TD Asset Management

INVESTMENT SOLUTIONS

Going Global

Searching for fixed income opportunities beyond our borders

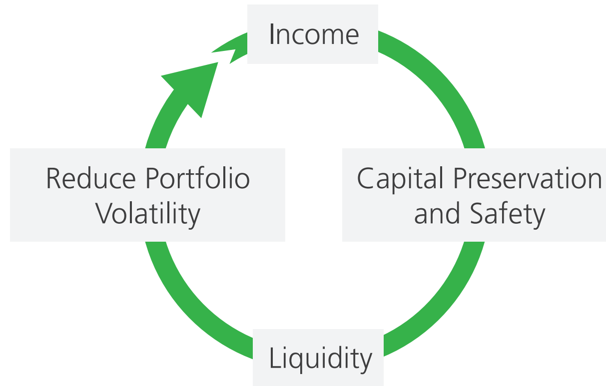
Interest rates have remained at their lowest levels in decades helping to drive discussion about the use of global bonds as a complement to traditional fixed income strategies. While short-term rates may be gradually on the rise, accommodative central bank policies coupled with strong investor demand will likely continue to keep bond yields at low levels for quite some time. In a world of “lower for longer”, global bonds can help provide investors with opportunities to diversify sources of income and enhance long-term risk-adjusted returns.

A World of Opportunities

Strategies to support the role of fixed income are evolving, and investors' expectations for their fixed income portfolios are being challenged. Fixed income continues to be a source of consistent income, but now plays an even greater role in enhancing portfolio stability (reducing volatility), liquidity and helping to provide a degree of safety as opposed to simply growing wealth and preserving real purchasing power within a persistent low yield environment.

Most bonds provide investors with a source of income through coupon payments, as well as the potential for capital gains (or losses) through price appreciation (or decline). Global bonds, however, are denominated in foreign currencies, and therefore provide an additional investment opportunity through currency fluctuations. The ability to gain currency exposure through global bonds depends on whether the bonds are hedged or unhedged.

Potential Role of Fixed Income



The components of a global bond strategy can be characterized as:

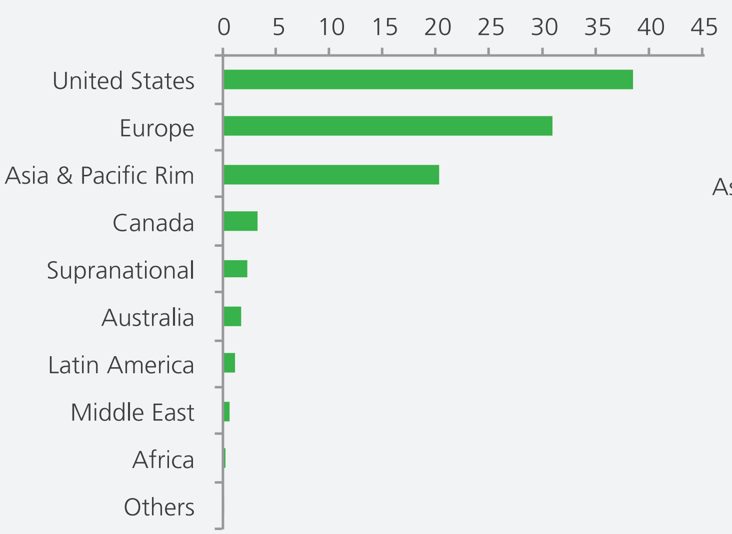
Total Return = Income Return + Price Return + Foreign Currency Return

This paper sets out the general characteristics of global bond investing and highlights the rationale for incorporating global bonds into an investor's strategic mix for a fixed income portfolio.

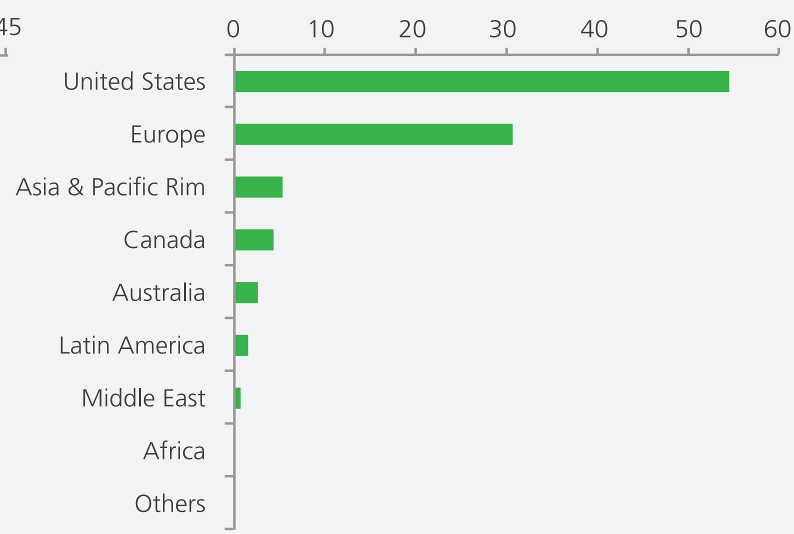
The Landscape

The global fixed income market is estimated at approximately $65 trillion*. Canada represents about 3% of this market, while North American assets make up about 40%. More importantly, a key source of income in the current low yield environment comes from corporate bonds. Again Canada represents a small portion of that, representing a mere 4% of global investment grade markets.

Regional Distribution of Global Markets



Regional Distribution of Global Investment Grade Markets



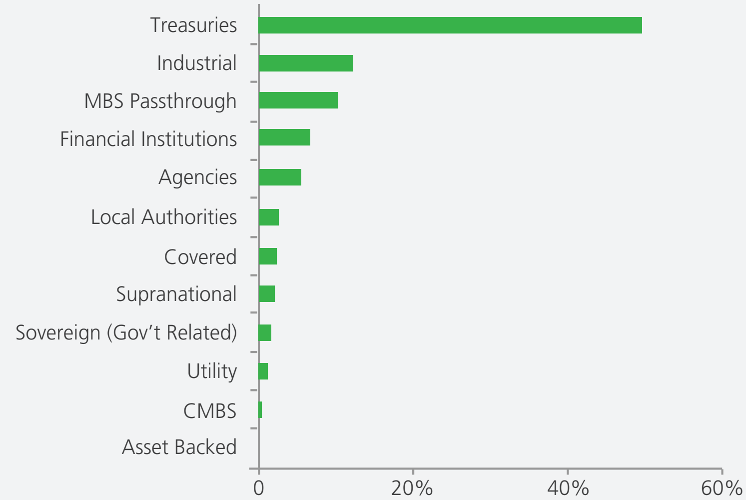
Source: Bloomberg Barclays Global Aggregate Bond Index, Barclays Global Investment Grade Corporate Index, June 30, 2017

*Source: Bloomberg Barclays Multiverse Bond Index in $Canadian as at June 30, 2017

Sources of Income (Income Return)

As the size and scope of the bond markets around the world continues to develop, the opportunity set for investors grows. Every day there are new and diverse bonds being created for investors looking to allocate a portion of their fixed income allocation to global bond markets. These bonds can take various forms and be issued by a multitude of different entities including sovereign governments, local authorities (municipalities), corporations and financial institutions throughout the world and can be found with varying characteristics, such as high grade and high yield bonds, developed and emerging markets and denominated in local or foreign currencies.

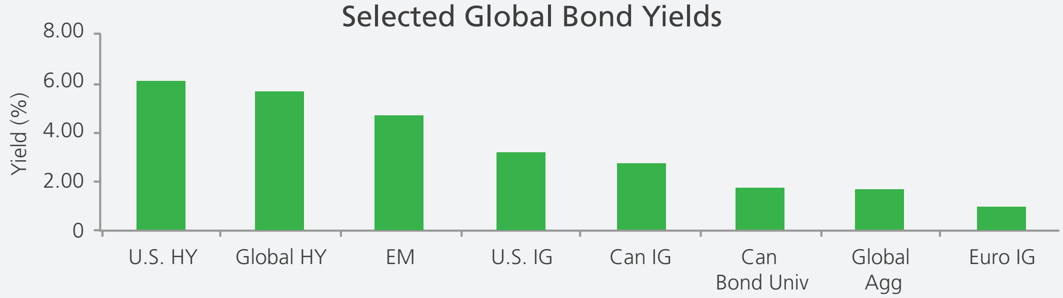
An overview of global sectors



Source: Bloomberg Barclays Multiverse Bond Index, June 30, 2017

When comparing bonds between various countries and sectors, their risk, and by extension returns, can vary significantly. The chart below illustrates the range in current yields of various bonds representing different geographies and sectors globally. By adding a global allocation of bonds, investors may have an opportunity to provide their portfolio with a boost in yields. In particular we see that the use of global corporate credit (e.g. U.S High Yield, Global High Yield, and U.S Investment Grade) significantly improves the prospect for income relative to government bonds.

Selected Global Bond Yields



Source: Factset; Bank of America Merrill Lynch US High Yield; Bloomberg Barclays US Aggregate Credit - Corporate - Investment Grade; Bloomberg Barclays Global Aggregate; Bloomberg Barclays Global High Yield; Bloomberg Barclays Euro Aggregate Credit – Corporate Bloomberg Barclays Emerging Markets USD Aggregate FTSE TMX, June 30, 2017

Diversification and Protection of Capital (Price Return)

This yield component has become increasingly important in recent years. We are unlikely to continue experiencing the same type of risk and return profile exhibited by bonds since the great financial crisis; achieving equity-like returns with bond-like risk will become more of a challenge. Effective security selection across a broader opportunity set helps to reduce overall volatility of returns in a fixed-income portfolio.

	10 Yr Return	10 Yr Volatility
Bloomberg Barclays Global Aggregate Index - C$	4.82%	2.75%
Bloomberg Barclays Global Investment Grade Corporate Index - C$	5.49%	4.75%
FTSE TMX Bond Universe Index	4.90%	3.63%
FTSE TMX Corporate Bond Universe Index	5.66%	3.20%
MSCI World Index GD - C$	6.71%	11.79%
S&P/TSX Composite TRI - C$	3.90%	13.39%
S&P 500 TRI - C$	9.45%	11.65%
The Bank of America Merrill Lynch US High Yield Master II - C$	9.72%	9.22%

Source: Barclays, FTSE TMX, S&P, Bank of America Merrill Lynch, FTSE TMX , MSCI. Returns to July 31, 2017

Bond returns, while often correlated across countries in the long-run, can vary in the short-term due to differences in global macroeconomic fundamentals and business cycles. As illustrated in the chart below, the top performing market in one year can often be among the worst performing the next, and vice-versa. Predicting which country or sector will out-perform can be a daunting task, even for the most seasoned investor. Therefore, through active diversification and portfolio allocation across global countries and sectors, investors are better able to protect their capital and reduce portfolio volatility.

Returns for a Canadian based fixed-income investor

2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017 YTD
3.68% Can Bond Univ	55.13% US Long	35.36% Global HY	9.18% US HY	33.14% US Long	16.96% Global HY	14.63% US HY	36.34% US Long	21.47% EM	13.42% US HY	5.37% Euro IG
-4.60% Euro Agg	31.07% Global Agg	33.76% US HY	8.83% Global HY	10.82% US IG	15.33% EM	14.53% Global HY	17.15% US IG	20.32% US Mtg	10.32% Global HY	4.14% Euro Agg
-5.94% Euro IG	30.07% US Mtg	13.99% EM	6.95% EM	9.79% US Mtg	13.02% US HY	14.17% Euro IG	16.41% US Mtg	19.11% US IG	6.08% EM	3.10% Global HY
-6.87% US Long	26.32% Euro Agg	5.41% Can Bond Univ	6.74% Can Bond Univ	9.67% Can Bond Univ	12.81% Euro IG	13.95% Euro Agg	14.20% EM	18.48% US Long	2.44% US IG	2.36% Can Bond Univ
-7.15% Global Agg	18.91% US IG	1.42% Euro IG	3.67% US Long	9.62% EM	10.43% Euro Agg	5.07% US IG	11.74% US HY	16.67% Global HY	1.66% Can Bond Univ	2.09% US Long
-9.90% US Mtg	14.45% Euro IG	0.79% US IG	3.31% US IG	8.26% Global Agg	7.39% US IG	4.89% US Mtg	9.65% Global Agg	16.15% Global Agg	0.11% US Mtg	1.79% EM
-10.82% EM	6.64% EM	-6.26% Euro Agg	1.01% US Mtg	6.96% US HY	3.60% Can Bond Univ	3.94% Global Agg	9.02% Global HY	14.36% US HY	-1.45% Global Agg	1.60% US HY
-11.32% US IG	6.41% Can Bond Univ	-6.91% US Mtg	0.04% Global Agg	5.68% Global HY	3.30% US Mtg	2.31% EM	8.79% Can Bond Univ	8.74% Euro Agg	-1.83% Euro IG	1.11% Global Agg
-12.50% Global HY	-7.93% US HY	-9.19% Global Agg	-7.17% Euro IG	2.37% Euro Agg	2.01% Global Agg	-1.19% Can Bond Univ	6.36% Euro Agg	7.06% Euro IG	-2.18% US Long	0.52% US IG
-13.33% US HY	-8.54% Global HY	-26.05% US Long	-9.44% Euro Agg	0.63% Euro IG	1.26% US Long	-6.80% US Long	3.77% Euro IG	3.52% Can Bond Univ	-3.15% Euro Agg	-0.68% US Mtg

US HY	BofA Merrill Lynch US High Yield Index
US IG	Bloomberg Barclays US Aggregate Credit Index – Corporate – Investment Grade
Global Agg	Bloomberg Barclays Global Aggregate Index
Global HY	Bloomberg Barclays Global High Yield Index
Euro IG	Bloomberg Barclays Euro Aggregate Credit – Corporate Index

Euro Agg	Bloomberg Barclays Euro Aggregate Index
US Mtg	Bloomberg Barclays US Aggregate Credit – Mortgage Index
US Long	Bloomberg Barclays US Aggregate Government – Treasury – Long Index
EM	Bloomberg Barclays Emerging Markets USD Aggregate Index (hard currency)
Can Bond Univ	FTSE TMX Bond Universe Index

Source: Factset. In Canadian dollars

Currency Return

In a hedged portfolio, foreign currency exposure is converted back into the domestic currency, typically using derivatives such as currency forwards. This allows investors to diversify their bond portfolio globally without having to take on additional currency risk.

On the other hand, an unhedged global bond portfolio provides exposure to currency markets and, by extension, captures potential risk and returns from currency fluctuations. Active global managers often seek out cheap and appreciating currencies to enhance total returns. The table below shows a simple illustration of five year returns against the Canadian dollar. Notice that returns are driven by fluctuations in the level of the spot exchange as well as the interest earned over the horizon. In other words interest rate differentials across countries can provide meaningful support to a portfolio return. A careful use of currency exposure can provide a compelling source of additional returns.

5-year cumulative returns against the Canadian Dollar

Major Currencies	Spot Return (%)	Interest Return (%)	Total Return (%)
South Korean Won	27.73	11.46	39.19
New Zealand Dollar	16.69	19.03	35.71
United States Dollar	27.52	3.40	30.93
Taiwanese Dollar	25.24	5.09	30.33
Brazilian Real	-22.52	51.76	29.23
Swiss Franc	26.29	-2.58	23.70
Singapore Dollar	17.23	3.77	21.00
Euro	15.03	-0.10	14.93
Danish Krone	15.01	-1.23	13.78
Mexican Peso	-5.97	19.13	13.16
Australian Dollar	-4.23	13.53	9.30
British Pound	5.75	2.82	8.57
Swedish Krona	4.69	1.56	6.25
South African Rand	-20.37	26.13	5.76
Norwegian Krone	-8.96	6.49	-2.47
Japanese Yen	-9.47	-0.15	-9.62

Source: Bloomberg Finance L.P, Five year total return, a positive number implies the local currency outperformed the Canadian dollar over the holding period.

Summary

Canadian fixed income markets are a small portion of the global opportunity set. In a world of low yields, the rationale for incorporating a broader opportunity set of fixed-income securities is compelling. We have seen that global markets, especially in the corporate area provide additional sources of income and that different bond market segments perform well at different times through history. Finally we have seen that currency can provide a complement to the return profile generated from a traditional Canadian based fixed-income approach.

So additional sources of income + additional diversification benefits + additional potential returns from currency form the bedrock of the case for introducing global bonds as a complement to a traditional fixed-income strategy. Global bonds can supplement the benefits of a core domestic bond portfolio by helping to provide increased diversification benefits; enhanced portfolio stability, and the potential for higher yields and returns, and capital preservation. By taking advantage of what the world has to offer, investors can create a fixed-income allocation that helps reduce risk and enhance return potential in an effort to meet long-term investment goals.