Strategies for a Rising Rate Environment

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Shortening the duration of a fixed-income portfolio is often considered the default option, but it is not the only way to hedge against a potential rise in interest rates. This article provides investors with a framework to analyze and implement a range of fixed-income strategies, and highlights various investment considerations that should carefully be taken into account.

Short-term interest rates in the US have been pegged at near-zero levels for almost three years, and two rounds of quantitative easing (QE) have been completed (and speculation has begun over whether QE3 will be undertaken). US economic growth, however, has only shown a glimmer of rebound. The housing market downturn, sustained high unemployment and restrained credit lending are all headwinds we still need to navigate. Furthermore, enduring political brinkmanship in the US and spreading contagion from sovereign debt crises in the euro area are further compounding the obstacles to overcome to return to a more normal economic environment.

We expect that the US economy will continue to improve, although we will likely need to overcome more hurdles in the future. Once we achieve more sustainable growth and rising inflation expectations, thoughts will inevitably turn toward rate normalization. Fiscal retrenchment (already in the works), quantitative tightening and rate increases will occur. How then should investors position their fixed income allocations? What fixed income strategies are likely to perform better while also preserving capital and fulfilling operating and liquidity needs?

Branching out from the core

We find today that a mainstay in many investors fixed income portfolio is an allocation to Core / Core Plus[1] strategies or their global counterparts. Closely monitoring this allocation over the last few years, investors have noticed shifting portfolio characteristics – increasing portfolio duration and higher Treasury allocations. Owing to relatively heavy, longer-dated recent Treasury issuance (which is expected to continue), the Core bond index[2] not only

[1] Core strategies are those benchmarked to the Barclays Capital Aggregate Bond Index; Core Plus strategies are also benchmarked to the same index but also allow off-benchmark investments in high-yield markets, international bonds, foreign exchange markets and emerging market debt.

[2] Barclays Capital Aggregate Bond Index as of June 30, 2011

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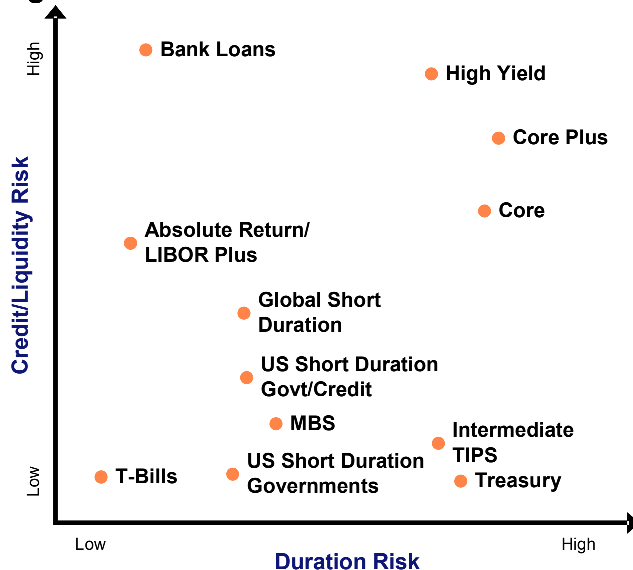
has a higher Treasury allocation of 33% but also a longer duration of 5.1, up from 22% and 4.6 three years ago. This trend is exactly opposite to the positioning needed to be defensive in a rising rate environment, as the safe-haven status of US sovereign credit quality comes under increasing scrutiny.

What then are the options outside of Core? Figure 1 below illustrates different investment options along duration and credit spectrums.

Figure 1: Investment Trade-Offs



Source: Fisher Francis Trees and Watts

The different strategies emphasize varying degrees of investment risk – duration, credit, volatility, prepayment, real interest rate, liquidity, etc. Investors must assess which risks they are willing to assume, depending upon their investment objectives and the purpose of the funds.

To hedge against rising interest rates, the first strategy typically explored is reducing duration. Differing portfolio characteristics of Core versus three often-considered shorter-duration strategies — Short Duration Government/Credit (SD G/C), Global Short Duration (GSD) and Treasury Bills (Bills)[3] — can be seen in Figure 2 below.

[3] As represented by the following indices: Barclays Capital Aggregate Bond Index, Merrill Lynch 1-3 year Government Corporate Index, Merrill Lynch 1-3 year G7 Global Government Index and 3-month Treasury Bills.

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Figure 2: Differing Portfolio Characteristics

	Core	Short Duration Govt/Corp	Global Short Duration	T-Bills
Duration (yrs)	5.1	1.8	1.8	0.1
Yield to Maturity (%)	2.8	0.7	0.7	0.0
Quality	AA+	AAA	AA+	Govt.
Treasury/Sovereign (%)	33%	57%	100%	100%

As of June 30, 2011. Sources: Barclays Capital, Merrill Lynch, Bloomberg, FFTW

While Core has a higher duration of 5.1 versus the 1.8 of SD G/C, it yields close to 2% more, due to (i) the additional yield picked up by investing further out on the (upwardly sloping) yield curve and (ii) in higher yielding credit and securitized sectors. This higher yield provides a buffer during periods of rising rates. If rates were to rise 1% (100 basis points) in a parallel move over the course of a year, all else being equal, the price of a Core portfolio will fall 5.1%, while a SD G/C portfolio will fall only 1.8%. But the Core portfolio would have earned 2.1% more during that period. Hence the return shortfall for the Core portfolio is only 1.2%.

We next examine how these four strategies have performed during periods of rising interest rates over tightening cycles in the past two decades, with the best-performing strategy highlighted in Figure 3.

Figure 3: Performance During Rising Rate Periods

Period	Fed Funds	Core	Short Duration Govt/Corp	Global Short Duration	T-Bills
1/94 – 6/95	+300bps	5.4%	4.9%	4.9%	4.7%
6/99 – 7/00	+175bps	4.4%	5.1%	3.2%	5.3%
6/04 – 8/06	+425bps	4.2%	2.5%	1.9%	3.1%

Sources: Barclays Capital, Merrill Lynch, Bloomberg, FFTW

Core strategies performed better than the other three short-duration portfolios during two of the last three tightening cycles. This can be primarily attributed to (i) the higher yield of Core investments providing a buffer to lower price returns, and (ii) rising rate environments creating bear-flattening yield curves that disproportionally affect the short-intermediate sector.

Longer duration portfolios, even those with higher credit weightings, are not only more volatile but also have a higher associated probability of delivering negative absolute returns. The frequency of negative returns for the same four strategies can be seen in Figure 4 below.

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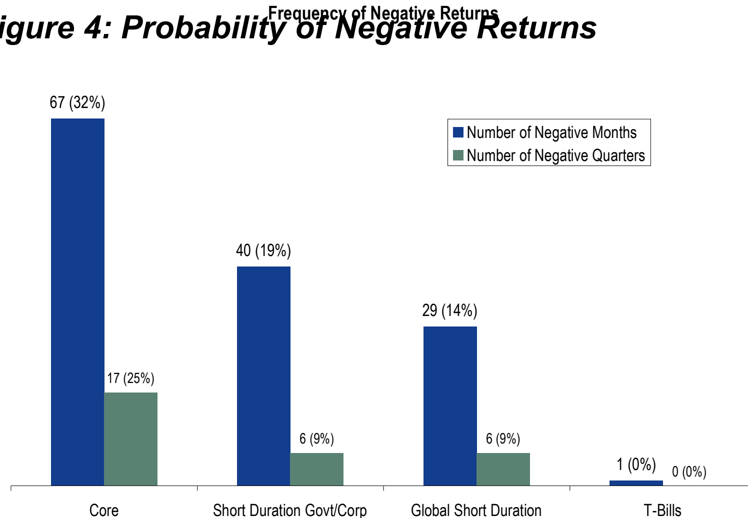
Figure 4: Probability of Negative Returns



From 1/1/1994 to 6/30/2011. Sources: Barclays Capital, Merrill Lynch, Bloomberg, FFTW

Any investment decision cannot be made solely on the basis of total returns. Preserving wealth is more important if the purpose of the funds is to meet spending needs or serve as dry powder for future opportunistic investments.

Timing is everything

Spot yields today are at historically low levels. The next move in interest rates is most likely going to be higher, but it is uncertain when this will occur and what the trigger might be. Despite S&P's US sovereign credit downgrade and the end of QE2, virtually no upward pressure on yields has materialized. Strategies premised on an upward rate move have thus far been frustrating, as the opportunity cost of going short is high. The steep yield curve and high forward yields provide a buffer against rising rates. In the near-term, we expect that Treasury yields will remain low and the yield curve will stay steep – the Federal Reserve has clearly communicated that rate increases will be on hold until mid-2013.

While it is virtually impossible to forecast the exact timing and magnitude of future interest rate movements, investors should prepare to reposition their fixed income portfolios should interest rates begin to rise. Shortening the duration of the fixed income portfolio is not the only option available. Actively managed strategies that investors should consider to hedge against interest rate risk include:

- **Actively managed duration and yield curve positioning**: Given the steepness of the yield curve, carry-and-roll-down strategies are very attractive, and going short today can be costly. Reducing duration exposure is only likely to pay off if rate increases are greater than those priced into (already high) forward-yield curves.
- **Increased credit or prepayment risk**: Investing in these spread sectors provides an incremental yield that can buffer against rising rates.

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- **Global investment**: Owing to diverging economic and monetary policy cycles, global investing provides greater opportunity today for active managers to capitalize on these differences and potentially deliver higher excess returns.
- **Absolute return approach**: Don't let the constraints of following a changing Core benchmark drive your investment portfolio. A low-duration, floating-rate strategy that combines three or four high-quality alpha trading styles (e.g., currencies) can deliver targeted and customized returns.

Reducing the duration of the fixed income portfolio is often seen as the default way to hedge against an imminent rise in interest rates. There are, however, a number of alternative strategies and related investment considerations that should be carefully taken into account. Investors should carefully weigh the costs and benefits to determine the fixed-income strategy that works best given their unique investment objectives.

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