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Frank joined Wespath in March 2012. As the managing director of Investment Management, Frank provides strategic investment support and risk management for Wespath and its subsidiaries' investment programs, as well as administrative and operational oversight. He leads a team of investment professionals responsible for sourcing, monitoring and reporting on all fixed income, equity and alternative investments, as well as the internally managed Positive Social Purpose Lending Program. Prior to this role, Frank was the director of Public Equities and Fixed Income at Wespath, where he oversaw the strategic direction and staff of the equities and fixed income investment programs.



## Global Bonds—Expanding Opportunities Benefitting from a Diversified Approach to Fixed Income Investing

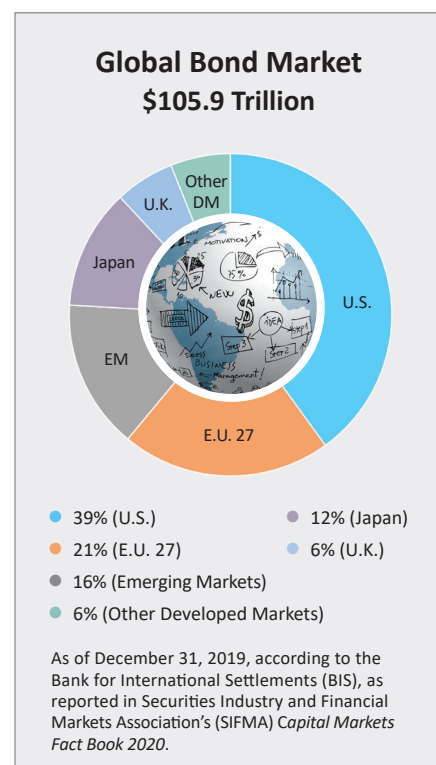
Acting on behalf of a combined \$24 billion in assets belonging to retirement participants and institutional investors, Wespath Benefits and Investments (Wespath) and Wespath Institutional Investments (WII) offer a wide range of investment funds designed to meet a variety of financial needs.

The funds we offer are composed of an array of investment instruments—from commonly held assets like publicly traded company stocks to more nuanced investments such as loans for affordable housing. These funds also hold a number of traditional fixed income investments.

Fixed income assets are debt agreements; one party borrows money from an investor, who receives a return on their investment through regular interest payments and, eventually, a return of the principal, or original loaned amount.

The most common form of fixed income asset is a bond. Borrowers, or bond issuers, can be national governments, local governments or corporations. When these entities need cash to fund a project, make improvements, or simply fill the gap between tax revenue and expenses, they might sell bonds to investors.

Investing in bonds benefits our funds in several ways. Namely, bonds are typically considered relatively low risk when the borrower is in sound financial health. But more importantly, bond investments provide a key source of diversification for our returns as well as a steady stream of income in the form of interest payments.



# Global Bonds—Expanding Opportunities (continued)

Wespath believes in the importance of diversification and incorporates this belief within our entire investment program. Investing in different fixed income instruments is one way we act on this belief, but we also apply this perspective within our fixed income investment program by investing in bonds from around the world.

The \$100+ trillion global bond market<sup>1</sup> offers investment opportunities that go well beyond debt issued by U.S.-based borrowers, which represent only 40% of said market.

We view global bond exposure as an important element of our diversified approach, which adds value for our stakeholders. By constructing well-balanced fixed income portfolios that include international debt and control for certain uncertainties, our funds can provide investors with a better risk-reward profile compared to a U.S.-only strategy.

## Diversification Can Reduce Risk

The key to successfully diversifying a bond portfolio is combining bonds that are not highly correlated.

Bonds that are uncorrelated perform differently under various market conditions and will likely react differently to new information. In other words, if the prices of two bonds move in an unrelated fashion after a market moving event, these two bonds are more likely to be uncorrelated.

Diversification through investment in uncorrelated bonds can help reduce a portfolio’s overall risk.

For the purpose of this paper, we define risk as volatility, or standard deviation of return. Standard deviation is a measure of volatility that indicates how significantly a variable—in this case, the returns of a bond or group of bonds—deviates from its average. Portfolio diversification reduces the volatility of returns, making the portfolio less likely to lose a large amount of value in a specified period.

Before presenting the diversification benefit of global exposure, let’s first analyze the impact of diversification using a U.S.-only example.

**Chart 1** compares the risk and return since January 1990<sup>2</sup> for two popular U.S. bond indices: the Bloomberg Barclays U.S. Treasury Index, a relatively narrow index that only tracks debt issued by the U.S. federal government, and the broader Bloomberg Barclays U.S. Aggregate Index, which tracks investment-grade treasury, government-related, corporate and securitized bonds.

The vertical axis in **Chart 1** measures annualized return and the horizontal axis measures annualized standard deviation of return (risk). Note that the standard deviation clearly decreased by expanding the investment universe.

**Table 1** adds another key metric to our analysis: the Sharpe Ratio. Nobel laureate William F. Sharpe designed the Sharpe Ratio to measure the excess return over the risk-free rate (e.g., short-term Treasury securities) per unit of risk. A higher Sharpe Ratio is indicative of an investment that is earning a higher return per unit of risk taken to generate that return.

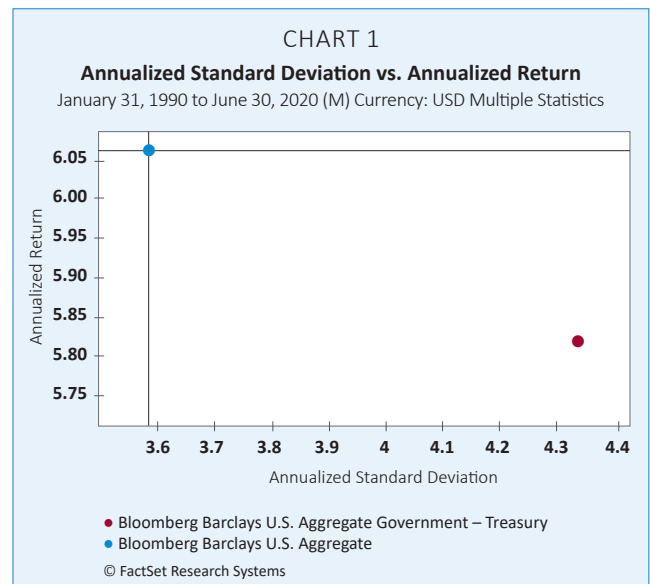


TABLE 1

Description	Annualized Return	Annualized Standard Deviation	Sharpe Ratio
Bloomberg Barclays U.S. Aggregate Government — Treasury	5.82	4.35	0.70
Bloomberg Barclays U.S. Aggregate	6.08	3.57	0.93

Just as we observed a more favorable picture of standard deviation in the broader bond universe, we also see that the Sharpe Ratio of this index is higher than that of its narrower counterpart.

<sup>1</sup> As of December 31, 2018, according to the Bank for International Settlements (BIS), as reported in Securities Industry and Financial Markets Association’s (SIFMA) Capital Markets Fact Book 2019.

<sup>2</sup> This time period represents the longest performance period common to all indices presented in this paper.

# Global Bonds—Expanding Opportunities (continued)



## Go Global

Extending this simplified example to a global bond portfolio, it follows that the additional diversification opportunities of the larger global opportunity set could deliver an even more attractive combination of return and risk.

Below, we will add a global bond index to our analysis: the flagship Bloomberg Barclays Global Aggregate Index, which includes the U.S. Aggregate Index plus the investment grade debt from twenty-four local markets around the world<sup>3</sup>.

Of course, these global markets operate in different currencies than does the U.S. market. So before we present the global analysis, let's briefly discuss currency exposure.

## Foreign Currency Exposure

For bond investors participating in non-U.S. markets, there can be additional complexity introduced by exposure to non-U.S. currencies. Some global bonds are denominated in the local currency of the issuer, and those securities provide interest payments and principal repayment in the local currency. For a U.S.-based bondholder, the future conversion of local currency to U.S. dollars introduces uncertainty because exchange rates can fluctuate due to differences in inflation, interest rates, trade and other shifting macroeconomic trends.

The complexity introduced by foreign currencies may discourage investors from investing globally, but investors can effectively eliminate this uncertainty through a process called “hedging.”

### An Example of How Hedging Works

A U.S. investor would like to buy bonds issued by the Mexican government. Let's assume the bonds are issued in Mexican pesos. The investor will have to exchange U.S. dollars for Mexican pesos in order to purchase the bonds. The bonds' future cash flows to the investor will include periodic interest payments and a one-time principal repayment made in pesos that the investor will need to exchange back to U.S. dollars. The exchange rate when the investor converts the pesos back to U.S. dollars will likely be different than it was at the time of purchase, impacting the overall return of the investment in U.S. dollar terms.

In order to avoid the uncertainty of fluctuations in the exchange rate, an investor can “hedge” the currency exposure, meaning that, at the original time of purchasing the bond, the investor enters into an agreement to exchange Mexican pesos for U.S. dollars at a predetermined exchange rate on future date. This largely eliminates the uncertainty of currency fluctuations.

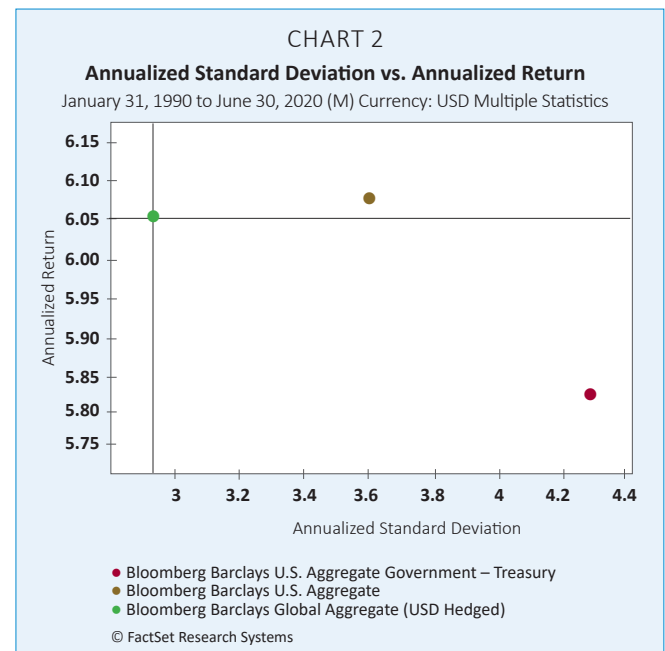


TABLE 2

Description	Annualized Return	Annualized Standard Deviation	Sharpe Ratio
Bloomberg Barclays U.S. Aggregate Government — Treasury	5.82	4.35	0.70
Bloomberg Barclays U.S. Aggregate	6.08	3.57	0.93
Bloomberg Barclays Global Aggregate (USD Hedged)	6.05	2.97	1.11

<sup>3</sup> Bloomberg Barclays Global Aggregate Index Factsheet, March 9, 2017

# Global Bonds—Expanding Opportunities (continued)

For the purpose of illustration in this paper, we present results with all foreign currency exposure hedged back to U.S. dollars

In **Chart 2** and **Table 2**, we expand our analysis beyond the \$22 trillion U.S. Aggregate Index and also plot the \$55 trillion Global Aggregate Index (U.S. dollar hedged)<sup>4</sup>. These exhibits illustrate that the Bloomberg Barclays Global Aggregate Index (U.S. dollar hedged) has exhibited lower volatility than the narrower U.S. Aggregate Index since January 1990, which is the earliest date for which Global Aggregate data is available.

**Table 2** once again shows that the larger, more diversified bond universe also provides better risk-adjusted returns. In fact, the Sharpe Ratio for the Bloomberg Barclays Global Aggregate Index (U.S. dollar hedged) is more than 19% higher than that of the Bloomberg Barclays U.S. Aggregate Index.



## The Bigger Picture

This is a simplified illustration of the potential for global diversification, but even using basic data, we can already see that diversification is an effective method for increasing return and decreasing risk in a fixed income portfolio.

Our belief in the benefits of diversification is multi-faceted, and the belief extends beyond our fixed income program through investments in different asset classes, including public stocks and alternative investments such as private equity.

Regardless of the asset class or strategy, we invest with a focus on the long-term and the needs of our stakeholders. It is our fiduciary responsibility to act on the opportunities and risks of the entire global investable landscape, and as that continues to evolve, so too will our investment program.

<sup>4</sup> Bloomberg Barclays Global Family of Indices, June 2019

### About WBI

Wespath Benefits and Investments (Wespath) is a not-for-profit agency that has been serving The United Methodist Church (UMC) for over a century. In accordance with its fiduciary duties, Wespath administers benefit plans and, together with its subsidiaries, including Wespath Institutional Investments, invests over \$24 billion in assets on behalf of over 100,000 participants and over 130 United Methodist-affiliated institutions (as of June 30, 2020). Wespath funds invest in a sustainable manner that supports long-term value creation while having a positive impact on the environment and society and upholding the values of the UMC. Wespath maintains the largest reporting faith-based pension fund in the world.



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### About WII

Wespath Institutional Investments (WII) is a not-for-profit subsidiary of Wespath Benefits and Investments (Wespath), a general agency of The United Methodist Church (UMC). WII provides investment solutions for institutional investors related to the UMC, including foundations, children's homes, older adult facilities, higher education institutions and healthcare organizations. WII offers diversified global exposure to its world-class investment managers through a family of daily priced funds. WII's investment process proactively incorporates the consideration of environmental, social and governance (ESG) factors into investments across asset classes and in the selection of external asset managers.

