Creating a More Efficient Fixed Income Portfolio with Asia Bonds
Creating a More Efficient Fixed Income Portfolio with Asia Bonds

Drawing upon different drivers for performance, Asia fixed income can improve risk-return profiles for European 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 European investors whose fixed income portfolios are predominantly exposed to the European 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 offers 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 in Europe. As government bond yields in Europe fall and the European Central Bank embarks on a Quantitative Easing (QE) program, investors now need to consider what the potential impact may be on the European bond market. The effects of QE on fixed income markets in the U.S. and Japan highlight one potential risk—lower liquidity. Despite aiming to improve liquidity in fixed income markets, central bank activity in both these countries has seen trading volumes fall in those securities being purchased. With securities taken out of the market and remaining holders such as financial institutions choosing not to shift into riskier assets, this has had a negative effect on liquidity.

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 Euro Aggregate Bond Index (Euro 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 also recognize the need to include a more diverse range of bonds in client 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 Euro 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 Euro Aggregate over the past decade (Figure 1). Duration in the index has increased by 1 year, while the proportion of government-related bonds in the index grew by 4.6 percentage points.

Figure 1. Over the past decade, interest rate risk has increased in the Barclays Euro Aggregate Bond Index

As duration in the Euro Aggregate has increased, investors using the Euro Aggregate as a core bond holding may be subject to higher levels of interest rate risk than in the past. In addition, the European Central Bank’s QE program could further influence the diversification, duration and liquidity of Europe’s bond markets.

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 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 delivering an attractive return per unit of risk.
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 3) 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 3. A diverse set of markets provide attractive opportunities for investment

Source: Bloomberg, Data as of 12/31/2014

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–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 Index) 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.

Source: Bloomberg
Asia fixed income has historically exhibited low correlations to European and global fixed income. 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, European 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 4.

Figure 4. Asia fixed income has low correlations to European and global fixed income

<table>
<thead>
<tr>
<th>CORRELATION MATRIX (12/31/2001–12/31/2014)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset Class</td>
</tr>
<tr>
<td>Local Currency Denominated Asia Bond</td>
</tr>
<tr>
<td>USD Denominated Asia Bond</td>
</tr>
<tr>
<td>Euro Bond</td>
</tr>
<tr>
<td>Global Bond</td>
</tr>
<tr>
<td>Emerging Market Bond</td>
</tr>
<tr>
<td>Euro High Yield Bond</td>
</tr>
<tr>
<td>Asia ex Japan Equity</td>
</tr>
</tbody>
</table>

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), Euro Bond (Barclays Euro Aggregate), Global Bond (Barclays Global Aggregate), Emerging Market Bond (J.P. Morgan Emerging Markets Bond Index Global), Euro High Yield Bond (Barclays Pan-European High Yield), Asia ex Japan (MSCI All Country Asia ex Japan Index) 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.

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 5). By taking a more holistic view of higher-yielding bond sectors, investors can make more informed choices when constructing their portfolios.

Figure 5. In multi-currency bond portfolios, Asian fixed income is an attractively positioned asset class

<table>
<thead>
<tr>
<th>Total Return, Annualized (12/31/2001–12/31/2014)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Euro High Yield</td>
</tr>
<tr>
<td>9.9%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Volatility (12/31/2001–12/31/2014)</th>
</tr>
</thead>
<tbody>
<tr>
<td>JPM GBI-EM</td>
</tr>
<tr>
<td>12.2%</td>
</tr>
</tbody>
</table>

Data shown from 12/31/2001 since returns for J.P. Morgan Government Bond Index-Emerging Markets (GBI-EM), Barclays Pan-European High Yield, 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 Euro 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 6. For example, Asia ex Japan fixed income makes up only 3% of the Barclays Global Aggregate Bond Index and 21% of the J.P. Morgan Emerging Markets Bond Index Global.

Figure 6. Global bond indices and emerging market bond indices offer limited exposure to Asia fixed income

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 European, U.S. 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 European bonds or Global bonds 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.
The views and information discussed represent opinion and an assessment of market conditions at a specific point in time that are subject to change. It should not be relied upon as a recommendation to buy and sell particular securities or markets in general. Nothing in these materials is or shall be considered to be an offer of advisory or investment services to any recipient. The subject matter contained herein has been derived from several sources believed to be reliable and accurate at the time of compilation. Matthews International Capital Management, LLC does not accept any liability for losses either direct or consequential caused by the use of this information.

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.

In Singapore, this document is available to, and intended for Institutional Investors under Section 304 of the SFA, and to Relevant Persons pursuant to section 305 of the SFA, as those terms are used under the relevant law. It should not be circulated or distributed to the retail public in Singapore.

In the UK, this document is only made available to professional clients and eligible counterparties as defined by the FCA. Under no circumstances should this document be forwarded to anyone in the UK who is not a professional client or eligible counterparty as defined by the FCA. Issued in the UK by Matthews Global Investors (UK) Ltd., which is authorised and regulated by the Financial Conduct Authority, FRN 667893.

This document has not been reviewed or approved by any regulatory body. This document is made available to institutional/professional use only.

©2015 Matthews International Capital Management, LLC

For Institutional/Professional Investors Only