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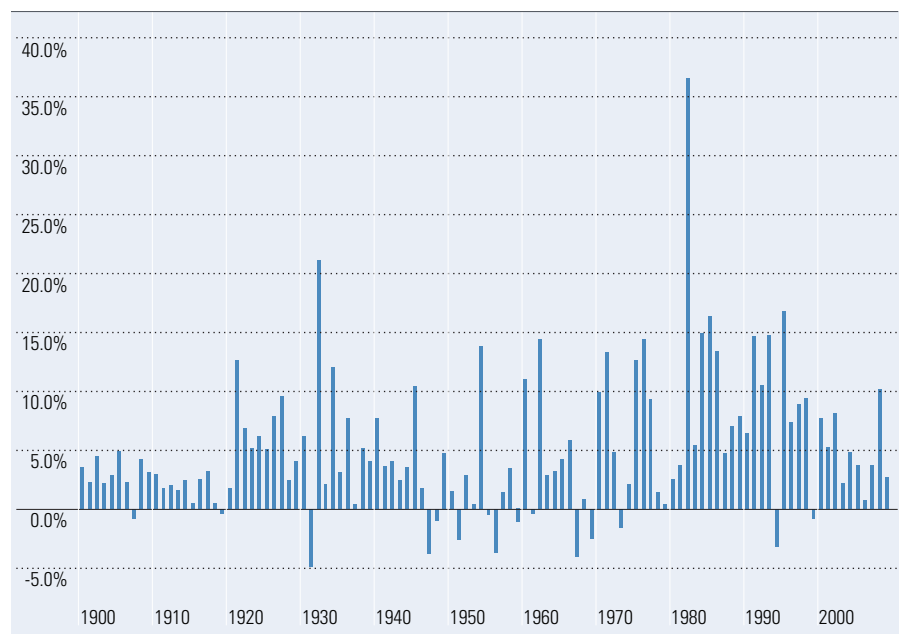
International Government Bonds – Rethinking The Benchmark

This Ibbotson Insight focuses on the changing returns outlook for international government bonds, and discusses issues with existing index benchmarks for this asset class. Should investors continue to look to the existing benchmarks as the most appropriate key performance indicators for their fixed interest assets, or target alternative return objectives to achieve their goals?

Current developments in global financial markets now see investors focused increasingly on global government bond markets as yields fall to near historic lows, while concerns about sovereign balance sheets remain elevated. Having averted the depths of the financial crisis in late 2008, governments are now bearing the burdens of the massive rescue packages that helped restore the global banking system to (a degree of) health. In reality, the leverage that almost brought the global financial system to its knees has not disappeared, is now affecting sovereign balance sheets, and is beginning to have a whole new raft of implications.

In our view, the most important long-term implications relate to the health of sovereign balance sheets, the volume of debt required to be refinanced on a regular basis, and government policies which are likely to restrain growth for many years to come. Investors therefore need to be aware of these actions, and in this Insight we identify some key elements investors need to consider for this to contribute positively to international fixed interest portfolios over the longer term.

Figure 1. International Fixed Interest – Annual Returns 1900–2009.



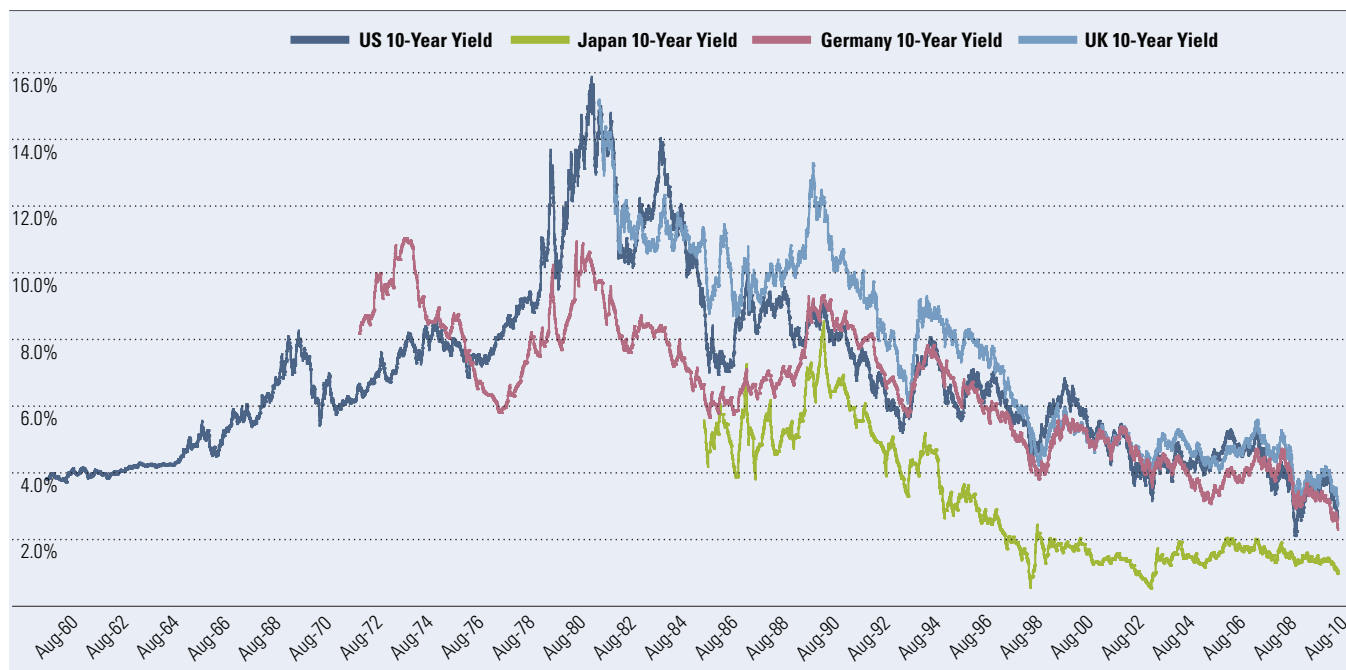
Source: Morningstar Desktop Consultant.

First, one might question why change the approach adopted over the last three years, where in many cases international fixed interest returns delivered annual returns in excess of long-term averages. The reality, though, is that these types of returns are the exception and not the rule.

Figure 1 shows that double-digit returns as delivered in 2008 have only been achieved 19 times since 1900. Recent returns have also relied largely on capital rather than income returns, and to maintain above-average returns in coming years yields will need to continue to fall. The question is, can they?

Economists the world over are presently divided as to what path the global economy will take over the next few years, and therefore have divergent views about where government bond yields go from here. However, one thing the majority of forecasters do seem to agree about is that most of the developed world is just beginning to emerge from one of the deepest downturns of the last 100 years. Rather than engage in a debate about near-term developments, then, we have instead taken a longer-term perspective and assumed that over time both gross domestic product growth and inflation return to trend rates of growth.

Figure 2. International 10-Year Government Bond Yields, August 1960–August 2010.



Source: FactSet.

This may well take some time, but yields are eventually set to push higher, rising from the near historic lows we see today (Figure 2). These rising yields will not be good news for fixed interest returns in years to come. With running yields at these historically low levels, we expect that income returns will find it difficult to offset negative capital price changes, undermining total returns and also diluting the diversification benefits of owning fixed interest in a portfolio. To illustrate, on the basis of the current duration of the Barclays Global Treasury benchmark index, it would require a rise in yields of just under 30 basis points to wipe out the current annual running yield of 1.70 percent.

Role of Fixed Interest in a Portfolio

Before exploring what we see as the role of international fixed interest assets going forward, it's worth first reminding ourselves of the role these investments should play in a diversified portfolio.

At Ibbotson, we believe that fixed interest assets should fulfil three key tasks in a portfolio: preserving capital, after adjusting for the effects of inflation; offering the ability to generate a stable, recurrent income; and providing diversification to growth assets in periods of

stress. We think that these attributes may in some cases have been overlooked in recent years as riskier assets – such as credit – were a dominant part of many global fixed interest portfolios.

This doesn't mean we don't believe that there's a role for these types of strategies in a fixed interest portfolio when valuations and market conditions are right, but rather we question what has been driving decision-making.

All fund managers make decisions on the basis of their own established philosophies and processes, but the ultimate goal is to deliver excess returns. Whether these returns are positive or negative in absolute terms has not seemed to matter, just that the fund manager's own return is better than the benchmark and/or their peers. Although we don't dispute the validity of these objectives, we're increasingly concerned that with yields at their present levels, longer-term benchmark returns could breach one of our core objectives for fixed interest assets – capital preservation.

Issues With Existing Benchmarks

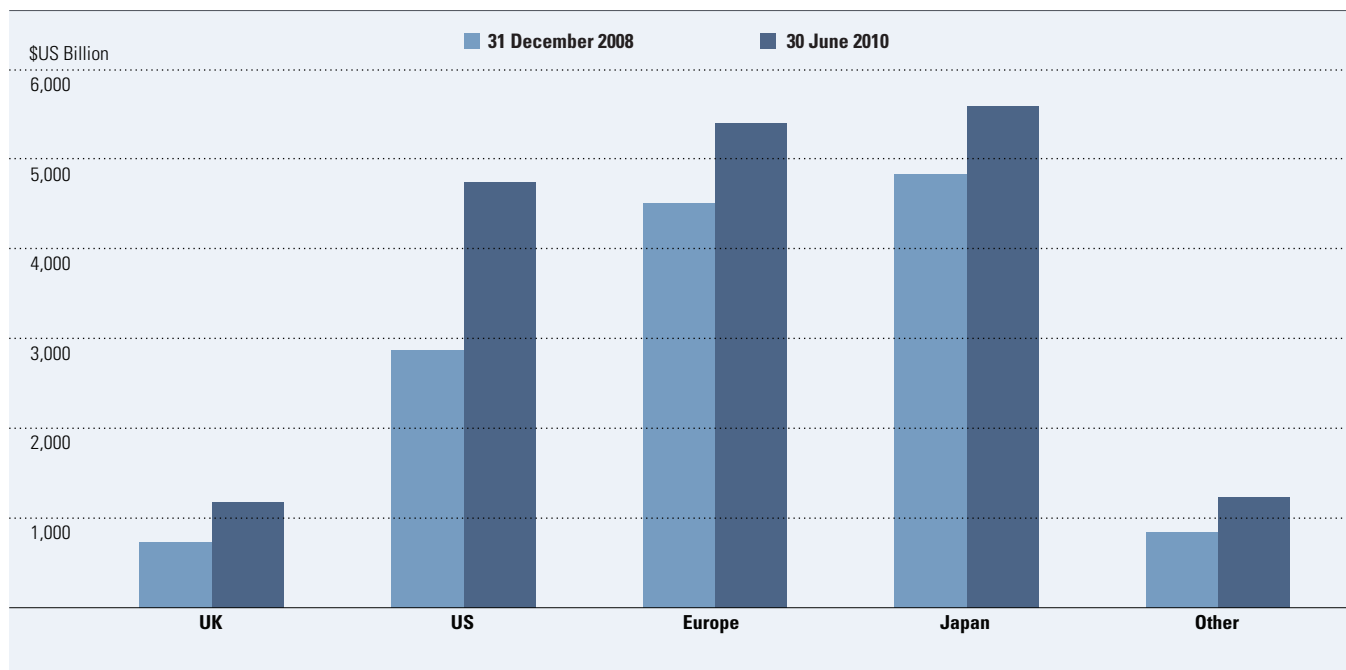
Negative returns are not the only reason we're increasingly uncomfortable about a relative

return objective. We're also uneasy about the composition of the benchmarks against which these returns are measured. Worries over benchmark composition in fixed interest are not new, but the transfer of leverage from corporate balance sheets to developed market sovereign countries makes these issues more acute.

To briefly revisit past concerns, market observers have long debated the composition of fixed interest indices, in particular the fact that they're dominated by the issuers of the most debt. Further, the fact that high levels of debt are typically commensurate with lower credit quality issuers means that this is not necessarily the defensive profile investors typically seek from their fixed interest investments.

Figure 3 shows the change in the composition of the Barclays Global Treasury Index from 31 December 2008 to 30 June 2010, and shows the volume of outstanding debt. Before 2008, developed market sovereign countries were already the largest issuers of bonds, and following the government bailouts the volumes of debt outstanding have risen significantly – in the case of the United States, for example, from US\$2.86 trillion at 31 December 2008 to US\$4.74 trillion at 30 June 2010.

Figure 3. Changes in Barclays Global Treasury Index Composition \$US Billion, 31 December 2008 and 30 June 2010.



Source: Barclays Index Analytics.

A benchmark dominated by issuers which have increased their outstanding debt by at least 50.0 percent over the previous 18 months is unlikely to be attractive to a fixed interest investor. Issuers such as emerging market sovereign countries are potentially much more attractive investment propositions given their growth and debt dynamics, but because of their lower relative financing needs are becoming smaller parts of the investible fixed interest universe.

New Ways of Benchmarking

So what should investors do to adapt to this dynamic – one which we expect to become even more acute in the years to come? The obvious answer is active investment management.

Although such an approach can frequently be successful, active management in fixed interest has often been found wanting when most needed, particularly when financial markets are stressed. Good examples are May 2010 and the latter part of 2008, when exposure to developed market sovereign debt should have delivered strong positive returns. The majority of active fund managers instead underperformed their benchmarks, and some produced negative returns. (More positively, however, many fund

managers have sought to take a risk-controlled approach to portfolio construction – by avoiding peripheral European Union sovereign country debt, for instance – as well as managing duration to dilute the impact of rising yields.)

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Other solutions to the issue of a more meaningful benchmark for international fixed interest have begun to emerge in the last 12–18 months, and have included attempts to address benchmark construction issues. The most notable have been the PIMCO GLADI Index and the Barclays GDP Weighted Index series. Weightings in these indices change on the basis of GDP growth rather than growth in debt volumes. In the case of the US, for instance, its increased weight in

these new indices is dependant on its expected two to three percent growth in GDP, rather than the increase of about 75.0 percent in its stock of debt.

These developments are clearly a positive step forward, but we believe this approach still has shortcomings, given that the starting point for index construction remains the heavily-indebted countries that dominate the existing indices (the US, Japan, Europe, and the United Kingdom). Although this is likely to subside in time, and there will undoubtedly be refinements to the current methodology, for now we think these options fall short of a viable long-term solution.

Revisiting Investor Objectives

One final alternative is to disregard established benchmarks and revisit the core attributes investors look for when making an allocation to fixed interest.

We believe that investors should consider the return outcome they want to achieve, and whether this addresses our three core attributes for fixed interest investing of capital preservation, stable income generation, and diversification from growth assets. Although the first two can be satisfied reasonably easily, delivering sufficient

positive returns to offset negative growth asset returns is something that will be increasingly difficult to deliver, particularly given current sovereign bond yield levels and other risks. In fact, from these levels and the duration of most fixed interest benchmarks, investors could be exposing themselves to the likelihood of significant negative returns over the longer term.

This leaves us considering a target return which will protect the real value of capital, while also delivering a stable return. We think that a cash objective or an inflation-plus target are issues investors should consider as an overarching objective. Such an approach also contains an inherent risk control mechanism by seeking to avoid negative returns. An approach like this one does deviate from traditional thinking about fixed

interest investing, but it's our opinion that the eventual risk/return outcome will be much more desirable.

To conclude, we expect that international government bond returns are likely to come under significant pressure in the future, and there's real potential for negative total returns. Because of this, although traditional international government bond benchmarks represent the return opportunity within the asset class, they should not represent the objectives of investors' fixed interest portfolios. Given that sovereign risks are likely to remain at the forefront of investors' thinking for many years to come, we believe that taking a risk-controlled approach is of the utmost importance and the key to delivering solid return outcomes.

However, although we acknowledge that bonds should benefit from 'flight to quality' flows in periods of stress, the fact that most sovereign bond yields are at or near historic lows calls into question one of the three principal reasons for investing in international government bonds – returns diversification. Going forward, investors should therefore build their fixed interest portfolios on the basis of capital preservation and income generation. To construct such a portfolio, traditional thinking about benchmarks needs to be reassessed, and the focus redirected to more absolute return targets. Many multi-sector managed funds already have this objective, and such thinking should be extended to the fixed interest asset class within the diversified portfolio. ■■

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