

LEAVING A TIP

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I know now may not be the time investors are thinking about an [interest rate hedging](#) angle for their bond portfolio, but maybe it should be. Typically, reallocating funds to ward off potential interest rate risk occurs when the upward trend is already in place. This is exactly the scenario I'd like to see investors avoid repeating. In other words, the time to consider rate protection is when rates are low, just as they are now!

I'll be the first to admit that my base case for rates is that they stay lower for longer. No argument there. However, that doesn't mean [U.S. Treasury \(UST\) yields](#) can't rise from their current historically low levels. That is what we bond guys call "statement risk"—you know, a client receives their monthly financial statement, and in the fixed income section, they see "red" (negative performance).



Source: Bloomberg, as of 6/22/20. Performance is historical and does not guarantee future results. Current performance may be lower or higher than quoted. Investment returns and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Standardized performance is available at www.wisdomtree.com. Performance data for the most recent month-end is available at wisdomtree.com.

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For standardized performance of USFR, please click [here](#).

So, how do fixed income investors search for rate-hedging solutions? One approach that one often encounters involves [U.S. Treasury \(UST\) Inflation-Protected Securities](#), or TIPS. These securities are referenced to the [Consumer Price Index \(CPI\)](#), whereby the coupon is fixed, but the principal is adjusted to changes in CPI.

Interestingly, TIPS do not necessarily offer investors the most beneficial strategy for potentially higher rates. These instruments are designed to protect investors from the effects of higher [inflation](#), which can certainly play a role in pushing rates higher, but they do not necessarily act as a full hedge on this front. Indeed, these instruments tend to be a bit longer-[duration](#) in nature, as well. To provide some perspective, the [BI](#)

[Bloomberg Barclays US Treasury Inflation Notes Modified Adjusted Duration Index](#) stands at 4.09 years, as of this writing. Only a month ago, this reading was more than double, at 8.69 years. So, while they may outperform a nominal UST 10-year as an example, if intermediate to longer-term rates do rise, TIPS may still experience some negative effects.

Let's contrast this strategy to one involving UST [floating rate notes \(FRNs\)](#). These securities are referenced to the weekly UST three-month t-bill auction, with the interest rate floating/adjusting to this offering's result, and essentially carry a duration of one week. Thus, UST FRNs are more directly tied to changes in interest rates, specifically Federal Reserve (Fed) rate moves, while TIPS are more directly tied to changes in inflation.

Given the unprecedented amounts of [fiscal](#) and [monetary policy](#) stimulus, one could argue that inflation may rear its ugly head at some point in the years to come. However, in the meantime, Fed Chairman Powell & Co. have made it abundantly clear of late there is no appetite to contemplate raising the Fed Funds target anytime soon. Thus, as the U.S. economy begins to recover, it looks as if the Fed will let it "run hot"—i.e., they will tolerate an uptick in inflation for longer than they normally would. Add in some incredible Treasury supply to finance multitrillion-dollar budget deficits, and you have the ingredients for the UST 10-year yield to retrace some of this year's decline.

The graph above highlights how the [WisdomTree Floating Rate Treasury Fund \(USFR\)](#), which is based on UST FRNs, outperformed the [Bloomberg Barclays US Treasury Inflation Notes TR Index](#) by 525 [basis points \(bps\)](#) at NAV during the most recent rising yield period from July 8, 2016 through November 8, 2018. I certainly don't expect the magnitude of rate increase to be at that level, but the graph highlights how these two strategies differed in terms of rate protection.

Conclusion

Ask yourself the question: what if the UST 10-year yield retraces 50% of this year's decline and heads back toward 1.25% (not an unreasonable scenario)? That is nearly double the yield of where the 10-year stands now. Considering how TIPS and UST FRNs have performed in past rising rate periods, I'd "leave the TIP" and choose USFR.

Unless otherwise stated, all data sourced is Bloomberg, as of June 22, 2020.

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DEFINITIONS

Interest rates: The rate at which interest is paid by a borrower for the use of money.

Hedge: Making an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.

Treasury yield: The return on investment, expressed as a percentage, on the debt obligations of the U.S. government.

Treasury Inflation-Protected Securities (TIPS): Bonds issued by the U.S. government. TIPS provide protection against inflation. The principal of a TIPS increases with inflation and decreases with deflation, as measured by the Consumer Price Index. When a TIPS matures, you are paid the adjusted principal or original principal, whichever is greater.

Consumer Price Index (CPI): A measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. The CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living.

Inflation: Characterized by rising price levels.

Duration: A measure of a bond's sensitivity to changes in interest rates. The weighted average accounts for the various durations of the bonds purchased as well as the proportion of the total government bond portfolio that they make up.

Bloomberg Barclays U.S. Treasury Inflation Notes Modified Adjusted Duration Index: Represents overall interest rate sensitivity of the bonds within the Bloomberg Barclays U.S. Treasury Inflation Notes Index.

Floating Rate Treasury Note: a debt instrument issued by the U.S. government whose coupon payments are linked to the 13-week Treasury bill auction rate.

Fiscal Policy: Government spending policies that influence macroeconomic conditions. These policies affect tax rates, interest rates and government spending, in an effort to control the economy.

Monetary policy: Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

Bloomberg Barclays U.S. Treasury Inflation Notes Index: Measures the performance of the U.S. Treasury Inflation Protected Securities (TIPS) market.

Basis point: 1/100th of 1 percent.