Vanguard

March 2025

Portfolio perspectives

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AJ Babb

Vanguard Portfolio Solutions

Edward Saracino

Vanguard Portfolio Solutions

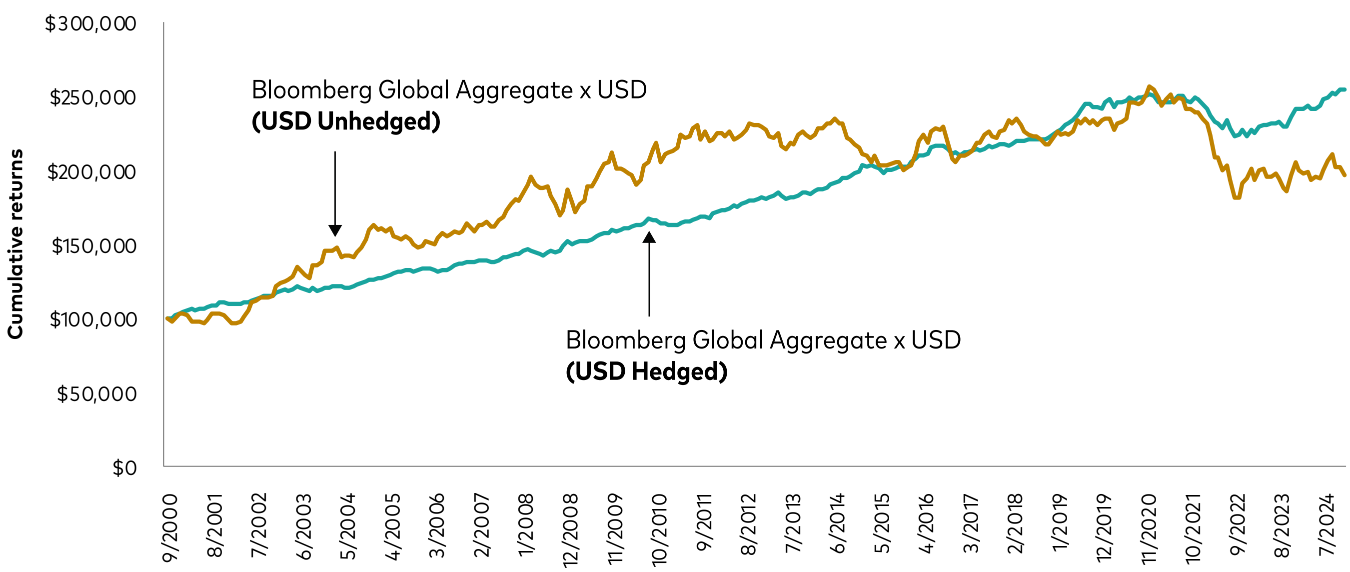
Think global: International bonds for smarter diversification

Many advisors we've spoken with have expressed concern over the recent volatility in long-dated Treasuries as said volatility responds to fiscal and monetary policy signals in addition to overall inflation expectations. While we are still very constructive on domestic bonds, one solution that advisors can consider is to diversify their fixed income exposure with international bonds, gaining access exposure to more securities, yield curves, countries, and macroeconomic regimes.

We continue to observe advisor portfolios reflecting a strong home bias in fixed income. In fact, according to our latest advisor trends research, where we analyze advisors' mutual fund and ETF positions in their portfolios, a majority of fixed income portfolios we observed hold an international allocation that makes up less than 15% of the bond portion of the portfolio.

It is important to keep in mind that not all international bond products are created equal. Specifically, the product's decision to hedge or not to hedge out currency exposure creates different outcomes. The investment case for hedged international bonds over unhedged has the potential to be additive from a risk and return perspective. Hedging the currency volatility allows the bonds to deliver bond-like returns with bond-like volatility **(Figure 1)**.

FIGURE 1: Hedging international bonds can reduce volatility while still providing consistent return potential



	UNHEDGED	HEDGED
Volatility of returns (3-year)	7.78%	2.83%

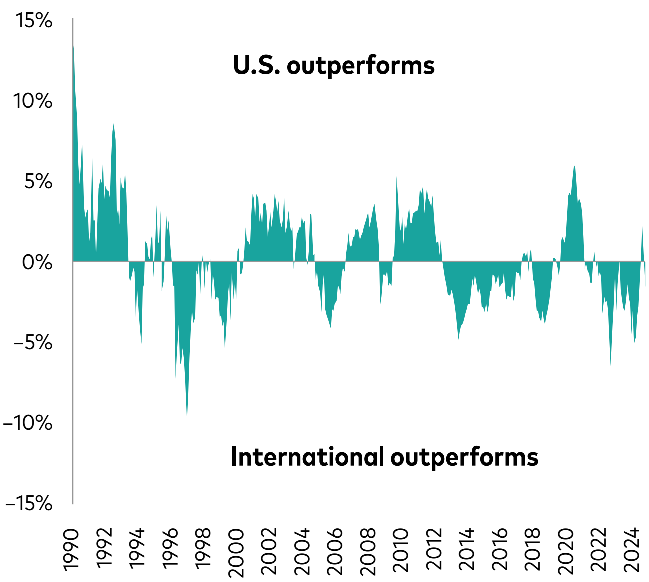
Past performance is not a guarantee of future returns. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index.

Source: Bloomberg indexes using the U.S. Aggregate Index and Global ex-U.S. (hedged) from September 30, 2000, to December 31, 2024. Volatility measured by standard deviation.

The case for improving risk-adjusted returns

We looked at data comparing international hedged fixed income versus U.S. domestic fixed income over a 30-plus year period (**Figure 2**). The results were compelling: Hedged international bonds have historically delivered returns comparable to U.S. bonds for investors, with reduced volatility over time.

FIGURE 2: International fixed income provides unique diversification opportunities



	U.S. AGG	GLOBAL EX-U.S. (HEDGED)
Average rolling return	5.28%	5.04%
Volatility of returns	5.32%	4.39%
Percentage outperformed	49.61%	50.49%

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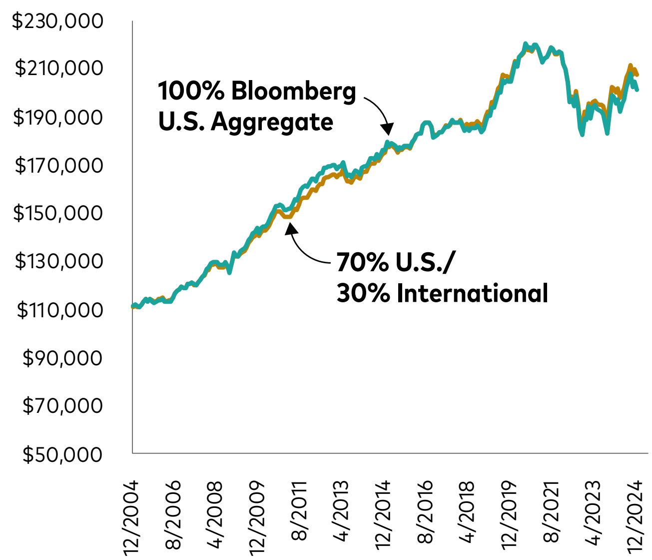
Source: Bloomberg indexes using the U.S. Aggregate Index and Global ex-U.S. (hedged) Index based on rolling 1-year return figures from March 1, 1990, to April 1, 2024. Volatility measured by standard deviation.

In addition, we modeled the performance of a fixed income sleeve assuming 30% of the sleeve was replaced with a hedged international bond index (**Figure 3**). Over the last twenty years, this portfolio has shown to have a similar return profile to that of the U.S. Aggregate while also lowering the risk profile.

FIGURE 3: Diversifying your fixed income sleeve with international exposure has produced similar returns with reduced volatility



	U.S. AGG	70% U.S./30% INTERNATIONAL
Average rolling return	3.20%	3.29%
Volatility of returns (3-year)	3.67%	3.29%

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Source: Bloomberg indexes using the U.S. Aggregate Index and Global ex-U.S. (hedged) Index from November 30, 2004 to December 31, 2024. Volatility measured by standard deviation.

What does this mean for U.S. investors today?

Monetary policy continues to diverge across the globe, and even greater divergence is a distinct possibility. Additionally, many advisors are asking questions about the implications of the growing U.S. debt. This presents an opportunity to make the case for international diversification especially when you hedge the international portion back to the U.S. dollar. Advisors who focus solely on a single yield curve severely limit their ability to benefit from international diversification's potential rewards and risk mitigation. Additionally, with the U.S. facing a structural deficit, alongside above-trend economic growth potentially exacerbating a steepening of the curve, the case for incorporating international bonds becomes even more compelling.

Vanguard's current 10-year capital market projections forecast nearly identical return scenarios for U.S. and international bonds with less volatility in favor of international. With uncertain market conditions, we continue to believe the underappreciation for international fixed income presents unique opportunities for advisors.

Next steps to consider: Are hedged international bonds right for my clients?

Vanguard offers an index vehicle (Total International Bond ETF—**BNDX**) to access the hedged international bond markets. If you want to explore if and how much of a hedged international bond allocation can help support your clients' financial goals, connect with your Vanguard sales representative, and request a conversation with one of our Portfolio Solutions specialists.

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