THE RE-EMERGENCE OF GLOBAL BONDS

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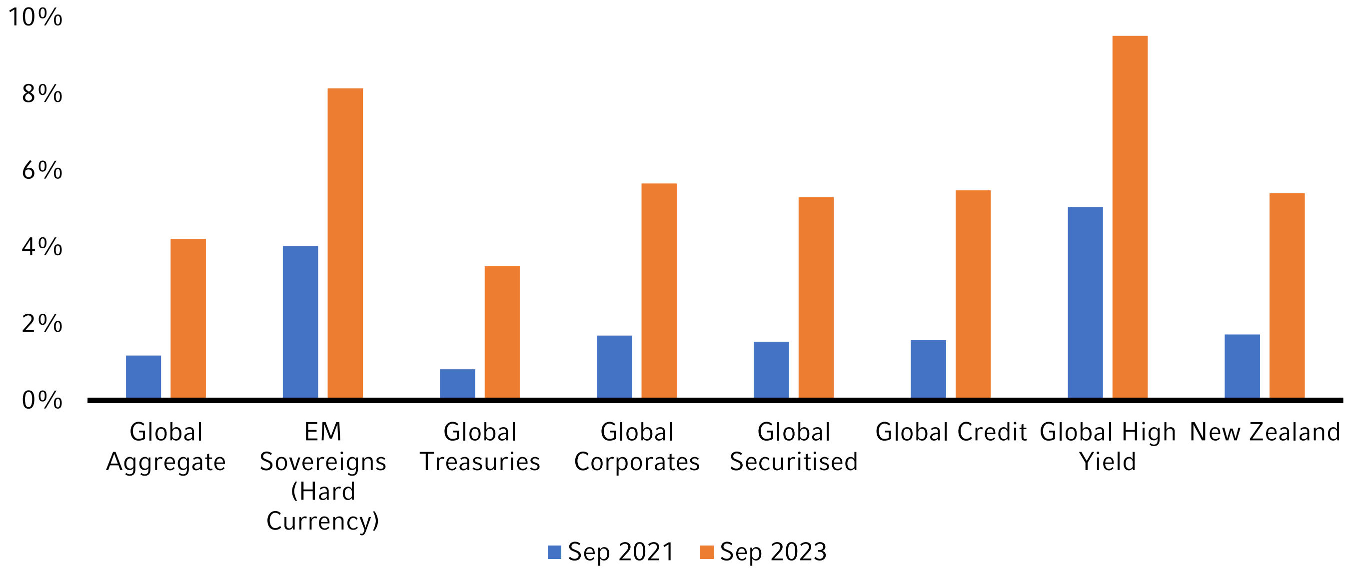
The global bond market is a massive and incredibly diverse opportunity set totalling more than NZ$100 trillion. In *The Re-emergence of Global Bonds*, we highlight the investment case for local investors and illustrate the benefits of adopting a multi-manager strategy to access this asset class.

Bond Market Yield-to-Maturity (Sep 2021 vs. Sep 2023)

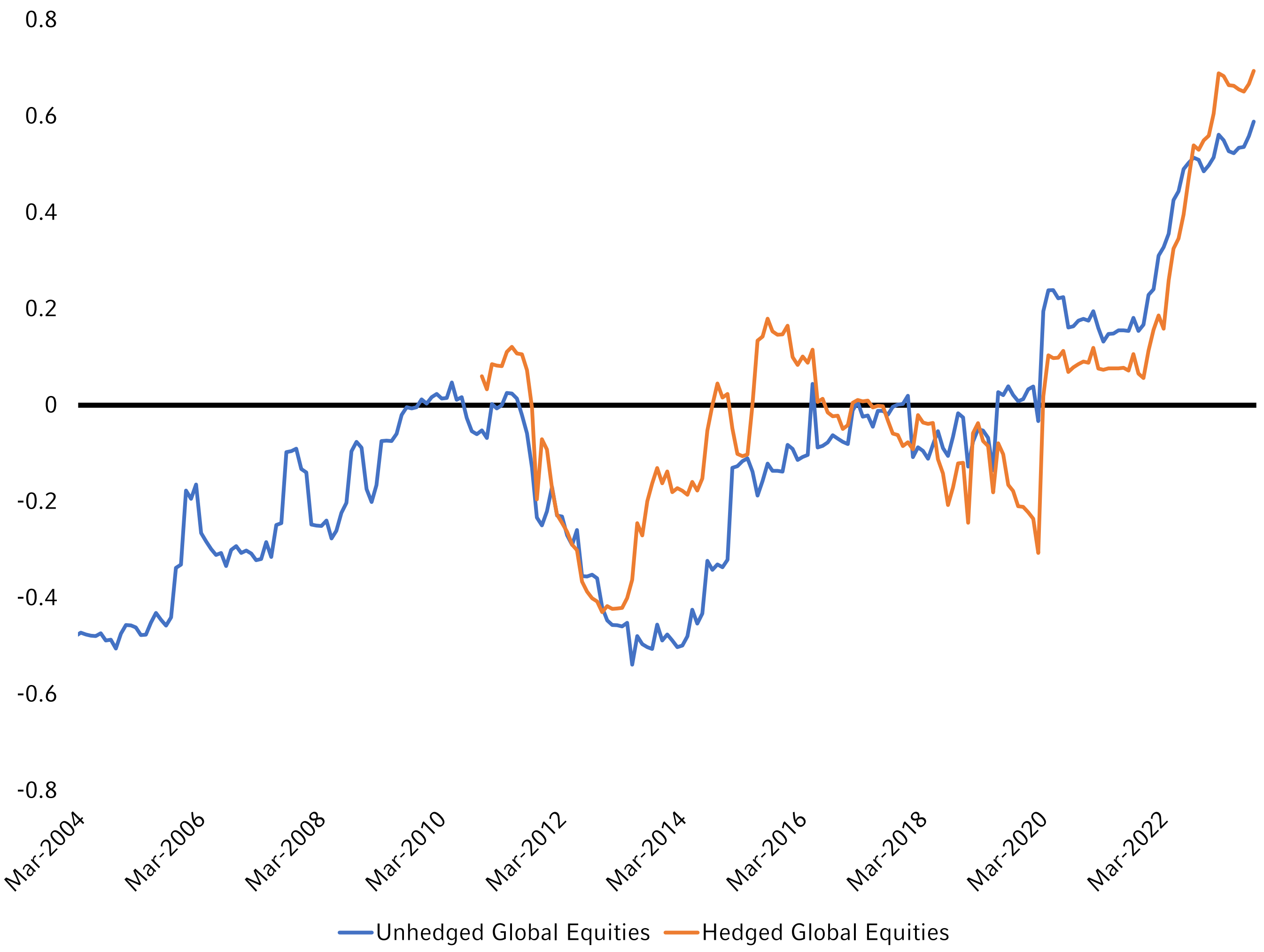


Bond yields have been extraordinarily low for much of the time since the Global Financial Crisis. At one point, as much as US$17 trillion[1] of the global bond market was 'negative yielding', meaning some lenders were effectively paying borrowers to take their money. This market dynamic led many investors to increase their exposure to riskier segments of the bond market in search of higher yields or even scale back their allocations entirely.

During 2022 the environment changed. Interest rates surged around the world causing bonds to experience one of their worst years on record.[2] The upside to this painful period is that future returns look much more attractive, as highlighted by the chart to the left, which compares current yields with those of two years ago.

Source: Barclays Bloomberg. Indices used: Bloomberg Global Aggregate NZDH, Bloomberg EM Hard Currency Aggregate Sovereign NZDH, Bloomberg Global Aggregate Treasuries NZDH, Bloomberg Global Aggregate Corporates NZDH, Bloomberg Global Aggregate Securitised NZDH, Bloomberg Global Aggregate Credit NZDH, Blomberg Global High Yield NZDH, Bloomberg Global Aggregate New Zealand.
[1]Bloomberg, Nov 2020. [2]CNBC Jan 2023.

Three-Year Rolling Correlation – Global Equities vs. Global Bonds



Source: Barclays Bloomberg, Morningstar Direct. Indices used – Global Equities – MSCI ACWI NR NZD & NZDH, Global Bonds – Bloomberg Global Aggregate TR NZDH. Data analysed was from Jan 2001 to September 2023.[3]-0.1 is the average three-year rolling correlation of MSCI ACWI NR NZD to the Bloomberg Global Aggregate TR NZDH from Jan 2001 – Sep 2023. [4]Motley Fool, 2022 Was the Worst Year since 1937 for this Investment Strategy - Jan 2023. [5]Morningstar Direct, Oct 2023. About 30% of the US$10 trillion in fixed income mutual fund and ETF assets are managed passively, versus about 55% of the US$23 trillion in equity mutual fund and ETF assets. Past performance is not a reliable indicator of future performance.

Why Include Bonds in Your Portfolio

Diversification benefits: Bonds have historically acted as both a defensive asset in market downturns and as a diversifier to risky assets such as equities. This is illustrated by the chart to the left, where the average rolling three-year correlation of global bonds to global equities is -0.1.[3] More recently, bonds and equities have moved closer in tandem, as illustrated by the rising correlations. 2022 was an extreme example, with both bonds and equities declining in what was the worst performance of the typical 60/40 equity-bond portfolio for decades.[4]

Income generation and potential for capital appreciation: Most segments of the bond universe offer regular coupons, which typically make up a large percentage of the total return. The income generating feature of bonds has historically made the asset class particularly attractive to a range of income-oriented investors, such as retirees, insurance companies and pension schemes. With yields recovering, the asset class offers high levels of current income and the potential for capital appreciation as interest rates stabilise or even decline.

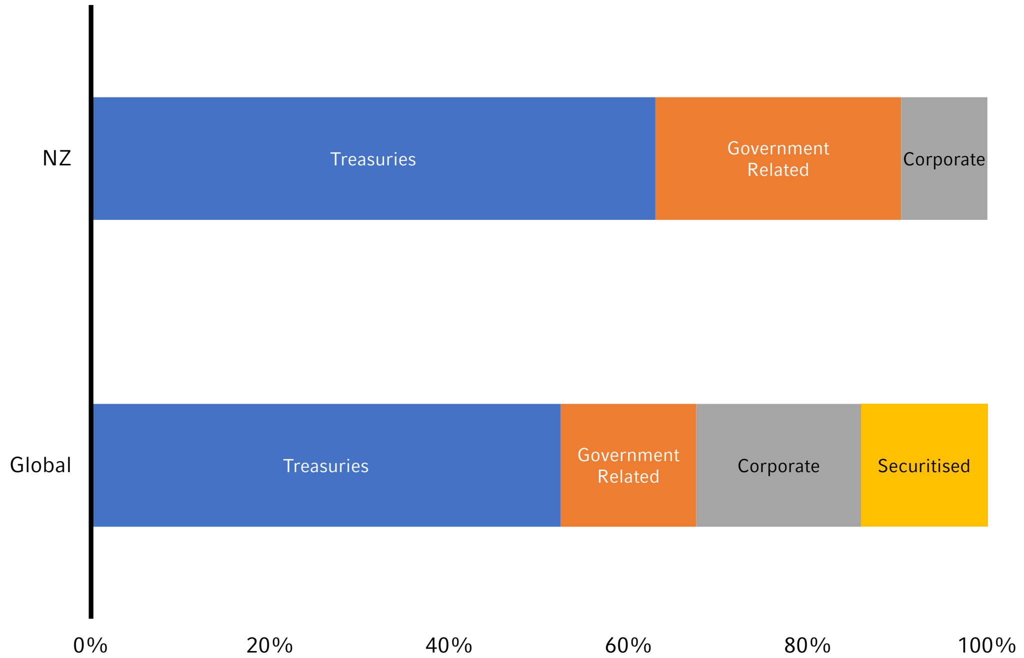
Potential for value-added via active management: Investors prefer active management within fixed income, presumably due to higher levels of confidence in the ability of active portfolio managers to add value.[5]
Our advice to local clients is to adopt active management due to some limitations in common fixed income benchmarks, coupled with the presence of managers that can consistently add value over time.

Global Bonds Offer Exposure to All Types of Securities

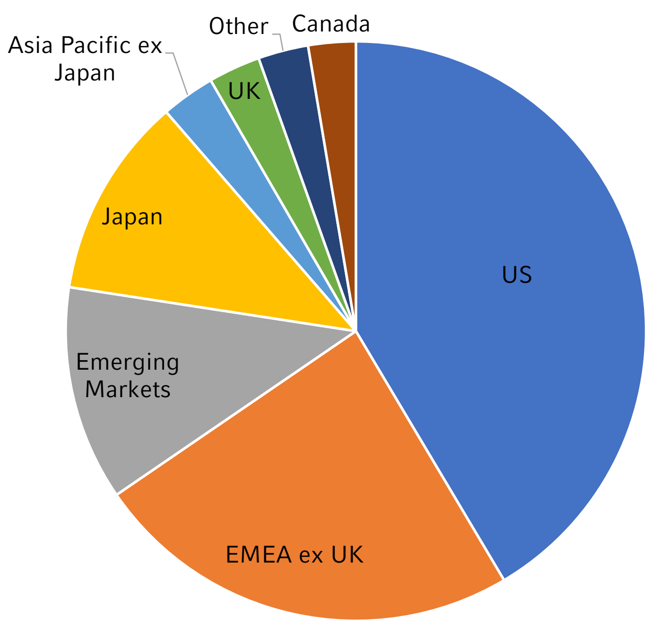
The local fixed income market is dominated by bonds issued by the NZ government and government-related entities like City Councils and the Local Government Funding Agency. Less than 10% of the leading local fixed income index is allocated to the credit and securitised sectors. This contrasts with the global market where more than 30% is in non-government related sectors.

Given the concentration of government securities, the local market index has typically had a higher credit rating than the broad global bond market index, and often a lower yield. This has often meant that investors can gain access to higher yields and return potential offshore as well as gain exposure to more sectors and product types. Additionally, with more than 29,000 issues and 4,000 issuers (versus 180 and 50 locally) there is an increased opportunity to add value through active management in the global market. With a range of NZD-hedged global bond funds available, currency risk need not be an issue for local investors.

Local vs. Global Bond Market Composition



Bloomberg Global Aggregate Regional Breakdown



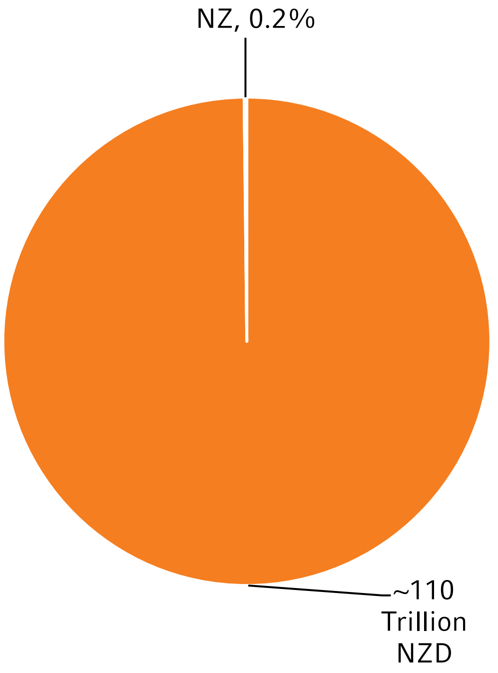
Source: Russell Investments, Barclays Bloomberg, Morningstar Direct. Indices used, Global Bonds – Bloomberg Global Aggregate TR NZDH, NZ Bonds – NZ Bond Composite 0+ yr TR. Data as of 30 Sep 2023.

Home Bias Makes Even Less Sense With Fixed Income

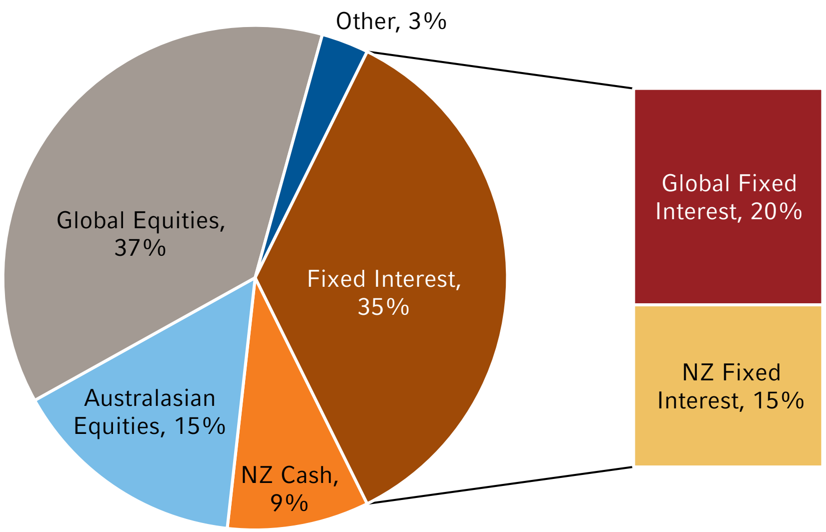
Home bias is a well-documented behavioural bias that explains the tendency of investors to 'over-allocate' to local assets. This has been attributed to familiarity and comfort, as well as to product availability and market access. Unlike with equities, investing in domestic bonds does not provide any tax advantage as they are subject to the same tax treatment as their offshore counterparts.

The New Zealand bond market represents less than 0.5% of the global opportunity set. While there may be a case for allocating more than that to local assets, in practice, many investors 'over-allocate' to New Zealand. We can see this trend clearly in KiwiSaver as evidenced by the average Balanced fund having over 40% of their bond exposure invested locally.

NZ as a Proportion of the Global Debt Market

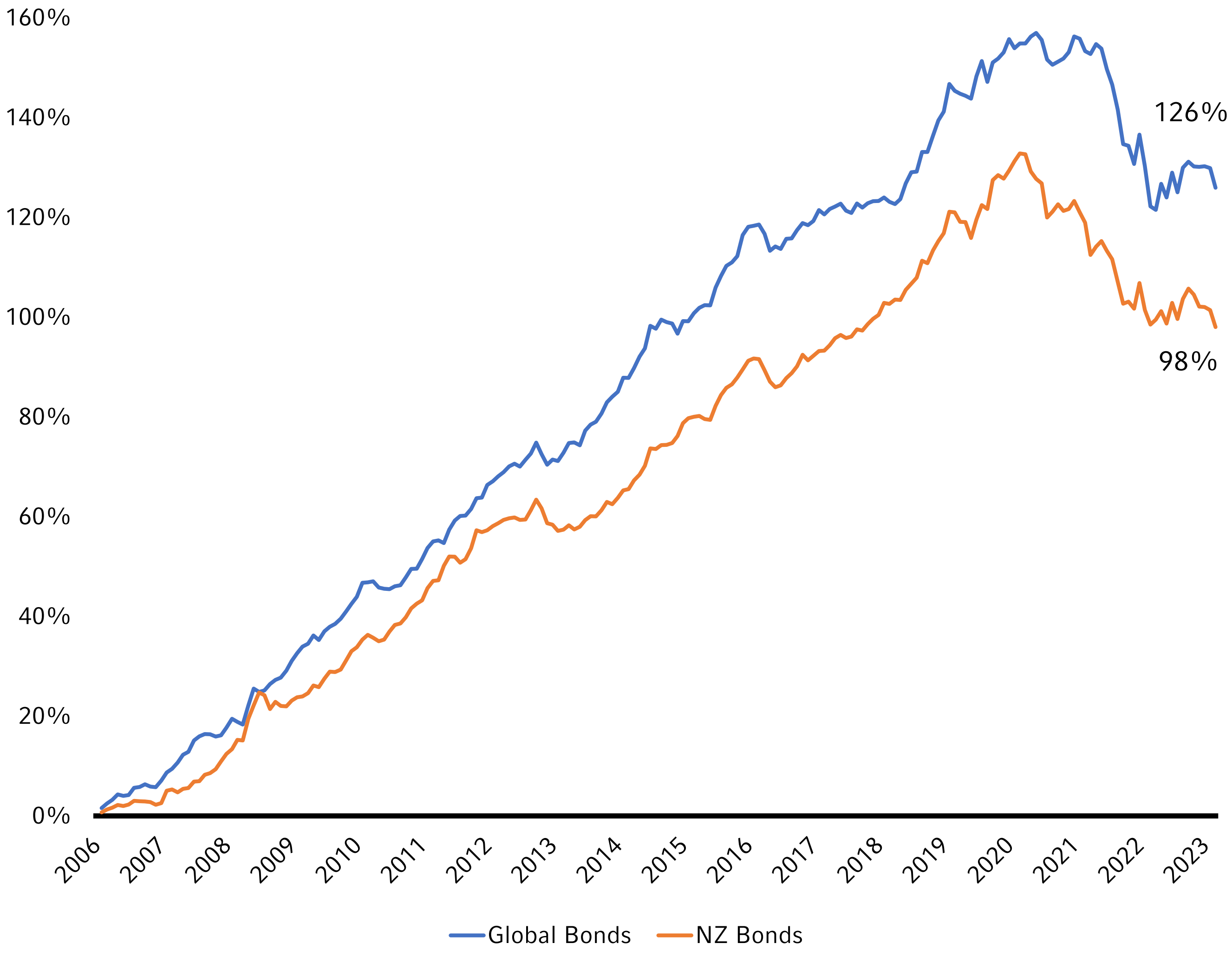


Average Balanced KiwiSaver Asset Allocation



Source: Bloomberg Barclays, Morningstar Direct. The Bloomberg Global Aggregate has been used to represent the size of the global debt market. The Bloomberg NZ 0+ Bond Composite has been used to represent the NZ debt market. Average KiwiSaver Balanced allocation is as of 30 Sep 2023.

Cumulative Return of Global and NZ Bond Indices



Global Bonds Have Outperformed Local Bonds Over the Long Term

The chart to the left shows the long-term cumulative performance of global bonds (NZD-hedged) versus local New Zealand bonds. Global bonds have outperformed on both an absolute and risk-adjusted basis, as evidenced by the higher Sharpe ratio.

This outperformance could be attributed to several factors, including; the more diversified nature of the global bond market, a broader exposure to a range of economic conditions, interest rates, and credit qualities.

Investors seeking improved risk-adjusted performance may find that the global fixed interest market offers a much broader opportunity set and potentially superior returns.

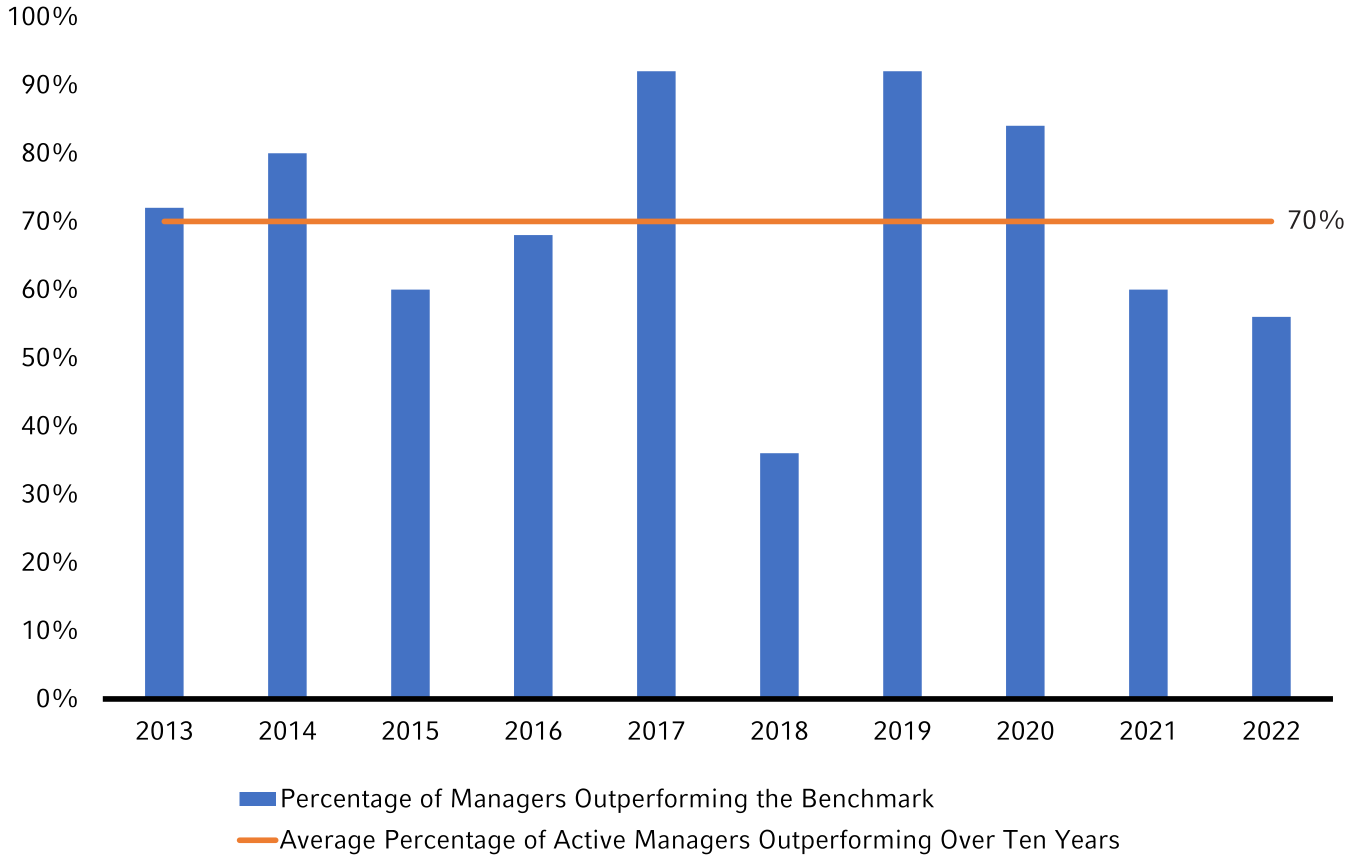
RETURN & RISK STATS (AUG 2006 – SEP 2023)	RETURN (P.A.)	VOLATILITY (P.A.)	SHARPE RATIO
Global Bonds	4.9%	3.4%	**0.44**
NZ Bonds	4.1%	3.5%	**0.20**

Source: Morningstar direct. Indices used: Global Bonds – Bloomberg Global Aggregate TR NZDH, NZ Bonds – S&P NZX Composite Investment Grade Bond Index. Cumulative return is since the inception of the S&P/NZX Composite Investment Grade Bond Index (1 August 2006) to 30 September 2023. The return over the same period for the NZ 90 Day Bank Bill Interest Rates NZD Index has been used in the Sharpe Ratio calculation. Past performance is not a reliable indicator of future performance.

Active Management Pays Off in Global Fixed Interest

The record of active management in fixed income is arguably more compelling than in equities. We certainly see this within our global fixed income manager universe, where most managers we monitor outperform the major market index. We also see this in our actively managed Global Fixed Interest Fund, which has outperformed by 0.9%[6] on an annualised basis (gross of fees) since its inception.

Percentage of Managers Outperforming the Benchmark by Calendar Year



Another reason to favour active management is that passive management is inherently more difficult to implement with bonds than it is with equities.

Many fixed income markets are much larger and broader than their equity counterparts. For example, the Bloomberg Global Aggregate Index comprises **~30,000 securities**, whereas the popular S&P 500 index has just 500. For large, broad indices like the Bloomberg Global Aggregate, full replication is not practical and sampling introduces the potential for undesirable tracking error.

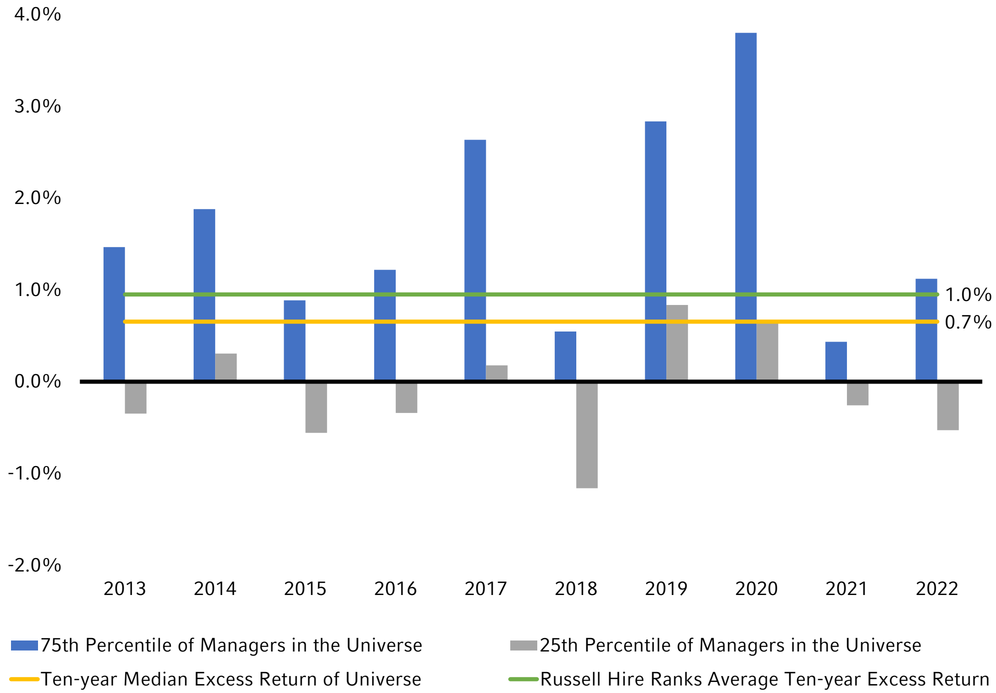
Source: Russell Investments Global Aggregate Bond Universe, comprised of 24 managers. All data analysed was unhedged and in USD. All managers analysed were benchmarked to the Bloomberg Global Aggregate TR USD. [6]Russell Investments Global Fixed Interest Fund NZDH, incepted December 2011. Past performance is not a reliable indicator of future performance.

Identifying the Winning Active Managers

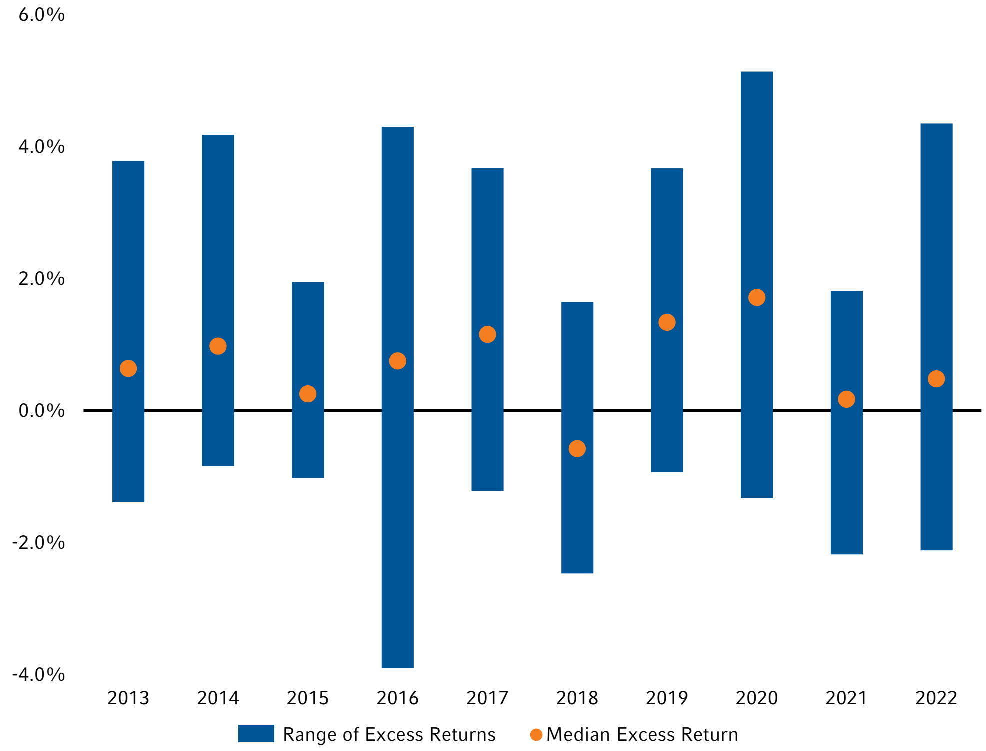
Identifying the teams and firms that add value in advance is a challenging proposition that can require substantial resource and expertise, particularly in an asset class like global bonds where managers are located across the globe.

The Russell Investments manager research process is built with the aim of identifying the winners in advance, and while we do not always get it right, our favoured managers have tended to outperform the median manager over time.

Excess Returns of Global Aggregate Bond Manager Universe



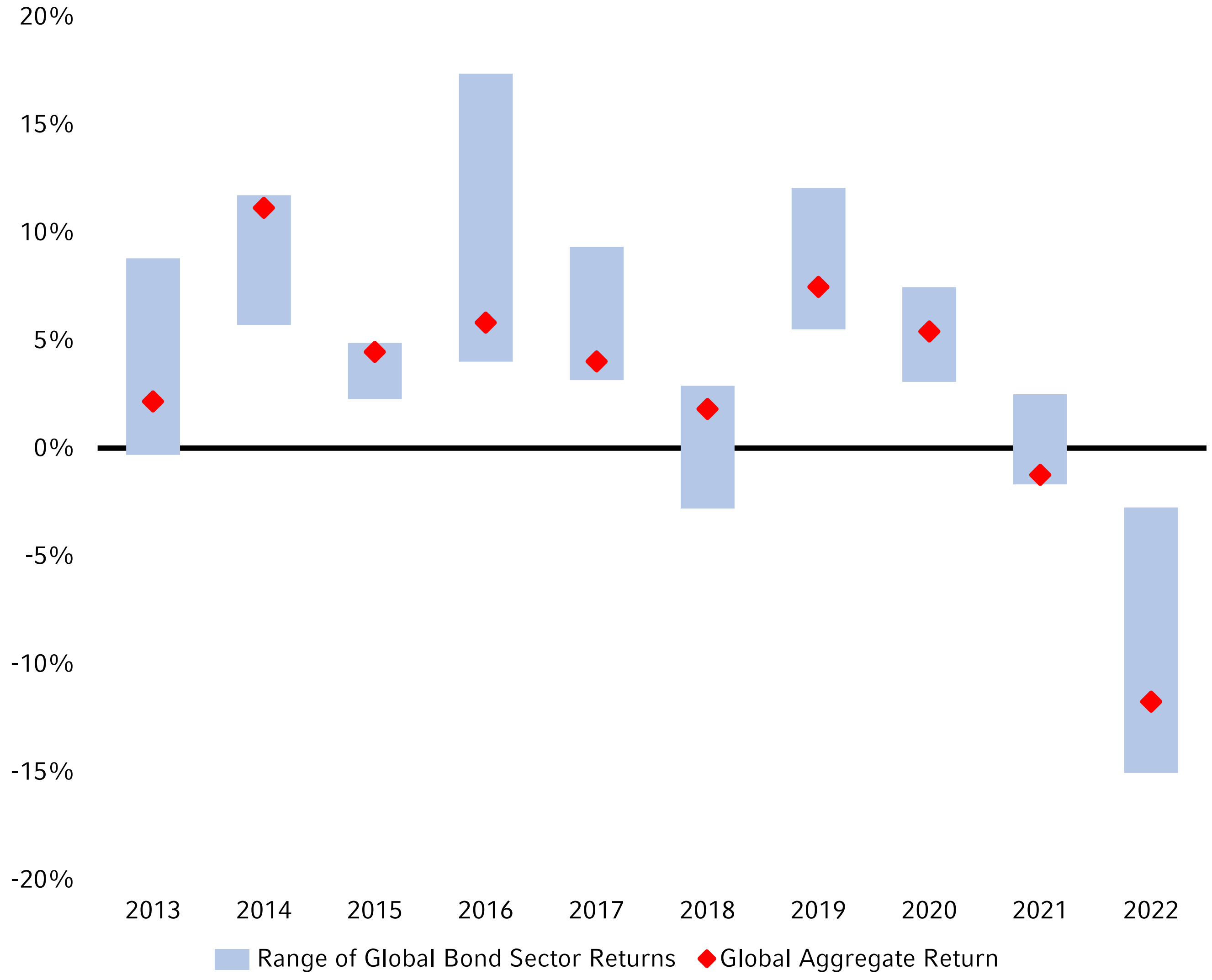
Range of Annual Excess Returns in Global Aggregate Bond Manager Universe



The above graph displays the variation that can occur in the excess returns of managers who manage to the same index. Having a portfolio manager that can make choices about when a particular manager or strategy may be in favour is essential, as is diversifying across different investment styles.

Source: Russell Investments Global Aggregate Bond Universe, comprised of 24 managers. All data analysed was unhedged and in USD. All managers analysed were benchmarked to the Bloomberg Global Aggregate TR USD Index. Russell hire ranks excess return is based on a five-year annualised excess return, measured over a ten-year period from 2013-2022. The range of annual excess returns graph includes the 21 managers with a ten-year performance history. Past performance is not a reliable indicator of future performance.

Annual Range of Global Bond Sector Returns



The Advantages of a Multi-Manager Approach

Given the weight of the global bond market in the investment opportunity set, many local investors are wary of allocating all their assets to a single global bond manager.

We can understand this position and it is one of the reasons why we adopt multi-manager investment approaches across many asset classes, including global bonds.

Through combining managers with different skill sets and complementing those with low cost, internally managed systematic strategies, we believe we can deliver superior results to investors attempting to build their own multi-manager strategy by investing in two or more global bond funds.

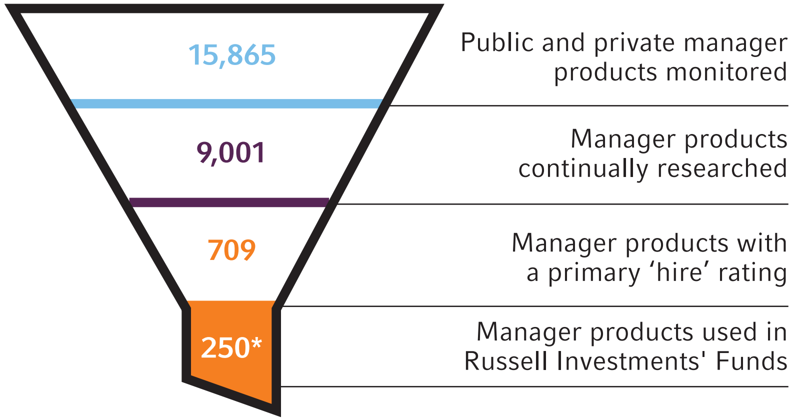
The graph to the left displays the variation in returns of the different bond sectors each year. Having one centralised manager that can lean into sectors at favourable times has the potential to add alpha to a portfolio.

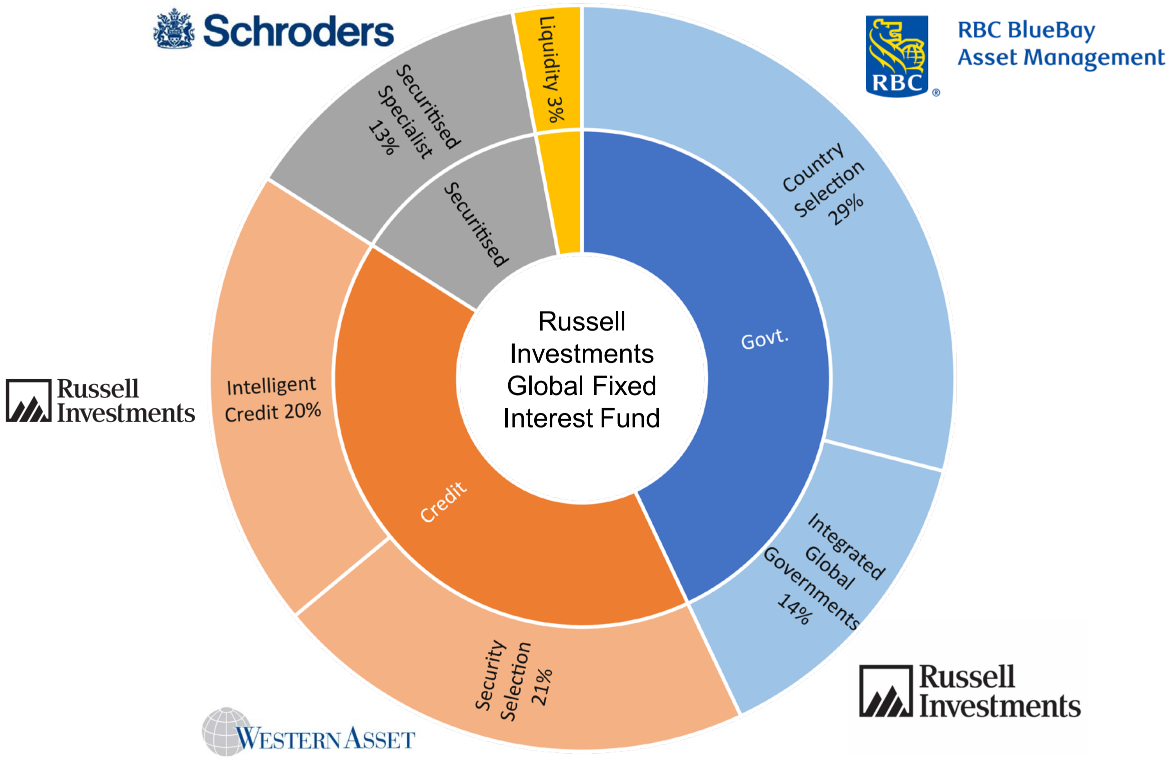
Source: Bloomberg Barclays. Index returns have been used to illustrate the range of global bond sector returns. Sectors used were Global Aggregate, EM Local Currency Government, Global High Yield, Global Aggregate subsectors: Treasuries, Securitised, Corporate, Credit. Index returns are all NZD hedged and are to 31 December each year. Past performance is not a reliable indicator of future performance.

Bringing It All Together

The Russell Investments Global Fixed Interest Fund is an active multi-manager fund, bringing together differentiated strategies from leading managers across the world, and tilting towards each as dictated by market conditions. The award-winning fund[7] incorporates insights from specialist fund managers, Schroders, Western Asset Management and BlueBay, with low-cost systematic implementation managed internally. The fund has outperformed its benchmark by 0.9%[8] per annum since its inception in December 2011.

Our global manager research team consists of 41 analysts, who conduct over 1,700 meetings a year, and monitor over 15,000 products. Only the very best strategies are included in our products.





*Products held in Russell Investments funds do not include Alternatives. Research numbers do not include closed-end private markets funds or products. [7]Winner of Morningstar Fixed Income Manager of the Year – New Zealand 2018 and 2021, finalist in 2013, 2014, 2015 and 2017. [8]Outperformance is on a gross basis and is to 30 September 2023 versus the Bloomberg Global Aggregate NZDH TR Index. Past performance is not a reliable indicator of future performance.

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