February 2024

Portfolio perspectives

Every quarter, our Portfolio Solutions experts share their insights and provide actionable solutions to help you effectively manage your clients' investment portfolios.

Find out if you have enough international bond exposure

As we've documented in our research, advisors are underweight exposure to international—both in their equity and fixed income sleeves.

Today, most advisors allocate 20% or less to international bonds compared to our recommended strategic asset allocation of 40%. While we understand that repositioning a fixed income sleeve to 40% international may not be practical (or palatable), we would encourage you not to abandon international bonds.

Despite asset classes becoming more correlated over the past few years, we have found that international bonds, including emerging market debt, can be good diversifiers in a portfolio (see Figure 1 below).

FIGURE 1: Correlations reveal the diversification benefit of international bonds

		1	2	3	4	5	6	7
Global Bonds hedged CAD	1	**1.00**						
Developed Market Equities	2	**0.23**	**1.00**					
US High Yield	3	**0.28**	**0.47**	**1.00**				
Canadian Equity	4	**0.20**	**0.67**	**0.18**	**1.00**			
Canadian Corporate Bonds	5	**0.80**	**0.40**	**0.45**	**0.38**	**1.00**		
Canadian Aggregate Bonds	6	**0.86**	**0.29**	**0.40**	**0.18**	**0.90**	**1.00**	
US Aggregate Bonds hedged CAD	7	**0.95**	**0.24**	**0.25**	**0.22**	**0.76**	**0.83**	**1.00**

Global Bonds represented by Bloomberg global aggregate hedged CAD, Canadian equity represented by FTSE Canada all-cap, Developed markets equity represented by MSCI EAFE, US high yield represented by ICE BofA US high yield TR, Canadian corporate bonds represented by FTSE Canada all corporate bonds, Canadian aggregate bonds represented by Bloomberg Canada aggregate, US aggregate bonds represented by Bloomberg US aggregate bonds hedged CAD.

Past performance is no guarantee of future results. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index.

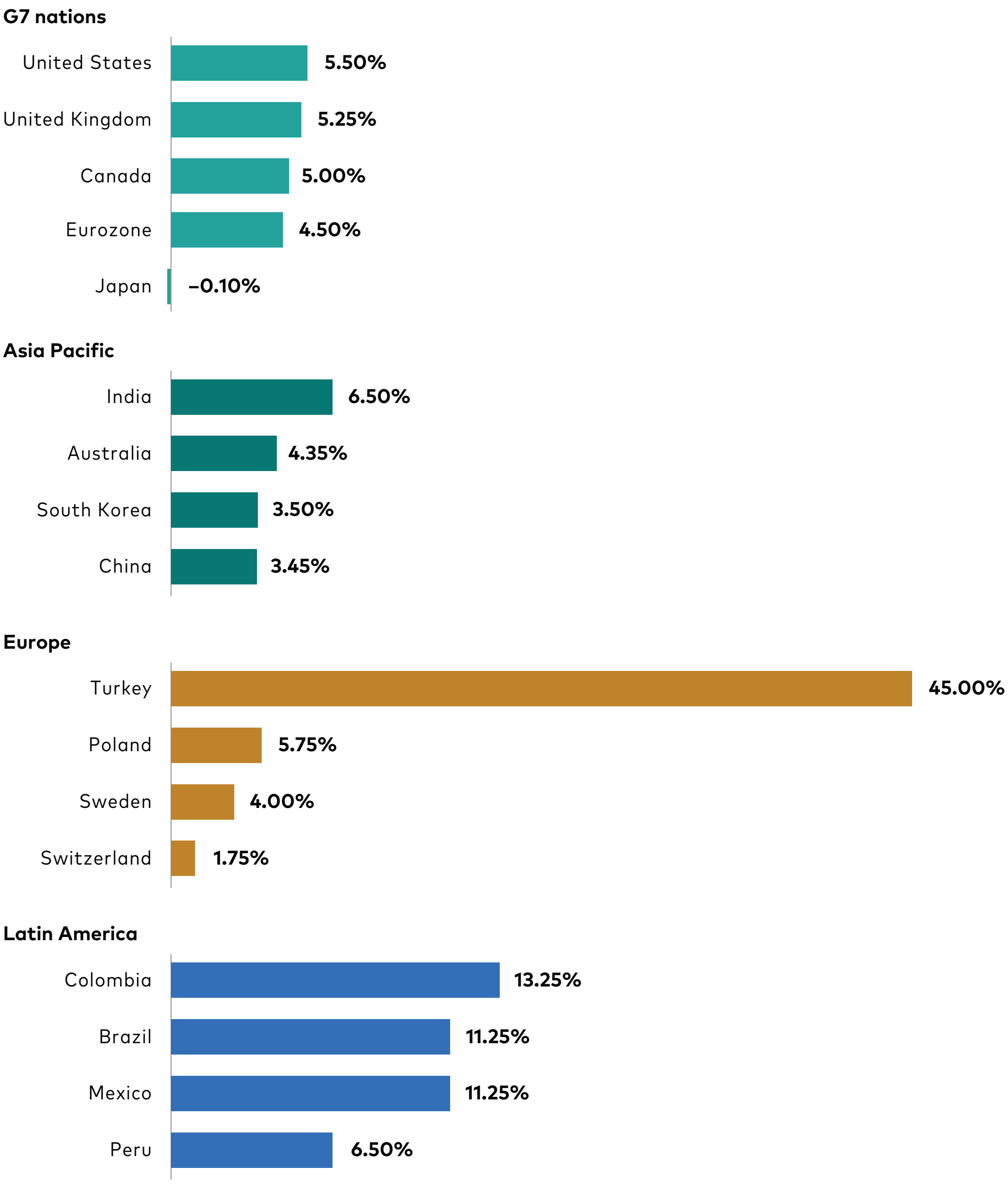
Sources: Vanguard and Morningstar, Inc.

Notes: Correlation coefficients are based on monthly returns from January 1, 2004 to January 31, 2024.

What about the longer duration profile and lower yields associated with international bonds?

It's true that international bonds in general have a longer duration profile and lower yields than their domestic counterparts. However, that shouldn't keep you from increasing your allocation to international bonds. While duration is a useful measure to understand interest rate sensitivity, it does have several limitations. Duration is an estimate that assumes a parallel shift in the yield curve. However, bond values in a diversified portfolio are impacted unevenly as interest rates move at different magnitudes along the yield curve, depending on such drivers as inflation expectations, economic growth, and monetary policy (see Figure 2). While duration works fine for sizing up a single-maturity government bond's interest rate sensitivity, it's less effective for broadly diversified bond portfolios with thousands of individual securities, let alone diversified CAD-hedged international bond funds that are exposed to various yield curves.

FIGURE 2: Central bank policy rates across the globe



Sources: Vanguard data, as of January 31, 2024.

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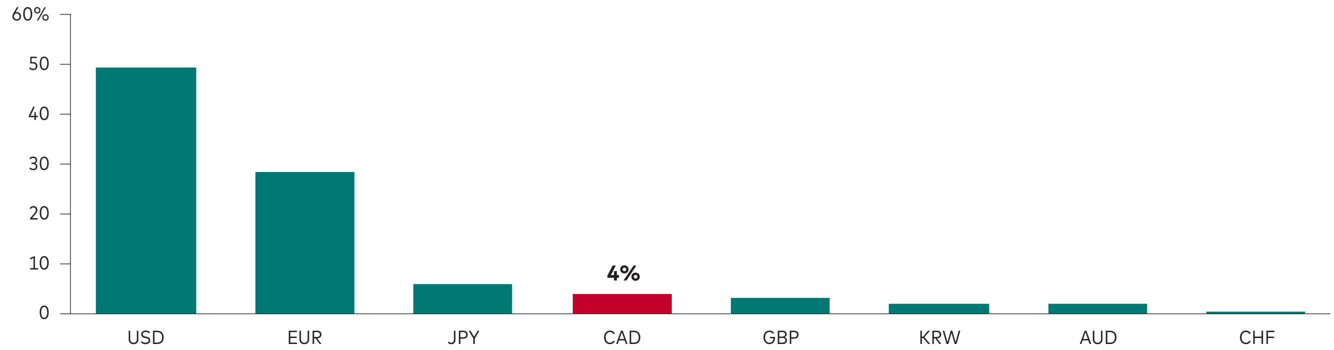
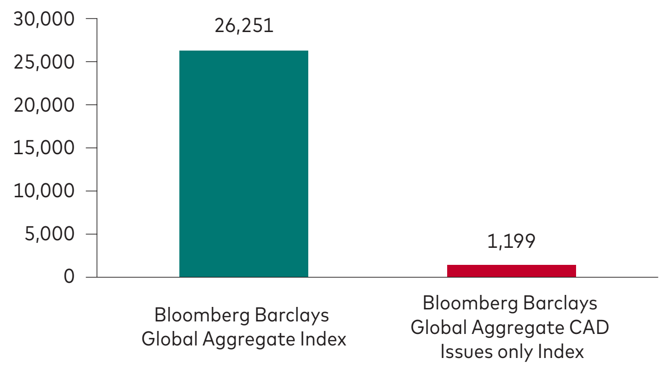
Despite a longer duration profile and lower starting yields, international bonds' direct exposure to multiple yield curves outside the direct influence of the Canadian market plays an important role in a well-diversified fixed income portfolio. Select international markets have lower yields but that does not necessarily translate into lower returns. Hedging to the Canadian dollar can often offset lower yields from the forward carry.

Investing almost entirely in Canadian bonds can result in limited access to the global bond universe, issuer concentration and may limit benefits of global currency exposure.

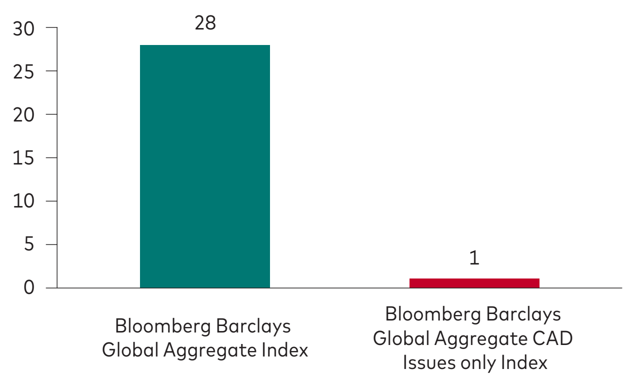
Proportion of CAD denominated bonds within the global aggregate index



Number of bonds



Number of currencies



Source: Bloomberg Barclays Global Aggregate and CAD Issues Global Aggregate Indices as of December 31, 2023.

Is your portfolio sending mixed signals?

As mentioned, some advisors may have more international bond exposure than they realize. That's because of their preference for active fixed income managers with flexible mandates, such as with multi-sector or core-plus strategies. These managers can allocate upwards of 30% in international fixed income, which can be surprising.

If you find yourself in this situation, what should you do? First, determine how much international fixed income shows up in your portfolios. Then decide how much you prefer to allocate going forward. As discussed, we believe there can be value in having a healthy allocation to international fixed income. But it should be a conscious decision.

Consider investing in the following diversified, low-cost ETFs for your international bond allocations.

Vanguard U.S. Aggregate Bond Index ETF (CAD-hedged) - VBU

Vanguard Global Aggregate Bond Index ETF (CAD-hedged) - VGAB

Vanguard Global ex-U.S. Aggregate Bond Index ETF (CAD-hedged) - VBG

Vanguard Global Credit Bond Fund (CAD-hedged) - VIC500

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