ADVISOR PERSPECTIVES

Rising Rates: Time to Position, Not Panic

July 12, 2013
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It finally happened. After endless discussion about the potential for rates to rise, they finally did—in a big way. During May and June, the 10-year US Treasury yield soared by nearly one percent, and markets reeled. Instead of panicking, investors should make sure their portfolios are positioned effectively.

Even with the Fed planning to keep short-term rates nailed down for a while, our forecast is for generally higher rates ahead. While there won't necessarily be a big leap like the one in the second quarter, investors should be positioning their bond portfolios for the reality of higher rates.

The good news: the bond market isn't a monolith. There are a lot of ways to reduce a portfolio's sensitivity, or "beta," to interest rates while staying true to investment goals. The display below uses US Treasury returns to represent the behavior of an extremely interest-rate-sensitive sector. A sector with a beta to Treasuries that's close to one is also highly rate sensitive. A beta of zero indicates a sector with no relationship to Treasury returns. When it comes to rising rates, the lower the beta the better.

Not All Bonds Are Created Equal
Bond Index Betas vs. US Treasuries (March 1997–June 2013)

As of June 30, 2013
US Treasuries are represented by Barclays US Treasury (a weighted index of all US Treasuries), US TIPS by Barclays US TIPS, US credit by Barclays US Credit (investment-grade bonds), municipal bonds by Barclays 5-Year Municipal, emerging-market bonds by J.P. Morgan EMBI Global Diversified and high yield by Barclays High Yield Credit Bond. March 1997 is the inception date for Barclays US TIPS.
Source: Barclays and J.P. Morgan

A broad-market US bond index such as the Barclays US Aggregate Index offers some insulation, with a beta of 0.70. A broad global index, such as the Barclays Global Aggregate Index hedged, has fared better, with a historical beta of 0.53. Credit quality also makes a difference: Investment-grade credit offers some buffering, with a beta of 0.74. High-yield credit, on the other hand, actually has a negative beta—its returns historically move in the opposite direction from those of Treasuries. That can be a valuable characteristic.

Here's a brief look at strategies that we think can help bond portfolios weather a rising-rate environment:

Go global. Country and regional bond markets don't travel in lockstep. Adding them to a single-country portfolio has historically enhanced risk-adjusted returns and expanded opportunities. But there's a catch: currency fluctuations can create unintended volatility, unless investors use a hedged approach designed to eliminate currency exposure. Going global also offers the potential for active management to take advantage of the diverse patterns of country returns.

Access credit sectors. High-yield bonds tend to be driven much more by changing credit conditions than by interest rates. That helps explain their inverse return relationship with Treasuries. A credit-sensitive sector can complement other sectors as rates rise. Investors who are particularly conscious of interest-rate risk might consider high-yield bonds with lower duration, which indicates less interest-rate sensitivity.

Tap into muni bonds. In addition to the favorable tax treatment that muni income provides, muni bond yields have historically risen less than comparable Treasury yields. We think intermediate-term muni bonds are in the sweet spot in terms of risk and return, and investors seeking to increase their yields might consider some exposure to lower-rated munis.

Add inflation protection. Rising rates are often accompanied by rising inflation expectations, which can hurt bond returns. TIPS (Treasury Inflation-Protected Securities) have been a popular investment and have produced strong returns. However, our research reveals that the driver of that performance also presents an unexpected risk: higher duration. As rates rise, this is likely to work against TIPS. In our opinion, investors should be looking to inflation-protection strategies with lower duration.

Leave the index behind. Broad indices are common benchmarks, but staying too close to their composition may limit a portfolio's ability to reduce duration or increase diversification. Benchmarks also present risks. For example, a country that issues more debt relative to others can become a bigger proportion of an index at a time when less exposure might make more sense. It's worth considering a strategy that emphasizes total return and doesn't track a specific benchmark.

There will be much more to come on the topic of rising rates, but suffice it to say that the fixed-income market offers a lot of flexibility to help investors prepare their portfolios.

The views expressed herein do not constitute research, investment advice or trade recommendations and do not necessarily represent the views of all AllianceBernstein portfolio-management teams.

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