# THE DURATION TRAP

Investors with a total return objective have historically been served well by the fixed income component of portfolios, such as a portfolio benchmarked to the FTSE Canada Universe Bond Index (the Universe Bond Index), which has delivered a reliable return experience and valuable diversification to more volatile equity investments.

The experience today for investors such as endowments, foundations, target benefit plans, and capital accumulation investors has been vastly different with double-digit negative fixed income returns year-to-date to May 20, 2022.This has been the result of the combination of high duration (sensitivity to changes in interest rates) and significant increase in interest rates.

This article investigates how investors found themselves in this duration trap and what options are available to limit future downside experience.

## Increased Interest Rate Sensitivity

With the multi-decade decline in fixed income yields investors had become accustomed to the implications for lower longer-term fixed income returns. However, as yields declined, governments and companies took the opportunity to significantly lengthen their bond maturities when issuing new debt. In doing so, they have contributed to the increase in the Universe Bond Index duration and associated increased sensitivity to changes in interest rates.

While it made sense for borrowers to seize the opportunity to reduce their borrowing costs and lock in certainty by extending the lending period, there was no compelling benefit for investors with a total return objective, especially in a lower yield environment.

It is a different situation for investors with liability-related objectives, such as defined benefit pension plans.

The resulting dynamics significantly increased the risk of negative returns in a rising interest rate environment. The math is simple, if a fixed income portfolio has a yield of 2% and the duration is 8 years, and interest rates across the yield curve rise 1%, then the portfolio value would be expected decline by 6% (not considering merits of active management).

## Desensitized

The initial response to lower yields was characterized by a "hunt for yield," which included the consideration of a core plus fixed income component that incorporated an allocation to strategies such as high yield and emerging market debt, and in some cases dedicated allocations to higher yielding assets.

Lower yields also triggered the decision by investors to look beyond fixed income and introduce allocations to less-liquid private markets, such as commercial real estate and infrastructure. Taken together, while this has witnessed a general reduction to domestic fixed income, in many cases fixed income still represents a sizable portion of total assets.

Investors have also had to deal with the desensitization to rising interest rates. For many years "experts" have predicted a rising interest rate environment that did not unfold. The volume of such predictions has led to many investors dropping their guard with respect to the ensuing risk.

Investors are currently experiencing some of the toughest fixed income markets in history, which combined with challenging equity markets, has seen the value of total portfolio assets significantly reduce from recent highs following the strong post-pandemic returns.

## Avoiding the Duration Trap

There is still uncertainty with respect to interest rates, so what can be done to limit further downside performance from fixed income?

## There are several potential considerations:

1. **Absolute Return Focus.** Fixed income strategies with an absolute return focus, where the investment manager has greater flexibility. The manager is afforded greater flexibility with respect to the duration range, the ability to adopt both long and short positions in securities, incorporate higher yielding below investment grade securities, or a combination of these. Some of these strategies have managed to broadly maintain a fixed portfolio's capital value while the Universe Bond Index has experienced double-digit declines.

2. **Total Return Objective.** An alternative to 1) above is to work with your fixed income investment manager to determine a target return considering current yield opportunities. Under this approach, the extent to which there is a willingness to experience some level of downside risk will influence the longer-term total return potential.

   For smaller-sized investors, the total return objective could be achieved by allowing the fixed income manager to invest opportunistically across a range of pooled funds, such as short-term, universe, and higher yielding funds.

3. **Higher Yielding Strategies.** The addition of higher yielding strategies (or increase to existing allocations) will by their nature have a lower duration compared to the Universe Bond Index, thereby reducing interest rate sensitivity. However, many of these strategies are still susceptible to negative returns as experienced year-to-date to May 20, 2022, with high yield and emerging market debt indices both declining significantly.

   Careful review of potential strategies will be required to appreciate the extent of the downside protection and diversification qualities. For example, Canadian commercial mortgage strategies in general have declined much less than universe bonds so far in 2022, although consideration would also need to be given to the less-liquid nature of these strategies.

4. **Private Market Strategies.** The addition of private market strategies (or increase to existing allocations) such as commercial real estate and infrastructure offer alternative and stable sources of income, as well as providing diversification to equities and fixed income. However, investors need to be comfortable with the less-liquid nature of these assets, since they are valued on a much less frequent basis compared to public market investments.

## Start the Conversation

The increased duration of the Universe Bond Index has created an environment where investors are experiencing some of the toughest fixed income markets ever witnessed. Uncertainty remains with respect to interest rates, but there are several considerations for investors to help manage the downside risk from fixed income investments. Start the conversation with your consultant or investment manager to see how your assets can be better protected.

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