

Fixed Income Investing In A Wider World

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With the staggering declines in equity markets over the past year, many investors are looking to global fixed income products to improve diversification, reduce volatility, and enhance risk-adjusted returns in their portfolios. The global fixed income asset class has the potential to provide diversification benefits beyond those offered by their domestic counterparts.

Fixed income investments are typically less volatile than equities and may provide a cushion when other asset classes are declining. Although during the recent downturn many asset classes fell together, in the long term global bonds have exhibited a low correlation with asset classes such as commodities, real estate, and equities. An allocation to global bonds can thus cushion the volatility of a diversified portfolio. Moreover, global bond returns are not much more volatile than U.S. corporate bonds, based on the 10-year standard deviation of returns (see graph below).

Global bonds can expand diversification relative to a domestic bond portfolio by allowing investors to take advantage of different economic conditions around the world, including interest rate and currency trends. For example, when the U.S. dollar weakens, the appreciation of foreign currency-based investments can add to a U.S. dollar-based investor's total return.

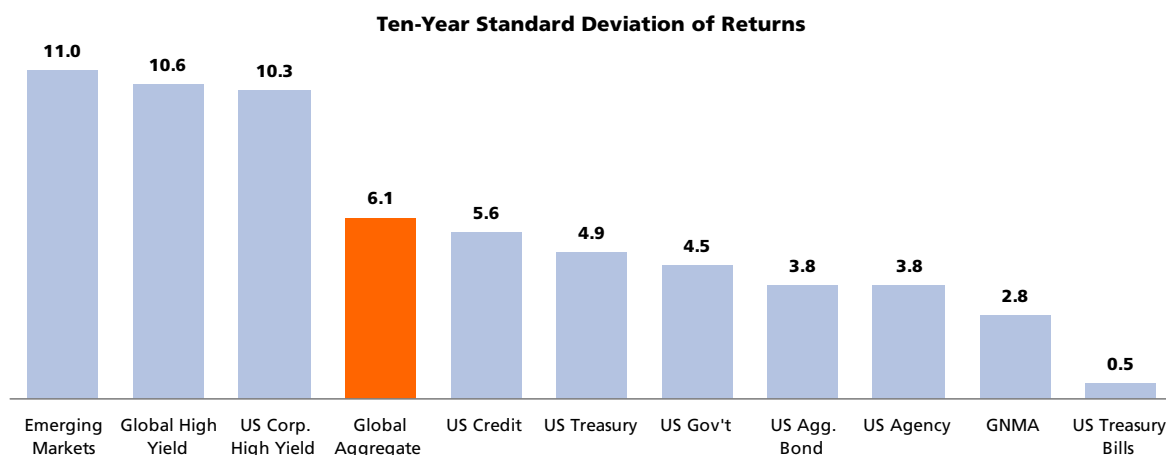
In addition, some global bond strategies can provide exposure to hard-to-access market segments and

regions, such as emerging markets. Bond funds investing in emerging markets offer the potential for higher returns but generally have greater levels of risk than funds that invest solely in developed markets.

Beyond providing a source of regular income, global bonds offer the opportunity for higher yields than domestic bonds, and, if spreads tighten, capital gains as well. Investing beyond U.S. borders offers the potential for higher total returns as many countries have historically paid higher income than the U.S. (see graph on the next page). Furthermore, because the returns of individual bond markets will vary from year to year, at times outperforming and underperforming the U.S. bond market, a diversified global bond portfolio can smooth the impact of losses when an individual market has a down year.

Investing globally broadens an investor's opportunity set, increasing chances to identify value and to diversify risk. Importantly, the global fixed income universe has broadened and deepened over the past several years: approximately 60% of the global bond market represents non-U.S. bonds. There are now opportunities to invest in sovereign, corporate, and municipal bonds, mortgage-backed securities, structured products, and derivatives. One can choose to invest in securities denominated in local or foreign currencies. Those who invest exclusively in the U.S. are therefore overlooking a significant investment opportunity.

Stepping Up To Global Fixed Income Exposure Is Only A Modest Stretch



Source: Morningstar, Barclays Capital Indexes. As of 3/31/09

Global deleveraging has resulted in opportunities to invest in high-quality bonds at attractive valuations. Current prices of investment grade corporate bonds factor in a five-year default rate of 40% in the U.S., 38% in Europe, and 51% in the United Kingdom. Such levels are worse than those witnessed in the Great Depression.

Many countries have cut their benchmark interest rates and/or begun quantitative easing programs in order to stimulate economic growth and ward off deflation. These steps should improve liquidity and lead to modestly tighter spreads.

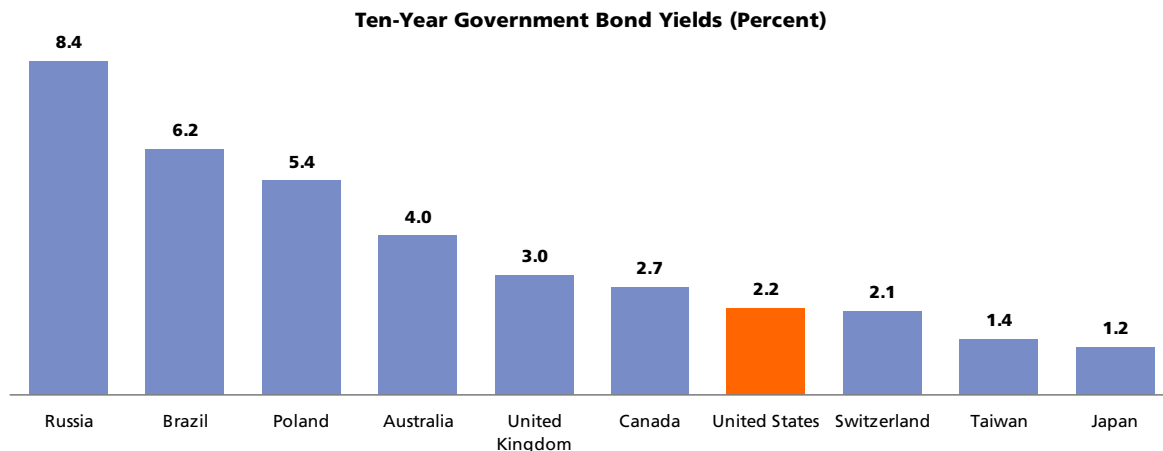
Although deleveraging continues, it seems as if government programs are starting to affect asset prices in a positive way. Credit will most likely become more expensive for new issuers, leading to

higher required rates of return for certain countries and types of debt. Central banks globally will maintain very low interest rates, as inflation is not seen as a near-term or even medium-term problem.

In this environment, it is prudent to invest at the higher end of the capital structure, where debt holders are the beneficiaries of cash flows ahead of equity holders. In a market where government rescue packages have created haves and have-nots, we believe we should invest along with the government.

The global bond market has grown in size and complexity over the years. An active global bond manager can bring the sophistication needed to conduct high-quality research and due diligence to take advantage of dislocations and find long-term value. ■

Many Countries Currently Have Higher Bond Yields than the U.S. Does



Source: Bloomberg. As of 12/31/2008

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