MJW Topix

The end for bonds?

Investors need to carefully consider the amount of duration in their portfolios

November 2016

Since June 2016, interest rates have been gradually rising. This accelerated sharply in early November on the news that Donald Trump had won the U.S. presidential election (his policies are expected to lead to higher U.S. inflation and therefore higher interest rates).

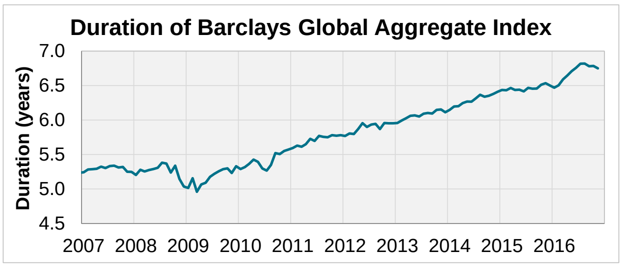
This unanticipated rise in interest rates (or yields) has led to negative returns from bonds (bond prices fall as yields rise). The losses have been worst for those strategies with the greatest duration.

Duration is a measure of the weighted average term of a bond's cashflows. Bonds with a longer term, or proportionately larger payments towards the end of their term, are said to have longer duration.

Duration is oft-quoted because it illustrates the inverse multiplicative relationship between price and yields. For example, if a bond has a duration of 5 years and yields rise by an unanticipated 0.5%, the bond will lose approximately 2.5% (0.5% x 5) of its value.

The changing index

The poor performance from bonds has come after a period where the duration in the global bond market has lengthened considerably – leaving investors more exposed to unanticipated rises in yields.

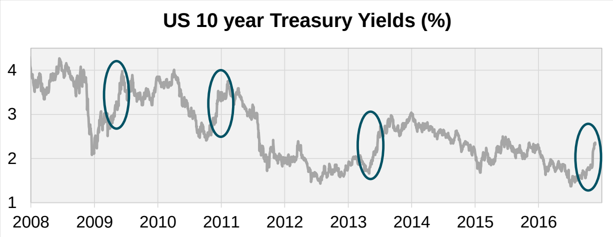


Since the global financial crisis (GFC), the duration of the headline global bond index (the Barclays Global Aggregate Index shown above) has increased from around 5.25 years to 6.75 years. This has come about from a combination of (i) issuers "terming out" their debt by issuing longer dated bonds to take advantage of lower interest rates and (ii) lower interest rates themselves lengthening the duration of the index through lowering the "weight" of coupon payments in the duration calculation.

Have we been here before?

While the most recent rise in yields has been steep (the US 10 year Treasury yield has increased by about 0.75% since 30 September), it is not atypical. Some commentators are calling an end to the "bond bull market" (i.e. that yields will now be in a multi-year upward trend). However there are many on the other side of the debate that believe the bond market has overreacted in recent weeks and yields may be due to rally (i.e. revert downwards).

Even just considering the period since the GFC, we have seen numerous "false dawns" of similar magnitude (see following chart). Investors that believed that rates would keep rising and removed duration from the portfolio following in these periods would have fared relatively badly over the subsequent months.



Possible responses

A possible response to rising yields and the lengthening duration of indices might be to divest from global bonds, placing the proceeds in cash or short duration bond funds. While this would reduce the risk of negative returns from rising rates, it comes with several disadvantages;

- Removal of tail hedge: Duration acts as a hedge against unanticipated adverse (or "left-tail") events. In these situations, interest rates tend to fall, providing a boost to the returns of bonds and offsetting losses elsewhere in the portfolio.
- Removal of diversity: Global bonds provide diversification from NZ bond and cash allocations. Domestic portfolios tend to have significant exposure to the NZ Government and the big four banks.
- Potentially lower returns: Our forward-looking investment assumptions and the higher running yield for global bonds both augur well for incrementally higher returns from global bonds compared to cash.

We are conscious of being reactionary to short term market volatility, i.e. locking in the losses experienced over the last few months. History has shown that while it feels "comfortable" to sell out of sectors that have done poorly, often the correct action is to make the "uncomfortable" choice and retain one's position.

Moreover, it is important to remember that bonds take losses in response to unanticipated rises in yields. That is, an increase in yields of more than what the market is pricing in.

With that said, observing the increase in duration of global bond indices over the last seven years, portfolios today may well have more duration exposure than their strategic position warrants. Therefore, there is an argument for considering a reduction in the exposure to global bonds to bring one's portfolio back into line with the level of duration that it would have had, were indices at their pre-GFC levels.

ABOUT MELVILLE JESSUP WEAVER

Melville Jessup Weaver is a New Zealand firm of consulting actuaries providing advice on superannuation, insurance and asset consulting. The firm, established in 1992, has offices in Auckland and Wellington and is an alliance partner of Willis Towers Watson, a leading global services company and is located on the web at willistowerswatson.com.

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