

Bonds Without Borders

May 11, 2016

Contributors: David Eichhorn, CFA



It may pay to be a little more cosmopolitan when it comes to your bond portfolio. Yield differences between comparable maturity instruments in different countries can offer opportunities to enhance returns, particularly for longer-term investors. By buying foreign bonds and using currency forwards to lock in future exchange rates, investors may be able to realize gains over what they could otherwise get by investing domestically.*

Consider a Canadian investor planning to buy a zero-coupon Canadian federal security. Instead of just purchasing that bond, say instead he (i) exchanges [Canadian dollars](#) into US dollars, (ii) buys a comparable maturity zero-coupon US Treasury bond, and (iii) enters a forward contract to exchange US dollars back into Canadian dollars on the bond maturity date. If he holds the bond until maturity and there is no counterparty (or issuer) default, he knows what amount he will earn, all-in, in Canadian dollars. If the yield on this “synthetic” Canadian bond is greater than what the Canadian bond would offer, he’s found a way to increase his return.

The table below gives a look at the additional yield available to an investor open to investing in such a way. To be sure, the exact type of bond and relative pricing between specific bonds may result in different realized spreads.

Source: Bloomberg. As of 3/31/2016. USD depreciation is based on expected inflation differences relative to CAD as indicated by the forward currency markets. Displayed CAD Zero yields are

based on a fitted federal yield curve.

In this example, the yield opportunity has looked persistent through time as well, particularly for 10-year STRIPS.

Source: Bloomberg.

Importantly, it is by holding the investment to maturity that the at-inception spread is earned; prior to maturity, if the spread tightens (widens) the investor may see an unrealized marked-to-market gain (loss).

These border-hopping trades can be utilized not only for government bonds but also for corporate securities. A Canadian investor wanting to gain access to a deeper market while maintaining interest rate exposure in Canadian dollars could combine currency forwards and US corporate bonds. We think this strategy could be particularly relevant for larger Canadian pension plans who are unable to obtain sufficient (or sufficiently desirable) exposure to Canadian corporate bonds. Naturally, this variation results in a different credit basis in the portfolio, but the yield and diversification benefits may justify the tradeoff.

**One important caveat: the difference in yield between foreign and domestic securities needs to be denominated in the domestic currency. We discussed this point in our white paper ["Spreading Confusion,"](#) but the main takeaway is that yield comparisons have to be apples-to-apples. Too often the press reports the nominal yield differences between countries without removing inflation expectations.*

Disclosure Information

By accepting this material, you acknowledge, understand and accept the following:

This material has been prepared by NISA Investment Advisors, LLC ("NISA"). This material is subject to change without notice. This document is for information and illustrative purposes only. It is not, and should not be regarded as "investment advice" or as a "recommendation" regarding a course of action, including without limitation as those terms are used in any applicable law or regulation. This information is provided with the understanding that with respect to the material provided herein (i) NISA is not acting in a fiduciary or advisory capacity under any contract with you, or any applicable law or regulation, (ii) that you will make your own independent decision with respect to any course of action in connection herewith, as to whether such course of action is appropriate or proper based on your own judgment and your specific circumstances and objectives, (iii) that you are capable of understanding and assessing the merits of a course of action and evaluating investment risks independently, and (iv) to the extent you are acting with respect to an ERISA plan, you are deemed to represent to NISA that you qualify and shall be treated as an independent fiduciary for purposes of applicable regulation. NISA does not purport to and does not, in any fashion, provide tax, accounting, actuarial, recordkeeping, legal, broker/dealer or any related services. You should consult your advisors with respect to these areas and the material presented herein. You may not rely on the material contained herein. NISA shall not have any liability for any damages of any kind whatsoever relating to this material. No part of this document may be reproduced in any manner, in whole or in part, without the written permission of NISA except for your internal use. This material is being provided to you at no cost and any fees paid by you to NISA are solely for the provision of investment management services pursuant to a written agreement. All of the foregoing statements apply regardless of (i) whether you now currently or may in the future become a client of NISA and (ii) the terms contained in any applicable investment management agreement or similar contract between you and NISA.