

Ask Legg Mason

Introduction to Fixed Income

This is the first in a series of educational guides that seek to explain some of the concepts widely used in fixed income investing.

INSIDE:

WHY CONSIDER INVESTING IN BONDS?

GLOBAL FIXED INCOME UNIVERSE EXPANDING

WIDE RISK SPECTRUM

DIVERSE ASSET CLASS



Introduction to Fixed Income

Why consider investing in bonds?

Bonds, which in their simplest form are no more than an IOU from a government or a company, are one of the largest asset classes, but probably the least explored by individual investors. Although bonds are generally viewed as a less risky and therefore lower returning asset class compared to equities, they are more risky than cash deposits. Fixed income investments can provide investors with many benefits. These include income generation, capital growth, lower volatility than equities and diversification of risk. Indeed, investing in a combination of sectors within the fixed income universe allows investors to maximise the potential of these benefits.

Global fixed income universe expanding

The range of entities issuing a wide variety of bonds makes the global bond universe a very diverse market. The major sectors within global bond markets, which we will explore in more depth in later guides, are:

- Government bonds – issued by both developed and emerging countries*
- Supranational (entities formed between governments, e.g. World Bank), local authority and public sector bonds (agency bonds)

- Asset- and mortgage-backed securities (ABS and MBS)
- Corporate bonds – investment grade and high yield (sub-investment grade)
- Emerging market debt – issued by governments and corporations in emerging markets

*Bonds issued by emerging markets are usually grouped under emerging market debt.

Bond markets have come a long way in recent years, expanding both in regional terms and on a sector basis. Bond market issuance was traditionally dominated by governments, local authorities and corporates in developed markets. However, bond markets have experienced considerable growth in emerging markets in recent years, with governments now issuing significantly more bonds in their local currencies as opposed to their traditional issuance in major foreign currencies. The fixed income universe has also expanded on a sector basis, with increasing issuance in securities backed by assets, such as mortgages or credit card payments.

Wide risk spectrum

The global bond universe comprises a wider risk spectrum than many investors may realise. The higher risk sectors of the bond universe, such as high yield corporate bonds or emerging market debt,

How have the various fixed income sectors performed?

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Highest Return	Mortgages	Global Govt Inflation Linked	Global High Yield	EMD Govt Local	EMD Govt (USD)	EMD Govt Local		Global Govt Bonds	Global High Yield	EMD Govt Local
	EMD Govt (USD)	Global Govt Bonds	EMD Govt (USD)	Global Govt Inflation Linked	EMD Govt Local	Global High Yield	Global Govt Inflation Linked	Mortgages	EMD Govt (USD)	Global High Yield
	Global Corporate		EMD Govt Local	Global High Yield	0-3mth US Treasury Bills	EMD Govt (USD)	Global Govt Bonds	0-3 month US Treasury Bills	EMD Govt Local	EMD Govt (USD)
	0-3 month US Treasury Bills	EMD Govt (USD)	Global Govt Inflation Linked	EMD Govt (USD)	Mortgages	Global Corporate		EMD Govt Local	Global Corporate	
	Global High Yield	Mortgages	Global Corporate	Global Govt Bonds	Global High Yield	Global Govt Inflation Linked	Mortgages	Global Govt Inflation Linked		Mortgages
	Global Govt Inflation Linked	0-3mth US Treasury Bills	Global Govt Bonds	Global Corporate	Global Govt Inflation Linked	Global Govt Bonds	EMD Govt (USD)	Global Corporate	Mortgages	Global Govt Bonds
	Global Govt Bonds	Global High Yield	Mortgages		Global Corporate	Mortgages	0-3 month US Treasury Bills	EMD Govt (USD)	Global Govt Bonds	Global Govt Inflation Linked
Lowest Return	Not Available		0-3 month US Treasury Bills		Global Govt Bonds	0-3mth US Treasury Bills	Global High Yield		0-3 month US Treasury Bills	

As at 31 December 2010. Returns in US dollar terms. Source: Bloomberg. 0-3mth US Treasury Bills: Merrill Lynch US Treasury Bills 0-3 Months, EMD Local: JP Morgan Global Bond Index Emerging Market Local Unhedged, EMD (USD Unhedged): Merrill Lynch USD Emerging Market Sovereign Plus Index, Global Corporate (USD): Merrill Lynch Global Broad Market Corporate Index, Global Govt Bonds (USD): Merrill Lynch Global Government Bond Index, Global Govt Inflation Linked (USD): Merrill Lynch Global Governments, Inflation-Linked Index, Global High Yield (USD): Merrill Lynch Global High Yield Index, Mortgages: Merrill Lynch Mortgage Master Index.

offer superior income returns compared to the lower risk sectors, such as government bonds, as the bond issuers have to compensate investors for the higher risk of default. However, they can also exhibit a greater volatility in capital returns and tend to be more correlated with equity market returns.

Performance returns of different fixed income sectors vary depending on the economic backdrop and investors' general appetite for risk. While the lower-risk sectors tend to perform well in a weakening economic environment in which investors become more risk averse and central banks cut interest rates, the higher-risk sectors tend to perform better in a period of economic recovery or robust growth when corporate earnings are improving and default rates are declining. The varying performance of the fixed income sectors over time is highlighted in the chart on the previous page.

As you can see, market leadership within fixed income changes from year to year as economic conditions and risk appetite changes. Looking at the more recent years, the less risky sectors of the bond market tended to perform better over the crisis period of 2007 and 2008, while 2009 has seen a reversal of fortunes with the higher risk sectors taking the lead. And this trend continued into 2010. While the chart gives you an indication of relative

performance, it masks the dispersion in returns between the top and bottom performing sector. In 2003, for instance, as the global economy emerged from the aftermath of the burst dotcom bubble, global high yield bonds led the market higher with an annual total return of +30%¹ in US dollar terms, while 0-3 month US Treasury Bills lagged the market with a return of +1%. In 2008, meanwhile, global high yield bonds fell by 28%, while global government bonds rose by 11%.

Diverse asset class, but jargon can be off-putting

Although the asset class has much to offer for both risk averse investors and those who are more willing to take on risk, many investors struggle with the jargon used in fixed income investing. In our series of educational guides we will cover the key concepts that investors are likely to come across in fixed income. We will kick off with some of the bond terminology such as yields, spreads and duration, followed by overviews of the major bond market sectors and the strategies fund managers use to generate returns in bond funds.

¹ Source: Bloomberg.

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