

# Why Global Bonds?

## Why Now? Why Brandywine Global?

### GLOBAL BONDS: AN OPPORTUNE INVESTMENT

Global bonds are a unique “opportunity class” that can produce superior returns, provide diverse sources of alpha and reduce the overall volatility of a purely domestic bond portfolio. Active global bond investors have an intrinsic advantage due to an expanded opportunity set. Investors who focus on government bonds in a single country are limited largely to binary duration decisions, while global managers who have the skill to manage currencies can capture much more complex relationships. In allowing managers to invest globally, investors diversify their source of return and, in our view, allow greater potential for outperformance.

The aftermath of the financial crisis of 2008 makes global bond markets even more appealing at this time. Currently, the U.S. and other G3 markets appear more synchronized and riskier than ever before. Comparatively, the non-G3 and developing markets have seldom been more appealing from a risk/reward perspective. Many of these countries are adopting pro-capitalistic policies and are well positioned for independent economic growth and prosperity.

An appropriately positioned strategy is critical to success when investing in global bonds. In our view, global fixed income investment portfolios built around indexes are less likely to provide strong returns. This is because index weights are directly proportional to the size of a country's debt issuance. Therefore, investors in index-oriented strategies are led to increase holdings in countries with huge deficits, not huge opportunities. In the current environment, this paradox is truer than ever as private sector borrowing and spending have been replaced by massive government debt issuance and spending in the developed world.

This paper discusses the reasons why investing in global bonds makes sense, why now presents a unique opportunity to invest in the asset class, and how even more upside can be captured in the asset class through a well-structured portfolio.

**Q:** *Why are global bonds a unique “opportunity class?”*

**A:** *Global bonds offer a larger, more diversified opportunity set of return sources relative to single-country portfolios*

### GLOBAL BONDS OFFER A GREATER OPPORTUNITY SET

Historically, the dispersion of returns across the sectors of domestic bond markets has been narrow and tightly bunched. By extrapolation, some investors mistakenly presume that the same must be true of the dispersion within global bond indexes. This faulty assumption leads some to

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shun the asset class because they believe they assume incremental risk without incremental upside potential. As seen in **Figures 1 and 2**, investors can achieve significantly more outperformance if they overweight the right countries in a global portfolio relative to overweighting the right sectors in a single-country portfolio.

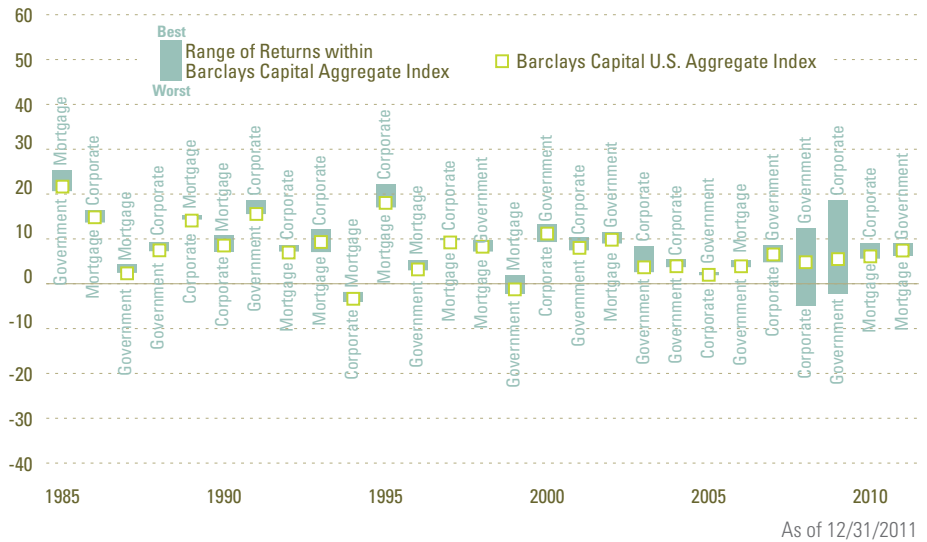
By investing in a single country, investors are limiting their potential sources of return. Conversely, by investing in global bonds, investors can limit risk and improve returns by focusing only on the countries with the most attractive economic and interest rate cycles. This creates the potential to produce superior returns, increase diversification and reduce the overall volatility relative to purely domestic bond portfolios.

Investors tend to have a myopic and home-biased view of global bond investing. What they fail to realize is that 74% of the world's sovereign debt is issued outside of the U.S. (see **Figure 3** on the next page). In contrast, only 50% of the world's publicly traded equity value is outside of the U.S. Still, global equity exposure is considered a natural portfolio choice, yet many investors still fail to advocate global fixed income exposure.

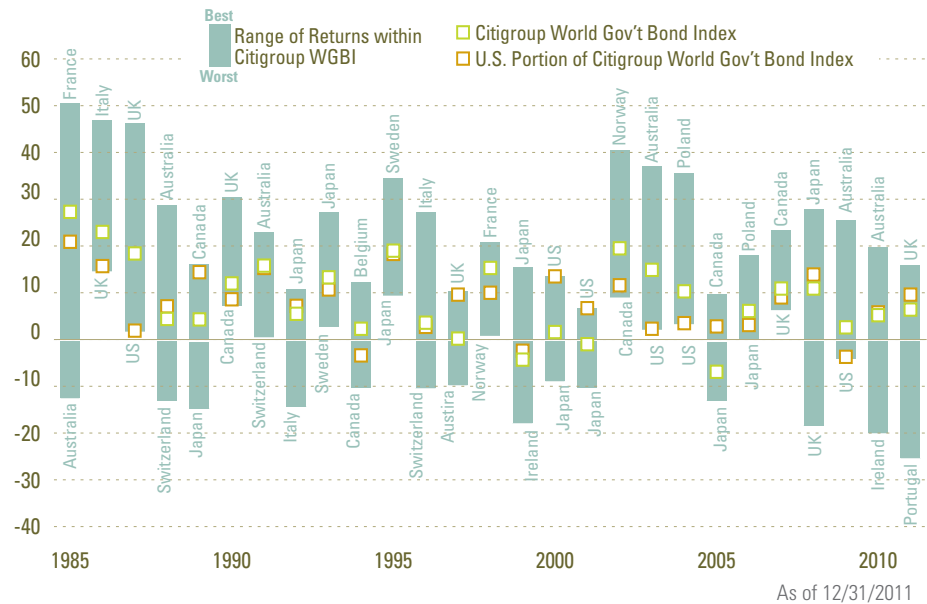
**GLOBAL BONDS HAVE MORE FACTORS FROM WHICH TO DRAW RETURN**

The dispersion of returns across the global bond markets is wide and often offers significant upside relative to U.S. bonds. A historical analysis of global fixed income returns shows repeatedly that the top-performing country in one year could be among the worst performing the next, and vice versa. Currency provides an additional investment opportunity on top of the standard factors for bond investors. A country's bond market may produce average performance in local currency

**Figure 1 Domestic Bond Index Dispersion/Opportunity<sup>1</sup>**  
 Annual Total Returns (%)



**Figure 2 Global Government Bond Dispersion/Opportunity<sup>2</sup>**  
 Annual Total Returns (%)



terms in a given year, but a cheap and appreciating currency can provide investors with an additional source of return (Conversely, a good bond return can be negated without prudent currency hedging). Investing in the right countries, coupled with currency appreciation or selective hedging, offers return potential usually far in excess of any one domestic market. Such a strategy can also provide an additional, uncorrelated alpha source to a multi-asset class portfolio.

**Q:** *Why is now a unique time for investing in global bonds?*

**A:** *Following the 2008 crisis, the policy response of monetary authorities in G3 economies is more likely than ever to result in poor returns for G3 domestic bond portfolios.*

#### THE U.S. BOND MARKET IS MORE HOMOGENOUS AND RISKIER THAN EVER BEFORE

The authorities responded to the breakdown of the financial system in 2008 with massive intervention in the form of both fiscal and monetary stimulus. Congressional Budget Office projections show that the U.S. government is currently on a course to accumulate record debt as a share of GDP. As a result of the policy response, debt backed by the U.S. sovereign as a share of the dollar-denominated bond market has also risen substantially. Government-related securities (Treasuries, agency debt and FDIC-guaranteed paper) now compose more than 80% of the broad U.S. Aggregate Index. The U.S. bond market has become increasingly homogenous with all this issuance backed by the same entity, the U.S. government. At the same time, the U.S. is flirting with the possibility of losing its premier credit rating.

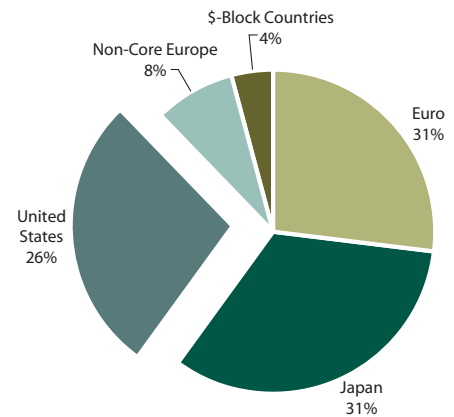
Due to the unusual nature of the policy response, the U.S. and other countries are issuing debt at extremely low yields; the average yield to maturity for the U.S. Aggregate<sup>1</sup>, for example, remains close to 3%. Over time, it will be very difficult for a U.S. core manager to earn significantly more than the index's yield. In the face of this threat, some managers may sacrifice credit quality in the search of higher yield. We believe that an investment in global bonds is a much more prudent choice.

#### INVESTING IN DEVELOPED AND DEVELOPING NON-G3 COUNTRIES HAS NEVER MADE MORE SENSE

The recent epic economic shifts make investing outside of the U.S. and other major developed-country bond markets even more compelling from a risk perspective. Investors who believe in recovery might be enticed by commodity-linked countries like Australia, New Zealand and Canada. Those who are wary of the euro can find opportunity elsewhere in Europe through countries like Poland, Sweden and the U.K. Investors wanting to capture the upside of exposure to China, yet who are uncertain about direct investment can purchase investment-grade debt in Singapore and Malaysia. All of these developed countries, in our opinion, offer compelling long-term opportunity relative to G3 sovereign markets.

Many developing countries have not been as affected by the financial crisis as the developed world, offering even more outsized opportunity. A large number of developing

**Figure 3** Investment-Grade Sovereign Debt Outstanding<sup>3</sup>  
Proportions of Index-Eligible Sovereign Debt



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countries have rebounded to levels past pre-crisis economic activity, which has led to strong currency markets. Central banks and governments in these nations have become more responsible in recent years and have succeeded in reining in inflation, building reserves and strengthening their economy.

Investors are gradually appreciating the structural improvement in many non-G3 economies. This has led to an increase in credit quality (see **Figure 4**) and liquidity, which has also reduced risk premia. This, in turn, provides for lower borrowing costs and underpins the ability of these countries to withstand volatility in global growth and financial markets. The response of the emerging world's markets in the most recent crisis, for example, offers a stark contrast to their behavior during the Argentinian or Russian defaults (see **Figure 5**).

Nonetheless, memories of volatile growth and inflation have kept emerging market yields attractive, which creates enormous opportunity for global bond investors. On top of this, there is pent-up potential for currency gains as many of these countries have resisted currency appreciation in order to keep export sectors competitive during the crisis. While some appreciation has occurred, future potential returns are likely in anticipation of the eventual convertibility of the Chinese yuan.

**MANY DEVELOPING COUNTRIES ARE EMBRACING CAPITALISM**

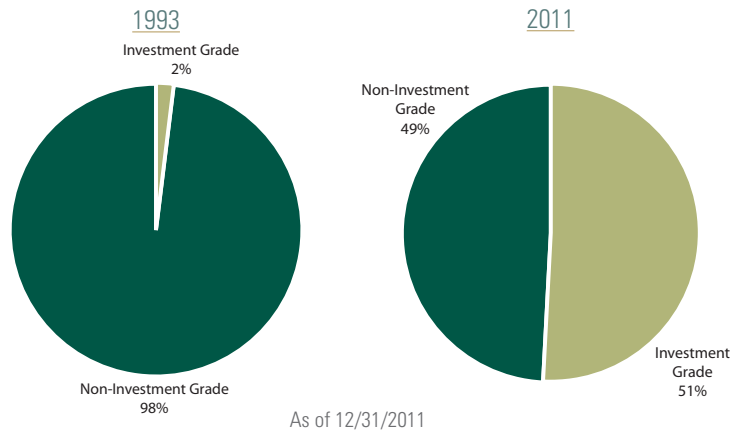
Following the crisis of 2008, there has been a shift in the U.S. further away from unfettered capitalism. The U.S. government is now heavily involved in multiple industries and is taking on a much more populist stance.

In contrast, many countries in the emerging world are embracing the principles of free-markets, their futures looking bright as they modernize, industrialize, and expand their financial systems while benefiting from the energy of their youthful, growing populations. There is even a form of tax competition taking place in many parts of the developing world. Multiple ex-communist states in Eastern Europe and Central Asia, for instance, now boast attractive flat-tax regimes. Even in the developed world, there are signs of tax competition. The current German government won the election while campaigning on a platform of lower progressive taxes. The French have followed suit with modest tax cuts. India has recently reduced restrictions on foreign ownership in a bid to attract capital. In Korea, the authorities are working to reduce corporate taxes and encourage research and development, and in Taiwan the government is reducing barriers to development with China. We believe that these policies will lead to greater economic success and, over time, stronger bond markets relative to the G3.

**THE NON-G3 WORLD IS TAKING THE INITIATIVE TO STIMULATE SPENDING DOMESTICALLY IN RESPONSE TO THE FALL OFF IN U.S. CONSUMPTION**

Going forward, the rest of the world can no longer rely on the U.S. consumer as the backbone of global demand and the developing world is taking

**Figure 4** Improving Credit Quality in Developing Markets<sup>4</sup>  
 S&P Credit-Quality Distributions Across Developing Markets



**Figure 5** Credit Spreads of Emerging Market Sovereigns vs. U.S. Corporates<sup>5</sup>  
 J.P. Morgan EM Bond Index Less Baa Rated U.S. Corporates (Basis Points)



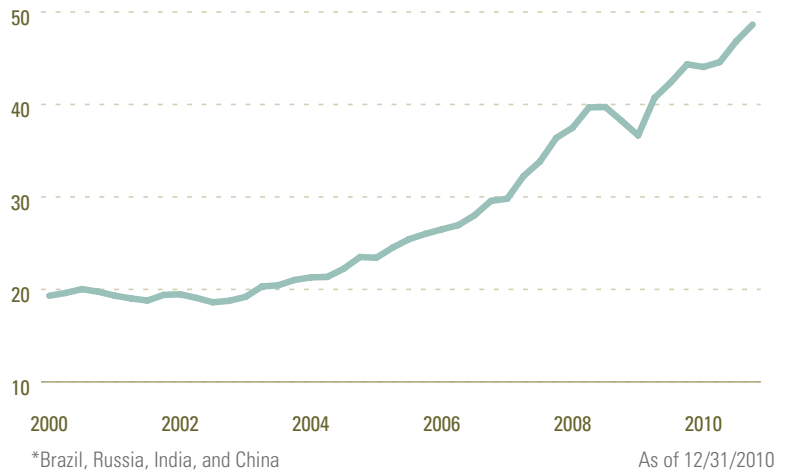
initiative to stimulate spending domestically in reaction to the fall off in U.S. consumption. For over 15 years there has been a unique balancing act between the U.S. and China, the two anchor economies of the global financial system. China's excess production and savings was absorbed by U.S. excess borrowing and spending. This combination fostered the impression of rapid, non-inflationary growth around the global economy for almost two decades. In hindsight, it is now clear that the U.S. was only able to sustain its excessive consumption through an unsustainable decline in lending standards and reduced cost of risk. This period is now over.

Private sector deleveraging combined with new lending standards and the recapitalization of the banking system mean that China and other developing economies need to find new sources of demand. There is every indication that this is happening. The emerging countries have stimulated their economies quickly to overcome the drag from the crisis. From a longer-term perspective, they are encouraging domestic spending as well. Brazil, Russia, India & China ("BRIC") consumption as a percentage of U.S. consumption has more than doubled over the last decade (see **Figure 6**). Additionally, the non-G3's share of global GDP has continually increased over time (see **Figure 7**). Going forward, we expect these economies to strengthen without the U.S. as the main driver of growth.

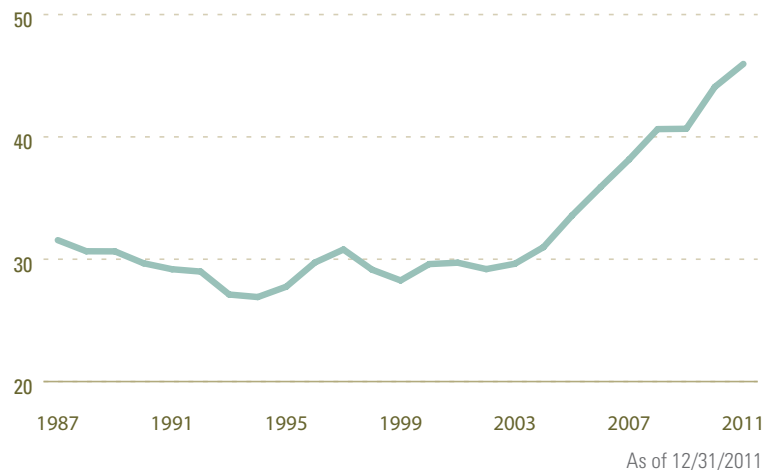
**Q:** *What is the preferred investor strategy within global bonds?*

**A:** *A macro-based, index-agnostic investment strategy that focuses on bonds and currencies is best suited for today's environment:*

**Figure 6** BRIC\* Personal Consumption Relative to the U.S.<sup>5</sup>  
 Absolute Values Compared at Market Exchange Rates (%)



**Figure 7** Non-G3 Share of Global GDP<sup>5</sup>  
 At Market Exchange Rates (%)



**GLOBAL BOND INDEXES MISLEAD INVESTORS AWAY FROM VALUE; THE POLICY RESPONSE FROM 2008's CRISIS MASKS INVESTMENT OPPORTUNITIES EVEN MORE AS A RESULT OF THE INDEX CONSTRUCTION PARADOX**

Stock indexes are meritocracies. The biggest companies in the S&P 500 made money for investors, achieved profitability and growth, and rose to positions of respect and prominence. Conversely, the countries with the largest allocations in capitalization-weighted, global fixed income benchmarks achieved that status by being the most indebted. They ran the biggest deficits and were the least disciplined in their control over costs relative to revenues. Using fixed income indexes as a framework for taking risk simply does not make sense. Investing in an index-like strategy leads investors to hold positions in countries that issue significant debt without any consideration for the return potential of those securities. In the current environment, major developed countries are issuing massive amounts of debt at extremely low yields. This represents a massive misalignment of interests between issuers and investors, since issuers are seeking to minimize their interest costs while investors seek to maximize their return.

In our view, the current massive debt issuance in the developed world illustrates the flaws of index-relative investing. Now more than ever, the index conceals opportunities and exposes investors to risk by driving them towards newly issued sovereign debt, “crowding out” the world’s emerging powerhouses.

Furthermore, fixed income indexes distort interest rate risk through the so-called “duration paradox.” As yields fall for a particular country, duration associated with that exposure extends. This means that a portfolio’s value becomes more sensitive to interest rate risk as yields for a particular country fall. Therefore an index-driven investment strategy implies taking on more interest rate risk in low-yielding countries and less interest rate risk in higher-yielding countries— the opposite of what a rational investor might want. On a duration basis, a portfolio that deviates from the benchmark is considered to have higher active risk. But in reality, investment around index characteristics is a recipe for an erosion of capital.

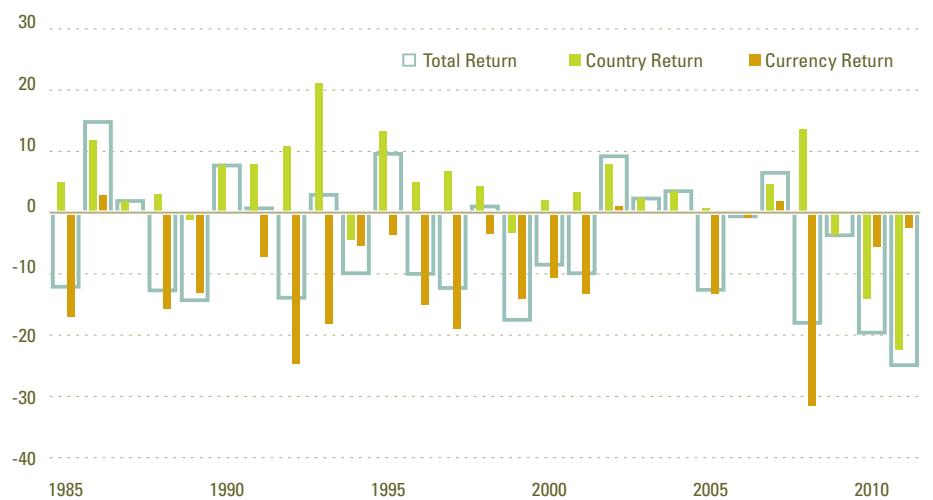
World government bond indexes further distort risk taking by biasing investors towards markets with overvalued currencies. A country’s weight in the index rises as its currency appreciates. Therefore, index-oriented strategies encourage investors to allocate more capital to markets where price risk is high and rising. Conversely, when currencies are undervalued and have the most potential to appreciate, their index weights are at a minimum. From an investment standpoint this is counterintuitive.

We believe the mainstay of a successful investment approach in global bonds is to focus where intrinsic value exists both with respect to interest rate levels and currency valuations. Our approach at Brandywine Global focuses first on identifying high real-yielding bond markets. We then employ rigorous country analysis to gauge the structural strength and weakness of an economy, exposure to shifting global forces and the significance of economic policy from the perspective of a fixed income investor. Given the index construction paradox, we believe that successful investing in global bonds relies as much on avoiding loss as pursuing gain. Rather than owning bonds issued by large index countries when we expect them to underperform, our strategy has the courage of conviction to concentrate investments in countries and currencies where we see the greatest total return opportunity. In some instances our positioning may appear “concentrated” relative to the index since we avoid owning overvalued countries and currencies. However, this is an example of where concentration – we believe – does not equal risk. Frankly the opposite may be true.

ACTIVE DISCRETIONARY HEDGING; THE COUNTRY AND CURRENCY DECISIONS ARE INTERTWINED

Global bond investors must make allocation decisions relative to both bonds and currencies. As the chart in **Figure 8** on the next page indicates, the total return in the worst markets is often driven by currency movements, which can be much more volatile than performance which is attributable to interest rate changes. Ideally, an investor would like to own a local bond in an unhedged fashion, since that allows for two sources of return. Successful investors, though, realize that this might not always be possible. Sometimes, looming interest rate cuts can make a local market attractive, while the same scenario could lead to currency devaluation. In such a market, a manager must be willing to hedge currency risk. On the contrary, in some very strong economies, a currency may be attractive and its bonds unattractive. While currency adds complexity, it also adds opportunity.

**Figure 8** The Impact of Currency Returns<sup>6</sup>  
 Total Return from Sovereign Debt with the Worst Performing Currency (%)



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Going forward, active hedging will be extremely important as a source of return because policy makers' main weapon for fighting deflation is currency devaluation. Mean reversion plays a very important part in our process of price/value discovery. Many managers use price swings in a momentum sense. Our approach looks for swings in prices that are so far away from underlying valuations that they trigger economic/policy reactions which, in turn, lead to reactionary processes that cause mean reversion. Many times these inflection points are signaled by changing human behavior.

Currencies and interest rates are economic regulators, and will often continue to trend until they change people's economic behavior, signaling that valuations have run far enough to start mean reversion. We look for these signs of behavioral change, as well as monitoring economic statistics. This is employed in both the currency and bond decisions. This is especially important in evaluating currency valuations as they tend to stretch but not break. Our style of discretionary hedging seeks to exploit these anomalies and has served us well over the last 15 years with almost half of our excess returns generated from currency decisions.

## SUMMARY

Global bonds offer a superior and diverse opportunity set, and allow the potential for increased active return. Focusing on a single market's economic and interest rate cycle to generate returns is one dimensional, risky, and restricts an investor's return potential. The impact of 2008's crisis and ensuing policy response further reinforces the need to look beyond the largest domestic markets, and embrace a global approach built not around an index but around the greatest opportunities within the global bond investment universe.

<sup>1</sup> Data Source: Barclays Capital Fixed Income Research, Global Family of Indexes. Represents the dispersion of the best and worst annual U.S.-dollar returns (unhedged) for the Barclays Capital Mortgage Backed Securities Index (BCMBSI), Barclays Capital Corporate Bond Index (BCCBI) and the Barclays Capital Government Index (BCGI). The BCMBSI includes GNMA, FNMA, and FHLMC mortgage pass-through securities. The BCCBI includes U.S. corporate bonds, Yankee debentures and comparable issues. The BCGI includes U.S. Treasury and Agency securities. Charts created by Brandywine Global.

<sup>2</sup> Data Source: Citigroup World Government Bond Index (WGBI). Represents the dispersion of the best- and the worst-performing countries utilizing annual total returns measured in U.S. dollars (unhedged). Also pinpoints the annual return for the U.S. portion of the SWGBI and the annual total return for the Index itself. The SWGBI is a market-capitalization weighted benchmark that tracks the performance of 18 Government bond markets. Charts created by Brandywine Global.

<sup>3</sup> Data Source: Bloomberg - Index provider for Citigroup World Government Bond Index data. Charts created by Brandywine Global.

<sup>4</sup> Data Source: Bloomberg. Charts created by Brandywine Global. Data represents the JP Morgan EMBI Global Bond Index. Credit Qualities represent S&P ratings.

<sup>5</sup> Data Source: Thomson Datastream, which Brandywine Global believes to be accurate and reliable. Charts created by Brandywine Global.

<sup>6</sup> Data Source: Citigroup World Government Bond Index (WGBI). Represents the performance of the worst-performing bond market utilizing annual total returns measured in U.S. dollars (unhedged). Also represented is that total return broken into the portion associated solely with currency appreciation/depreciation and the portion associated with local market appreciation/depreciation. The SWGBI is a market-capitalization weighted benchmark that tracks the performance of 18 government bond markets. Charts created by Brandywine Global.

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