THREE YEARS SINCE TAPERING: RE-EXAMINING THE RISING RATES TOOLKIT

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Nearly three years ago, the U.S. Federal Reserve started the process of reducing monetary accommodation by "tapering" the pace of its asset purchases. On the same day,[1] WisdomTree launched a suite of rising rates bond strategies that sought to maintain exposure to the bond market but manage the risk of rising rates. While these strategies are based on commonly followed bond indexes, they also provide the opportunity to manage interest rate risk the same way many institutions do, by hedging or even going short (e.g., negative) duration. Since that time, interest rates have declined for maturities greater than five years, while rising at shorter maturities. Below, we highlight the potential risks for bond portfolios during sustained periods of rising rates.

Quantifying Bond Market Performance

In our analysis, we show the impact on three variants of the Bloomberg Barclays U.S. Aggregate Index (Agg) and the Bank of America Merrill Lynch 0-5 Year U.S. High Yield Constrained Index (High Yield in table and graphic): unhedged, zero duration[2] and negative duration.[3] In the chart below, we highlight the impact on returns since tapering began, a period when interest rates fell and periods when interest rates have increased.

Market Performance

Rising Rates– Aggregate and High Yield Performance

Rising Rates

Since Tapering: High Yield and Agg Produce Similar Results

Interestingly, the performance of the unhedged Agg and Bank of America Merrill Lynch 0-5 Year U.S. High Yield Constrained Index since tapering began are essentially the same. Over the past three years, the decline in longer-term interest rates has boosted returns of the lower yielding aggregate strategy. Over the same period, credit spreads widened, causing a drag on high-yield performance. While spreads have come in since February (boosting high-yield bond returns), they still remain wider than at the end of December 2013. The key question for investors now is which risk they should assume going forward?

Duration vs. Credit

In our view, positive total returns of the Agg over the next 12 months will be solely predicated on stable or falling interest rates. As a result, investors should consider hedging their aggregate positions or increasing exposure to credit (or both).

In general, interest rate and credit risk are the primary levers that a bond investor can pull to generate performance. In the two most recent periods of rising rates, credit has added value while interest rate risk has detracted.

Through a zero duration strategy, investors can now separate their bets on credit from their view of nominal interest rates. In both periods, hedged strategies predictably outperformed unhedged strategies.

However, high-yield strategies outperformed investment grade strategies because of their higher income potential and the perception that rates were rising in response to a stronger U.S. economy.

The other interesting element is that explicit bets on rising rates (negative duration) outperformed hedged high-yield positions. Over both periods, nominal interest rates were the primary driver of total returns. Therefore, investors seeking to make a tactical play that rates are going to rise should determine whether they favor rates or credit or some combination of the two.

The Other "Duration" of Rising Rates

While we have previously highlighted the efficacy of rising rates strategies over shorter periods, we believe investors should also prepare for a scenario in which rates rise over many months or even years. Recently, there has been much debate about the prospect of a generational low in the U.S. 10-Year yield in July 2016.[4] Generally speaking, previous periods of rising rates were palatable because coupon rates (and yields) were much higher than they are today.
While investors may have lost value during a period of rising rates, eventually, they could "earn" their way out of it. This is precisely the reason why over the last 30 years, the Bloomberg Barclays U.S. Aggregate Index has experienced negative returns in only three calendar years: 1994, 1999 and 2013.[5] Because of current interest rates, it is far more likely that investors will experience periods of negative total returns even when rates rise by modest amounts. In our view, this is precisely why investors should consider to be over-weight in credit risk at the expense of interest rate risk.
In our view, the Bloomberg Barclays U.S. Aggregate Index is ill-suited to deal with a rise in U.S. interest rates. As an alternative, investors now have a greater number of tools at their disposal to potentially hedge or profit from a rise in U.S. interest rates. Given that many of these alternative approaches now have real-time track records, we believe more investors should consider how they can best protect their portfolios from a potential generational shift in the bond market.

[1]December 18, 2013.

[2]Bloomberg Barclays Rate Hedged U.S. Aggregate Bond Index, Zero Duration and BofA Merrill Lynch 0-5 Year U.S. High Yield Constrained, Zero Duration Index.

[3]Bloomberg Barclays Rate Hedged U.S. Aggregate Bond Index, -5 Duration and BofA Merrill Lynch 0-5 Year U.S. High Yield Constrained, Negative Seven Duration Index.

[4]Source: Bloomberg, as of 11/18/16.

[5]Source: Bloomberg, as of 11/18/16.

Important Risks Related to this Article

Fixed income investments are subject to interest rate risk; their value will normally decline as interest rates rise. In addition, when interest rates fall, income may decline. Fixed income investments are also subject to credit risk, the risk that the issuer of a bond will fail to pay interest and principal in a timely manner or that negative perceptions of the issuer's ability to make such payments will cause the price of that bond to decline.

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DEFINITIONS

Tapering : A shift in monetary policy by which the Federal Reserve would begin decreasing the amount of bonds it purchases.

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.

Short (or Short Position) : The sale of a borrowed security, commodity or currency with the expectation that the asset will fall in value, the opposite of Long (or Long Position).

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.

Maturity : The amount of time until a loan is repai.

Bloomberg U.S. Aggregate Bond Index : Represents the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, as well as mortgage and asset backed securities.

BofA Merrill Lynch 0-5 Year US High Yield Constrained, Zero Duration Index : Tracks the performance of the combination of a long position in short maturity US high yield bonds and a short position in on the run US Treasuries where the net interest rate exposure of the index is adjusted to a zero year duration. Market values of long and short positions are rebalanced at month-end.

Zero duration strategies : Refer to WisdomTree's Interest Rate Strategies that target an overall portfolio duration of zero; namely, the WisdomTree Barclays U.S. Aggregate Bond Zero Duration Fund and the WisdomTree BofA Merrill Lynch High Yield Bond Zero Duration Fund.

Negative duration strategies : Refer to WisdomTree's Interest Rate Strategies that target a negative overall duration; namely, the WisdomTree Barclays U.S. Aggregate Bond Negative Duration Fund and the WisdomTree BofA Merrill Lynch High Yield Bond Negative Duration Fund. .

Credit spread : The portion of a bond's yield that compensates investors for taking credit risk.

Widen : an increase in the amount of compensation bond holders require to lend to risky borrowers. When spreads widen, the market is implying that borrowers pose greater risk to lenders.

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

Credit risk : The risk that a borrower will not meet their contractual obligations in conjunction with an investment.

Investment grade : An investment grade is a rating that signifies a municipal or corporate bond presents a relatively low risk of default.

10-year government bond yield : Yields on the 10 year government debt security.

Coupon : The annual interest rate stated on a bond when it's issued. The coupon is typically paid semiannually. This is also referred to as the "coupon rate" or "coupon percent rate.&rdquo.

Bloomberg Barclays Rate Hedged U.S. Aggregate Bond Index, Zero Duration : Combines long positions in the Barclays U.S. Aggregate Index with short positions in U.S. Treasury Bonds to provide a duration exposure of 0 years. Market values of long and short positions are rebalanced at month-end.

BofA Merrill Lynch 0-5 Year US High Yield Constrained, Negative Seven Duration Index : Tracks the performance of the combination of a long position in short maturity US high yield bonds and a short position in on the run US

Treasuries where the net interest rate exposure of the index is adjusted to a negative seven year duration. Market values of long and short positions are rebalanced at month-end.