Going global with bonds:

The benefits of a more global fixed income allocation

Advisor brief May 2018

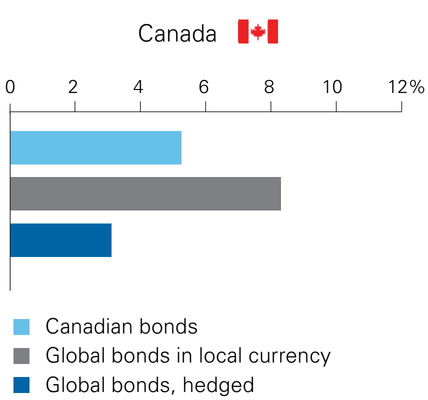
Creating a more global allocation within your clients' fixed income portfolio can reduce their risk without necessarily decreasing their expected return, provided the currency risk is hedged. By adding more global bonds to a portfolio, investors gain exposure to a greater number of securities, markets, and economic and inflation environments. In this brief, we analyze the benefits of a more global fixed income portfolio from the perspective of a Canadian investor.

The volatility of local market bonds

Investing in bond markets outside of Canada may seem like it would add risk, but that is not necessarily the case. Instead, through exposure to multiple markets, a more global bond portfolio can add diversification and reduce market-specific risk factors. Since the events influencing the Canadian bond market may not apply to other bond markets (and vice versa), adding global bond market exposure can smooth returns for clients over time.

In Figure 1, we see that over roughly the last 30 years a global fixed income portfolio has had lower volatility than the Canadian market, provided that the currency is hedged. (Hedging helps reduce currency risk, which can otherwise add significant volatility to a global bond portfolio.)

Figure 1. Hedged global bonds tend to have lower volatility than local market bonds
Annualized volatility of local and hedged and unhedged global fixed income

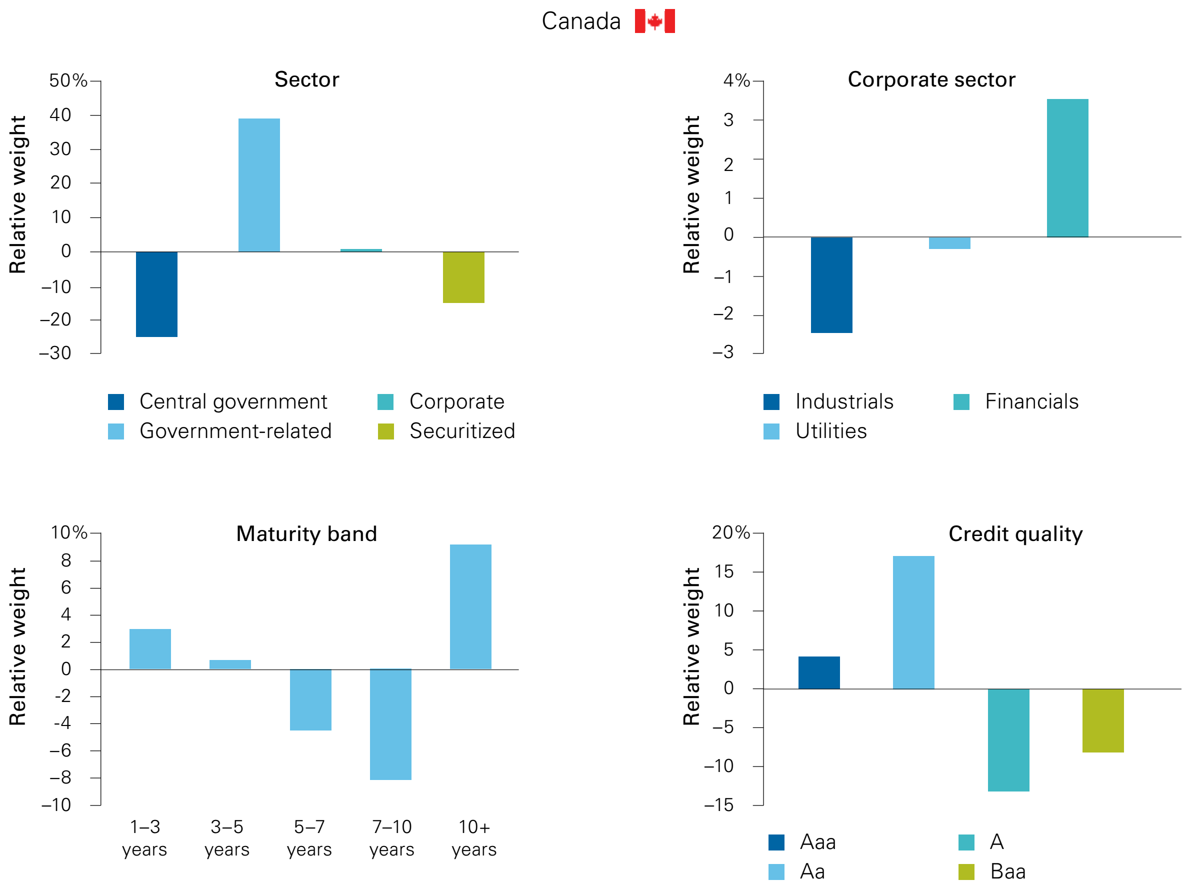


Notes: Data cover the period from January 1, 1988, to June 30, 2017. Canadian bonds are defined as fixed income securities within the global bond universe issued in Canadian dollars. Global bonds are represented by the Citigroup WGBI to January 31, 1999, and the Bloomberg Barclays Global Aggregate Bond Index thereafter.
Source: Vanguard calculations, using data from Bloomberg Barclays and Thomson Reuters Datastream.

Diversification potential of global bonds

The global investment-grade fixed income market can be broken down into a variety of sub components, including sector, maturity, quality and currency. In Figure 2, we can see how the Canadian bond market compares to the global bond markets in aggregate. For example, the Canadian market is overweight government-related provincial bonds, the financial sector, higher-quality issues, and longer duration bonds. By investing in a more global bond portfolio, investors can reduce their exposure to a Canadian investment concentrated in these areas.

Figure 2. Local-market-specific risk factors relative to the global bond market



Notes: Data represents the Bloomberg Barclays Global Aggregate Bond Index as of June 30, 2017.
Source: Vanguard calculations, using data from Bloomberg.

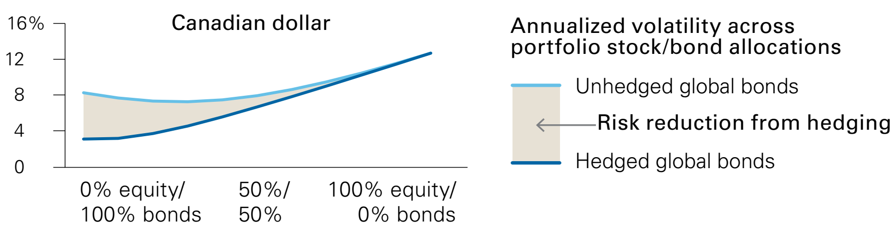
Interest rate risk is another example of a risk factor that has relatively low correlation across markets, since rates may be rising in one market and falling in another. In turn, diluting or cancelling out the interest rate movements within a more global portfolio can create a more stable return profile.

When it comes to allocating assets to global bonds, a fully market-proportional allocation provides the broadest exposure, but diversification benefits can be achieved at less than market proportional allocations. Investors can weigh the market-specific risk factors of the Canadian market with their desire to maintain local exposure.

The importance of hedging

A global bond investment can diversify a portfolio and reduce volatility, but it does expose a client's portfolio to currency risk and the associated volatility when converting from one currency to another since currencies tend to deviate from their fair value in the short and intermediate term. Hedging the currency, on the other hand, tends to result in a more stable return stream. Figure 3 demonstrates this by showing the historical annualized volatility for hedged and unhedged exposure to the Canadian dollar for a range of global balanced portfolios of varying asset allocations.

Figure 3. Hedging the currency of global bonds reduces volatility



Notes: Data cover January 1, 1988, to June 30, 2017. Global stocks are represented by the MSCI All Country World Index. Global bonds are represented by the Citigroup WGBI to January 31, 1999, and the Bloomberg Barclays Global Aggregate Bond Index thereafter. Each portfolio is rebalanced on a monthly basis.

Sources: Vanguard calculations, using data from Bloomberg Barclays and Thomson Reuters Datastream.

Conclusion

Including global bonds significantly expands the opportunity set and diversification potential within a fixed income portfolio, regardless of the investor's local market. The benefits of adding hedged global bonds can be realized without necessarily decreasing returns, provided the currency exposure is hedged.

While a fully market proportional global investment provides the broadest exposure, diversification benefits can also be achieved at less than market proportional allocations.

For more information on the benefits of a global bond portfolio, please contact your Vanguard sales executive or visit vanguardcanada.ca to read our latest research paper, *Going global with bonds: The benefits of a more global fixed income allocation.*

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