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Bond market dilemma: Lowering duration without sacrificing yield

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Fixed-income investors limit their opportunity set when they focus on benchmark-tracking or benchmark-hugging strategies. But many investors do it anyway.

Investors faced with macroeconomic and capital market uncertainties have been moving into short-duration fixed-income solutions. Dominated by shorter all corporate or government/corporate debt, these solutions offer little diversification by sector, credit quality or country allocation — where wider spreads and higher yields are often found.

Traditional benchmarks like the Bloomberg U.S. Aggregate Bond Index and the Bloomberg Short-Term U.S. Aggregate Bond Index have delivered annualized returns of 4.9% and 3.8% since 2000, respectively. But these benchmarks have changed their composition pretty significantly since the Great Recession. The Agg's weight in Treasury securities ballooned, corporate and securitized exposure in the index shrank, and the benchmark extended duration and lowered yield as a result. While duration for the Short-Term Agg is relatively constant, yields are currently very low. Meanwhile, the duration of the Agg is at its peak since 2000. Longer duration means greater risk of price declines if rates rise even modestly.

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Bond market dilemma

How to lower duration without sacrificing yield

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Faced with the dilemma of historically low bond yields and high equity market valuations, investors are using short-term bonds to "park" assets until they decide what to do next. But instead of renting a short-term bond "parking space" solution, some investors are considering the benefit of owning a lower duration[1] solution as a longer term investment, one that's diversified across fixed-income sectors and designed to provide income and capital appreciation.

A challenging macro environment

Fixed-income investors are facing a challenging macroeconomic environment amid the recovery from the global pandemic. While the federal funds target rate range remains anchored at 0%–25%, we're seeing higher levels of inflation and consumer inflation expectations as global economies reopen and the outlook for future inflation — based on the Fed's 10-year model and current trading in 5-year forwards — remains low. As a result, interest rates may climb higher, but not significantly (see Exhibit 1).

Exhibit 1: Core inflation and inflation expectations (%)

[1] Duration is a measure of a bond's price sensitivity to changes in interest rates.

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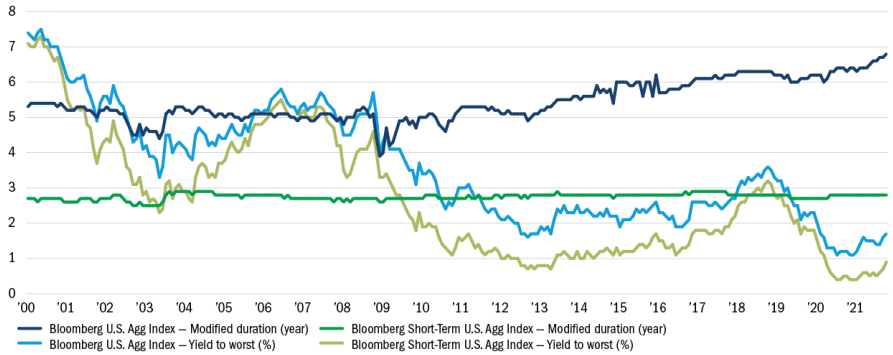
Traditional bond benchmarks are delivering lower yields with no reduction in duration risk

Duration and yields



Source: Bloomberg, data as of 06/30/21. **Past performance does not guarantee future results.** The Bloomberg U.S. Aggregate Bond Index (U.S. Aggregate) is a broad-based benchmark that measures the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS (agency and non-agency). The Bloomberg Short-Term U.S. Aggregate Bond Index is a subset of the Bloomberg U.S. Aggregate Index and measures the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes treasuries, government-related and corporate securities with up to, but not including, five years to maturity. It is not possible to invest directly in an index.

The constituents in the Morningstar Short-Term Bond category overwhelmingly use versions of shorter all-corporate or government/corporate indices — offering little diversification by sector, credit quality or country allocation — where wider spreads and higher yields are often found. Not surprisingly, the Short-Term Agg has a 99% correlation to the Bloomberg 1–5 Year Government/Credit Index, one of most frequently used indices in the category.[1]

Better return due to sourcing better income opportunities

Investors could benefit from owning lower duration, diversified fixed-income solutions that invest in higher income-producing sectors, such as high-quality high yield, emerging market debt and broad use of structured assets. Together, with investment-grade corporate bonds, these sectors typically experience low correlation and can provide attractive income and capital appreciation, while keeping overall duration reasonably low.

Bottom line

The short end of the yield curve is often referred to as the “sweet spot,” where investors can typically find the most attractive risk-reward profiles. Today, investors need to consider an approach that allows them to remain invested in key sectors that can generate income while also navigating the uncertainty of interest rate moves and market volatility.

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DISCLOSURES:

[1] Source: Bloomberg, 01/01/00-06/30/21

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Duration is a time measure of a bond's interest-rate sensitivity, based on the weighted average of the time periods over which a bond's cash flows accrue to the bondholder. Yield to worst is the lowest potential yield that can be received on a bond without the issuer actually defaulting.

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