

Looking Beyond U.S. Bonds



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Changes in the world's economic and financial landscape have made the world smaller economically while simultaneously expanding investment opportunities. Although U.S. investors have been taking advantage of this larger opportunity set by including the stocks of non-U.S. companies in their equity portfolios, they have been hesitant to do the same with their bond portfolios. In this article, we will discuss the rationale for including non-U.S. bonds in fixed income portfolios.

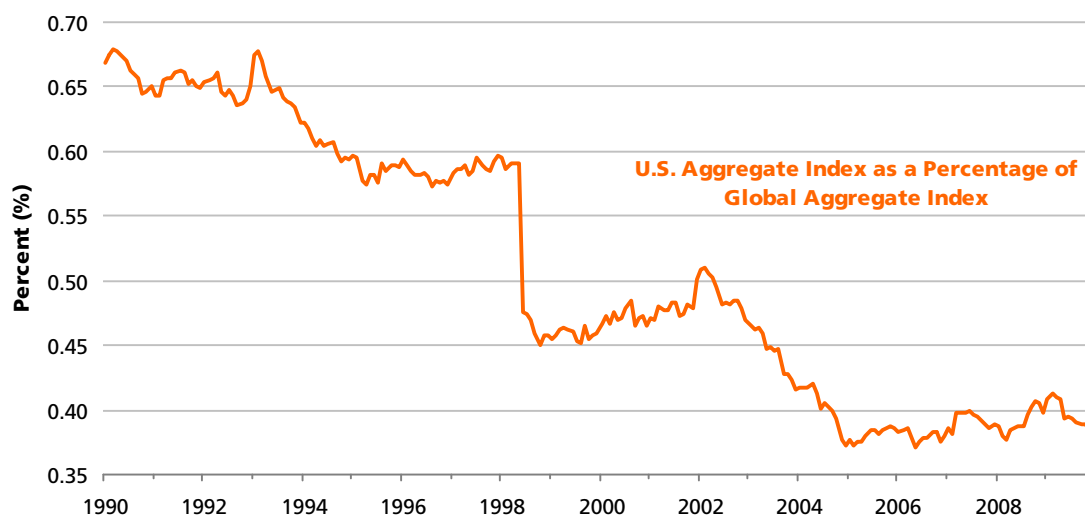
Increasing Globalization Means an Increased Opportunity Set

Institutional investors have recognized the trend toward globalization and have made significant allocations to international equities in their investment portfolios; however, few have done the same in international fixed income. In the U.S., the average public defined benefit plan allocates 18.5% of its assets to international equity but just 1.8% to international fixed income (according to a November Bank of America Merrill Lynch report).

Global fixed income instruments provide investment managers with a broader opportunity set from which to source alpha. Empirical evidence and capital market theory advocate the broadest possible global market portfolio in order to realize potential diversification benefits.

Evidence of the shrinking role of the U.S. in both the global economy and fixed income market abounds. The U.S. bond market currently accounts for approximately 40% of the world bond market, and this share has been trending downward over the past several years (see chart below). Since 2005, emerging markets have led in terms of debt issuance, growing faster than the Asia-Pacific region, the European Union and the U.S. Given current GDP growth expectations for countries like Australia, Brazil, Russia, India and China, strong issuance out of the emerging world is likely to persist.

The U.S. share of the world bond market has declined

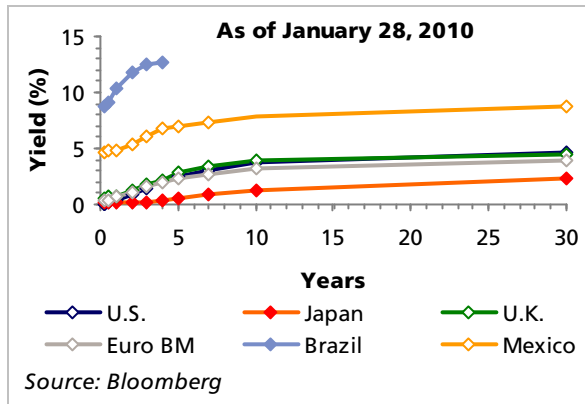


Source: Barclays Capital, ING Investment Management

Interest Rates and Inflation Environments Around the World

With global economies rebounding, bond investors in all regions face risks from rising interest rates and inflation. Because inflation and interest rates are likely to vary across countries and regions as the recovery takes hold, U.S. investors can obtain diversification with respect to these risks by investing in non-U.S. bonds. In addition, while bond yields within most developed markets are near historical lows, other bond markets offer attractive spreads (and attractive returns) compared to U.S. Treasuries.

Interest rates vary widely...



...as do asset spreads

Asset Spreads (as of 1/22/09)		
	Yield	Spread to 10-Year
10-Year Treasury	3.61%	—
U.S. AA Corporate	4.76%	1.15%
U.S. A Corporate	5.22%	1.61%
U.S. BBB Corporate	5.72%	2.11%
Australia 10-Year Sovereign (AAA)	5.43%	1.82%
Brazil 7-Year Sovereign (BBB)	13.30%	9.69%

Source: Bloomberg, Barclays Capital

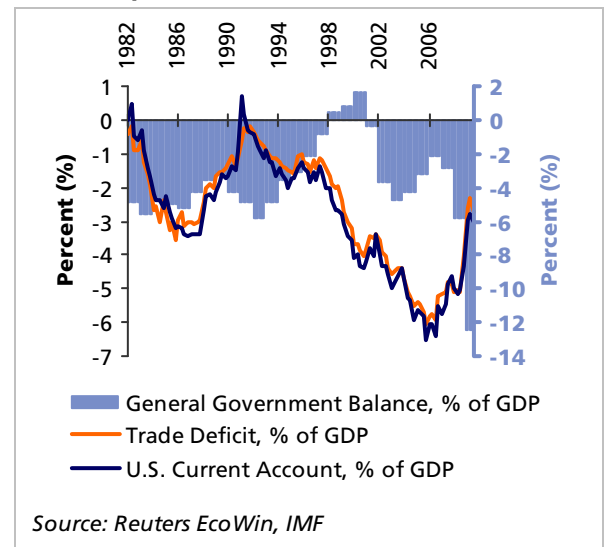
Potential for U.S. Dollar Depreciation

The potential for a depreciating greenback makes global bonds a compelling option for U.S. investors, particularly in light of the current attractive valuations of many non-U.S. issues.

During the height of the financial crisis, investors flocked to the U.S. dollar as a safe haven, though the dollar gave up most of those gains as risk appetite returned to the world financial markets over the course of 2009. And the risk of continued weakness in the U.S. dollar is quite real.

Historically, currency valuations have been driven by such factors as relative GDP and productivity growth, government debt levels, current account balance and inflation. Many of these metrics have exhibited trends that could lead to a weaker dollar and potential currency gains from an unhedged portfolio of global bonds. For example, owing to stimulus spending, the U.S. fiscal deficit has widened sharply; for 2009, it exceeded 12% of GDP, up from approximately 5.9% in 2008. The large and persistent current account deficit in the U.S. could also be a structural drag on the dollar. And although it's not considered much of a near-term threat, the re-emergence of inflation down the road would likely put downward pressure on the dollar.

Indicators point toward a weaker dollar



Efficient Frontier Analysis

When it comes to implementing investment strategies, many institutional investors employ asset allocation models to optimize portfolio weights. Such models are very sensitive to risk, return and correlation assumptions, and thus sometimes fail to allocate to asset classes that may be beneficial to well-diversified portfolios. Changing these investment assumptions slightly can result in asset allocation outcomes with attractive risk-return characteristics.

For example, many investors often assume that non-U.S. bonds offer lower returns and higher risk than their U.S. counterparts. As a result of these misguided risk/return assumptions, non-U.S. bonds are frequently excluded from portfolio design considerations; as shown below, an efficient frontier constructed using the beta returns of U.S. and non-U.S. bonds — i.e., employing market indexes and thus assuming no alpha generation — results in portfolios with little or no allocation to non-U.S. bonds.

	Expected Return	Standard Deviation	Sharpe Ratio
Beta Only, as of July 2009			
U.S. Equity — All Cap — Russell 3000 Index	8.00%	16.30%	0.30
Non-U.S. Equity — MSCI All Country ex-U.S. Index	9.80%	17.50%	0.38
U.S. Bonds — Barclays Capital Aggregate Index	4.00%	5.00%	0.18
Non-U.S. Bonds	3.60%	7.75%	0.06
Cash	3.10%	1.50%	N/A
Alpha, as of July 2009			
U.S. Equity — All Cap — Russell 3000 Index	0.00%	0.00%	N/A
Non-U.S. Equity — MSCI All Country ex-U.S. Index	0.00%	0.00%	N/A
U.S. Bonds — Barclays Capital Aggregate Index	0.00%	0.00%	N/A
Non-U.S. Bonds	0.00%	0.00%	N/A
Cash	0.00%	0.00%	N/A
Beta + Alpha (no correlation between alpha & beta), as of July 2009			
U.S. Equity — All Cap — Russell 3000 Index	8.00%	16.30%	0.30
Non-U.S. Equity — MSCI All Country ex-U.S. Index	9.80%	17.50%	0.38
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Cash	3.10%	1.50%	N/A

Efficient Portfolios	Allocation				Non-U.S. Equity as % of Total Equity	Non-U.S. Bonds as % of Total Bonds	Expected Return	Standard Deviation	Sharpe Ratio
	U.S. Equity — All Cap — Russell 3000 Index	Non-U.S. Equity — MSCI All Country ex-U.S. Index	U.S. Bonds — Barclays Capital Aggregate Index	Non-U.S. Bonds					
Mix 1: 8% Eq / 92% FI	8.0%	0.0%	75.7%	16.3%	0%	18%	4.38%	4.71%	0.27
Mix 2: 28% Eq / 72% FI	5.9%	21.9%	69.2%	3.0%	79%	4%	5.78%	6.13%	0.44
Mix 3: 38% Eq / 62% FI	3.2%	35.2%	61.5%	0.0%	92%	0%	6.50%	7.55%	0.45
Mix 4: 48% Eq / 52% FI	1.4%	46.6%	52.1%	0.0%	97%	0%	7.09%	8.97%	0.44
Mix 5: 57% Eq / 43% FI	0.0%	56.9%	43.1%	0.0%	100%	0%	7.62%	10.39%	0.44
Mix 6: 66% Eq / 34% FI	0.0%	65.8%	34.2%	0.0%	100%	0%	8.11%	11.81%	0.42
Mix 7: 75% Eq / 25% FI	0.0%	74.6%	25.4%	0.0%	100%	0%	8.57%	13.24%	0.41
Mix 8: 83% Eq / 17% FI	0.0%	83.2%	16.8%	0.0%	100%	0%	9.00%	14.66%	0.40
Mix 9: 92% Eq / 8% FI	0.0%	91.6%	8.4%	0.0%	100%	0%	9.41%	16.08%	0.39
Mix 10: 100% Eq / 0% FI	0.0%	100.0%	0.0%	0.0%	100%	N/A	9.80%	17.50%	0.38

Source: ING analysis

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However, allowing for only a modest amount of alpha generation dramatically changes the resulting efficient frontier and portfolios. In our example below, we assume a non-U.S. bond investment generates 100 basis points of return in excess of the benchmark, putting it on an even keel with the expected return for U.S. bonds. As a result of this small change, the resulting efficient portfolio allocates nearly one-third of fixed income assets to non-U.S. bonds. In addition, the Sharpe ratio and expected return of the resulting portfolio rise, with only a modest increase in the standard deviation.

Conclusion

Dramatic changes in the global economy indicate that globalization is a permanent condition and not

a temporary set of circumstances. The current economic landscape and potential for a weak U.S. dollar may make global bonds attractive for U.S. investors. Regardless of economic forecasts, expanding an investment manager's opportunity set by allowing for a global allocation of assets — including exposure to currencies — provides additional potential to increase investment returns and improve portfolio diversification. A global bond manager is best positioned to take advantage of all opportunities around the world based on relative interest rates, inflation rates and currency values. Capital market assumptions used in asset allocation analysis should take into account the higher expected alpha and tracking error of this increased opportunity set as they will have a major impact on the outcomes from asset allocation models. ■

	Expected Return	Standard Deviation	Sharpe Ratio
Beta Only, as of July 2009			
U.S. Equity — All Cap — Russell 3000 Index	8.00%	16.30%	0.30
Non-U.S. Equity — MSCI All Country ex-U.S. Index	9.80%	17.50%	0.38
U.S. Bonds — Barclays Capital Aggregate Index	4.00%	5.00%	0.18
Non-U.S. Bonds	3.60%	7.75%	0.06
Cash	3.10%	1.50%	N/A
Alpha, as of July 2009			
U.S. Equity — All Cap — Russell 3000 Index	1.00%	2.00%	0.50
Non-U.S. Equity — MSCI All Country ex-U.S. Index	0.75%	4.00%	0.19
U.S. Bonds — Barclays Capital Aggregate Index	0.50%	2.00%	0.25
Non-U.S. Bonds	1.00%	2.50%	0.40
Cash	0.00%	0.00%	N/A
Beta + Alpha (no correlation between alpha & beta), as of July 2009			
U.S. Equity — All Cap — Russell 3000 Index	9.00%	16.42%	0.36
Non-U.S. Equity — MSCI All Country ex-U.S. Index	10.55%	17.95%	0.42
U.S. Bonds — Barclays Capital Aggregate Index	4.50%	5.39%	0.26
Non-U.S. Bonds	4.60%	8.14%	0.18
Cash	3.10%	1.50%	N/A

Efficient Portfolios	Allocation				Non-U.S. Equity as % of Total Equity	Non-U.S. Bonds as % of Total Bonds	Expected Return	Standard Deviation	Sharpe Ratio
	U.S. Equity — All Cap — Russell 3000 Index	Non-U.S. Equity — MSCI All Country ex-US Index	U.S. Bonds — Barclays Capital Aggregate Index	Non-U.S. Bonds					
Mix 1: 9% Eq / 91% FI	9.1%	0.0%	73.1%	17.8%	0%	20%	5.08%	5.02%	0.39
Mix 2: 31% Eq / 69% FI	14.7%	16.1%	51.6%	17.6%	52%	25%	6.49%	6.46%	0.52
Mix 3: 42% Eq / 58% FI	14.1%	27.6%	42.4%	15.9%	66%	27%	7.20%	7.89%	0.52
Mix 4: 51% Eq / 49% FI	13.1%	38.3%	35.5%	13.2%	75%	27%	7.80%	9.33%	0.50
Mix 5: 60% Eq / 40% FI	12.4%	48.0%	28.3%	11.4%	79%	29%	8.34%	10.77%	0.49
Mix 6: 69% Eq / 31% FI	12.0%	57.1%	21.0%	10.0%	83%	32%	8.84%	12.20%	0.47
Mix 7: 78% Eq / 22% FI	11.2%	66.3%	14.6%	7.9%	86%	35%	9.30%	13.64%	0.45
Mix 8: 86% Eq / 14% FI	10.2%	75.6%	8.4%	5.8%	88%	41%	9.74%	15.08%	0.44
Mix 9: 94% Eq / 6% FI	10.1%	84.0%	0.8%	5.1%	89%	86%	10.16%	16.51%	0.43
Mix 10: 100% Eq / 0% FI	0.0%	100.0%	0.0%	0.0%	100%	N/A	10.55%	17.95%	0.41

Source: ING analysis