Matthews Asia

Seeking a More Efficient Fixed Income Portfolio with Asia Bonds

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Drawing upon different drivers for performance, Asia fixed income may improve risk-return profiles for U.S. fixed income investors.

Asia fixed income offers investors attractive total return potential and distinct investment characteristics that can help improve the overall risk/return profiles of their fixed income holdings. For U.S. investors whose fixed income portfolios are predominantly exposed to the U.S. fixed income markets, Asia fixed income provides currency diversification, the potential for yield enhancement and exposure to markets that follow different economic and credit cycles.

In this white paper, we take a closer look at the characteristics of Asia fixed income and explore how investors can use it to help build more efficient fixed income portfolios. We believe that treating Asia fixed income as a distinct asset class may offer investors clear benefits that include a low correlation to U.S., European and global fixed income markets, exposure to attractive regional fundamentals and attractive historical performance compared to other high-yielding fixed income sectors.

This discussion is particularly timely, given the current economic backdrop as the U.S. begins to consider tightening monetary policy while large parts of the developed and developing world are heading in the opposite direction. The potential impact on bond markets could be pronounced and, therefore, it seems prudent for investors to assess the composition of their fixed income portfolio and look deeper at the underlying risk/return characteristics.

Challenges for Fixed Income Investors

In a low-yield environment, many investors may already be looking outside traditional fixed income benchmarks for yields. For example, some investors may be adding high yield, global or emerging market bonds to their portfolios, rather than relying exclusively on traditional exposures such as the Barclays Global Aggregate Index (Global Aggregate) or the Barclays U.S. Aggregate Bond Index (U.S. Aggregate). The result is a global search for yield. However, in a difficult environment for fixed income investing, some investors may be tempted to reach for yield without thoroughly considering how much risk is being added in exchange for the incremental yield gained.

Investors may also recognize the need to include a more diverse range of bonds in their portfolios in order to create 'all-weather' investment strategies. Recent increases in duration and in the correlations among common fixed income investments lurk in the background. The U.S. Aggregate, which contains a mix of bond sectors, can provide a starting point for viewing some of the trends taking place in the broader fixed income marketplace. Consider changes in the index over the past decade (Figure 1). Duration in the index has increased by 1.3 years, while the proportion of Treasuries in the index grew by 11.1 percentage points.

Figure 1. Over the past decade, diversification in the U.S. Aggregate has decreased, while interest rate risk has increased

U.S. AGGREGATE						
	Percentage of Index			Duration*		
Sector	2014	2004	Change	2014	2004	Change
Treasury	35.8%	24.7%	+11.1%	5.6	5.4	+0.2
Government related	9.5%	15.2%	-5.7%	5.5	4.1	+1.4
Securitized	31.4%	39.5%	-8.1%	4.3	3.0	+1.3
Corporate	23.2%	20.7%	+2.5%	7.3	5.9	+1.4
Index overall	—	—	—	5.6	4.3	+1.3

*Duration is a measure of the sensitivity of the price of a fixed income investment to a change in interest rates.

Source: Barclays

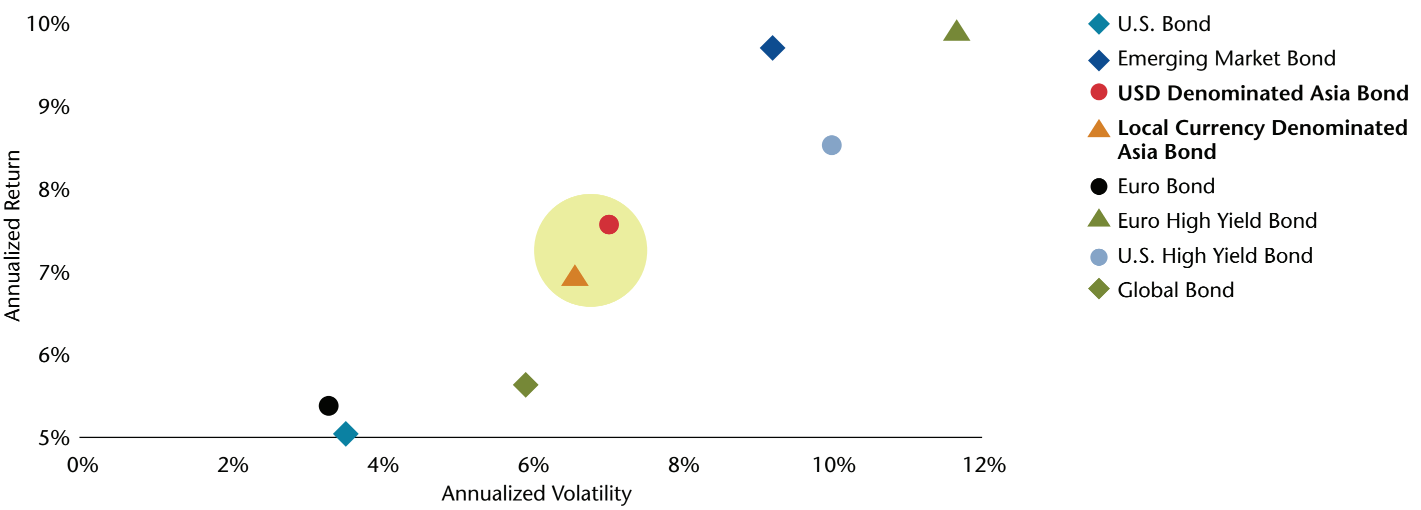
As duration in the U.S. Aggregate has increased, investors who have a portfolio benchmarked against this index as a core bond holding may be subject to higher levels of interest rate risk than in the past. In addition, diversity of the index has decreased as the proportion of Treasuries has increased.

Seeking a More Efficient Fixed Income Portfolio

Asia fixed income has the potential to help investors achieve higher yield and better total return for their fixed income portfolios within a defined risk/return framework. In other words, adding Asia fixed income to an investor's overall fixed income portfolio may create a more efficient portfolio on a risk-adjusted basis over the long term.

With a long-term perspective in mind, investors may reap the rewards of investing over a full market cycle. In Figure 2, we compare the risk/return characteristics of the local currency denominated Asia Bond (HSBC Asian Local Bond Index) and the U.S. dollar denominated Asia Bond (J.P. Morgan Asia Credit Index) against a range of core developed and emerging market indices. The chart shows where Asia fixed income is positioned along the risk/return continuum, providing investors with a distinct asset class in either local or U.S. dollar currency and historically delivered an attractive return per unit of risk.

Figure 2. Asia fixed income well-positioned along the risk/return continuum



12/31/2001–12/31/2014

Data shown from 12/31/2001 since returns for Local Currency Denominated Asia Bond (HSBC Asian Local Bond Index–ALBI), USD Denominated Asia Bond (J.P. Morgan Asia Credit Index–JACI), U.S. Bond (Barclays U.S. Aggregate), Emerging Market Bond (J.P. Morgan Emerging Markets Bond Index Global), Euro Bond (Barclays Euro Aggregate), Euro High Yield Bond (Barclays Pan-European High Yield), U.S. High Yield (BofA Merrill Lynch U.S. High Yield Master II) and Global Bond (Barclays Global Aggregate) are all available from this date.

Performance for all indices is in USD terms, except for Barclays Euro Aggregate and Euro High Yield, which are in euro terms. Past performance is no guarantee of future results.

Source: Bloomberg

As the chart below indicates, Asian fixed income historically has also exhibited relatively low sensitivity to U.S. interest rates compared to other mainstream fixed income segments.

Figure 3. Asia bonds have among the lowest beta to U.S. Treasuries (12/31/2001–12/31/2014)

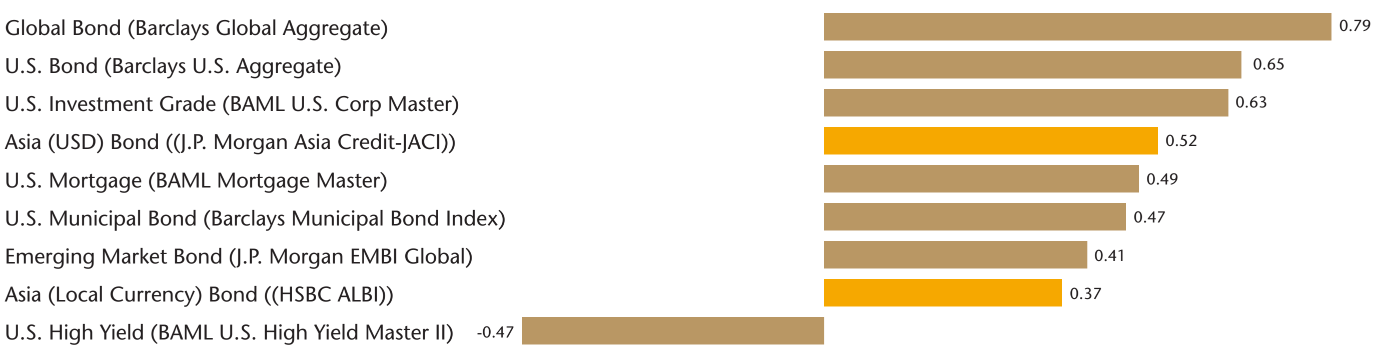


Chart shows beta of each asset class to the BofA Merrill Lynch U.S. Treasury Current 5 Year Index, based on monthly returns.

Data shown from 12/31/2001 since returns for BofA Merrill Lynch U.S. Corporates Master Index, BofA Merrill Lynch U.S. High Yield Master II Index, J.P. Morgan Emerging Markets Bonds Index Global, BofA Merrill Lynch Mortgage Master Index, Barclays Global Aggregate Bond Index, Barclays U.S. Aggregate Bond Index, Barclays Municipal Bond Index, HSBC Aslan Local Bond Index (ALBI) and the J.P. Morgan Asia Credit Index (JACI) are all available from this date.

Source: Bloomberg

We note that, over the short term, Asia fixed income has the potential to be more volatile than U.S. bonds or Global bonds and fixed income investments are subject to additional risks, including, but not limited to, interest rate, credit and inflation risks. Investing in emerging markets involves different and greater risks, as these countries are substantially smaller, less liquid and more volatile than securities markets in more developed markets, and therefore investors should have a time horizon of at least three to five years in mind when considering Asia fixed income.

Risk Considerations

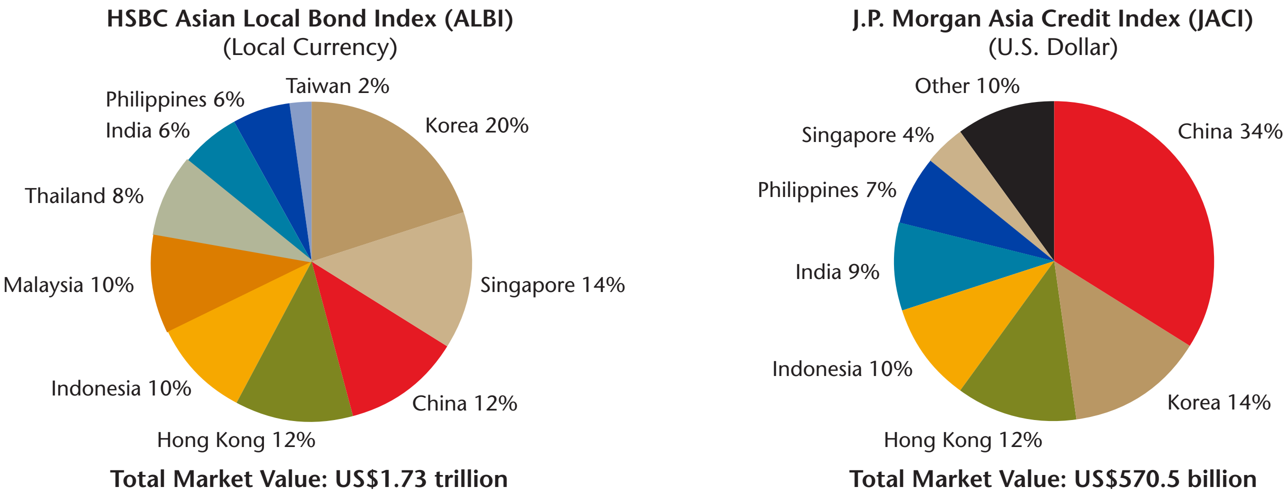
Fixed income investments are subject to credit, currency, and interest rate risks. Credit risk is the change in the value of debt securities reflecting the ability and willingness of issuers to make principal and interest payments. Currency risk is a decline in value of a foreign currency relative to the U.S. dollar which reduces the value of the foreign currency and investments denominated in that currency. Interest rate risk is the possibility that yield will decline due to falling interest rates and the potential for bond prices to fall as interest rates rise. Investing in international and emerging markets may involve additional risks, such as social and political instability, market illiquidity, exchange-rate fluctuations, a high level of volatility and limited regulation.

Multi-Currency Bond Portfolios Offer Fixed Income Diversification Benefits

Asia fixed income represents two distinct bond markets—local currency and U.S. dollar bonds. The local currency bond market, represented by the HSBC Asian Local Bond Index, is about $1.73 trillion (larger than the U.S. high yield bond market) and offers currency diversification. The U.S. dollar bond market in Asia, represented by the J.P. Morgan Asia Credit Index, is about $570.5 billion. These two markets together (Figure 4) provide compelling investment opportunities across the three return drivers of credit, currencies and interest rates.

Although predictions regarding currencies can be difficult over a short-term horizon, we believe that over the long run there is a strong structural argument for the appreciation of many Asian currencies relative to major global currencies. In many Asian countries today, we see healthy government and corporate balance sheets, falling inflation, higher foreign exchange reserves and lower external debt. We believe that strong regional fundamentals—absolute and relative—combined with deepening capital markets and different interest rate cycles make a compelling case for including local Asia currency exposure in investors' portfolios.

Figure 4. A diverse set of markets provide attractive opportunities for investment



Sources: Bloomberg; Data as of 12/31/2014

Asia fixed income has historically exhibited low correlations to U.S. and other fixed income markets. One reason is that a multi-currency portfolio of Asia fixed income investments has different and more diverse drivers of return than a single currency portfolio. For example, U.S. government bond returns are driven primarily by changes in interest rates. In contrast, returns for a multi-currency fixed income portfolio such as a diversified Asia fixed income portfolio will be driven by three distinct elements—credit, currencies and interest rates. The diversity of these risk and return drivers results in low correlations with mainstream fixed income segments as illustrated in the chart in Figure 5.

Figure 5. Asia fixed income has low correlations to U.S. and global bonds

CORRELATION MATRIX (12/31/2001–12/31/2014)

Asset Class	Local Currency Denominated Asia Bond	USD Denominated Asia Bond	U.S. Bond	Global Bond	Emerging Market Bond	U.S. High Yield	U.S. Equity	Asia ex Japan
Local Currency Denominated Asia Bond	1.00							
USD Denominated Asia Bond	0.60	1.00						
U.S. Bond	0.46	0.66	1.00					
Global Bond	0.67	0.61	0.73	1.00				
Emerging Market Bond	0.63	0.84	0.56	0.56	1.00			
U.S. High Yield	0.47	0.66	0.21	0.31	0.73	1.00		
U.S. Equity	0.42	0.41	-0.06	0.18	0.55	0.69	1.00	
Asia ex Japan	0.60	0.54	0.06	0.31	0.59	0.69	0.76	1.00

Correlations shown from 12/31/2001 based on monthly-returns for Local Currency Denominated Asia Bond (HSBC Asian Local Bond Index—ALBI), USD Denominated Asia Bond (J.P. Morgan Asia Credit Index—JACI), U.S. Bond (Barclays U.S. Aggregate), Global Bond (Barclays Global Aggregate), Emerging Market Bond (J.P. Morgan Emerging Markets Bond Index Global), U.S. High Yield (BofA Merrill Lynch U.S. High Yield Master II), U.S. Equity (S&P 500 Index), Asia ex Japan (MSCI All Country Asia ex Japan Index) are all available from this date.

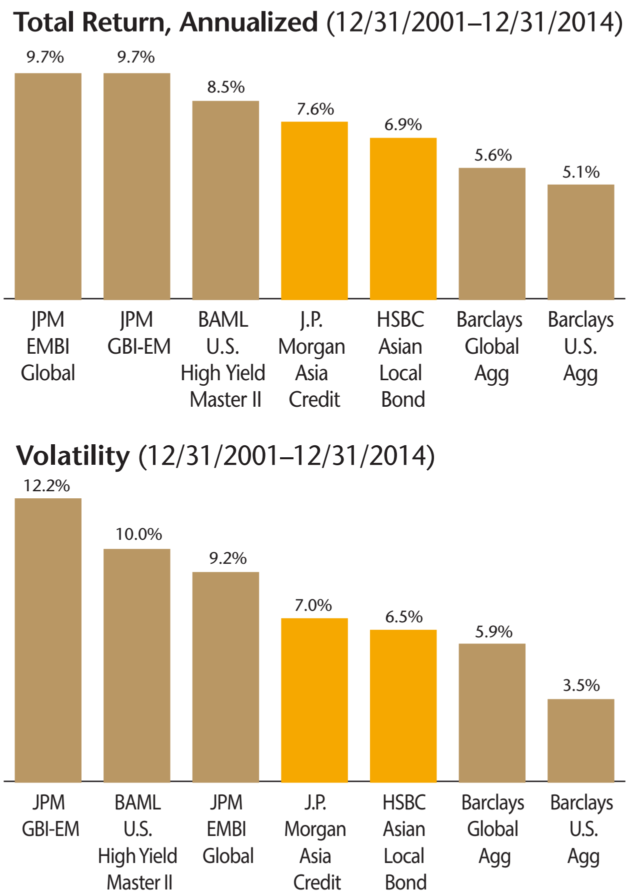
It is not possible to invest directly in an index.

Sources: Bloomberg and MICM

Comparison with Other High Yielding Sectors

To compare Asia fixed income with emerging market or high yield bonds, it is prudent to look beyond yield. Currency fluctuations tend to render misleading straight yield comparisons between single currency and multi- currency bond strategies. More effective metrics to consider may include total return and volatility (Figure 6). By taking a more holistic view of higher-yielding bond sectors, investors can make more informed choices when constructing their portfolios.

Figure 6. In multi-currency bond portfolios, Asian fixed income is an attractively positioned asset class



Data shown from 12/31/2001 since returns for J.P. Morgan Government Bond Index-Emerging Markets (GBI-EM), BofA Merrill Lynch U.S. High Yield Master II, J.P. Morgan Emerging Markets Bond Index Global, J.P. Morgan Asia Credit Index (JACI), HSBC Asian Local Bond Index (ALBI), Barclays Global Aggregate and Barclays U.S. Aggregate are all available from this date.

All performance quoted represents past performance and does not guarantee future results. It is not possible to invest directly in an index.

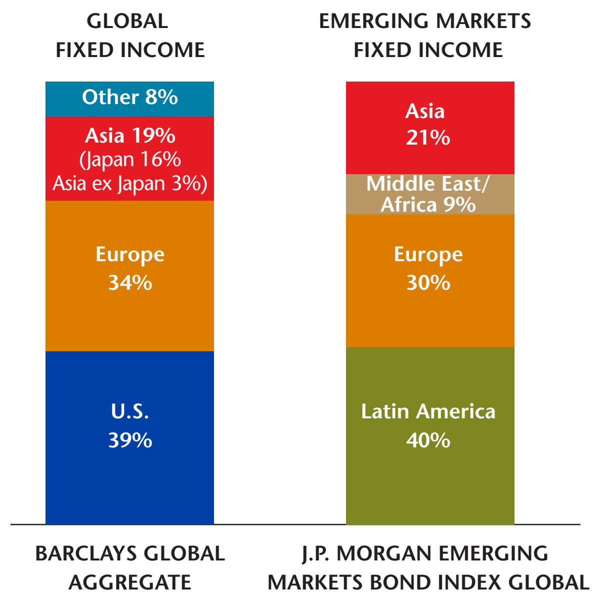
Volatility is the standard deviation of returns.

Source: Bloomberg

A Distinct Asset Class

While Asia fixed income is often included as a sector within global bond indices and emerging market bond indices, the exposure gained through these indices is relatively small as seen in Figure 7. For example, Asia ex Japan fixed income makes up only 3% of the Barclays Global Aggregate Bond Index and Asia makes up 21% of the J.P. Morgan Emerging Markets Bond Index Global.

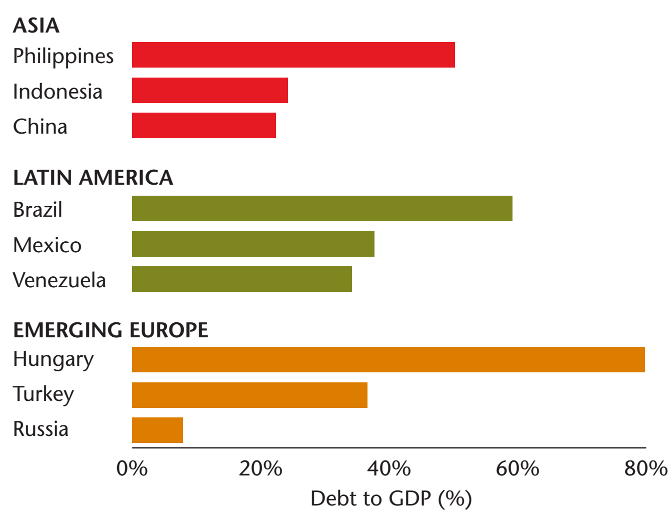
Figure 7. Global bond indices and emerging market bond indices offer limited exposure to Asia fixed income



Sources: Bloomberg, J.P. Morgan, as of 12/31/2014

Asia fixed income is systematically underrepresented in global indices because Asian countries have less debt than those in other regions. For example, Figure 8 illustrates how the top country allocations within global emerging market bond indices also have higher levels of debt to GDP. Conversely, countries in Asia with less debt typically have a lower representation in global emerging market benchmarks.

Figure 8. Debt to GDP of top three constituencies of the J.P. Morgan Emerging Markets Bond Index Global



Source: Bloomberg; Debt/GDP data as of 12/31/2013; Top country weights data as of 12/31/2014

With Asia fixed income being systematically underweighted in both global and emerging market benchmarks, we believe that investors can benefit from treating Asia fixed income as a distinct allocation within their broader fixed income portfolios.

The Importance of Active Management

Employing a passive approach typically results in a suboptimal portfolio because the overwhelming majority of benchmarks are weighted by market capitalization. When applied to fixed income, this results in benchmarks with the highest allocations to issuers with the most debt, not the highest credit quality. Consequently, a passive portfolio would expose the investor to the most indebted issuers, not the most creditworthy issuers. Given Asia's strong fundamentals, this often leaves global fixed income investors far less allocated to Asian issuers than they might expect or intend.

Additionally, portions of the Asia fixed income markets remain relatively inefficient, which creates opportunities for active managers to generate alpha through fundamental analysis of credit, currencies, and interest rates across the region.

Getting Started

Many investors are already looking beyond broad market benchmarks when building fixed income portfolios. For investors who may be looking to diversify portfolios away from their home country bond sectors, Asia fixed income can serve as a strong diversifier. Rather than thinking about Asia fixed income as part of the emerging markets debt category, we encourage investors to think about Asia fixed income as its own distinct asset class. Because Asia fixed income is a relatively inefficient asset class compared to U.S., European and Global bond markets, choosing an active manager can potentially help to mitigate risks and enhance returns. Clearly, allocations to Asia fixed income should be tailored to an individual client's objectives, time horizon and risk tolerance. Over the short term, Asia fixed income has the potential to be more volatile than some U.S., European bonds or Global bond markets and, therefore, investors should have a time horizon of at least three to five years in mind when considering Asia fixed income. However, for investors who are focused on the long term, including an allocation to Asia fixed income may help to improve the risk return profile of their fixed income portfolio.

To learn more about Asia fixed income, visit **matthewsasia.com** to access additional insights and white papers.

Key Terms

Diversification does not ensure a profit or protect against a loss. The impact of adding international bonds to a diversified portfolio may expose investors to the movement of global currencies. Including global currencies in a bond portfolio may increase currency volatility.

U.S. Treasuries are backed by the full faith and credit of the U.S. government. Unlike mutual funds which are not guaranteed and involve risks including the possible loss of principal.

Alpha: A measure of performance on a risk-adjusted basis. Alpha takes the volatility (price risk) of a mutual fund and compares its risk-adjusted performance to a benchmark index. The excess return of the fund relative to the return of the benchmark index is a fund's alpha.

Beta: A measure of the volatility, or systematic risk, of a security or a portfolio in comparison to the market as a whole. Beta is used in the capital asset pricing model (CAPM), a model that calculates the expected return of an asset based on its beta and expected market returns.

Duration: A measure of the sensitivity of the price (the value of principal) of a fixed-income investment to a change in interest rates. Duration is expressed as a number of years. Rising interest rates mean falling bond prices, while declining interest rates mean rising bond prices.

Volatility: A statistical measure of the dispersion of returns for a given security or market index. Volatility can either be measured by using the standard deviation or variance between returns from that same security or market index. Commonly, the higher the volatility, the riskier the security.

Standard Deviation: In finance, standard deviation is applied to the annual rate of return of an investment to measure the investment's volatility. Standard deviation is also known as historical volatility and is used by investors as a gauge for the amount of expected volatility. A high standard deviation indicates a higher degree of risk. A large dispersion tells us how much the return on the fund is deviating from the expected normal returns.

Correlations: In the world of finance, a statistical measure of how two securities move in relation to each other. Correlations are used in advanced portfolio management. Correlation is computed into what is known as the correlation coefficient, which ranges between -1 and +1. Perfect positive correlation (a correlation co-efficient of +1) implies that as one security moves, either up or down, the other security will move in lockstep, in the same direction. Alternatively, perfect negative correlation means that if one security moves in either direction the security that is perfectly negatively correlated will move in the opposite direction. If the correlation is 0, the movements of the securities are said to have no correlation; they are completely random.

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