

Rising Rate Strategy Performance in a Falling Rate Environment

Published October 14, 2014

Rick Harper

Chief Investment Officer, Fixed Income and Model Portfolios

In financial markets, there is no free lunch. After a difficult market environment for bond investors in 2013, the prevailing consensus to start the year was that long-term bond yields would continue to rise in 2014. This view has yet to materialize in the markets. However, the market reprieve for assuming interest rate risk has provided us with valuable information about the performance of various bond strategies. In the following analysis, we attempt to explain the costs of hedging and their impact on total returns in a less-than-ideal market for [rising rate strategies](#). **Yield, Duration and Recent Performance for “Rising Rate” Indexes**

As of 9/30/14	Yield to Worst (YTW)				12/18/13 – 9/30/14
Aggregate Strategies	Net	Long	Short	Duration	Total Return (%)
Barclays U.S. Aggregate Index (LBSTRUU)	2.36%	2.36%	N/A	5.62	3.84%
Barclays Rate Hedged U.S. Aggregate Bond Index, Zero Duration (BAZDTRUU)	0.60%	2.36%	-1.62%	0.00	1.44%
Barclays Rate Hedged U.S. Aggregate Bond Index, -5 Duration (BUAFTRUU)	-0.30%	2.36%	-2.52%	-5.00	-3.88%
High Yield Strategies	Net	Long	Short	Duration	Total Return (%)
BofA Merrill Lynch 0-5 Year U.S. High Yield Constrained Index (HUCD)	5.88%	5.88%	N/A	2.43	2.41%
BofA Merrill Lynch 0-5 Year U.S. High Yield Constrained, Zero Duration Index (HZCD)	5.16%	5.88%	-0.71%	0.00	1.97%
BofA Merrill Lynch 0-5 Year U.S. High Yield Constrained, -7 Duration Index (H7CD)	3.50%	5.88%	-2.38%	-7.00	-3.68%

Sources: Barclays, BofA Merrill Lynch, Bloomberg, WisdomTree, as of 9/30/14. The Federal Reserve began tapering the pace of its asset purchases on 12/18/13. You cannot invest directly in an index. Index performance does not represent actual fund or portfolio performance. A fund or portfolio may differ significantly from the securities included in the index. Index performance assumes reinvestment of dividends but does not reflect any management fees, transaction costs or other expenses that would be incurred by a portfolio or fund, or brokerage commissions on transactions in fund shares. Such fees, expenses and commissions could reduce returns. Past performance is not indicative of future results.

For definitions of terms and Indexes in the chart, visit our [glossary](#). The table above highlights how hedged and negative duration variants of traditional fixed income indexes have performed in a falling interest rate environment compared to long-only strategies. In the case of zero duration strategies, investors were primarily rewarded by assuming credit and prepayment risk but did not necessarily benefit from falling U.S. interest rates. Since these strategies seek to reduce or modify exposure to movements in nominal U.S. interest rates, it should stand to reason that returns will generally be lower than long-only strategies as rates fall. Interestingly, even though returns have lagged, both zero duration strategies generated positive total returns. In the case of the high-yield strategy, underperformance was less pronounced,

given the lower costs of hedging. Even though it did not pay to hedge over this time period, we now have the ability to quantify the risk versus reward relationship in real time. Shifting the focus to the negative duration strategies, we believe that these strategies make sense for investors who have a greater degree of conviction about rising rates. In the most recent period, as interest rates fell, these approaches underperformed due to losses on their short positions. In the case of the high-yield strategy, this approach lost value on both sides of the trade as credit spreads widen and interest rates fell. However, in both approaches, returns from income were able to help offset or finance a portion of these losses. Total returns from negative duration strategies didn't lose as much as the strategies gained from the move in rates. This can largely be attributed to the fact that the long bond portion helps to defray some of the costs associated with maintaining these positions. While examining these strategies independently can give some insight into the future drivers of total return, we believe that the real value of these strategies is how they can be incorporated into a broader portfolio of interest rate sensitive assets. As shown above, hedging interest rate risk during periods in which rates actually fall is likely to create a drag on investment returns. This is to be expected; hedging risk incurs a cost. However, with investors relatively complacent about rising rates, we believe that these strategies can offer valuable cover when the Fed starts to shift policy.

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.