic fixed income allocation within the broader credit or opportunistic income bucket. For others, it may function as a diversifying sleeve alongside more benchmark-aware emerging debt exposures, particularly where the investor wants to separate return-seeking implementation from benchmark construction. By virtue of the 3% hurdle, the assets owned in our Total Return strategy are unlikely to be repeated in core USD (Aggregate benchmarked) portfolios nor in U.S. corporate High Yield ones, which may offer some level of exposure diversification.

The trade-off is straightforward: greater flexibility can improve the ability to allocate capital based on valuation and expected return, but it also requires greater tolerance for tracking error, peer dispersion, and a less conventional reporting frame than a benchmark-relative mandate would provide. Adoption may therefore depend not only on return objectives, but also on the investor's risk budgeting and internal governance capacity.

Ultimately, the strategy is best viewed not as a universal replacement for benchmark-relative EMD, but as a complementary solution for investors seeking a more explicit and flexible way to pursue return objectives in an inefficient and evolving asset class.

Q. "Final Thoughts?"

Emerging market debt remains a complex and evolving asset class, and the most effective way to access it will depend on an investor's objectives, constraints, and decision-making framework. For some, a benchmark-relative strategy will remain the preferred approach; for others, a total return framework may offer a more precise way to target outcomes.

If these issues are top of mind, we would welcome a conversation about where a total return EMD strategy may fit within a broader fixed income allocation.