

INTEREST RATE RISK: HEDGE, SWAP OR SHORTEN?

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As 2016 draws to a close, many investors are evaluating what (if any) changes need to be made to their portfolios for 2017. For fixed income investments, a crucial question will be how much [interest rate risk](#) is worth taking as we head into the new year. Historically, investors could make these changes in two key ways: shorten [duration](#) or swap from fixed [coupon](#) bonds to [floating rate notes](#)¹. However, while these approaches reduce exposure to interest rate risk, they also require the investor to substitute one form of risk for another. In our view, a more intuitive approach could be to simply [hedge](#) the interest rate risk of the investor's existing bond strategy². Below, we highlight the potential trade-offs of each approach as well as their performance over the last three years.

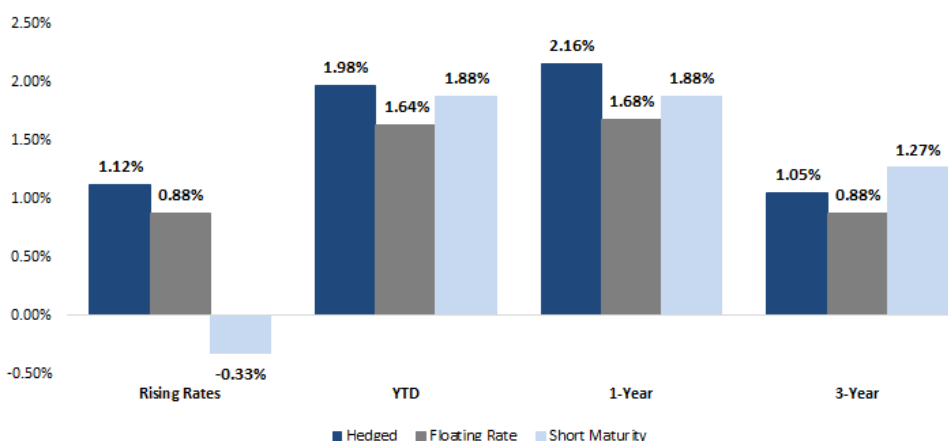
Rate-Hedging Mechanics

In its most basic terms, an interest rate-hedged bond strategy³ can be thought of as two portfolios in one: a portfolio of bonds representing the [Bloomberg Barclays U.S. Aggregate Bond Index \(Agg\)](#) and a hedging portfolio. The hedging portfolio seeks to offset interest rate risk from the Agg by shorting [U.S. Treasuries](#) of similar duration. When interest rates rise, bond prices decline. However, since the strategy is [short](#) U.S. Treasuries, these positions increase in value as rates rise. While no hedge is always perfect, this approach can meaningfully reduce risk in a rising rate environment. Below, we identify how this approach compares in a variety of interest rate environments.

Understanding Trade-offs

All three approaches can reduce interest rate risk in the portfolio. However, they also come with their own key trade-offs. In the case of a short-[maturity](#) bond portfolio,⁴ while it did generate the highest total returns over the last three years, it also had the most interest rate risk. This dilemma is illustrated in the most recent period of rising rates.⁵ While the hedged and floating rate generated positive total returns, short maturity lost value. During sustained periods of rising rates, losing less than your performance benchmark feels like more of a consolation prize than a desired outcome.

Holding Period Returns Diverge During Rising Rates



Source: Bloomberg, as of 12/14/2016.

Past performance is not indicative of future results. You cannot invest directly in an index.

Turning next to the floating rate strategy, the overall interest rate risk of the strategy is determined by how frequently its [coupon rate](#) resets. The reason some investors like floating rate notes is that when short-term interest rates rise, investors can participate in this

increase by receiving greater income potential. However, interest rate risk in these approaches can vary from anywhere between one week and six months. In this instance, the duration is approximately .13 years (45 days).⁶ While this seems prudent in a rising rate environment, the difficulty many investors have with these strategies is that floating rate note issuance is dominated by financial companies. In fact, this floating rate strategy is currently over 51% financials.⁷ While banks have made great strides in de-risking after 2008, many investors don't wish to make such a concentrated sector bet in their bond portfolio.

Finally, the primary reason we favor an interest rate- hedged approach to the Agg is that other than altering the interest rate risk profile, the characteristics of the long portfolio are exactly the same as the most commonly followed fixed income benchmark in the world. In this respect, it gives investors the opportunity to manage the primary driver of risk in their performance benchmark. However, the execution of this approach is not risk-free. In our view, the primary risk is driven by the fact that no hedge is perfect. While the strategy seeks to offset the interest rate risks in the Agg, it's not possible to perfectly offset the long bond exposure in the portfolio. Therefore, it's possible that the strategy could underperform due to changes in the shape of the [yield curve](#).

Conclusion

Investors have a variety of options for managing interest rate risk in their bond portfolios. While each approach comes with its own list of trade-offs, each has the potential to add value in a rising rate environment. In our view, many investors have become complacent in the amount of interest rate risk that they assume. While the last several months have been painful, investors need to continue to refine their approach to managing risk in all facets of their portfolio.

¹Represented by the [Bloomberg Barclays U.S. Floating Rate Note 5 Years Index](#).

²Represented by the [Bloomberg Barclays U.S. Aggregate Index \(Agg\)](#).

³Represented by the [Bloomberg Barclays Rate Hedged U.S. Aggregate Bond Index, Zero Duration](#).

⁴Represented by the [Bloomberg Barclays 1-3 Year Credit Index](#).

⁵Rising rates period represents 7/8/16 through 12/14/16.

⁶Source: Bloomberg, as of 12/14/16.

⁷Source: Bloomberg, as of 12/14/16.

Important Risks Related to this Article

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DEFINITIONS

Interest rate risk : The risk that an investment's value will decline due to an increase in interest rates.

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.

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."

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.

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.

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.

Treasury : Debt obligation issued by the U.S. government with payments of principal and interest backed by the full faith and credit of the U.S. government.

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).

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

Yield curve : Graphical Depiction of interest rates on government bonds, with the current yield on the vertical axis and the years to maturity on the horizontal axis.

Barclays U.S. Dollar Floating Rate Note (FRN) Index : provides a measure of the U.S. dollar denominated floating rate note market.

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.

Bloomberg Barclays 1-3 Year Credit Index : composed of U.S. dollar-denominated, investment-grade corporate, sovereign, supranational, local authority and non-U.S. agency bonds with remaining maturities between one and three years.