BONDS

CASHING IN ON FOREIGN DEBT

By Ben Levisohn and Tara Kalwarski

safe U.S. Treasuries fell nearly 3%. Investors have taken notice: Since Apr. 15, $5 billion has flowed into international bond funds, which include in their portfolios sovereign debt from a wide range of foreign governments. Is it time to jump on the bandwagon?

Not necessarily. Many of the concerns that plague U.S. Treasuries, from fast-growing debt to inflation fears, lurk abroad. To fight the global recession, countries have been selling record amounts of bonds. Britain is expected to issue bonds worth 225 billion pounds this year, 75% more than it issued in 2008. Meanwhile, the ratio of debt to gross domestic product tops 100% in Greece and is headed in that direction in Italy and Ireland as their debt increases and economies contract. Volatile currency markets have made managing debt loads increasingly difficult for such countries as Ukraine, Hungary, and Latvia, which have bonds denominated in dollars and euros as well as in home currencies.

As a result of such conditions, Standard & Poor's (which, like *Business Week*, is a unit of The McGraw-Hill Companies) has so far downgraded the credit ratings of 16 countries this year, vs. 5 in 2007 and 18 for all of 2008. "The potential for default is very real in some countries," says Chris Diaz, manager of the ING Global Bond Fund.

Investors may already have foreign sovereign debt in their portfolio. Among all bond funds, 42% have a position in such debt, according to mutual fund tracker Morningstar. You'd expect that in funds like the Templeton Global Bond Fund and the TCW Total Return Bond Fund. But foreign government debt also pops up in unlikely places. Peek inside the Goldman Sachs Equity Growth Strategy Fund, and there's a small allocation to foreign government debt.

Why is it there ? In some cases, the debt of foreign governments is a safe place to park cash—a lot of equity funds do just that. But developed world debt has other advantages. While U.S. rates are about as low as they can go, the Euro-

AAA
Can withstand Great Depression-like conditions—25% decline in GDP, 25% unemployment, and an 85% drop in the stock market—and still make good on its debt.

BBB- to AA+
Can withstand substantial stress—a 6% GDP decline, 15% unemployment, and 60% drop in the stock market—and still make good on its debt.

BB- to BB+
Can withstand moderate stress—a 1% drop in GDP, 8% unemployment, and a 50% drop in the stock market—and still make good on its debt.

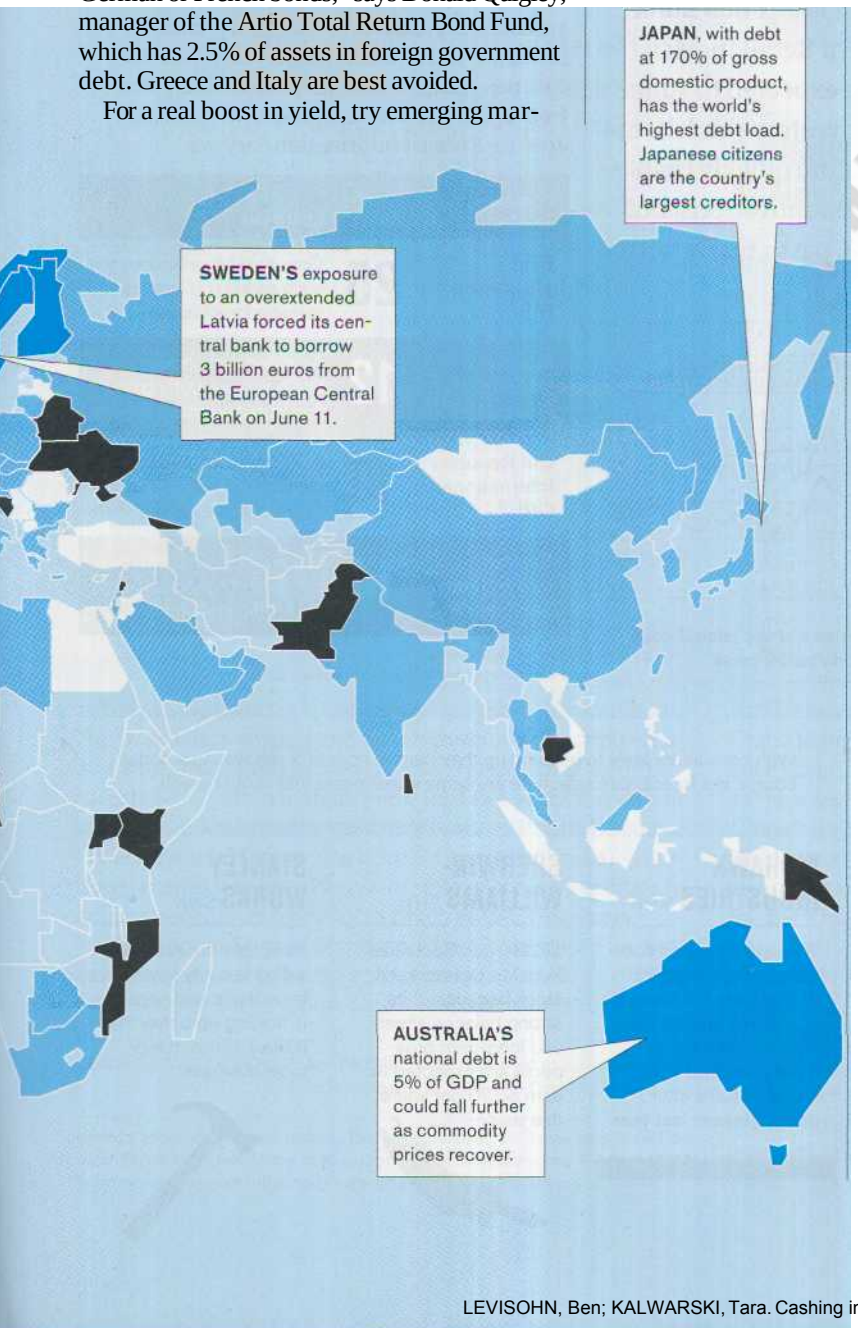
B+ and below
Little room for error.

Data: Standard & Poor's

pean Central Bank still has room to bring short-term rates down, which would boost the price of its government-backed debt. (A bond's yield has an inverse relationship to its price.) In Europe, the focus is still on the threat of deflation—a period of falling prices in goods and services that can have a nasty spiral effect—not on when inflation will return.

Still, investors need to be selective, as not all euro zone countries are created equal. France and Germany, for instance, have their own financial crises to deal with, but low debt levels and top credit ratings make their bonds attractive. "You get a little more yield if you go to German or French bonds," says Donald Quigley, manager of the Artio Total Return Bond Fund, which has 2.5% of assets in foreign government debt. Greece and Italy are best avoided.

For a real boost in yield, try emerging markets. Investors with memories of the 1997 Asian bank crisis and the resulting ripple of developing world defaults might see this as a risky bet. And a look at Latvia and Ukraine makes it clear that not every emerging-market country has managed to outrun the past. Such countries as these depend on outside capital to keep their economies moving. Now foreign capital has fled, and those economies are suffering.



CREDIBLE CENTRAL BANKS

But this isn't 1997. Now, countries like Brazil and Russia have stockpiles of cash and, as important, credible central banks. These changes are reflected in their ratings, which, while still well below those of the U.S. and other developed countries, are investment grade. The bonds have hefty yields—more than 10% for Brazilian and Russian bonds. "They are riskier [than developed world bonds], but you get an extra 8% for taking the risk," says David Morton, a fixed-income manager at Rocaton Investment Advisors in Norwalk, Conn. The PowerShares Emerging Markets Sovereign Debt exchange-traded fund, up nearly 20% this year, is a way to get diversified emerging-market bond exposure.

Just because a foreign government is able to pay its debts, though, doesn't mean it will. Last December, Ecuador chose to default and restructure its debt; bondholders got 35$ on the dollar. It's best to steer clear of serial defaulters such as Argentina (it defaulted in 1982,1989, and 2001), says Robert Smith, managing director of Turan, an investment boutique in Boston. Smith says he is "flabbergasted" by the recent 50% price gain in Argentina's bonds.

A big wild card in sovereign debt investing is currency exposure. The coupons on bonds are often paid in local currencies, and U.S. investors must decide if they want a currency play. When choosing a fund, investors should pay attention to whether a fund takes on currency risk, which increases volatility, or tries to remove it.

Some firms offer two versions of the same fund—one with currency exposure, one without. The difference in performance can be large. In 2008 the hedged version of the Pimco Foreign Bond Fund lost 2.8%, nearly two percentage points worse than the unhedged version. But in 2007, taking currency risk would have nearly tripled returns. Ultimately, it comes down to an investor's view of the dollar. Says Pimco's global product manager, David Fisher: "If you think the dollar is going to depreciate, it makes sense to have exposure to other currencies." BW

LEVISOHN, Ben; KALWARSKI, Tara. Cashing in on foreign debt. **BusinessWeek,** São Paulo, p. 56-57, 29 jun. 2009.