PGIM FIXED INCOME

The Case for Going Global

Transcript

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Robert Tipp, CFA, Chief Investment Strategist, Head of Global Bonds: Hi, and welcome to The Case for Going Global webcast. I'm Robert Tipp, Chief Investment Strategist and Head of Global Bonds here at PGIM Fixed Income. And today, with my colleague, Investment Strategist George Jiranek, we will make the case for hedge global bonds as a way to increase risk-adjusted return and as a way to broaden the investment opportunity set for active management. We'll do this using seven exhibits, starting off by perhaps clearing up a misperception regarding going global and fixed income. And to do this, let me turn it over to George.

George Jiranek, CFA, Investment Strategist: Thanks, Robert. We'll start with -- a simple observation that we've made is that investor allocations to international bonds are low. And what we're showing on this slide right here is that for pensions and retail investors across different countries, the international share of bond and equity allocations. So, for example, if you look at the very left-hand side of this chart, for Canada, we can see that for pensions, around 80% of their equity allocation is towards international equities, whereas if we look at their bond allocation, only 20% or less than 20% of their bond allocation is international. And this is a pattern that we observe across both pensions and retail investors. And in general, what we notice is -- for equities, a lot of these investors are investing at least 50% of their equity allocation towards international equities. However, when we look at bonds, this share is a lot lower. And for many of these investors, it's less than 20%. And, you know, one reason why international allocations might be low is the so-called home bias in which investors invest in securities that they're more familiar with, so domestic securities, and don't invest as much as they might need to in international securities. But what this home bias doesn't explain is why international bond allocations are much lower than international equity allocations. Now, turning to the next slide, one reason we think this might be this case is mistaken volatility. So when investors allocate internationally, they might be wary of currency returns. And so for equities, the currency volatility might not be as pronounced since equities are volatile in themselves. But for less volatile fixed-income returns, currency returns can introduce substantial volatility when allocating to the asset class. So what we're showing here is the volatility over the last 20 years of global bonds on an IDA hedge basis, a domestic benchmark, and a global aggregate bond allocation on a hedge basis from the perspective of six major currency investors. And what we can see is this hesitation to allocate volatility of this asset class is really high. However, when we hedge basis, we see that this volatility is much lower. And one key insight of this chart is not only is the global bond volatility on a hedged basis much lower than the unhedged basis, but it's also generally lower than the domestic bond volatility. Turning to the next slide, one main reason why this is the case and something that we think of as an asset class is country diversification. So after you remove the effects of currency volatility through hedging, you're left with an exposure to many different countries. And assets in these countries have less-than-perfect correlations. So what we're showing here is the correlation simplistically of 10-year government bonds across major currencies. And so when you combine these less-than-perfect correlations across -- many difficult hedge bonds as an asset loss. And given that we notice that global hedge bonds have lower volatility, one feature of this -- or one characteristic or result of this feature is that global hedge bonds have generally had higher risk-adjusted returns than many popular domestic benchmarks. So on the top panel, we're showing total return divided by the volatility of global hedge bonds against each domestic benchmark. And what you can see is, generally, these global hedge bonds have higher risk-adjusted returns. That is, they have a higher return per unit of volatility that -- per unit of volatility. Further -- what we notice is that this result isn't episodic, so we split the sample into two decades. So the first decade and the second decade. And what you can see is this result is robust across decades. The second thing that we also find interesting here is the risk-adjusted performance is perhaps a little bit better in the first decade. And the major difference between the first decade and the second decade is interest rates were a lot higher and volatile back then as opposed to the second decade, which encompassed most of the GFC and low interest rate period. This feature, to the extent that we have moved away from the low interest rate environment of the post-GFC world, would better position global hedge bonds to reduce risk going forward. Now, I'll turn it back over to Robert, who will go through the risk-adjusted returns for global hedge and domestic for each of the individual currencies.

Robert: Thanks, George. So here really we're looking at the risk-return history for each country through a different lens. To get oriented, each graph shows, for each country, on the y-axis, return, and on the x-axis, standard deviation. The white square marks the return on risk over the last 20 years for domestic fixed income in a given market. The solid black square for global hedged fixed income hedged back to the local currency for that market. So the top left showing domestic Australia in the white square, and the black square showing 100% global hedged back into Australian dollar. The points in between show a mix going in 10% increments from 100% domestic, the white square, to 100% global hedged, the black square. We further divide the countries into three categories: Groups 1, 2, and 3. Group 1 includes Australia, the UK, and US, which, at least, looking back in time, have had really a very favorable trade-off, where you have both higher returns realized with less risk, so moving in the ideal northwesterly direction. Japan, Group 2, shows that adding global has, yes, increased return, but it's also increased risk moving in the northeast. And then, Group 3, Canada and Europe, we moved to the southwest. So global hedged has had less risk than domestic, but it's also had less return. So the general conclusions I'd take away from this page put one way is that three of the countries saw a fair trade-off between risk and return: Japan, Canada, and Europe, either had more return with more risk or less return with less risk, but three of the countries: the UK, US, and Australia had a very favorable outcome of better returns with less risk. Put in the negative, we could say the major takeaway is what did not happen. No country experienced over a long holding period lower returns with more risk. The outcomes were either fair or very favorable. But that's all looking backwards. We need to look forwards. And to do this, we take a look at yield relationships to get an idea of the timing question for going global. We really need to look at this two ways. The set of bars to the left show for each country the hedged yield increment of going global, which is a representation of the instantaneous yield pickup or give up of going into global bonds. The exhibit on the right shows for each country the absolute relative relationship between the countries. So, for example, if we look at the US, which is the furthest to the right in both of these exhibits, we can see that there's a big hedged yield pickup of going into foreign bonds from the US, and that's because as of the end of August, the last data point here, the US curve was quite flat or inverted relative to the average global market. If we look at the exhibit on the right, though, the US is relative to hedged foreign. The dot is a little bit low, indicating that absolute yields for global bonds are a little bit lower than average relative to the US, so if we had mean reversion and global yields moved up to their longer-term averages, a US investor may give up a little bit of that hedged yield advantage that they're getting through the hedged yield through a bit of capital depreciation if foreign yields end up rising relative to the US. Another example worth looking at is that of Japan, where the green dot on the left is at the extremes in the negative, indicating that Japan, a steeply positive yield curve country, going from there into global bonds where yields are generally flat or inverted results in a big hedged yield carry give up, so a negative to be sure. The graph on the right, however, tells a different story. The foreign yields are actually very high in absolute terms relative to Japan. This is no surprise in that Japan is just at the beginning of their rate hiking cycle, whereas most other developed countries are at the end of their hiking cycles and now headed into the easing territory. So the yield differential for foreign bonds is very high relative to Japan. So while Japanese investors may give up carry instantaneously going into global bonds, they may make this up over the long run through capital appreciation as foreign yield differentials decline relative to Japanese yields. Let's look though at another aspect of going global. So far we've just been looking at passive index returns. Let's take a look at the broader opportunity set for active management. Let me turn back to George.

George: Yeah. Thanks, Robert. So here, we're just showing the size of the global aggregate against many of the popular domestic benchmarks that we showed earlier, and the key thing that jumps out immediately is just how much larger the global aggregate is. So as we alluded to earlier, this larger size and its much more diverse nature in the sense that the global aggregate has a much more balanced mix of non-government and government securities further adds for diversification benefits. One good example here is if we look at Australia, most of its benchmark is comprised of government or government-related securities, which leaves diversification benefits of corporates and other securitized on the table. The second point we'd like to make here is the global aggregate gives an expanded opportunity set for active management, both to add value through curve positioning and spread sector positioning. And finally, I'll turn it over to Robert for some conclusions.

Robert: Great. Thanks, George. So let me just recap what we've covered in brief. Hedge global bonds relative to most domestic bond markets are typically less volatile, realizing a fair or even favorable tradeoff between risk and return comparing markets at the index level, which in turn historically has translated into higher risk-adjusted returns. Furthermore, going global offers a much wider opportunity set for adding value through active management. So let me thank you, George, and to all of you for joining our webcast today, and I encourage you to check out our blog, *The Case for Going Global, in Pictures*, available now on PGIMFixedIncome.com.

IMPORTANT INFORMATION

Source(s) of data (unless otherwise noted): PGIM Fixed Income, as of November 2024.

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