Fund uses a bottom-up approach in searching for high yields and values, while maintaining reasonably good quality credits.

International Fixed-Income Investing: A Worldwide Search for High Yields

An interview with E. John deBeer, portfolio manager, Loomis Sayles Global Bond Fund

Global bond funds have swung in and out of investor favor as yields have soared and then markets have crashed. Most recently, the performance of emerging market bond funds have caught the attention of investors, with equity-like annual returns. Those returns, though, come on the heels of significant losses in 1994. Seeking higher yields overseas is not without additional risk.

Nonetheless, many investors are in search of higher yields, whether they can be found in the U.S. or abroad. One international bond fund that has done particularly well in recent years is the Loomis Sayles Global Bond Fund. True to its name, the fund invests globally, including the U.S. within its purview. In 1995, the fund held the number two spot for performance among foreign bond funds, with a 23.9% return, compared to 14.6% for the average. Through September 30, the fund was among the top 25% in its category over the last year (up 18.4% compared to 11.7% for the average), the last three years (up 8.3% compared to 4.9% for the average) and the last five years (up 9.7% compared with 7.2% for the average).

Currently, the fund has about $23 million in total assets.

In early October, Portfolio Manager E. John deBeer discussed the management of the fund with Maria Crawford Scott.

What is the investment objective of the global bond fund?

We start with the presumption that all of our investors are U.S.-based, so they look to us to invest in foreign countries to increase their bond returns above what they think they can get in the U.S. When we invest in other countries, we're always making the investment judgment that the foreign bond will do better than what we can find in the U.S.

We use a bottom-up approach, so that we are making decisions on a bond-by-bond or country-by-country basis against the U.S. We do not use the approach taken by many traditional global bond managers, which is to take the index and overweight or underweight a given country.

Basically, we keep our eye on the overall characteristics of the portfolio, and the one thing we really stress is yield, which we want to keep above the U.S. market. Yield works all the time, and that's why we like to have higher yield than the market. However, we also keep a reasonably good quality profile in the portfolio, generally averaging around single A.

The fund also invests in U.S. bonds?

Yes, it's a true global fund. But we don't always invest in the U.S.—our commitment has been as low as zero and it's been as high as 50%.

How does your bottom-up approach work?

Our group here follows 32 countries on a routine, ongoing basis. And the person responsible for each country is charged with producing an interest rate forecast, a forecast of whether the credit is stable to improving or declining, and a currency forecast. When you combine those three forecasts, you are almost automatically predicting a rate of return for that given country. Having said that, making forecasts is a humbling process—one thing you know about a forecast is that it's going to be wrong. The question is: By how much and in what direction? But since we apply the same principles consistently to each of the countries, it lets us rank the investments as to which might be the best and which might be the worst, and that's how we really do our bottom-up approach.

What kind of things do you look for in a country?

We look for a number of things—for instance, a high real interest rate is normally a good sign, as is a country that appears to have changed to a more favorable political climate. By that, I mean that it has gone from being one that was very much job-growth-oriented with a big deficit and a fairly high inflation rate to a country that recognizes that's not a productive way to prosper and has adopted a policy of lower inflation rates and smaller budget deficits, which actually causes job growth on its own. To get a political change like that can take several years, and it can also take an additional time period once the political changes occur to let the financial markets believe it.

Loomis Sayles Global Bond Fund is part of the Loomis Salyes family of funds, 1 Financial Center, Boston, Mass. 02111, (800) 633-3330.

What kind of a trade-off is there between a high real interest rate and credit stability?

That's a good question. A high real interest rate suggests that the markets are skeptical and there's something unstable about the country. The point is well-taken. But if you find a high real interest rate and then do your homework on the political side, you may see evidence of stability, and decide that, while the market believes there's a serious problem, your own judgment is that this in fact is an opportunity. In other words, we are looking for value—high yields due to misjudgements.

How do you determine the percentage allocation to each country?

As a general rule, we feel that to have less than a 5% commitment to any place over a long period of time is an exercise in futility—you have to have at least 5% to make it meaningful. And then to go over 10%, you would have to have either a very large country with a big bond market, like Germany or Japan, or someplace with an unusually good situation where you feel comfortable going higher than 10%. Occasionally, in a smaller country, we will go as high as 11% or 12%, but most of the time, it's between 5% and 10%, if we have any commitment at all.

Do you see a distinction between the bonds of emerging countries and those of the more developed countries?

Yes, although at the end of the day, we agree with the ratings services that a BBB bond is a BBB bond, whether it's Poland or a U.S. corporation with a BBB rating. One of the things we are doing is trying to anticipate the ratings services, finding instances where the country is rated too low, which is a buying opportunity for us, or if we see some changes that we don't like and the rating services haven't noticed, then we might sell for credit reasons. That principle becomes exaggerated when you're looking at emerging markets. They're more volatile—the markets are more volatile and the political climate is more volatile.

Recently the foreign bond funds that have done particularly well have been the emerging market bond funds. Your fund seems to hold a mixture of emerging markets and more developed countries.

That's right, although now it is a 16% commitment to emerging markets, and a larger commitment of about 27% to the European countries. Starting in about September, we felt that some of the enthusiasm for the emerging markets had driven the markets to the point of proper valuation, so they were yielding no more than a similarly rated U.S. corporation. We didn't view them necessarily as very risky, we merely felt that it did not make sense to have a heavy concentration in an area where we don't see many bargains. So we sold some of our holdings, primarily Mexican bonds.

How do you judge the merits of a foreign bond relative to those of a U.S. bond? For instance, what prompted you to sell the Mexican bonds?

Within our portfolio we have a modest position in a U.S. corporate bond, Tele-Communications, rated BB, and selling at about 220 basis points over Treasuries. The Mexican bonds were selling at a spread (their yield compared to Treasuries) of very close to that amount, and they also were rated BB. Our judgment was that Mexico had done very well for itself, but the markets recognized that and were very enthusiastic. On the other hand, cable companies are out of favor with the markets, but our analysts think that long-term, they're very attractive. So, right now our judgment is that the yields are about the same, the ratings are about the same, but we think we may eventually see an improving credit trend in Telecommunications, which would lead to an increase in the value of those bonds, whereas we don't see those prospects in Mexico. I should add, there was no currency involved in that decision.

How much currency hedging do you do?

We have a pretty conservative overall policy. To go back to what I said in the beginning, we think it's fairly important to remember that our investors are measuring their returns in U.S. dollars. We will only hedge from an existing position in the foreign portfolio back into U.S. dollars—we don't use any kind of derivatives.

Of course, as we go about choosing which countries that we think are the most attractive, a final step is to apply an overall judgment as to whether the dollar is going to effectively go up or down against the currency. In other words, we're perfectly willing to accept currency risk in a country if we think the currency is very attractive, but we're also quite comfortable hedging the risk away and just going for the bond value underneath.

There also appear to be several convertible bonds among your holdings.

Yes, we like to use "busted" convertibles if we can find them. That's a case where the stock in a company has been driven down so low that it looks to the marketplace as though it will be many years before it will ever recover; in that instance, the company's convertible will trade like a straight bond. But if it's a good enough company, usually in a few years the stock will recover and with the convertible, you get a good, solid, conventional bond yield while you're waiting for the stock to recover. Our only exposure to Japan right now is in two of those busted convertibles—we have some in Mitsubishi Bank and some in Sumitomo Bank.

Most of our holdings, though, are in government bonds.

What is the average maturity of the bonds you hold?

We do tend to have somewhat longer maturities in our portfolio, which comes about as a result of the philosophy that if we find a country we like, or a bond we like, we want to purchase it and lock in that value. And it frequently ends up being that we will buy a longer maturity in a country just because we like the country. So, while the average portfolio maturity has been shorter than the market in the past, most of the time it's been longer.

Last year, you were the second highest performing global bond fund. To what do you attribute that?

Last year, it was a combination of two things. One was a recovery from 1994, which was a poor year. We are value investors, and it's not a lot of fun riding in a rough period. But if you think the value was there when you bought the bonds, you just grit your teeth and hang on, which is what we did in 1994. So part of the good returns in 1995 was the recovery, especially in our European holdings. And also in the beginning of '95, we did take some positions in the emerging markets, including Argentina, Mexico, and Brazil.

What is your long-term outlook for the global bond market?

I'm not sure what anybody means by long-term these days. As long as the inflation rates behave themselves, we think the bond markets around the world are reasonably attractive. There have been several times since, say, 1979, that real yields have been much higher in bonds, and they were excellent values. That's unfortunately not the case today. But they're okay, and better than average.

And some countries will do better than others. We think that the two trends that will be the most important, not so much for 1997, but for 1998 and beyond, are: Europe combining into a single currency unit, and the increasing convergence of Asian countries, not only as a manufacturing and exporting power, but as a financial power. Asian countries have more external reserves combined now than Europe, and much more than we do in North America. So the raw financial power, the money that's being piled up in Asia is going to be increasingly important.

How does a global bond portfolio fit into an individual investor's portfolio?

I think individual investors should take the long view, meaning that there will be countries that will come in and out of favor, just as there are stocks that come in and out of favor in the stock market, and they should be seeking the markets where they can get the best yields. The world's economies are becoming increasingly interlocked not just because we all have TV sets, but because trade is becoming a more important portion of every country's economy, and investors need to recognize that in any asset strategy. If they start strictly with U.S. equities, or fixed-income, they'd be taking a very narrow view of what's really going on in the world.

On the other hand, we used to be able to say that because of the differences in economic cycles around the world, global bonds could provide pretty good diversification. But for various reasons, recently most of the bond markets of the world go up and down just about the same as the U.S. So, while a global bond fund in theory should provide diversification to an investor's U.S. bond portfolio, in the last couple of years, it has not.