Reflecting on Five Years of the T. Rowe Price Dynamic Global Bond Fund

Portfolio Manager Arif Husain evaluates performance and discusses the future.

March 2019

Arif Husain
Portfolio Manager

KEY INSIGHTS

- The fund's core goals of providing regular income/return potential, capital preservation and diversification away from equity markets have largely been achieved over the five-year horizon.
- Performance has disappointed more recently as some "return-seeking" positions have not performed well enough at a time when the cost of insurance has also acted as a drag on returns.
- We continue to believe in the fund's approach of picking the best ideas from our bottom-up research, while implementing a balanced approach to help stabilize performance at times of stress.

To mark the five-year anniversary of the T. Rowe Price Dynamic Global Bond Fund ("the fund"), Lead Portfolio Manager Arif Husain talks about how the fund has performed against its core objectives. He explains what has worked well and—just as importantly—what hasn't and the lessons learned.

Q. It's Been Five Years Since The Fund Was Launched. Do You Feel You Have Achieved What You Set Out To Do?

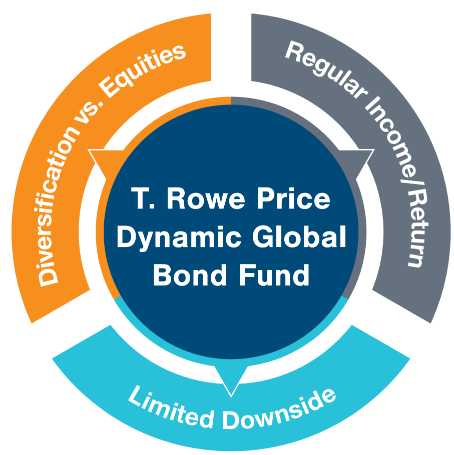
When the fund was launched five years ago, we decided to be very transparent about our three key goals: to generate regular income/return potential, to minimize drawdowns for our clients and to provide them with genuine diversification away from equity markets. If we were to grade the fund on achieving those core goals since inception, we would likely give ourselves an A for minimizing drawdowns and for diversification, and a B for delivering regular income/returns. More recently, however, we have done a poor job at delivering performance, which is disappointing.

Q. What Has Worked Well For The Fund?

The fund has been successful in achieving two of its fundamental aims: downside risk management and diversification versus equity markets.

Over the past five years, there have been numerous periods of volatility in which the fund delivered robust performance. This includes China's currency devaluation back in the second half of 2015, the political

Core Goals Of The Fund



uncertainty surrounding the UK's vote to leave the European Union and Donald Trump's unexpected victory in the U.S. presidential election. More recently, in February last year and again in December, the fund steered its way through sharp equity markets corrections. It's important to remember that the fund is designed to help offer stability during such periods thanks to the implementation of defensive hedging positions, including owning high-quality duration, shorting credit markets and emerging market currencies and, on occasion, holding put options on equities. This means that during periods of market turbulence, the fund can benefit from price falls of risky assets.

Downside control has more to do with our approach to risk management. Over the years, we have developed a very robust set of tools that allow us to dissect risk and understand diversification and vulnerabilities across different positions. Our ability to understand and anticipate the potential reaction function of the different positions in the fund has helped us to lower downside risk, even at times when we got it wrong.

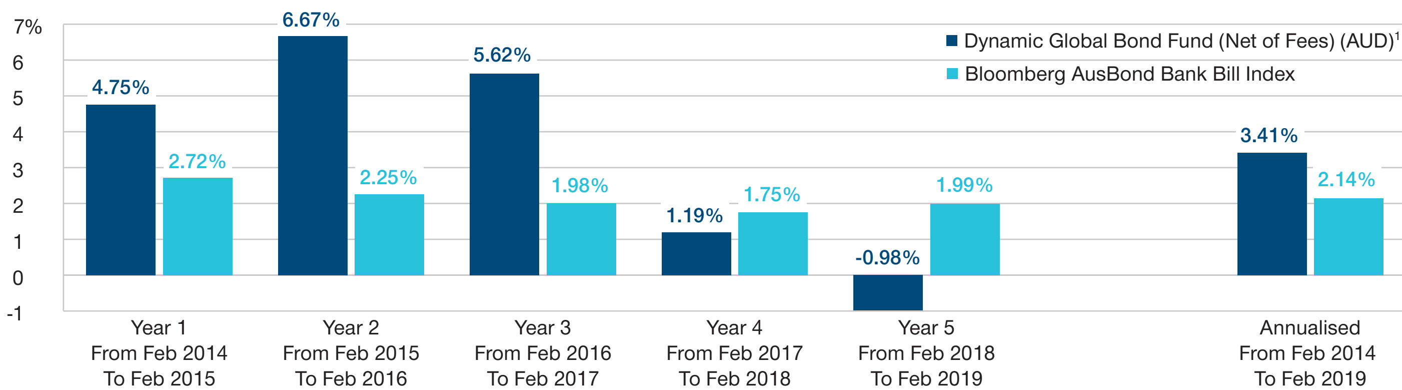
Q. What Has Been Most Challenging?

The past two years have been a challenging period for the fund. Traditional safe havens, such as the Japanese yen, have not worked as well as they have done during previous periods of stress. Similarly, being short credit did not benefit the fund as much as expected during the February/March 2018 period when high yield bonds remained relatively stable despite an aggressive sell-off in equity markets.

Another factor that has disappointed recently has been the fund's "return-seeking" positions, which are drawn from our bottom-up global research platform and driven by research analysts' high-conviction ideas. These positions, which are typically emerging markets bonds and/or higher-yielding corporate issuers, have not performed well enough. A consequence of managing a high-conviction portfolio is that each position represents a certain level of risk to the fund, which leaves it vulnerable to when an idea doesn't deliver as planned or gains take longer than anticipated to materialize. It is

(Fig. 1) Long Term Performance Broadly In Line With Goals

Annual Performance of the Fund Versus the Bloomberg AusBond Bank Bill Index
From February 28, 2014, to February 28, 2019



Past performance is not a reliable indicator of future performance.

[1]Net-of-fees performance is based on end-of-month redemption prices after the deduction of fees and expenses and the reinvestment of all distributions. Figures include changes in principal value. Investment return and principal value will vary, and an account may be worth more or less at termination than at inception.
Sources: T. Rowe Price, Bloomberg Index Services Limited (see Important Information), and J.P. Morgan. J.P. Morgan. Information has been obtained from sources believed to be reliable, but J.P. Morgan does not warrant its completeness or accuracy. The index is used with permission. The Index may not be copied, used, or distributed without J.P. Morgan's prior written approval.

(Fig. 2) Correlation With Equity Markets Close To Zero

26-Week Rolling Correlation of the Fund with the S&P/ASX 200 Index
As of February 28, 2019

Sources: ASX and T. Rowe Price.

important to note, however, that there are controls in place to mitigate the downside risk from such exposures. This includes calibrating each individual position after taking into account its liquidity and past volatility and how it will impact the balance of overall risk in the fund. In addition, before we even enter a new position, exit strategies are discussed not just in terms of potential gains and loss levels, but also with regards to a change in the underlying thesis of the position. This helps us to tactically manage the position through its life in the fund.

Q. What Lessons Have You Learned Over The Past Five Years?

While idiosyncratic positions are essential to achieving the fund's objectives, they must be sized correctly. One of the lessons learned over the years has been to reduce concentration at the individual high yield issuer level. This followed the notable negative performance impact on the fund during 2017 from one of the return-seeking positions we held in the European high yield market.

We believe our investment process has worked over the five-year period, although we recognize it has been more challenging for the fund recently. Our investment team is strong, and we continue to add new members to support our already deep research sources that span the globe, covering every major sector in the asset class. This depth will enable us to continue to uncover inefficiencies and identify attractive investment ideas from across the full fixed income investable universe. As mentioned before, sizing these positions correctly will be important.

Q. Have You Made Any Changes To The Structure Of The Fund Since Its Launch?

The simple answer is no. We remain validated in our investment approach and the fundamental way we structure the fund, which delivered a robust income/return over time. To achieve diversification across sources of return and risk, it remains important that the foundation of the portfolio is made up of core stable positions. These continue to be government bonds and/or high-quality investment-grade corporate bonds that exhibit low volatility and where yield curves are modestly steep. While these are only expected to deliver modest returns, we believe we can generate additional performance from our return-seeking positions, an area which is essential to get right, particularly after disappointing recently. To balance the fund's overall risk profile and maintain our track record of acting as a true diversifier to equity markets, we need to maintain a number of defensive positions at all times.

Q. Looking Back, Is There A Particular Environment Where The Fund Should Be Expected To Perform Better?

Our investment process is deep and broad enough to generate investment ideas for the fund. Portfolio construction has proved efficient in maintaining the right balance between the "return-seeking" ideas on one side and the defensive hedges on the other. Having said that, it has become clear that for the fund to show its true colors, a certain level of volatility in markets is needed, a factor we always knew but has very much been reinforced again recently. Volatility helps us on two fronts: first to generate more idiosyncratic opportunities that our process can uncover and, second, it allows us to realize periodic gains on the insurance positions we have in place.

Another observation to make is that we live today in a world of much flatter yield curves across most fixed income markets. This means it is more difficult to generate regular income from our core positions in the absence of volatility. If I had to pinpoint what has changed most in markets over the past five years, it is that yield curves now offer much less maturity premium.

Q. What Role Should The Fund Play In Investors' Portfolios Going Forward?

Our role is to continue to offer a diversification alternative for our clients while generating sustainable income/ return potential and to minimize drawdowns when some of our positions underperform. We will continue to seek to achieve these objectives through balanced portfolio construction and successful security selection in countries, currencies and individual credits.

The road ahead may be a challenging one for financial markets. Global growth is slowing, and some major economies are moving toward the late stages of the cycle. At the same time, political uncertainty is elevated, and it is unclear what central banks could do in a future downturn as they exhausted much of their firepower during the last financial crisis. This all points to more periods of volatility ahead—an environment we aim to do well in.

WHAT WE'RE WATCHING NEXT

Investors should anticipate further periods of volatility. Global growth is slowing, and political uncertainty undermines a number of developed countries, such as the UK. This comes at a time when central banks are moving away from their accommodative policies. With yield curves extremely flat, its unclear whether high-quality duration will continue to offer the best form of protection in future times of stress. All of this points to more periods of turbulence ahead, an environment that the fund aims to do well in.

INVEST WITH CONFIDENCE®

T. Rowe Price focuses on delivering investment management excellence that investors can rely on—now and over the long term.

T. Rowe Price®

ID0002077 (03/2019)
201903-789741