

Ask Legg Mason

The Importance of Being Global in Fixed Income

The advantages of investing in a global rather than a regional bond fund

When considering investing in a particular bond sector, such as investment grade or high yield corporate bonds, many investors opt for funds that focus on the bond market of the country or region they are based in (the UK, eurozone, US etc.). However, investing in a global fund, which is able to utilise the entire investment universe within a particular sector, has a number of benefits:

- A larger investment universe to choose from
- Potential to take advantage of pricing differences between regional bond markets
- Potential to take advantage of bond issuers' multi-currency issuance

In short, a fund manager can take advantage of these differentials in order to enhance the returns on a portfolio and to reduce volatility by offering greater diversification.



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A larger investment universe

A global fund allows a manager to seek out undervalued opportunities from a much larger and more diverse investment universe (see Figure 1). Taking the investment grade corporate bond sector as an example, the global universe contains around six thousand bond issues, almost double the number of issues in the US market, four times the eurozone market and ten times the UK market (Figure 2). In addition, these markets offer a more diverse universe in terms of sectors and credit quality. While industrial issuers, for instance, dominate the US market, financial institutions make up the largest share in Europe.

Regional valuation differences in credit

Investment grade or high yield corporate bonds can trade at very different valuations across regional markets. The spread chart (Figure 3 below), for instance, shows that the US and UK investment grade credit markets reached much more extreme

levels than the eurozone during the crisis in late 2008. Valuation differences can be driven by various factors, including differences in the economic and corporate earnings outlook between regions, investors' appetite for risk or supply and demand conditions.

Enhanced returns and reduced volatility

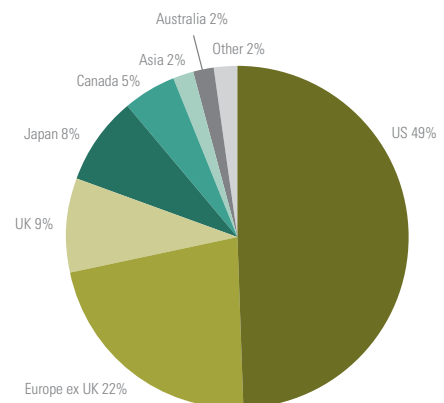
Broadening the investment opportunities available to a manager increases the scope to enhance the returns on a portfolio and to reduce volatility by offering greater diversification. The manager can focus on those countries, sectors, bond issuers and bond issues in the global universe that are positioned to deliver the best opportunity for returns as market conditions change. At the same time, the manager can reduce the volatility in returns by diversifying across a wider bond universe and taking advantage of differences in performance across regions.

Figure 1: A Larger and More Diverse Investment Universe

Number of Issues	Aaa	Aa	A	Baa	Total
US Corporate	21	309	1381	1622	3333
Industrials	20	124	684	926	1754
Utilities	0	20	227	398	645
Financials	1	165	470	298	934
Euro aggregate Corporate	17	265	684	382	1348
Industrials	1	57	225	256	539
Utilities	0	3	102	16	121
Financials	16	205	357	110	688
Sterling aggregate Corporate	11	134	290	180	615
Industrials	1	31	65	88	185
Utilities	0	3	66	27	96
Financials	10	100	159	65	334

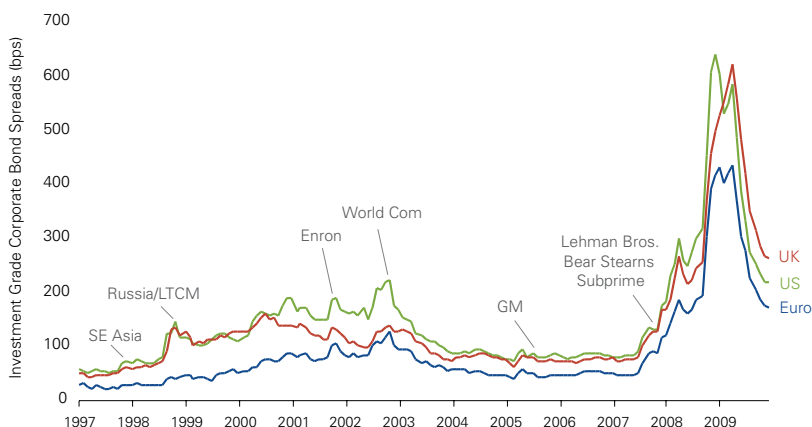
Source: Barclays Capital, as of 30/11/2009.

Figure 2: Barclays Capital Global Aggregate Corporates: constituents by country



Source: Barclays Capital, as of 30/11/2009.

Figure 3: Regional Valuation Differences in Credit



Source: Merrill Lynch, as of 30/11/2009.

Taking a global view offers more opportunities

Managers looking to purchase credit at cheap valuations in late 2008 could find better relative value in the US and UK compared to the eurozone, as valuations reached more extreme levels.

Multi-currency issuance

Many large companies issue bonds in a number of different currencies, for example in euros, sterling and in US dollars, to tap into capital markets in a number of regions. Due to demand from retail investors for local currency bonds, these bonds tend to trade at more expensive levels than bonds issued in other currencies. However, the credit risk of the issuer is the same. A manager of a global portfolio can look at the various markets and take advantage of the valuation differentials to enhance returns in the portfolio.

Figure 4 below is an example of multi-currency issuance by Swiss healthcare company Roche, showing the spreads the bonds traded at when issued (3 April 2009).

Looking at the four-year bonds, for instance, which were issued both in euros and in US dollars, investors could have purchased the bond issued in US dollars at a wider spread, and therefore cheaper valuation, than the one issued in euros.

What about currency risk?

Investing outside of their home market is a concern for investors in terms of exposure to currency movements. However, currency exposure can be hedged in global products, allowing the fund manager to take advantage of bond market returns while minimising any additional currency impact. A currency hedge can be implemented at a relatively low cost.

Taken together, in our view the advantages of going global in terms of fixed income investing far outweigh any perceived disadvantages.*

Figure 4: Multi-currency Bond Issuance by Swiss healthcare company Roche

CUSIP	Description	Tenor	Currency	Spread over Govts at Issue (03/04/09)
XS0415624393	ROSW 4 5/8 03/04/13	4 years	Euro	279.5
XS0415624120	ROSW 5 5/8 03/04/16	7 years	Euro	298.8
XS0415624716	ROSW 6 1/2 03/04/21	12 years	Euro	360.6
XS0415625283	ROSW 5 1/2 03/04/15	6 years	GBP	270
XS0416141025	ROSW 0 03/04/10	1 year	Euro	3M Euribor + 95
771196AN2	ROSW 0 03/04/11	2 years	USD	335
771196A05	ROSW 0 03/04/12	3 years	USD	335
771196AS1	ROSW 0 03/04/13	4 years	USD	345
771196AU6	ROSW 0 03/04/14	5 years	USD	365

Source: Bloomberg.

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* There may be other specific risks involved with investment in a bond fund. Investors should ensure that they fully understand these risks before making an investment.

The value of an investment in a bond fund and the income from it may be affected by changes in interest rates, in exchange rates, general market conditions, political, social and economic developments and other variable factors. Past performance is not a reliable indicator of future results.

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