Duration management

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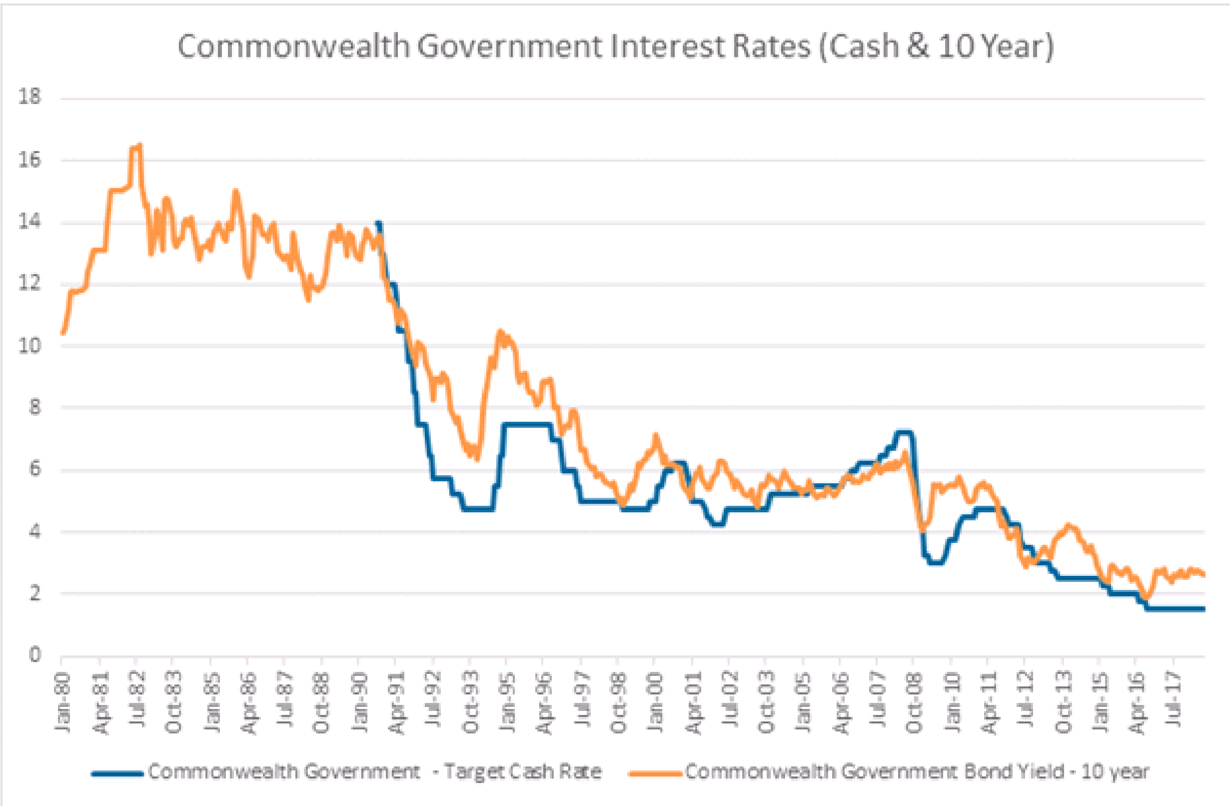
By guest contributor **Kev Toohey, General Manager, Atchison Consultants**

With the 35-year secular fall in interest rates seemingly on a plateau and shorter-term cyclical expectations of interest rates being focused upwards, there is a temptation for investors to avoid interest duration in their fixed interest portfolios in the attempt to time the rates cycle.

Interest duration is a measure of the sensitivity of the price of a bond to changes in interest rates. Whilst duration is expressed as a number of years, it allows a shorthand calculation of the expected percentage capital loss or gain from a change in a bond's yield of +1% or -1% respectively.



Role of Fixed Interest in a portfolio

For most investors, defensive assets seek to provide three attributes for a portfolio:

- A positive level of income,
- Capital preservation, and
- Diversification from equity downside periods, particularly those caused by economic recession and an investor flight to safety.

Over the last 35 years Government bonds, which carry positive interest duration and limited credit default characteristics, have done a reasonable job in achieving each of the above. However, the way forward for each of the above attributes is much less clear, where:

- Nominal yields are historically low,
- Low initial yields provide a thin buffer to offset capital loss on mark-to-market revaluations, and
- Unprecedented monetary intervention globally has seen distortion of traditional relationships between equity and debt.

The above factors provide a temptation to step out of traditional government duration positions and rely on credit and cash-like duration defensive alternatives. Whilst there is a role for such credit and shorter duration strategies within a portfolio, some investors have a complete absence of any high credit quality duration within their portfolio.

As with most things, duration and credit should be taken in moderation; too much or too little of either will leave you exposed at some point in the cycle. Short duration credit portfolios are suitable to extract the credit premium available above cash levels; however, they should not be expected to provide a traditional defensive offset under conditions of an equity market drawdown.

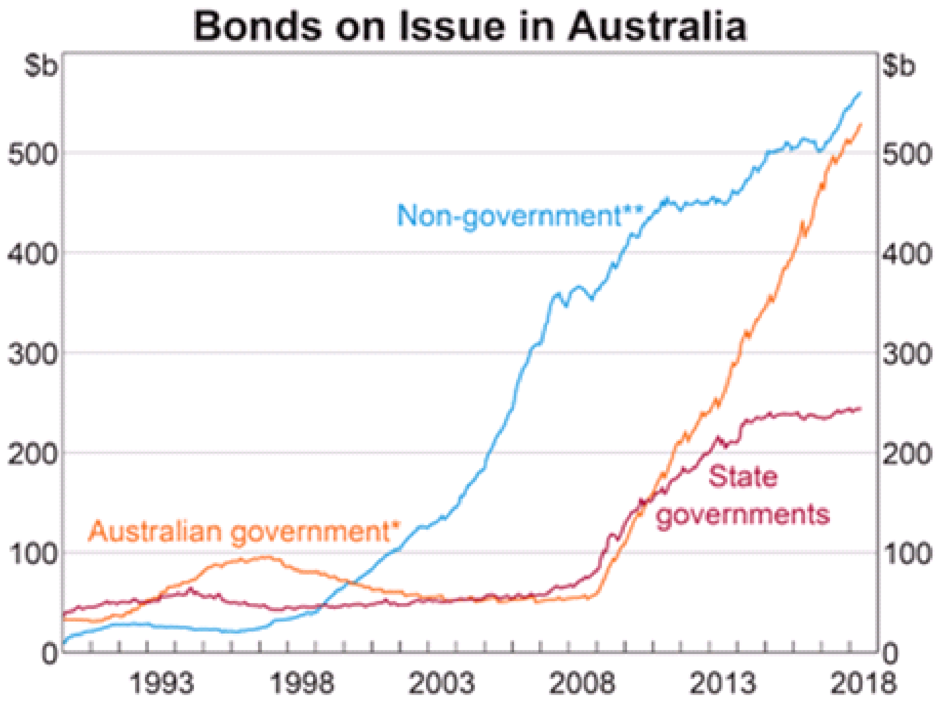
Herein lies the relevant conflict; how should investors extract the defensive portfolio characteristics sought of fixed interest – whilst mitigating the risk of rising interest rates?

Passive Duration Management as an option?

Passive allocation to benchmark duration is not preferred in a period of rising interest rates. This is underlined by the material lengthening of the issuance-weighted benchmark duration as issuers borrow longer to lock in historically cheap borrowing costs. The result for passive benchmark investors has been an unmanaged lengthening of duration exposure inversely related to interest rates, driven by issuer supply dynamics. Whilst cheap and transparent, these passive management strategies lack any ‘at the wheel’ management of the relevant duration exposures.

Active Duration Management as an option?

A silver lining of the recent Australian government fiscal deficits recorded over the last 10 years has been the step change in the issuance of government bonds (both federal and state) available to investors.



* Excludes bonds purchased by the Australian Government

** Excludes ADIs' self-securitisations, includes government-guaranteed bonds

Sources: ABS; AOFM; RBA; State Treasury Corporations

The above increase in government issuance widens the scope for market participants to actively manage exposures across the duration curve.

The next five years will be a test of skill for active fixed interest managers. Investors cannot expect the undercurrent of falling interest rates to support return outcomes.

The requirements of active duration management are the ability to dial up duration in the aim of protecting downside outcomes in risk-off environments together with the skill to mitigate marked-to-market losses as interest rates rise.

The divergence of portfolio outcomes over the next 5 years is likely to be heavily influenced by investors' abilities to manage their duration exposure. Mandate design and identification of manager capability will be the determining factors.