

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 notes¹. 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.

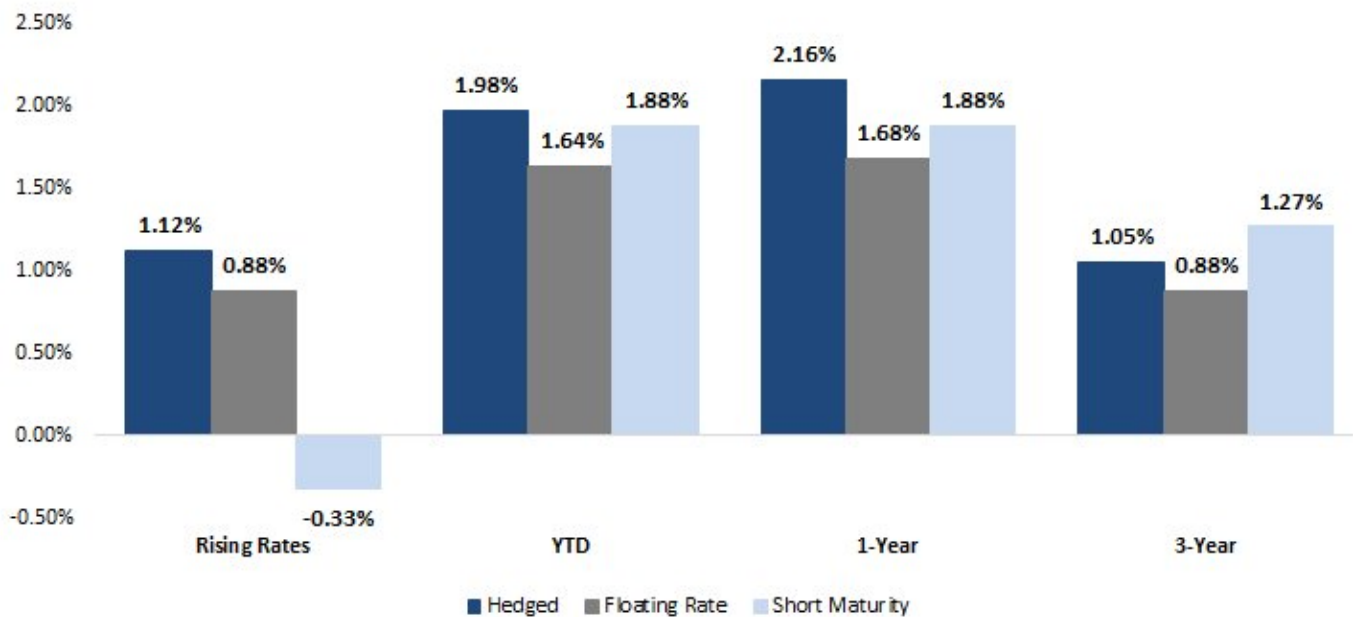
Rate-Hedging Mechanics

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

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.