Financial Planning

Foreign Indebtedness

The falling dollar has sparked an interest in international bonds, but advisers remain cautious.

By Susan Weiner

July 1, 2005- International bond funds are attracting more money from more investors. Average monthly inflows to international and global debt funds rose from $327 million in 2003 to $618 million in 2004 and $1.38 billion for just the first four months of 2005, according to AMG Data Services. Yet they are far from common in client portfolios. Some financial advisers have a hard time getting clients to consider international stocks, let alone bonds, despite years of proselytizing.

"It's funny that U.S. citizens will purchase a Toyota time and time again because of the high-quality product. But they will not buy Toyota stock or bonds," says Matthew Chope of the Center for Financial Planning in Southfield, Mich.

Even many advisers think international bond funds are too risky. For example, Jennifer Lane of Compass Financial Planning in Wellesley, Mass., shuns non-U.S. bonds because she prefers to keep her clients' bond investments conservative. "I don't even recommend [U.S.] high-yield bonds," she says.

Fears--at least of credit risk--may be overdone. After all, international bond funds hold primarily investment-grade bonds of politically stable, developed countries, and they're mostly government bonds. About half of the JPMorgan non-U.S. government bond index lies in continental Europe, 35% in Japan, with the United Kingdom, Sweden, Canada and Australia accounting for most of the balance, according to Suhail Dada, global product manager at Newport Beach, Calif.-based Pimco. Like other fixed-income managers, Pimco treats emerging markets as a separate, more volatile asset class.

Given advisers' fondness for blanketing all asset style boxes, it's surprising that they're overlooking the big box of international fixed income. "If you only invest in U.S. stocks, U.S. bonds and international stocks, you've left out $20 trillion [of investable assets]," says David Rolley, co-manager with Ken Buntrock of the Boston-based Loomis Sayles Global Bond Fund.

Broadening the asset mix to include international bonds is likely to benefit clients. Indeed, a U.S. investor who added international bonds to a portfolio of Treasuries would have reduced overall portfolio volatility *and* gained a modest pickup in yield over the past 10 years, Dada says. (Results would vary, of course, by the time period selected.)

IT'S DIFFERENT OVER THERE

While advisers have long touted international stocks as a way to diversify, foreign stocks have generally become more correlated with U.S. stocks, says Loomis Sayles' Ken Buntrock. In contrast, international bonds have become less correlated to U.S. bonds. The correlation between the investment-grade Lehman Brothers Global Aggregate index (which includes roughly two-thirds non-U.S. securities) and the Lehman Brothers Aggregate index has fallen to 26% for the year ending March 31, 2005. That's down, he adds, from 10- and five-year correlations of 69% and 70%, respectively.

On a Roll

Fixed-income investors willing to look beyond U.S. shores have been rewarded over the past five years. As of April 30, world bond funds were up 8.3% annually. During the same time period, the S&P 500 lost 2.9% annually.

Top-Performing World Bond Funds

	Ticker	YTD Return (%)	1-Year Return (%)	3-Year Return (%)	5-Year Return (%)	10-Year Return (%)	Net Assets ($MM)
Oppenheimer Intl. Bond A	OIBAX	-0.9	14.4	18.5	13.5	N/A	2,771.8
Evergreen Intl. Bond Instl	ESICX	-2.8	12.4	18.1	12.8	8.4	802.3
Delaware Pooled Global Fixed-Income	DPGIX	-2.2	15.4	18.0	12.7	9.3	296.8
Templeton Global Bond A	TPINX	-1.9	14.5	15.9	12.4	8.4	1,687.5
Delaware Pooled Intl. Fixed-Income	DPIFX	-2.5	15.8	18.6	12.2	N/A	64.5
Loomis Sayles Global Bond Instl	LSGBX	-1.2	10.3	15.0	11.6	10.6	1,183.3
GMO Intl. Bond III	GMIBX	-1.4	15.6	17.9	11.5	8.4	469.5
American Century Intl. Bd Inv	BEGBX	-2.0	13.9	17.4	11.2	6.3	1,275.1
PIMCO Global Bond (Unhedged) Instl	PIGLX	-1.0	12.3	14.8	10.8	7.8	1,324.9
American Funds Capital World Bd A	CWBFX	-0.9	13.1	14.2	10.4	7.1	2,501.7
World Bond Average		-0.8	9.9	11.1	8.3	6.9	
S&P 500		-4.0	6.3	4.2	-2.9	10.4	

Data is as of April 30, 2005, for distinct share classes. Three-, five-, and 10-year return figures are annualized.
Source: Morningstar

One reason that international bonds may perform differently than U.S. bonds is the various countries' different interest-rate policies. "It's fairly clear that our central bank will be among the most restrictive in the developed world in the upcoming year," says Paul Winter of Five Seasons Financial Planning in Holladay, Utah. "So I would expect bond prices abroad to do better relative to ours."

Or, as William Nemerever, co-manager of the fixed-income group at private investment management firm GMO, puts it, international bonds "offer diversification against U.S. rate moves." But the Boston-based manager adds that the divergence in global rates has shrunk in recent years.

There are also inefficiencies in global bond markets, many of them fueled by home-country bias, Rolley says. Around the world, people prefer their own countries' securities over those issued by other countries. When funds don't flow freely across international borders, there isn't one truly global market for bonds. Instead, market conditions may differ by country, creating temporary inefficiencies--such as 19% yields for overnight securities in Brazil, Rolley continues.

In addition, there simply aren't as many players in foreign bond markets, and they may define "cheap" and "rich" differently, Nemerever says. That also contributes to valuation disparities across borders.

THE HEDGING DEBATE

Foreign exchange moves are an even bigger source of divergence between international and U.S. bonds. In fact, they're at the crux of the argument over whether to invest in an international bond portfolio that hedges its exposure to foreign currencies. Because foreign exchange rates are so volatile, rate swings tend to overwhelm the benefit of fixed-income diversification. As a result, unhedged international bond funds "don't behave like fixed income," Dada says. "They're more volatile, like equities." They're also an efficient way to bet against the dollar, short of buying foreign currencies.

So deciding between a hedged and an unhedged fund is important. "Our outlook is for a falling dollar against most currencies and especially the euro," says David Malone, a security analyst at FinArc, an investment management firm in Needham, Mass. "We would not want hedging in this instance."

Malone has plenty of company. The dollar naysayers' rationale typically includes downward pressure from the U.S. government's current-account and budget deficits, declining interest in U.S. markets from foreign investors and a shift from fixed to floating rates for the Chinese yuan.

But can you count on the dollar to drop? "I doubt most planners have the time and resources to call foreign currency movements," says Eve Kaplan of Kaplan Financial in Berkeley Heights, N.J. In addition, Kaplan believes investors have already seen the biggest bounce from foreign currencies' appreciation versus the dollar.

Short-term blips in foreign exchange rates can be painful. The dollar collapsed versus the euro and the yen during the fourth quarter of 2004, but its 2005 rally was still going strong at the end of May. "You don't want to bet your entire bond portfolio on currency," Rolley advises. His fund uses hedging tactically--for example, "to buy bonds where we like the bonds, but not the currency."

Advisers have to understand their clients' risk tolerance before deciding between hedged and unhedged funds. "Where are they allocating their risk budget?" Dada asks. Is it in fixed income? Or are they pursuing the traditional goals of capital preservation and income from their fixed-income allocation?

In the first case, an unhedged fund would be appropriate, according to Dada. It will expose client portfolios to the volatility of foreign currency fluctuations, both positive and negative. In the latter, choose a hedged fund and sleep soundly at night, Dada says. The hedged fund will provide the simple diversification of fixed income.

GMO's Nemerever adds another question to ask: "Do your clients want foreign exchange exposure all the time? Or do they say, I want a manager who has it only when it's worthwhile?'" In that case, he recommends choosing a manager who has flexibility on hedging.

ALLOCATION BASICS

Whether an international bond fund is hedged or not, clients should have a fairly high tolerance for risk, Malone says. "We would most likely use international debt as an addendum to foreign and fixed-income exposure and not as part of a core portfolio for every client."

Winter takes a different view. "As a proponent of low-correlation asset classes, I put at least some allocation to international or emerging markets bond funds in the vast majority of client portfolios," he says.

Some advisers consider global, in addition to international, bond funds. But Nemerever warns, "Don't get caught up in a global fund. It will have a lot of U.S. bonds and dilute your exposure ."

Many advisers agree. Louis Kokernak of Haven Financial Advisors in Austin, Texas, says that some global bond funds have a majority position in U.S. bonds, which he views as a negative. Raymond Benton, president of Benton & Co. in Denver, is blunt: "Global is a category for those too lazy to do their own allocation."

On the other hand, advisers may choose a respectably performing global fund because there aren't enough international bond funds with comparable performance available to small retail investors. "I tend to use the Loomis Sayles Global Bond Fund...because the expense ratio is reasonable and it has a four-star ranking," Kaplan says. "Many of the good international bond funds close quickly, and many that remain open have high--*e.g.*, $1 million--minimums."

As with other asset classes, expenses are important in international bond fund selection. Other fairly standard considerations include relative and risk-adjusted performance, turnover, manager tenure and investment philosophy and process.

For some, the overall caliber of the fund manager is what makes or breaks a fund. "The important factor should be the experience, wisdom, discipline and courage of the fund manager," Benton says. Naturally, the managers of big bond funds stress the breadth and depth of their resources devoted to international bonds.

ON THE HORIZON

But as interest in international bonds expands, even the biggest managers don't have enough products to meet the growing demand from advisers. "I would welcome an international bond ETF," Kaplan says, referring to exchange-traded funds. Yet none of the big providers--Barclays Global Advisors, State Street Global Advisors or Vanguard--currently offers an international bond ETF, or even an international bond index fund, to U.S. retail investors.

Kokernak hopes to see an international bond ETF on the market within the next six to 24 months. And, sooner or later, advisers may convince firms to roll out new products. Pimco, for example, launched its unhedged international bond fund in April 2004. "Financial advisers told us they wanted it to address client concerns about the dollar," Dada says. And they put their money where their mouths were: As of March 31, the fund had $1.3 billion in assets.

Some advisers would like to see an international high-yield bond fund introduced. "We are currently looking at international junk as a complement to our domestic junk asset class," says Tom Orecchio of Greenbaum and Orecchio in Old Tappan, N.J. He already makes an allocation to emerging market bond funds. Both of these asset classes are alluring to investors stretching for yield in a low-return environment.

Some changes in international bond funds may not involve new product categories. Instead, managers may put new instruments into international bond funds. They may buy credit default swaps instead of physical bonds or use futures to manage fund duration synthetically, Buntrock says. Nemerever mentions options on bonds and currencies made available by bond issuers.

In addition, as they mature, emerging markets could play a bigger role in international bond funds. Ten years ago, the credit quality of emerging markets averaged about B or BB, with only one or two countries even on the borderline of an investment-grade rating. Now more than half of emerging market bonds, including those of Mexico and Russia, are investment grade, Buntrock says.

Some newer instruments, such as non-U.S. inflation-linked bonds, aren't very popular in international bond funds. "They're priced rather expensively compared to Treasury inflation-protected securities [TIPS]," Dada says, because home-country demand outstrips supply. In fact, he adds, "we sometimes add TIPS to global funds."

Whether new international bond funds and instruments proliferate may ultimately depend on the future of the dollar. There seems to be an inverse correlation between dollar weakness and interest in international bonds.

"Note that the interest in these funds comes only after a substantial decline in the dollar's value," Benton says. "Prior to that, the category had underperformed for years, and many asset allocation platforms had dropped it altogether." This is one correlation that's likely to persist, thanks to investors' penchant for chasing the latest hot asset class.

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