

Investment:

The Case For Global Fixed Income



The global fixed income markets have significantly expanded and developed over the past two decades, with many advances occurring in more recent years. There are now more than 100 countries with fully or partially functioning fixed income and/or currency markets. This broadening opportunity set involves not only geographic expansion but also new instruments that can provide specialized exposures.

Investors who were once limited to the bond markets of developed countries and a narrow range of currencies now have options that include a broader range of currencies from both emerging and developing economies, a variety of duration exposures and a wide gamut of country exposures.

This broader global fixed income opportunity set has gained favor as the recent global financial crisis has waned, risk appetite has revived and credit market conditions have improved. Among the factors institutional investors in this marketplace may want to consider are trends pointing toward a stronger recovery in the developing economies than in Europe, Japan and the United States.

While some developing economies have been severely impacted by weakening global markets, others have withstood it quite well. Learning from past crises has played an important role in this outcome. Developing market governments broadly used the economic growth cycle of the past few years to reduce outstanding sovereign debt burdens, improve fiscal positions, move to floating exchange rates and build up foreign exchange reserves. As a result, in general they entered the current financial crisis in stronger credit positions relative to past global crises. Consequently, the deterioration of sovereign creditworthiness during the crisis has typically been much greater in advanced than in developing economies.

Additionally, the relative resilience of developing markets has been enhanced by their limited involvement in the problems that led to the financial crisis. This was partially reflected in the lower amount of leverage apparent in many developing countries, as well as in domestic demand. Those countries that had a very large component of domestic demand (or are now seeing increased domestic demand) versus a reliance on exports have been better cushioned through this crisis.

Today, with U.S. and Canadian interest rates at or near all-time lows, an outlook for a weakening U.S. dollar and the pace and drivers of recovery in the developing markets, we believe that some of the strongest fixed income opportunities over the next several years could be found outside the U.S. and Canada.

As investors shift their perceptions of the two main categories of international bonds – developed world bonds and developing market bonds – it should become more apparent that a truly global perspective can support portfolio diversification while benefiting from economic conditions and monetary policies that vary around the world. Here are some specifics regarding the potential risk/return benefits a global fixed income allocation may be able to add to an overall portfolio:

- **Risk Reduction**

Adding global fixed income positions to a portfolio may potentially reduce volatility on multiple fronts based on its asset class and sector characteristics in which varying economic conditions and business cycles in different countries around the world drive returns.

- **Portfolio diversification**

It is a well-accepted investment principle that adding international equities to a hypothetical domestic equity portfolio can lower the portfolio's overall risk profile. In an analogous way, adding global fixed income exposure may further improve the diversification and returns of a traditional single-country fixed income allocation.

- **Record of low correlation**

Fixed income performance generally tends to have a low correlation with equity markets. Diving deeper, investing in both core and non-core fixed income sectors may provide enhanced diversification regardless of the prevailing interest rate environment. As illustrated in *Chart 1*, fixed income sectors have had varying

degrees of correlation with one another. Diversifying a fixed income portfolio heavily weighted in the traditional core sectors with low-correlation sectors may help reduce a portfolio's overall volatility while increasing total return.

Chart 1: Five-Year Correlations For The Period Ending September 30, 2009

		Core					Non-Core Sectors						
		Treasuries	Agencies	Mortgage-Backed Securities	Asset-Backed Securities	Investment Grade Corporate	International	High Yield	Blended Emerging Market Debt	TIPS	Municipals	Preferreds	Bank Loans
Core Sectors	Treasuries	1.00											
	Agencies	0.76	1.00										
	Mortgage-Backed Securities	0.83	0.67	1.00									
	Asset-Backed Securities	-	-	-	1.00								
	Investment Grade Corporate	0.36	0.58	0.54	0.56	1.00							
Non-Core Sectors	International	0.62	0.66	0.54	-	0.50	1.00						
	High Yield	-0.27	-	-	0.68	0.65	-	1.00					
	Blended Emerging Market Debt	-	0.37	0.38	0.65	0.81	0.46	0.82	1.00				
	TIPS	0.53	0.54	0.59	0.56	0.64	0.60	0.43	0.68	1.00			
	Municipals	-	-	0.32	0.56	0.56	-	0.50	0.44	0.37	1.00		
	Preferreds	0.05	-	-	-	0.53	0.35	0.46	0.42	0.26	0.33	1.00	
	Bank Loans	-0.50	-0.30	-	0.73	0.42	-	0.86	0.62	0.27	0.41	-	1.00

- Hedge against country risk**

Within the global bond market, the world's best-performing bond market has varied from year to year, as highlighted in *Chart 2*. This record should encourage investors to reevaluate their home-country bias when considering fixed income allocations. It also illustrates that actively managing exposure has the potential to enhance returns.

Chart 2: Average Annual Total Returns Of The Top 10 Global Bond Markets

10-Year Period Ending December 31, 2008

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Japan	15.53%	United States 13.48%	Poland 30.38%	Norway 40.90%	Australia 37.35%	Poland 35.96%	Mexico 21.29%	Poland 17.96%	Canada 23.83%	Japan 27.82%
Canada	4.29%	Poland 9.64%	United States 6.73%	New Zealand 37.01%	New Zealand 33.66%	Norway 18.02%	Canada 9.77%	Sweden 17.24%	Poland 19.90%	Switzerland 15.92%
Australia	4.07%	Canada 6.77%	Norway 3.93%	Switzerland 35.07%	Canada 29.11%	Sweden 17.45%	Malaysia 4.85%	South Korea 15.80%	Norway 18.90%	United States 13.89%
New Zealand	-1.83%	Switzerland 2.57%	Switzerland 1.32%	Sweden 31.15%	Sweden 26.98%	Eurozone 16.00%	United States 2.80%	United Kingdom 14.57%	Australia 15.51%	Taiwan 8.72%
United States	-2.45%	Singapore 2.35%	Canada 1.15%	Denmark 29.18%	Denmark 25.05%	New Zealand 15.89%	Taiwan 2.34%	Malaysia 13.00%	New Zealand 13.41%	Singapore 7.12%
Norway	-2.70%	United Kingdom 1.02%	Denmark 0.71%	Eurozone 29.09%	Eurozone 24.98%	Denmark 15.68%	New Zealand 1.13%	Singapore 12.45%	Denmark 13.13%	Denmark 5.50%
United Kingdom	-4.30%	Eurozone 0.40%	Eurozone 0.64%	Poland 23.68%	Norway 15.67%	Canada 15.42%	Poland 0.63%	Denmark 11.62%	Eurozone 12.86%	Eurozone 3.96%
Sweden	-7.50%	Denmark 0.11%	United Kingdom 0.43%	United Kingdom 21.09%	United Kingdom 13.52%	Switzerland 14.74%	South Korea 0.37%	Eurozone 11.32%	Singapore 12.31%	Malaysia 3.31%
Denmark	-14.90%	Sweden -0.74%	New Zealand -1.59%	Australia 20.50%	Switzerland 12.81%	United Kingdom 14.34%	Australia -1.06%	Mexico 10.70%	Malaysia 9.87%	Thailand 1.69%
Switzerland	-16.33%	Norway -2.98%	Singapore -2.04%	Singapore 17.35%	Japan 9.92%	Australia 11.60%	Singapore -2.65%	Australia 9.66%	Japan 9.47%	Australia -4.56%

- **Hedge against inflation pressures**

In an inflationary environment, the most common response for central banks with the mandate to target inflation is to raise interest rates. In anticipation of this, a global fixed income strategy may reduce, eliminate or provide negative duration exposure in countries where higher government bond yields are likely to materialize.

- **Exposure to Multiple Drivers of Return**

Beyond the potential for risk reduction, global bonds provide compelling total return opportunities. An individual country's circumstances provide the framework for identifying investment opportunities primed for interest rate and currency changes. These strategies can combine global fixed income instruments with derivatives to help isolate an investment opportunity within a country's yield curve, currency or also sovereign credit opportunities.

- **Interest rate opportunities**

In a country with faltering economic growth, interest rate cuts may be on the horizon that would increase the attractiveness of the country's local market debt. If a manager has the added flexibility to actively manage exposures, the manager may be able to hedge away the currency risk inherent in this falling rate environment.

- **Currency appreciation**

Evaluating a country's currency can reveal similar opportunities. Identifying economies with positive dynamics in their external balances, relative purchasing power, inflation, fiscal sustainability or growth can help bring to light potential opportunities for currency appreciation. Exposure to such a currency can be built either by owning an unhedged position in bonds or by using currency forwards overlaid on a hedged bond position.

Currencies could also move to the disadvantage of a global bond investor, if one's home currency strengthened against the foreign bond's currency. However, if such a development is anticipated, action can be taken to hedge out the adverse currency exposure by purchasing a contract to exchange currencies at a set rate at a later date, thereby reducing the currency risk of the investment.

- **Sovereign credit**

In a rising inflationary environment, an active investment manager with the ability to increase sovereign credit exposure to countries whose economies in terms of trade and fiscal revenues benefit from raw materials exports could potentially benefit from higher commodity prices. Moreover, an active manager could also potentially capitalize on the disparate spreads amongst sovereign credits amid the varying policy responses and implements of policy unwinds enacted by central banks and governments worldwide.

- **Interest income**

Yields are another attractive aspect of global fixed income investing. Developing market bonds tend to offer higher yields than those from developed markets. And even if global yields were similar, adjustments to relative exchange rates can provide the potential for return opportunities beyond the pure yield generated by global fixed income investments. Attractive yields may be further enhanced by currency dynamics when each component of the return is evaluated and exploited separately.

Enhanced Alpha Potential

An actively managed global bond portfolio that seeks to exploit country-specific differences may be able to reduce correlations to traditional asset classes even further and potentially enhance alpha potential. For global fixed income strategies, three independent alpha sources are key: currency, duration and credit exposures. When assessing investment opportunities, the expected return from each potential alpha source can be isolated to help ensure that the attractive risks are held and positions are properly hedged.

New investment opportunities can play a useful role here, primarily as a risk management tool that is designed to isolate particularly attractive risk components within securities. For example, a strategy for a given country may keep the duration element and seek to hedge out the currency by using currency forwards. Alternatively, cross-country valuations may reveal a currency opportunity that coexists with a country's unfavorable interest rate environment. The manager who can isolate one from the other can potentially enhance portfolio performance.

Chart 3 provides an example of the variation in historical bond market results depending on the currency tactic chosen.

Chart 3: Global Bond Markets: The Importance of Active Management (%)

12-Month Returns For The Period Ending September 30, 2009

	Local Currency Bond Return	Currency Return vs. USD ⁴	Unhedged USD Total Bond Return
GGBI ²	7.08	6.46	14.00
EMBIG ³ (USD)	—	—	18.67
Brazil	21.13	8.27	31.15
Indonesia	30.28	-2.43	27.11
Japan	3.19	18.57	22.36
South Africa	8.43	9.28	18.49
Australia	5.75	11.89	18.32
New Zealand	7.17	8.31	16.08
Switzerland	6.23	8.06	15.79
Euro Area	10.73	4.06	15.23
South Korea	8.90	2.44	11.56
India	13.10	-2.37	10.42
Norway	6.79	1.90	8.82
Singapore	6.45	1.47	8.39
Sweden	7.64	-0.29	7.33
Canada	7.61	-0.94	6.60
Malaysia	7.11	-0.53	6.59
United States	6.42	—	6.42
United Kingdom	11.78	-10.27	0.30
Mexico	11.83	-18.64	-9.01
Poland	6.89	-16.76	-11.02

Broader Opportunity Set

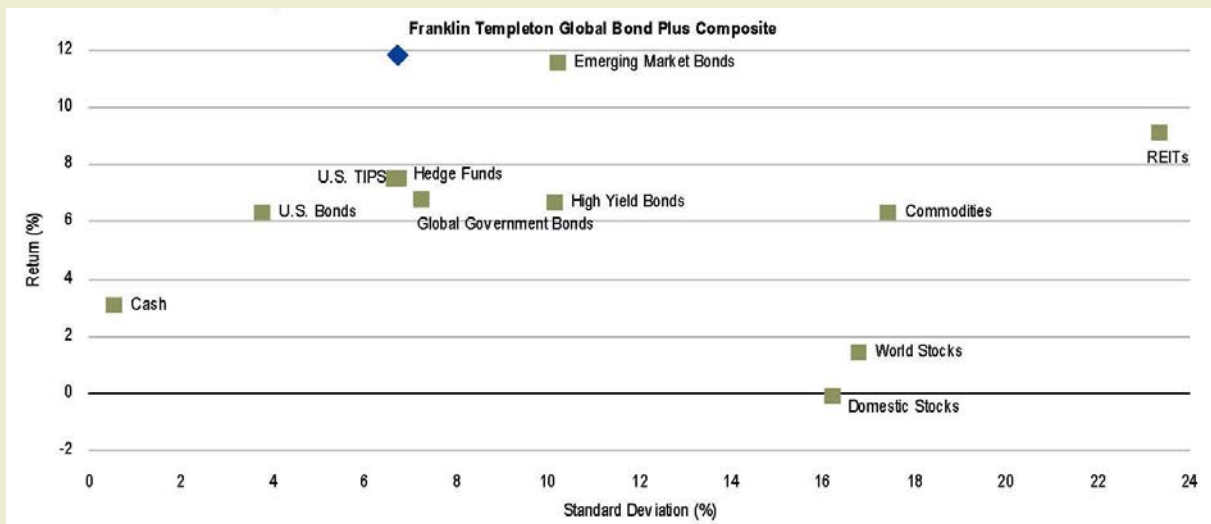
Global fixed income benchmarks are fairly narrow. Typically, 80 per cent of the benchmarks will focus on bonds from the U.S., the UK, the European Union, and Japan. Sometimes, though, opportunities may be more prevalent outside of these markets.

Active managers can help investors who seek to take advantage of the full global fixed income opportunity set.

For example, as of September 30, 2009, a representative account of the actively managed Franklin Templeton Global Bond Plus Composite (the Composite) was invested in over 25 countries and over 20 currencies. Given its ability to invest more broadly, the representative account's average credit quality was 'A,' in contrast to the 'AA' of its benchmark, the JP Morgan Global Government Bond Index, for the same period. For a graphical illustration of how the Composite has performed compared to its benchmark, see *Chart 4*.

Chart 4: Active Management At Work – Risk Vs. Return

10-Year Period Ending September 2009



As countries and regions recover from the unprecedented global downturn at different rates, we believe that geographic diversification makes sense not only from a risk standpoint, but also from a potential return vantage, allowing investors to access opportunities emerging in multiple fixed income opportunities may be more prevalent outside of these markets. With that said, we believe that an actively managed global bond strategy has the potential to serve institutional investors better than most passive strategies, based on its flexibility to react to risks and capitalize on opportunities outside of global bond benchmarks.

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