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Diversifying client portfolios

One option is global bonds, which have low correlation to Canadian bonds

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With the painful losses of the recent bear market still fresh, many advisors are examining their investment strategies to improve the diversification in their clients' portfolios. Based on an analysis of global bond performance conducted by my firm, **Tacita Capital Inc.** of Toronto, this is one asset class that deserves serious consideration.

Investment-grade global bonds have a low correlation with other major asset classes. From January 1986 through June 2008, global bonds — as measured by the Citigroup world government bond index (in Canadian dollars) — had a correlation of only 0.28 with Canadian bonds (as measured by the DEX universe bond index). Global bonds had a correlation of negative 0.32 with the S&P/TSX composite index. And similar low correlations of zero and 0.21 respectively occurred vs the S&P 500 composite and the MSCI EAFE indices (in C$).

Unfortunately, this diversification effect arises in part from the currency impact of the C$ and comes at a price of high volatility. The annualized standard deviation of global bonds was 9.7%, two-thirds more volatile than Canadian bonds. Also, global bonds suffered eight drawdowns in excess of 5%, a much more painful experience than the three drawdowns experienced by Canadian bonds.

Despite this volatility, in a portfolio optimization analysis, global bonds earned a substantial role within the fixed-income component of all portfolios across the efficient frontier even when reaching as high as 40% of the total fixed-income exposure. The low correlation to the other asset classes creates such a powerful diversification effect that efficient portfolios have a meaningful global bond component, notwithstanding the high volatility.

Unfortunately, many advisors and investors judge global bonds in isolation from their effect on a portfolio and find the volatility too extreme for a fixed-income class. Also, this volatility makes global bonds a poor candidate for liability-matching strategies. Fortunately, currency hedging can dramatically reduce the volatility of global bonds.

The Canadian hedged version of the Citigroup world government bond index had a standard deviation of 3.8%, 60% less volatile than the unhedged index. The hedged version also experienced no drawdowns in excess of 5%.

However, this low volatility comes at the cost of a reduced diversification effect. Hedged global bonds had a 0.75 correlation with Canadian bonds, indicating how domestic and global interest rates often move in tandem. The correlation with the S&P/TSX composite index climbed modestly, but only to a still appealing minus 0.03, while low correlations stayed intact for U.S. and international stocks.

Critically, in a series of optimization runs, we were able to create equally efficient portfolios using hedged global bonds in comparison to their unhedged counterparts. As a general rule, more conservative portfolios had a higher proportion of hedged global bonds relative to their unhedged counterparts, while more aggressive portfolios had a lower proportion. Hedged global funds, due to their low volatility, also expanded the range of choices for conservative portfolios.

Advisors will find that among global bond mutual funds, there is a tremendous range in duration, credit quality, regional exposure, fees and currency-hedging practices. For the five years ended June 30, the annualized standard deviation ranged from a low of 1.5% for DFA Five-Year Global Fixed Income Fund to a high of 13% for Scotia Global Bond Fund. The former hedges 100% of its currency exposure and focuses on low-duration, high-quality bonds; the latter is unhedged and actively manages duration and credit quality.

Hence, fund selection is critical to appropriate portfolio construction.

Fortunately, more currency-hedged funds are being launched. For example, Fidelity Investments Canada ULC launched a currency neutral version of its global bond fund in 2007. **IE**

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