T. Rowe Price's International Offering Emphasizes Quality Ratings

Global Bond Funds: To Hedge or Not to Hedge?

by Danielle L. Schultz, CFP

Every day brings new headlines about European countries with severe credit problems; investors may be in for some interesting times if they invest internationally. But international bond funds that specialize in high-quality securities have the potential to diversify risk away from an all-U.S. portfolio and take advantage of currency fluctuations while providing a more stable return than stock investing.

> "Diversified international bond funds will invest primarily in developed countries."

A Chance to Put Cash in Other Currencies

International bond funds are mutual funds or exchange-traded funds that invest in bonds from non-U.S sources: governments and some corporations. Generally, diversified international bond funds will invest primarily in developed countries, but they may include a smattering of bonds of emerging nations as well. International bond funds offer you the opportunity to diversify away from the U.S. dollar and add a type of investment that's difficult to purchase or evaluate as an individual bond purchase.

An important decision when selecting international bond funds is choosing whether your fund will be hedged or unhedged. If the fund is hedged, that means the manager has taken steps to help ensure against currency fluctuations between, for example, the yen or euro and the U.S. dollar. In a hedged fund, the fluctuations in value will come only from the bonds and the fund should behave more like a typical bond fund — slow and steady.

On the other hand, a fund that's unhedged will allow maximum benefit and maximum risk from currency fluctuations. If you're choosing this type of investment to diversify your portfolio and are seeking investments that move independently of each other, you may want to choose an unhedged fund such as T. Rowe Price International Bond (ticker: RPIBX). (*No investment recommendations are intended. This fund is presented for educational purposes only.)*

The Manager Behind the Curtain

Although international bond funds can be compared with a benchmark index (Morningstar uses the Barclays Capital Aggregate Bond Index in its charting), this is more useful for looking at the fund relative to other bonds — including broad U.S. bonds. No international bond fund is a true passively managed index fund: All of them have a heavy component of manager judgment in selecting investments. So in choosing bond funds in this category, it's worthwhile to look at exactly what their composition is. Some keep a significant portion of their assets in cash. But if you're opting for a bond fund in order to purchase bonds, it only makes sense to go for one that's invested in international bonds as much as possible.

The investment objective of the T. Rowe Price International Bond Fund is to "provide high current income and capital appreciation by investing primarily in high-quality, nondollar-denominated bonds outside the U.S." The fund's mandate is to invest at least 80 percent of its assets in bonds, with at least 65 percent of those assets in bonds that are rated A- or better — in other words, the three highest credit grades.

Up to 20 percent of the bond fund's assets may be invested in junk bonds, which are often used by bond managers to improve returns but come with added risk. Currently, the fund has 81.4 percent of investments in the top three credit categories. This provides something of a safe haven against the roiling of international credit, although you do give up some return with that emphasis on quality.

T. Rowe Price International Bond's Assets
% of total net assets as of Dec. 31, 2011

Rating	Percent
AAA	38.6%
AA	28.4
A	14.4
BBB	11.5
BB	3.0
B	2.1
CCC	0.1
Not rated	0.3
Reserves	1.6

Numbers may not total 100% due to rounding.
Source: T. Rowe Price website

A Preference for Europe and Asia

RPIBX has been managed since 2000 by a team led by Ian Kelson. Kelson generally keeps duration close to the intermediate range of 6.2 years. Although the fund invests primarily in government bonds of developed countries in

T. Rowe Price International Bond's Portfolio Allocation by Nation	
Japan	27.07%
Germany	17.80
United Kingdom	9.13
Netherlands	5.82
Canada	4.34
France	3.79
United States	3.74
Italy	3.61
Mexico	3.54
Malaysia	2.11
Source: Morningstar	

Europe and Asia, it has about 31 percent of assets in corporate bonds and a smattering of investments in emerging nations — for example, 3.3 percent of assets is invested in Mexico. Because of the emphasis on quality ratings, the fund has no exposure in Ireland and Portugal and has reduced investments in Italy and Spain.

Performance

Although the fund is more volatile than the Aggregate Bond Index (beta of 1.29), it corresponds quite closely to the SB World Government Bond Index (beta of 1.09). In 10 of the last 12 years, the fund has outperformed the general bond index benchmark. (*The SB World index has been recently renamed the Citigroup World Government Bond Index.*)

T. Rowe Price International Bond's Performance Figures for quarter ending March 31	
1-year return	2.73%
3-year return	8.03%
5-year return	5.69%
10-year return	8.04%
Quarterly since inception	6.86%
Inception date: Sept. 10, 1986	
Source: T. Rowe Price website	

According to Morningstar, the fund has had a 7.7 percent annual gain for the 10 years ending April 11, compared with 6.9 percent for its peer group. But like all international investing, this fund has a higher risk than a typical U.S. bond fund. If you select this fund to add to your portfolio, you are most likely to benefit based on fluctuations in currency — profiting when the dollar is weak — and on the strength of management selection in diversifying across countries whose economies don't move in lockstep with the United States.

Costs

This is a no-load mutual fund with total fund operating expenses of 0.82 percent, higher than what would be expected from a U.S. index fund but moderate for an international fund. At a share price of $9.77 (April 9), the fund yields 2.6 percent.

As of Dec. 31, 2001, $10,000 invested in the fund would have grown to $20,852 by Dec. 31, 2011. The minimum purchase in the fund is $2,500 ($1,000 for IRAs), and there's a 2 percent redemption fee if investments are held less than 90 days.

Caveats

International bond funds are subject to all the risks of general bond funds: interest rate fluctuations, quality downgrades and the chance that bonds will lag the performance of the stock market. In addition, international bond funds are subject to risks of specific countries' credit problems, political risks of default, currency fluctuations (the stronger the U.S. dollar, the worse non-U.S. markets will perform), and sometimes accounting vagaries, especially in emerging markets.

Because this is a market with no ready exchange (such as the New York Stock Exchange), it requires a great deal of analysis of political and economic conditions around the world, as well as individual issues. Therefore, the success of a fund is usually dependent on the judgment calls of its managers.

But because international bonds can help diversify a portfolio away from exclusive dependence on U.S. markets, funds such as the T. Rowe Price International Bond Fund may be worth considering as part of your asset allocation.

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