Why invest in international bonds?

Hi, I'm Chris Philips. You may not realize it, but international bonds make up the largest part of the world's securities markets. With that in mind, let's talk about global bond investing and our new international bond fund, which will offer investors the potential for additional diversification in their portfolios.

At Vanguard, the power of diversification is a core component of our investment philosophy. This includes both broad asset classes such as stocks, bonds, and cash, as well as sub-asset classes such as foreign securities. Traditionally, investors have included foreign equities in their portfolios for diversification, but have neglected foreign bonds.

Foreign bonds have several attractive characteristics:

- As I mentioned, they represent the largest component of the global capital markets—33% in 2012.
- What's more, foreign bonds have performed somewhat differently than the other three major segments—U.S. stocks, U.S. bonds, and foreign stocks.
- Foreign bonds offer exposure to enduring risk factors, and they also have modest correlations to traditional and sub-asset classes.

As a result, foreign bonds have the potential to diversify traditional portfolios in much the same way that international equities do.

When Vanguard enters a new market or market segment, we only do so with our clients' best interests in mind.

Previously it was very difficult to gain access into this marketplace in a cost-effective and risk-controlled framework. But over the last few years, these hurdles have fallen enough to make such a product beneficial to our clients. So Vanguard is taking this strategic opportunity to offer our clients long-term exposure to this important asset class in a low-cost way through Vanguard Total International Bond Index Fund.

The new fund will seek to track a benchmark that's provided by Barclays—an index that includes thousands of high-quality government and corporate bonds from more than 50 countries around the world. It can be best viewed as a complement to our Total Bond Market Index Fund.

For those investors interested in further diversifying their portfolio, foreign bonds can make sense. Our research has shown that adding some exposure to foreign bonds in a variety of portfolios can reduce risk on average.

We think fixed income investments should play a role in just about every investor's diversified portfolio even with today's low rates.

Historically, bonds have been important diversifiers to the risks of global equity markets.

The bonds included in Vanguard's fund are investment-grade securities issued around the world.

In addition, the risks of currency movements will be mitigated through the process of hedging.

So this new fund can represent an important slice of investors' overall fixed income exposure.

Investing in international bonds means exposure to the movements of global currencies. Although currency movements tend to be driven by fundamental factors over long horizons, currencies can stray significantly from fair value in the short to intermediate term.

In the near-term, currency exposure represents an uncompensated risk that results in higher volatility but without expecting higher returns. While this exposure also impacts global stocks, it has a much bigger effect on the risks and returns of bonds because of the lower-risk nature of investment-grade bonds.

Vanguard will seek to mitigate this risk exposure by using futures or forwards to offset the exposures in the portfolio. In practice, this means that while exchange rates between the dollar and, say, the Euro, are constantly changing, investors likely won't see the effects of those movements in the fund returns. The objective is to tie the investment return to the performance of the underlying assets—less the costs of hedging.

Currency hedging helps protect against uncertainty in currency exchange rates. By doing so, the fund's investment returns are expected to correlate more closely with the performance of international bonds and exhibit less volatility.

While investors in international bonds are exposed to the risk of interest rate movements, the political landscape, and the economies of many different markets, the primary factors driving international bond prices are relatively uncorrelated to the same U.S. factors. That implies a diversification benefit. And by hedging currency risk as we do with the Total International Bond Index Fund, an allocation to international bonds can lead to lower average portfolio volatility over time.

I invite you to find out more about this new fund on our website. Thank you very much for your time.

Important information

Investments in stocks or bonds issued by non-U.S. companies are subject to risks, including country/regional risk and currency risk.

Diversification does not ensure a profit or protect against a loss in a declining market.

Total International Bond Index Fund will be subject to currency risk, which is the chance that currency hedging transactions may not perfectly offset the fund's foreign currency exposures and may eliminate any chance for a fund to benefit from favorable fluctuations in those currencies. The fund will incur expenses to hedge its currency exposures.

In the global capital markets pie chart, U.S. stocks are represented by the MSCI US Broad Market Index. International equities are represented by the MSCI AC World Ex USA IMI. U.S. bonds are represented by the Barclays US Aggregate Bond Index. International bonds are represented by the Barclays Global Aggregate ex-USD Index.

In the currency exposure chart, hedged international bonds are represented by the Citigroup World Government Bond Ex-US Hedged Index through 1989 and the Barclays Global Aggregate ex-USD Hedged Index thereafter. Unhedged international bonds are represented by the Citigroup World Government Bond Ex-US Index through 1989 and the Barclays Global Aggregate ex-USD Index thereafter. U.S. bonds are represented by the Barclays U.S. Aggregate Bond Index.

Past performance is no guarantee of future returns. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index.

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All investing is subject to risks.

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