

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 almost seven thousand bond issues, almost double the number of issues in the US market, four times the eurozone market and ten times the UK or any other EU 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

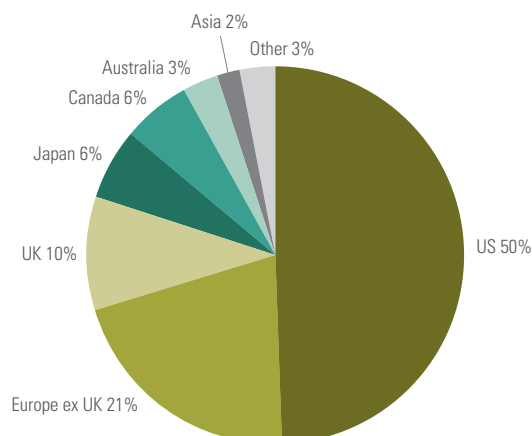
Broadening the investment opportunities available to a manager increases the scope to enhance the returns on a portfolio and to reduce volatility by offering greater diversification. The manager can focus on those countries, sectors, bond issuers and bond issues in the global universe that are positioned to deliver the best opportunities 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	40	341	1,666	1,942	3,989
Industrials	40	136	906	1,107	2,189
Utilities		26	285	436	747
Financials		179	475	399	1,053
Euro-aggregate corporate	2	188	633	483	1,306
Industrials	1	36	227	300	564
Utilities		1	103	35	139
Financials	1	151	303	148	603
Sterling corporate	5	90	283	252	630
Industrials	1	21	72	107	201
Utilities		3	73	50	126
Financials	4	66	138	95	303

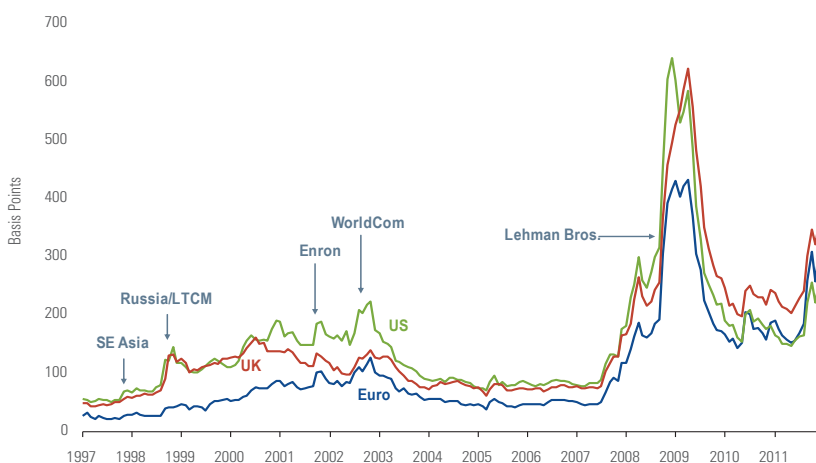
Source: Barclays Capital, as of 30/11/2011.

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



Source: Barclays Capital, as of 30/11/2011

Figure 3: Regional Valuation Differences in Credit



Source: Merrill Lynch, as of 30/11/2011

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. More recently, Eurozone bonds have become cheaper particularly relative to the US market.

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
771196AQ5	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.

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