Insights

Global Bond Investing

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Global bond investing refers to an investment strategy that incorporates non-U.S. bonds. Though they may appear exotic to some, bonds issued outside the United States (either by governments, corporations, or other entities) are a critical global market that presents significant long-term investment opportunity. Global bonds are an appropriate investment for many types of portfolios that have a fixed-income component. To use them effectively, you should understand how global bond investing works and how global bonds can help you meet your financial goals.

Why invest abroad?

One reason for investing abroad is the potential for higher total returns. In any given year, some individual foreign bond markets are likely to outperform the U.S. bond market. Likewise, foreign bonds as a group may generate higher returns than U.S. bonds in some years but not in others. Market leadership changes from one year to the next: The U.S. led the global bond markets in just two of the last 10 years.

Of course, if foreign bond markets underperform the U.S. bond market, diversifying overseas could reduce an investor's total return in the short term. But over the longer term, a bond portfolio with non-U.S. exposure provides meaningful diversification. Interest rate movements in foreign bond markets frequently do not correlate with those in the U.S. While interest rates in one or more markets may at any time be moving in the same direction as U.S. rates, longer-term correlations are low. A diversified portfolio should be cushioned from the full impact of potential losses when one market or the other has a down year. Additionally, since interest rate levels can vary widely from country to country, a diversified portfolio may also generate higher current income than one invested in bonds of a single country. Diversification cannot assure a profit or protect against loss in a declining market.

Chart I: Best-Performing Bond Market in U.S. Dollars

Year	Best Market	U.S. Rank Out of 13 Major Markets
2008	Japan	2
2007	Canada	11
2006	Sweden	12
2005	Canada	2
2004	Sweden	13
2003	Australia	13
2002	Sweden	12
2001	United States	1
2000	United States	1
1999	Japan	4

Source: J.P. Morgan

Primary factors affecting returns on foreign bonds for U.S.-based investors

Many factors are the same as for U.S. bonds, including interest rate levels, credit market conditions, actual and expected inflation, and the pace of economic growth. A bond's price also reflects its particular characteristics, such as credit quality

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and maturity as well as supply and demand for bonds with those characteristics.

However, there are important differences between domestic and foreign bond investing that can increase overall risk. Many countries have less political stability and less diverse economies than the U.S. Political or economic upheaval in such countries could jeopardize local bond markets, so the investor must continually monitor and interpret the internal developments of other countries. This risk can be reduced by investing in government bonds of developed nations, which offer more diverse economies and better transparency.

The impact of currency translation generates the most day-to-day volatility. Initially, dollars must be converted to the local currency to purchase a foreign bond. Subsequently, price quotations, interest, and any sale or redemption proceeds must be converted from that foreign currency back into U.S. dollars. Because exchange rates fluctuate constantly with changes in each currency's supply and demand situation, currency movements can increase or decrease the bond's dollar value (and investment return) even if its price remains unchanged.

A closer look at currency translation on local market returns for U.S.-based investors

Look at returns expressed in local currencies and compare them with the same returns expressed in U.S. dollars. If the local currency was weak versus the dollar for the period in question, the return in dollars will be lower than in local currency terms because more of the local currency was needed to buy one dollar than before. But if the local currency rose against the dollar (meaning the dollar was weak), returns will be higher in U.S. dollar terms because fewer units of the local currency were needed to purchase one dollar.

During the six months ended December 31, 2008, the U.S. dollar strengthened against most currencies. As a result, returns to U.S. investors in those markets were decreased by currency translation, sometimes significantly.

Table I: Impact of Currency Fluctuations on Bond Returns to U.S. Investors for the Six Months Ended December 31, 2008

	Local Market Return	Local Currency vs. U.S. Dollar	Return to U.S. Investors
Australia	-25.47%	-27.35%	-45.85%
Belgium	-51.30	-11.77	-57.03
Canada	-36.14	-17.82	-47.52
France	-26.80	-11.77	-35.42
Germany	-28.76	-11.77	-37.15
Japan	-35.88	16.94	-25.01
United Kingdom	-19.43	-27.76	-41.79
United States	-29.21	0.00	-29.21

Source: MSCI Rimes

This chart is for illustrative purposes only and does not represent an investment in any T. Rowe Price fund. Past performance cannot guarantee future results.

Portfolio managers may use sophisticated hedging techniques involving forward exchange contracts or options to cushion the impact of potentially negative currency movements. Mutual fund prospectuses spell out the types of hedges a fund can use, the expected frequency of use, and the potential effects of hedging activity on a fund's total return. Hedging may or may not mitigate currency impacts in the short term. Over longer time frames, currency impacts have tended to wash out, however, lessening the need for or benefit of hedging.

Special considerations for emerging bond markets

Emerging market bonds are debt securities issued by governments and corporations of countries described as less developed or developing by organizations such as the World Bank. Developing countries have a relatively low gross national product per capita, and the credit quality of their bonds may be lower than an equivalent U.S. bond. These bonds carry high yields to compensate investors for their additional risk.

Prices of emerging market bonds can be severely affected, not only by rising interest rates and adverse currency fluctuations, but also by the deterioration of credit quality or outright default by the issuer. Also, the low level of liquidity in emerging markets means that potential buyers may stay on the sidelines during unfavorable market conditions until bond prices are slashed.

Mutual funds offer a convenient way for individuals to access the opportunities in many developing markets. Funds are, in fact, the single largest source of demand for emerging market bonds, so their cash inflows and outflows can increase the market's volatility. However, not all emerging market bond funds are alike: some emphasize yield, some appreciation, some both equally, so be sure to select a fund whose objectives and program are appropriate for your risk tolerance and investment time horizon.

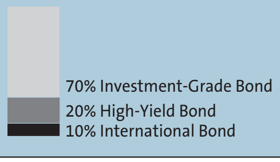
Bond funds investing in emerging markets offer the potential for significantly higher returns than those investing in more developed markets but are more apt to sustain losses because of greater volatility. These losses can be mitigated through diversification and investing in a combination of emerging and developed markets.

Fitting global bonds into your portfolio

Before making any investment decision, you need to evaluate your overall financial picture and long-term objectives. To build a portfolio that works for you, we suggest you identify your goals and time horizon and then determine an appropriate asset allocation.

For example, of the fixed-income portion of a well-diversified portfolio, 10% might be in international bonds. (The amount of your portfolio that you should have in fixed-income instruments will vary depending on your time horizon; visit troweprice.com for more information.)

Chart II: Suggested Portfolio Diversification—Fixed Income



While you should always keep in mind the special risks of international investing, you should also consider its significant advantages. Diversifying internationally or globally can help smooth the fluctuations of your fixed-income portfolio and can offer a way to take advantage of yields that may be higher than in the U.S.

Insights reports provide background information on many aspects of investing. *Request a prospectus by calling 1-800-638-5660; each includes investment objectives, risks, fees, expenses, and other information that you should read and consider carefully before investing.* T. Rowe Price Investment Services, Inc., Distributor.

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