Richard Bernstein Advisors

RBA Fixed Income Insights

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Duration management for the next 40 years

Traditional long-only fixed income managers had one of the worst quarters on record in Q1 2022 as higher interest rates left “bottom up” portfolios overweight duration. As we have discussed before, in a world where macro variables drive returns, owning 1000s of individual bonds leaves the impossible task for controlling credit and duration risk at the portfolio level. Instead, portfolios constructed with illiquid individual bonds become “index-like” and static, unable to react to new information and new regimes. Although we don’t think the pain is over for these types of portfolios, we do believe that fixed income – even in a world where inflation and interest rates are rising – can still be prudently used to help diversify and protect a portfolio from equity drawdowns. To thrive, managers will need to use liquid alternatives that allow for creative solutions and macro positioning in a low-cost way. **The basic 60/40 portfolio might not be as dead as many believe- it just looks different.**

Specifically, to be an effective fixed-income investor going forward may require using tools that separate credit from interest rate risk and allow investors to be nimble enough to manage cyclical trends within a secularly shifting world. To this end, we are frequently asked two questions 1) what is the best way to use Treasuries to manage duration?, and 2) why have any duration at all?

These questions are a bit more complex than they appear. First, cycles almost always overwhelm a secular view. Case in point, during the 40-year bull market in Treasuries there were 9 periods lasting a year or longer (11 years of the 40) where government debt lost more than 5% per year. In other words, throughout the entire 4 decades, a static portfolio left money on the table versus an actively managed one. Tactical duration management will be a key to navigating a secular rising rate environment marked by intermittent periods where yields fall.

Duration comes in many shapes and sizes, especially when constructing a portfolio with ETFs that allow for rate hedged products, and fixed-income investors will need to be creative. There has been a meaningful increase in the breadth of fixed income ETFs over the past few years, which now allows investors to be very specific about the type of interest rate and credit exposure they target. Further, ETFs allow managers to be very nimble and deviate from their benchmarks without the need to turn over huge portions of their portfolios to change those exposures.

For example. Imagine the following 4 portfolios built on the day the 10-year yield bottomed on August 4th, 2020. Portfolio 1 has no Treasury exposure; instead, all the portfolio’s rate risk is embedded in short duration investment grade corporate debt. Portfolios 2, 3, and 4 all have the same underlying holdings– long maturity corporate bonds hedged to zero duration through an interest rate swap – paired with a Treasury position of varying tenors to get to the same duration as portfolio 1. The interest rate sensitivity of a portfolio with a 15% weight in 20+-year Treasuries and 85% interest rate-hedge IG corporate bond exposure is more or less equivalent to that of a portfolio 100% comprised of traditional 1-3-year maturity IG corporate bonds.

Many investors would look at portfolio 1 as the optimal portfolio because Treasury yields have increased 200bp over the last 20 months. In fact, the best performing portfolio, by a wide margin, is portfolio 4, which holds the longest maturity (20+year) Treasury! Though it may not look pretty from an individual holding perspective, the investors need to focus on portfolio-level results.

Portfolio	US Investment Grade Corporate	Treasury	Portfolio Duration	IG Return	Treasury Return	Portfolio Return
1	100% 1-3y	0% Treasury	2.8y	-3.2%	--	**-3.2%**
2	40% LT hedged with Swaps	60% 3-7y Treasury	2.8y	9.0%	-8.3%	**-1.4%**
3	65% LT hedged with Swaps	35% 7-10Y Treasury	2.8y	9.0%	-12.1%	**1.7%**
4	85% LT hedged with Swaps	15% 20+ Treasury	2.8y	9.0%	-21.0%	**4.6%**

Portfolio returns from 8/4/2020 – 4/4/2022. This is for illustration purposes only. Does not take into consideration fees and commissions.

By separating duration from credit, and by using interest rate swaps to hedge the long maturity credit risk while owning longer dated Treasuries, portfolio 4 was able to take advantage of a) a flattening Investment Grade spread curve, b) a flattening Treasury curve, and c) widening swap spreads (i.e., the underperformance of Swaps vs Treasuries).

One could question the need for any Treasury exposure, but there is such uncertainty regarding the economic environment, it seems prudent that investors have some duration in their portfolio as a recession hedge. As with all hedges, the "premium" yield given up is the cost for holding the position, i.e., no hedge is free. Given fixed income is often used to dampen equity volatility and protect to the downside in the event of a recession, maintaining a small amount of duration seems to make sense and likely should be added to (while remaining underweight) if rates continued to increase and uncertainty continued to mount.

If an investor who buys a 10-year Treasury at 3% yield held that bond for 2 years, the level at which yields would need rise before losing money is ~3.7%. If the 10-year yield increased to 4.5%, a level not seen in 15 years, the cost to hold the position is 3.5% per year. That cost seems reasonable given the investor would make 24% if the economy went into recession at the end of those 2 years and the 10-year yield fell to 1%.

Maintaining recession protection by holding moderate duration exposure is very different from using Treasuries as a total return investment and overweighting duration. We would likely only take such a position when the probability of recession has gone up significantly from current levels or if there were other fundamental reasons to shift course (rapidly falling inflation, central bank QE, etc.). We doubt investors are in one of those times today and, therefore, have a large underweight to duration, used solely as a portfolio hedge.

We believe being able to manage extreme variations of duration, including knowing when and when not to pair with credit risk, will be vital to portfolio management in what will likely be a secularly rising rate environment marked by periods of rate rallies. To us that means portfolios constructed using ETFs and focused on macro factors are the future of fixed income management.

Michael Contopoulos
Director of Fixed Income

Please feel free to contact your regional portfolio specialist with any questions:
Phone: 212 692 4088
Email: sales@rbadvisors.com