Investing in Foreign Bonds

As yields on high-quality bonds have slipped in the United States, more investors are turning to foreign bonds and foreign bond funds to boost portfolio yield potential and provide greater diversification.\(^1\) In the past decade, there’s been substantial growth and maturation of world bond markets. That, combined with the ongoing globalization of businesses and capital flow, can make foreign bonds a viable option for many investors. In fact, over 60% of the world’s outstanding sovereign debt was issued outside of the United States.\(^2\)

Investing in foreign bonds has many advantages, including:

- **Increases diversification of an investment portfolio.** Foreign bonds may help reduce exposure to economic or political instability in a specific country and can improve a portfolio’s risk profile.
- **Hedge against a weak or falling U.S. dollar.** When a foreign currency is strong compared to the dollar, your returns increase because your foreign earnings convert into more dollars.
- **Attractive yield potential.** Returns from foreign bonds are typically higher than returns offered via U.S. Treasury securities. However, it’s important to note that with those attractive yields come additional risks — the risk of changing political conditions and fluctuating currencies — which are generally not factors when investing in domestic debt.
- **Less correlation.** The monetary and budget policies of many foreign nations are often unsynchronized with those of the United States, which can be a good thing from the standpoint of portfolio diversification.

Over time, foreign bonds have produced competitive returns, even besting the equity market at times. In the ten years ended August 31, 2013, average total returns of foreign bonds outperformed the Standard & Poor’s 500 on a risk-adjusted basis, and have outpaced the U.S. bond market as well, though at higher levels of risk.

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<tr>
<td>1 Year</td>
<td>-6.23%</td>
<td>-2.47%</td>
<td>18.71%</td>
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<td>5 Year</td>
<td>3.41%</td>
<td>4.94%</td>
<td>7.31%</td>
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<tr>
<td>10 Year</td>
<td>5.17%</td>
<td>4.77%</td>
<td>7.12%</td>
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<td>10-Year Sharpe Ratio</td>
<td>0.61</td>
<td>1.38</td>
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Sources: Citigroup, Barclays, Standard & Poor’s. Data as of August 31, 2013. It is not possible to invest directly in an index. Past performance is no guarantee of future results.

Also note that, although the U.S. and foreign equity markets have been much more in sync during the past 10-15 years, U.S. and foreign bond markets have exhibited relatively low correlation. For one-year periods ending between 2000 and 2012, the correlation was only 0.25.\(^3\) The closer the correlation moves to 1, the more that U.S. and foreign markets have moved in tandem.

There are many types of foreign bonds, both from government entities as well as corporations. Here is an overview.

**Eurobonds**

A eurobond is a bond issued and traded in a country other than the one in which its currency is denominated – not always a European nation. Eurobonds are attractive financing tools as they give issuers the flexibility to choose the country in which to offer their bond according to that country’s regulatory constraints. They are usually issued in more than one country of issue and traded across international financial markets. But they are unsecured, leaving bondholders without the first claim to the issuer’s assets in case of default.
Below are some common types of eurobonds.

- **Straight eurobonds** – This type of bond has a fixed coupon that is usually paid annually and returns principal at maturity, which is typically between three and seven years.
- **Floating rate bond notes** – Short- to medium-term bond issues that pay a coupon interest rate that “floats” (goes up or down in relation to a benchmark rate plus some additional spread).
- **Zero-coupon bonds** – This type of bond does not have interest payments – instead interest is paid at maturity. This bond is typically purchased at a discount. Investors in this type of Eurobond may be looking for some kind of tax advantage.
- **Convertible bonds** – This type of bond can be exchanged for another instrument, usually a share of stock from the issuing organization. The bondholder decides whether to convert the bond.
- **High-yield bonds** – Rated to be below investment grade (a credit rating below BBB by Standard & Poor’s or Baa by Moody’s).

**Global Bonds**

A global bond is a type of bond that is issued in multiple markets in different currencies. There are three types of bonds:

- Corporate bonds issued by high-quality, multi-national organizations.
- Government bonds, issued by sovereign nations.
- Brady bonds, U.S. dollar-denominated bonds issued by foreign countries backed by the U.S. Department of Treasury.

By issuing global bonds, a government or corporation is able to attract funds from a wider set of investors and potentially reduce its cost of borrowing. Investing in global bonds opens up a whole new opportunity set of potential return sources in the form of different economies, yield curves, and currencies.

**Sovereign Debt**

Issued by national governments, sovereign bonds are generally among the safest investments in most countries. Even if countries are not particularly creditworthy, their sovereign bonds are usually safer than their other domestic alternatives.

Sovereign debt comes in two general categories: those issued by the national governments of large, developed economies and those issued by emerging market countries.

- Bonds issued by developed countries (such as Canada, Great Britain, and Germany) usually are considered safe, have high credit ratings, and offer relatively low yields.
- Bonds issued by emerging market countries usually are perceived as more risky, have lower credit ratings, and thus carry higher yields.

**Yankee Bonds**

Yankee bonds are U.S. dollar denominated bonds issued by foreign governments and corporations and sold in the United States. The benefit to American investors is that they can purchase the securities of foreign issuers without being subject to price swings caused by variations in currency exchange rates. As a result, Yankee bond prices are influenced primarily by changes in U.S. interest rates and the financial condition of the issuer. Additionally, they are regulated by the U.S. Securities and Exchange Commission (SEC) and are rated by American ratings agencies such as Moody’s Investors Service and Standard & Poor’s. As a result, Yankee bonds tend to be lower in risk than certain other foreign bonds.

**Investment Risks**

As with all types of investments, there are a number of risks associated with foreign bonds, including the following.

- **Credit risk** – Like domestic bonds, foreign bonds are subject to credit risk — the risk that the bond's issuer will be unable to make scheduled interest payments or repay the principal when the bond matures.
- **Currency risk** – Any time you hold a foreign currency, you are subject to currency risk, which is the potential for loss due to fluctuations in exchange rates. Currency risk can literally turn a profit on a foreign investment into a loss.
- **Sovereign risk** – This is the risk of a government becoming unwilling or unable to meet its loan obligations, or reneging on loans it guarantees. This risk is especially present in emerging markets, where governments are more likely to be unstable. There is also the risk of the lack of regulation and the difficulties bondholders may have navigating court systems in foreign countries.

- **Inflation risk** – As inflation rises, bonds that have already been issued lose value in the secondary market. In an inflationary environment, bonds issued more recently are usually more attractive because they’ll often have higher interest rates, as central banks such as the U.S. Federal Reserve and European Central Bank often raise rates in response to inflation fears.

- **Interest rate risk** – As interest rates rise, bond prices fall as investors are able to realize greater yields by buying newly issued debt that reflects the higher interest rate.

- **Liquidity risk** – As with many U.S. corporate bonds, it can be difficult to find a buyer for an international government or corporate bond.

Which foreign bonds or bond funds best complement your portfolio will depend on a number of factors, including your existing holdings and appetite for risk. Let me work with you to identify the investments that best suit your specific needs.

**Sources:**


**Footnotes/Disclaimers:**

1 Diversification does not ensure a profit or protect against a loss.


3 Source: Standard & Poor's, 2013. Performance is for the one-year period ended January 1, 2000, through the one-year period ended December 31, 2012. U.S. Bonds are represented by the Citigroup Broad Investment Grade Bond index. Foreign bonds are represented by the Citigroup Non-U.S. Dollar World Government Bond index.

Investments in foreign/international securities involve risks associated with interest-rate and currency-exchange-rate changes as well as market, economic, and political conditions of the countries where investments are made. Past performance is not a guarantee of future results. Index results do not take into account the fees and expenses associated with purchasing individual securities or fund shares, and individuals cannot invest directly in an index. Bond Funds and bond holdings have the same interest rate, inflation and credit risks that are associated with the underlying bonds owned by the funds. The return of principal in bond funds, and in funds with significant bond holdings, is not guaranteed.

**Investors should carefully consider the investment objectives and risks as well as charges and expenses of a mutual fund before investing. To obtain a prospectus, contact your Financial Advisor or visit the fund company’s website. The prospectus contains this and other information about the mutual fund. Read the prospectus carefully before investing.**

Zero Coupon Bonds are taxed each year on the amount of interest that has accrued from the last year even though the accrued interest is not actually paid to investors in that year. The market value of convertible bonds and the underlying common stock(s) will fluctuate and after purchase may be worth more or less than original cost. If sold prior to maturity, investors may receive more or less than their original purchase price or maturity value, depending on market conditions. High Yield Bonds are issued by companies without a long track record of sales or of questionable credit strength that are generally rated BB or lower. High yield bonds pay a higher yield than investment grade bonds to compensate for its higher risk.

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