

Bond Basics

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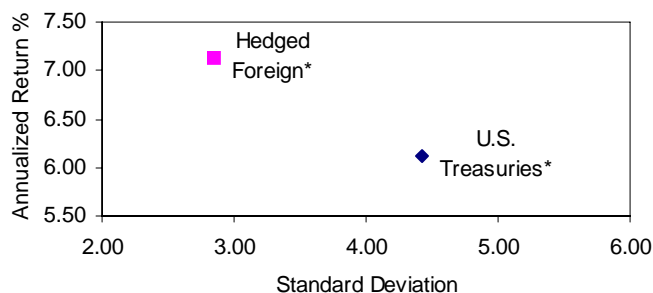
Global Bond Market Growth Expands Opportunities

Today's global fixed income market provides more opportunities than ever before, as non-U.S. bonds comprise over half of the global marketplace and represent a wide range of fixed-income sectors. For investors, the growth of the international bond market brings a wealth of new alternatives for diversification that cannot be ignored. A bond portfolio that also includes a global allocation may offer investors the benefits of diversification, wealth preservation and attractive returns.

- **Diversification:** A fixed income allocation in a portfolio can offer diversification and hedge against volatility and risks in other asset classes, particularly in times of economic uncertainty or deflation. While bond returns in different countries can frequently be correlated due to the global business cycle, local and regional macroeconomic fundamentals also frequently dominate yield changes. Therefore, diversification across many bond markets can produce a portfolio with potentially lower volatility relative to a portfolio consisting only of domestic bonds.
- **Wealth Preservation:** Fixed income allocations are typically less volatile than stocks and periods of negative returns tend to be short-lived and relatively modest. Investing in bonds may preserve investors' capital and potentially provide offsetting returns when other investments, such as stocks, are providing negative returns. By spreading fixed-income investments among the bonds of countries at different stages of the economic and interest rate cycle, investors can potentially reduce overall risk and portfolio volatility relative to a portfolio of domestic bonds.
- **Attractive Returns:** Bonds can provide a steady source of income and, as part of a total return strategy, potential capital gains as well. Active management of a bond portfolio can potentially enhance total returns. An allocation to global bonds within a fixed income portfolio can offer investors the potential to enhance returns as well as improve portfolio diversification.

In this article we will examine the broader opportunity set available for investors in the global bond market, and consider both hedged and unhedged portfolios, as well as some of the related risks.

U.S. Treasuries vs. Hedged Foreign Bonds Risk Return 4/91-10/07



*Citigroup World Government Bond Index, Excluding U.S., and CWGBI U.S., Excluding Rest of World
Source: Citigroup

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Broader Opportunity Set

As the structure and depth of the international bond markets continues to evolve, new and diverse opportunities are available to institutions and individuals who choose to invest a portion of their portfolio globally. Growing issuance in inflation-indexed, corporate and securitized products have created new opportunities for investors, and financial innovation and deregulation have facilitated development of derivatives markets across the world. In some cases, international futures and swaps markets have significantly greater depth and trading volume than their U.S. counterparts.

According to Merrill Lynch, the size of the world bond market is estimated to be approximately \$67 trillion, with the share of U.S., Euroland and Japanese securities each representing less than 50 percent of this total. From the standpoint of just about any investor, significant opportunities can be found outside their own country.

Fixed income securities are issued by a variety of sovereign governments and agencies, corporations and financial institutions, municipalities and authorities throughout the world, in sectors as varied as government bonds, corporate bonds, municipal bonds, mortgage backed securities, structured products and a growing variety of exchange traded and over-the-counter derivatives.

Global bond opportunities can be found in high grade and high yield bonds, developed and emerging markets and investments denominated in local or foreign currencies.

Including credit markets, the U.S. remains the largest market for global debt by a wide margin, with 51% more outstanding debt than Euroland, the next largest market. However, Euroland has been the largest of the global sovereign markets since 1999, when euro-sovereigns eclipsed U.S. Treasuries in size shortly after the adoption of the euro.

Although the U.S. and Euroland markets accounted for 61% of outstanding foreign debt they only grew at a 3% rate while all other sovereign issuance grew at 9% in 2006. In fact China's outstanding sovereign debt grew 23% in 2006.

Hedged or Unhedged

Inherent in investing in bonds that are not domestic is the question of exposure to the foreign currency that is used to purchase the bond. Because there are many efficient hedging techniques, the decision to include global bonds as part of a portfolio and whether or not to include exposure to a foreign currency can be made separately.

In a hedged portfolio, the foreign currency exposure of owning international bonds is converted back into the domestic currency through hedging techniques, allowing investors to diversify their portfolio without taking any currency risk. The risk premiums embedded in high-grade bonds in developed markets tend to be quite small, making a portfolio of hedged global government bonds, for instance, an efficient way for investors to potentially reduce volatility in a core fixed income portfolio.

For investors with the ability to take greater risk, foreign currencies can be a good opportunity for returns and, given their low or negative correlations to stocks and bonds, a potential source of diversification. An unhedged global bond portfolio can be an efficient way to gain exposure to currency markets and capture potential returns from currency re-alignments. However, foreign

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exchange markets are volatile, so investors must be careful to make an unhedged allocation in accordance with their tolerance for risk.

Additional Risks

Another potential risk common to all bonds is the possibility that an issuer will default and fail to pay either interest or principal. Government debt is typically judged to be the least likely to default, but the increase in non-government debt as a share of the global bond market has contributed to a general rise in the market's overall default risk. This does not suggest any particular issuer is more or less likely to default. Comprehensive individual country and credit analysis is an important part of the global fixed income investment process.

Conclusion

The global bond market continues to grow and evolve, creating an ever expanding set of opportunities for investors. Fixed income investments in international markets can augment the benefits of a core domestic bond allocation by providing potentially higher returns, wealth preservation, and the reduced overall portfolio risk associated with additional diversification. The growth of regional bond markets and the many potential benefits of investing globally are leading many domestic investors to look outside their own countries to leverage the best investment values around the world.

Past performance is not a guarantee or a reliable indicator of future results.

Each sector of the bond market entails risk. Municipals may realize gains and may incur a tax liability from time to time. The guarantee on Treasuries, TIPS and Government Bonds is to the timely repayment of principal and interest; shares of a portfolio that invest in them are not guaranteed. Mortgage-backed securities are subject prepayment risk. With corporate bonds, there is no assurance that issuers will meet their obligations. An investment in high-yield securities generally involves greater risk to principal than an investment in higher-rated bonds. Investing in non-U.S. securities may entail risk because of non-U.S. economic and political developments, which may be enhanced when investing in emerging markets.

Diversification does not ensure against loss.

Currency rates in non-U.S. countries may fluctuate significantly over short periods of time and may reduce the returns of a portfolio.

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