Short duration: How to position portfolios when central banks steer a new course?

February 2018

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After a lull last summer, central banks have been looking for the exit. In the US, the Federal Reserve has finally put the 2013 taper tantrum behind it, promising to unwind the balance sheet – potentially as soon as September – and to continue tightening where possible. Across the Atlantic, meanwhile, the European Central Bank's (ECB) ultra-dovish stance is slowly being replaced by a more hawkish tone as growth picks up, the labour market tightens and inflation looks set to return.

As concerns over duration risk begin to mount, investors and fund selectors are turning their attention to short-duration bond funds. In fixed income, a short-duration approach can lower the sensitivity to rising interest rates while maximising risk-adjusted returns compared to medium- and long-duration bonds. Yields are generally lower, but the risk of capital loss in the event of even a small rise in interest rates is far lower.

While the spectre of rising interest rates has been looming over markets for years now, recent comments by central bank officials suggest that tightening now looks all but inevitable. Given this shift, how can bond investors tap into short-duration funds to shield themselves from these risks? And what are the benefits of doing so?

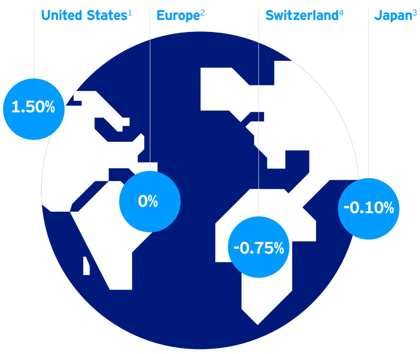
Ignore central banks' warnings at your peril

Central banks' response to the financial crisis has been unprecedented: since 2008, the world's 50 biggest central banks cut interest rates more than 700 times. On average, that's a cut every three days. And with vast quantitative easing (QE) measures and interest rates held at roughly 60-year lows, central banks have gone to great lengths to support markets and suppress any volatility. Bond yields have also reached record lows, falling to negative yields in many parts of the world. Rather than worry about duration risk, therefore, investors have had to look further afield or take more credit risk to achieve an acceptable level of income.

With the recovery now gathering pace in many regions, and especially in Europe, thoughts have turned to positioning portfolios for rising rates. Although central banks now go to great lengths to telegraph their future intentions, known as 'forward guidance', the taper tantrum of 2013 still points to potential volatility in the bond markets; back then, US short-term bonds lost 0.2%, while intermediate-term bonds shed 2.8% in value and long-term bonds lost 6.4%, according to Morningstar data. All of this occurred while interest rates remained at 0.

The Federal Reserve has already raised interest rates a number of times, and has begun to unwind its balance sheet too. Stronger GDP and employment figures, as well as higher inflation expectations, lend credence to the Fed's theory that any weakness was 'transitory', giving them the flexibility to raise rates three or four times this year. Gradual tapering and future rate expectations has led to rising yields, with the 10-year crashing through multi-decade technical resistance as it hones in on 3%. What has become clear is that capital losses on long-dated bonds could be especially pronounced.

Global interest rates



Last change:
1. 13/12/2017 2.10/03/2017 3. 01/02/2017 4. 15/01/2017

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15%

the amount a government bond with a 15-year duration will decrease in value if interest rates rise by

1%

3%

the average yield on a 'high yield' European high corporate bond.

Closer to home, the European Central Bank (ECB) has its own $5 trillion dollar balance sheet to worry about. In October last year, the ECB outlined its plans to cut its bond-buying programme by 30 billion euros a month, from 60 billion, starting in January, and is unlikely to extend its QE beyond September 2018. Observers are assuming that their bond-buying programme will finish so long as inflation begins to improve.

Still, the ECB faces a tough balancing act between reducing QE to combat stronger growth and recognising that markets are still quite jittery and inflation weak, especially with a buoyant Euro; it has gained almost 15% in the past year (until early February), with the EUR/USD cross reaching a high of 1.25 earlier in 2018.

Yet with the Eurozone economy expanding for 18 consecutive quarters, the ECB will not want to fall behind the curve and a quicker-than-expected tightening could occur if inflation surges in 2018, especially as higher commodity prices and tighter labour conditions begin to feed through to prices.

This may seem like a stretch given the weaker CPI prints of late, and the lack of wage growth from labour tightening has confounded US central bankers, who are still relying on the trusty Phillips Curve. Even so, ongoing ECB tapering now looks a near certainty, and a move from negative real rates will follow at some point as the economic recovery begins to build. Given that many European bonds – both government and corporate – are richly priced and offer extremely low yields, any move by the ECB could herald significant capital losses.

The need to go short
While many factors can influence a bond's price, duration risk is one of the biggest threats facing investors. The higher the bond's duration, the greater its sensitivity to interest rate changes. For example, a government bond with 15-year duration will decrease in value by approximately 15 percent if interest rates rise by one percent.

By contrast, short duration bond funds offer some protection against interest rate hikes, as well as any increase in market volatility. In the current environment with flat yield curves, short-term corporate bond funds (with an average maturity of 1-5 years) in the UK and Europe can capture around 95% of the yield offered by the broader credit market, while still only assuming 35% of the duration risk.

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Maturities can vary, but are generally between one and five years. While the yield is usually less than longer-dated bonds, where you get rewarded for taking more duration risk, there are ways to increase the income from these securities. This includes investing down the credit scale in higher yielding securities, or looking at different geographies – such as the European periphery - where coupons are higher.

With credit spreads across Europe already so tight – the average yield on a 'high yield' European corporate bond is still only around 3% – there is a case to be made for holding high-quality, low-duration funds. The prospective yield may be low, but the fund will still offer sturdy protection against the risk of inflation and rising rates.

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There is also a case to be made for selecting an active fund with a wide credit and geographical remit. While some investors may opt for a short-dated treasury, gilt or bund fund, which now make up dozens of popular ETFs, these securities have a high correlation to interest rate rises. By contrast, active managers can pass-over 2-year treasuries or German bunds and instead invest in corporates or other countries such as Australia and peripheral European countries if their mandate allows. This flexibility is particularly important for those investors looking to maximise income.

Portfolio positioning
Short-duration bond funds need not to replace core or investment grade fixed income funds, but it does make sense to have some protection from interest rates and inflation. With the Federal Reserve raising rates by just 25 basis points between July 2016 and February 2017, for example, the average US core bond fund dropped -3.2%. Short-term corporate bonds finished roughly flat.

By contrast, core bonds do a much better job at holding up during volatile periods. During the 2007-2008 bear market, the average US core fund (which mostly holds treasuries and MBS) returned 6.57% compared to a loss of 3.9% for short-term corporates. Europe, meanwhile, is harder to compare given the different circumstances and still-zero interest rates. But impressively, the average short-term corporate manager, as tracked by Citywire, actually help up remarkably well during the last financial crisis, and has fared okay of late. By contrast, investment grade has notably underperformed lately – with many bonds returning negative yields in real terms.

So depending on your outlook for the economy, keeping a ballast of shorter-duration high-quality bonds seems sensible. And in the US, at least, avoidance of duration risks has led to clear underperformance in recent years.

It is also important to weigh up your goals when selecting a short-duration fund. If you dislike volatility, then you may want to think about investment grade short-term bonds, which have high credit quality, low yield and can have duration of less than a year. These bonds may not offer the same protection against inflation, given real yields will be extremely low or even negative, but they will protect you against interest rates while remaining highly liquid.

And if you want to add a little more yield, you could consider a flexible short dated high quality Euro bond fund, many of which also add selective opportunities in longer dated or slightly higher yielding bonds.

Performance figures

	07.16 - 01.18	2007-2008
AMERICAN		
Core bond fund	-0.2%	6.57%
Short-term corporate	1.41%	-3.90%
EUROPEAN		
Euro Investment Grade (US Core Bond equivalent)	-0.21%	0.60%
Euro - Short Term Corporate (average manager)	3.90%	1.75%

Source: Citywire

Past performance is not a guide to future returns

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Risk Warnings
The value of investments and any income will fluctuate (this may partly be the result of exchange-rate fluctuations) and investors may not get back the full amount invested.

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