

Global bonds attracting attention ... but risks remain

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Global bonds are attracting interest from investors searching for higher yields in a world where major markets offer minuscule returns but Greece's credit problems are a vivid reminder of ever-present sovereign debt risk.

This is one asset class not easily tackled by do-it-yourselfers. Apart from the unpredictable vagaries of interest rate movements, there are equally hard-to-divine shifts in international currencies to consider. Choosing global bonds may better be left to mutual funds, a niche where active fund managers may have a leg up on index funds.

In ETFocus, Hahn Investment Stewards' Wilfred Hahn says global bond indices track "capitalization-weighted" benchmarks, so countries with the largest debt issuance get more weight. This bias means investors are overexposed to nations with credit problems.

Hahn cites iShares International Treasury Bond Fund (IGOV/NASDAQ), almost 25% in Japan: "a country that has mismanaged its public finances" and tripled its public debt since the early 1990s.

But Hahn doesn't believe active bond managers are better at beating bond indexes than their equity fund counterparts. Bond managers get returns through higher-yielding securities when markets are stable but languish when credit spreads widen. He suggests investors choose high-quality country bond ETFs, favour

emerging market debt over Western government debt and investment-grade corporate over sovereign bonds in the most indebted nations.

Morningstar Canada says higher yielding bond exposure (including corporate "junk bonds" rated below the minimum grade investment rating of BBB-) should be only a small part of portfolios because their risk profile is "similar to equities."

Senior fund analyst Al Kellett lists two analyst picks: Trimark Global High Yield Bond and TD High Yield Income, both focused on bonds below investment grade.

Like its peers, the Trimark bond suffered double-digit losses in the credit meltdown of 2008 but bounced back with a 31.6% return in 2009. Manager Rex Chong hedges half the fund's currency exposure but may go to 75%.

TD High Yield Income enjoyed a "monster" return of 69% in 2009, Morningstar says. Its focus is U.S. bonds rated below BBB. It doubled down on Nortel bonds after they fell to 16¢ on the dollar, then rebounded past 70¢. It is now in short-maturity bonds and 17% cash, minimizing risk by owing 150 bonds in 30 industries.

Over 10 years, Morningstar's top global bond fund is the U.S. dollar version of Templeton Global Bond Fund, with a 6.6% compound return. It has more than a third invested in emerging markets including Mexico, Brazil and Russia. California-based Michael Reed suggests Canadians split their foreign bond budget between it

and Templeton's Strategic Income Fund. Managers add value through duration or interest rate management, currency and sovereign credit. Each contributes a third of return but lately managers benefited "from one of the greatest currency bull markets ever seen."

This active approach is hard to get with ETFs because of the index deficiencies cited by Hahn. But with MERs over 2%, there's room for ETF makers to undercut Templeton. iShares Canada recently launched two U.S. bond funds focused on high-yield and corporate bonds, with MERs of 0.6% and 0.3% respectively.

Fund analyst Dan Hallett suggests investors choose funds with broader mandates that let managers choose where to go. They often include emerging markets debt. An alternative is closed-end funds like Templeton Emerging Markets Income (TEI/NYSE) fund.

Canadians want higher yields but more issues exist in the United States than here, says Tom Nakamura, manager of the AGF Canadian High Yield Bond Fund and AGF Global High Yield Bond Fund. In addition to corporate high yielders, both include emerging markets. "Right now, the least in favour is our traditional domestic core bond fund."

The debt crisis in Europe is "another refresher course on the price of risk," Nakamura concludes.

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