Portfolio preparation for rising rates

Wealth Management

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Not all bonds are created equal when it comes to interest rates. There are several strategies investors can implement now to better position their portfolios for a potential rising-rate environment.

As we look ahead to the end of 2021, we see the 10-year Treasury yield as likely to move moderately higher, reaching 1.75%—nearly 40 basis points higher than its current level. In our view, this type of yield shift should not panic investors: a $100,000 position in 10-year bonds, for instance, stands to decline by roughly $4,000 if yields reach our target; and for hold-to-maturity investors, any drawdown below par will be recovered at maturity, absent a credit event.

Even though we believe hasty action would be counterproductive, there are several strategies investors can implement now to better position their portfolios for a potential rising-rate environment.

Cut allocations to challenged asset classes

Investors would do well to remember the Wall Street aphorism that the best hedge is a sale. Fixed income as an asset class faces multiple headwinds, and while we view exposure to bonds as a component of prudent portfolio management, investors should try to meet portfolio needs as efficiently as possible.

Too many investors, in our view, perceive rising rates as a signal to automatically shift into shorter-maturity bonds; this minimizes the loss per bond, but ties up excessive amounts of capital in investments with an expected loss. Investors can instead reduce their dollar exposure to fixed income as a whole, but focus on higher-yielding, longer-maturity bonds to keep the same level of coupon income. And since the price of these longer-duration bonds moves more when yields fluctuate, an investor can maintain the same level of portfolio exposure to interest rates with significantly lower fixed income holdings. The capital freed up by this approach can be invested in other asset classes with higher expected returns, potentially benefiting the portfolio overall.

Pick the right type of bonds

Not all bonds are created equal when it comes to interest rates. High-grade bonds such as Treasuries, agency mortgage-backed securities, and higher-quality investment-grade corporates are the most sensitive to a rising yield curve. Lower-rated, high-yield bonds, on the other hand, tend to do better in a rising-rate environment because weaker companies often benefit from the growth conditions that drive interest rates higher, and declining credit spreads can help cushion the price impact of rising Treasury yields.

As an alternative to adding credit risk, investors can look to bonds with structural protections against rising interest rates. A floating-rate note (FRN) is one example. In a fixed-coupon bond, the price of the bond adjusts to rising rates; with FRNs, the coupon moves with the changes in the market interest rate. Often issued by banks and other high-quality issuers, FRNs give investors a solid interest rate hedge with limited credit risk. One potential problem is that most floating-rate bonds are linked to short-term rates; if rates rise, for example, as a result of inflation fears caused by an accommodative Fed, the coupon may not adjust sufficiently to compensate for the increase in longer-term yields.

Preferred shares and hybrid securities can help correct for this risk. These securities typically have a fixed dividend or coupon that switches to a variable amount at a predetermined date. One benefit for investors is that

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some of these securities link future cash flows to 5-year or even 10-year Treasuries, creating a better match with the time horizon of the typical investor portfolio. Preferreds and hybrids are typically junior subordinated securities, but some of these issues are still investment-grade rated despite their lower-priority status.

Convertible bonds ("converts") do not directly link to market interest rates, but empirically they have performed well in rising-rate environments. The tendency of equities to rise alongside interest rates has allowed converts to outperform traditional fixed income assets in rising-rate environments for at least two decades; a more detailed discussion can be found in our report on convertible bond performance.

Hedge the position

There are relatively few practical ways for an individual investor to hedge the interest rate component of a high-grade bond portfolio. The methods most commonly employed by institutional investors—shorting Treasuries, using bond futures, or entering a swap agreement—require complicated documentation and frequent margin posting, and therefore are effectively closed to individual investors.

Hedging is also expensive. Investment-grade bond spreads—the income left over after interest rate risk is hedged—are currently less than 0.5% for 5-year maturities. To generate reasonable income, an investor would likely have to add significant leverage to hedge their investment-grade bond positions.

The need for leverage may tempt some investors to instead use leveraged ETFs to express a negative long-term view on bond prices. This is a mistake, in our view. Leveraged ETFs provide a multiplier of returns measured on a *daily* basis; this makes them inappropriate for long-term hedging. If, for example, bond prices were to rise from $100 to $140 before falling to $100 again, a negative-levered ETF would show a significant loss, rather than the essentially unchanged value of a properly constructed hedge.

A better alternative for investors seeking a leveraged means of expressing a short-term negative view on interest rates, in our view, would be to use deep in-the-money options on Treasury ETFs. However, this is a relatively advanced strategy suitable for only a few investors.

First, do no harm

While fixed income investors currently face difficult market conditions, we see the bigger risk for most investors as over-reacting and over-trading. The heavy lifting required to deal with market volatility is best accomplished through portfolio diversification and periodic rebalancing. Adjustments to market views—particularly a relatively small rise of 40 basis points in 10-year rates—are, at best, secondary drivers.

In our view, investors should consider extending duration to reduce assets tied up in high-grade bonds, then look towards bonds with structural protections—or a long history of positive performance—during rising-rate environments. More importantly, they should avoid complicated strategies that we view as appropriate only for large institutional investors, and instead rely on time-tested portfolio management.

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