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FIXED INCOME 2.0
THE GLOBALIZATION OF BOND MARKETS

INTERVIEW BY THERESA BAGGS

The fixed income market is redefining itself on a global stage. Enter the next generation: Fixed Income 2.0, a more transparent and level playing field than ever before for this asset class. InSIGHTS recently sat down with J.R. Rieger, Global Head of Fixed Income at S&P DJI, to discuss effectively navigating the globalization of bonds and its potential implications on investor holdings.

J.R. RIEGER
Global Head of Fixed Income
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InSIGHTS: Why are we seeing a shift in attention to global fixed income?

J.R. : It's a combination of two key factors and their effects on the market. The first is an extended period of quantitative easing that has pushed yield down in the U.S. The second is periods of risk on/risk off seen across various regions around the world, like unrest in Greece and Ukraine, which are driving volatility in the equity and commodities markets. Plain and simple, investors are turning to fixed income as a solution because its cash flow and returns have been historically less volatile than other asset classes. In addition, we see a hunger for securities that have higher yield than what is available in U.S. markets. With rates at record lows in the U.S., some investors have abandoned their usual "comfort zone," opting to venture outside of the domestic market and into higher yielding countries, like Australia and New Zealand, and into even lower credit quality bonds from the emerging market countries in their hunt for yield. This is what we call the globalization of bond markets.

InSIGHTS: What regions are most prominently catching on to this trend?

J.R. : U.S. and European investors have a particular interest in China fixed income because China has opened its doors after all these years to foreign investment. Global investors are attracted to China's onshore bond market because they have access to quality instruments at a yield that is not readily available at that quality in other markets, and the currency risk in China is less volatile than in other countries. Also sought after, and more readily available to foreign investors, are dim sum bonds, which are denominated in Chinese renminbi but are issued in Hong Kong or other markets outside of mainland China, allowing foreign investors an easier way to gain exposure to Chinese credit and currency risk. Sukuk bonds comply with Shariah (Islamic) law, and they are a fast-growing asset class in Asia.

The ETF market, while more advanced in the U.S. and Europe, is still in its infancy across Asia and Latin America. The ETF market is quickly catching on to these markets, as investors see the appeal of ETFs as a transparent way to access bond market diversification at a low cost. For instance, Mexican legislative changes have categorized fixed income ETFs as "look-through" instruments to resolve pressures on capital solvency requirements and generally favor adoption of fixed income ETFs in insurance portfolios.

Demand can also be very telling. We're seeing investor interest in frontier markets such as Africa and the Middle East. India, in particular, has experienced a great deal of attention, and it is expected to be the world's next fastest-growing economy, surpassing China. But there are tax consequences that make investments in India complex. Until India fits into a more global market model, it will be difficult for those bonds to trade freely on a global scale.

InSIGHTS: Are we also seeing a trend of fixed income ETFs in Europe?

J.R. : Yes, we are seeing a strong ETF trend in Europe, and many fixed income ETFs are available. However, uncertainty surrounding the eurozone has driven some complications in the European markets, resulting in a flight to quality. For instance, Germany and France have very low yield for their debt; investors have flocked in a risk-off mindset to buy those bonds in order to protect themselves from happenings in the market. Other investors need to find yield and are going outside of Europe to find it. When you add up the debt from all eurozone countries, yield is still quite low. What's interesting is that unpredictability in Europe is somewhat contributing to the globalization of bond markets in the rest of the world because it is pushing investors to find other investments to help meet various strategies.

InSIGHTS: So, how is the globalization of bond markets affecting fixed income as a whole?

J.R. : We are seeing an advent of ETFs crossing over from equities to over-the-counter fixed income markets. ETFs bring an increased level of price transparency to a fixed income investor, much like an equity investment. They change the way individual investors can obtain access to these often difficult-to-understand and opaque markets, and we are seeing this trend around the world. For example, fixed income ETFs are in place in Latin America, and a China fixed income ETF was launched in the U.S. late last year. One of the things I hear when I talk to financial advisors is that they view the bond market as complicated. Well, ETFs un-complicate the bond market because buying an ETF is very much like buying an equity. You have the benefits of price transparency, low transaction cost, and intra-day liquidity, as well as a more efficient way to get access to a diversified portfolio. Investors looking for yield can turn to ETFs and make actionable decisions about getting exposure to those markets, just like buying a stock. That one vehicle is helping to drive globalization of bond markets. Looking at emerging markets' often-complicated tax structures for investments, an ETF is simpler because investors are buying and selling ETF shares rather than a series of individual bonds.

Comparing the performance of a small-cap value manager to a small-cap value index allows one to better understand the manager's sources of return beyond and above their exposure to the value and small-cap factors. Lastly, they can also be used in macro-analysis. For example, if stocks with higher momentum or lower dividends, or value stocks, etc. are behaving notably differently, that can provide a valuable insight into the evolving dynamics of the market.

InSIGHTS: What are the challenges of investing in global bond markets, and how are they mitigated?

J.R. : Currency risk is a challenge when looking at bonds globally. The challenge with going global is that investors worry about currency getting weaker or stronger. If a U.S. investor owns bonds in another currency and the U.S. dollar is getting stronger, that's negative for that investment. To eliminate currency risk, foreign bonds can be issued in one's domestic currency—for example, U.S. dollar issues in Europe, commonly known as euro-dollar bonds. This is another way bonds are being globalized.

InSIGHTS: What role do indices play in this transformation of the bond market?

J.R. : Indices can be used for both benchmarking and as the basis for investment products, including ETFs. The globalization of bond markets has created a need for more benchmarks in the space. In 2014, S&P Dow Jones Indices started an aggressive build-out of our fixed income offerings globally. Core fixed income is a strategy designed to reduce risk and/or generate income. Indices come into play to track the performance of the core market, i.e., investment-grade sovereign bonds, sovereign inflation-linked bonds, and corporate bonds in both U.S. and global currencies. We launched nearly 700 new indices in 2014 as part of that initiative. Noteworthy, and continuing to be developed, is the S&P Aggregate™ Bond Index Family, which is designed to measure the performance of publicly issued investment-grade debt in various regions around the world. We have launched two indices from this family, the S&P U.S. Aggregate Bond Index and the S&P Canada Aggregate Bond Index, and we intend to launch additional indices from this family later this year. Also worth noting are the S&P Global Developed Sovereign Bond Index, the S&P Global Developed Sovereign Bond Inflation-Linked Index, and the S&P Global Emerging Sovereign Inflation-Linked Bond Index . These indices are designed to track the performance of local currency-denominated securities that are publicly issued by developed and emerging countries for their domestic markets. These indices represent the core fixed income markets globally, allowing for a broad global market comparison and a way to identify global trends precisely by region.

Benchmarking needs also extend beyond core. A big chunk of the "more" is the shift toward alternatively weighted indices. As an index provider, S&P Dow Jones Indices offers ways for investors to look at markets from unique weighting perspectives. This includes sustainability focused options and frontier and emerging market exposure. Multi-asset class strategies allow investors to asset allocate while still looking at their investment holistically. When fixed income is a component to an investment strategy, using asset allocation models with multi-asset class strategies creates an opportunity to include fixed income into the framework of an increasing number of portfolios. Also, as foreign bond markets become more sophisticated and easier to invest in, the necessary tools to measure the performance of these markets is critical. Geopolitical headline news and global economic recovery concerns can cause high volatility in the markets. Indexing allows a way to track volatility, evaluate trends, and weigh risks in various markets. Indexing can combine different asset classes from different countries around the globe, tailoring to unique investment strategies. It also offers an insightful window into markets that have traditionally been difficult to get timely data from, like emerging and frontier markets.

InSIGHTS: Do you think the globalization of the bond markets has staying power?

J.R. : Absolutely. We are seeing a trend of more access to global markets, not less. Today's technology allows global markets to communicate and interact in ways we have not seen before. No longer can only large-scale investors have access to markets on the other side of the world. Global investing has now trickled down to the retail investor, allowing them to gain diversification across all time zones, and the global ETF market is one of the main vehicles to support this access.

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PERFORMANCE DISCLOSURE

S&P Dow Jones Indices defines various dates to assist our clients in providing transparency on their products. The First Value Date is the first day for which there is a calculated value (either live or back-tested) for a given index. The Base Date is the date at which the Index is set at a fixed value for calculation purposes. The Launch Date designates the date upon which the values of an index are first considered live; index values provided for any date or time period prior to the index's Launch Date are considered back-tested. S&P Dow Jones Indices defines the Launch Date as the date by which the values of an index are known to have been released to the public, for example via the company's public Web site or its datafeed to external parties. For Dow Jones-branded indices introduced prior to May 31, 2013, the Launch Date (which prior to May 31, 2013, was termed "Date of Introduction") is set at a date upon which no further changes were permitted to be made to the index methodology, but that may have been prior to the Index's public release date.

Past performance of the Index is not an indication of future results. Prospective application of the methodology used to construct the Index may not result in performance commensurate with the back-test returns shown. The back-test period does not necessarily correspond to the entire available history of the Index. Please refer to the methodology paper for the Index, available at www.spdji.com for more details about the index, including the manner in which it is rebalanced, the timing of such rebalancing, criteria for additions and deletions, as well as all index calculations.

Another limitation of using back-tested information is that the back-tested calculation is generally prepared with the benefit of hindsight. Back-tested information reflects the application of the index methodology and selection of index constituents in hindsight. No hypothetical record can completely account for the impact of financial risk in actual trading. For example, there are numerous factors related to the equities (or fixed income, or commodities) markets in general which cannot be, and have not been accounted for in the preparation of the index information set forth, all of which can affect actual performance.

Additionally, it is not possible to invest directly in an Index. The Index returns shown do not represent the results of actual trading of investable assets/securities. S&P Dow Jones Indices maintains the Index and calculates the Index levels and performance shown or discussed, but does not manage actual assets. Index returns do not reflect payment of any sales charges or fees an investor may pay to purchase the securities underlying the Index or investment funds that are intended to track the performance of the Index. The imposition of these fees and charges would cause actual and back-tested performance of the securities/fund to be lower than the Index performance shown. For example, if an index returned 10% on a US $100,000 investment for a 12-month period (or US$ 10,000) and an actual asset-based fee of 1.5% was imposed at the end of the period on the investment plus accrued interest (or US$ 1,650), the net return would be 8.35% (or US$ 8,350) for the year. Over a three-year period, an annual 1.5% fee taken at year end with an assumed 10% return per year would result in a cumulative gross return of 33.10%, a total fee of US$ 5,375, and a cumulative net return of 27.2% (or US$ 27,200).