Three Ways to Keep Your Head Above Water as Rates Rise

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by Douglas Peebles of AllianceBernstein

Volatility in yields got you down? Fearful of more rising rates ahead? Worried your bond portfolio will sink into the red? We have strategies that will help keep you dry, even if the waves get high.

Three Rules for Surviving Rising Rates

1) Stay properly invested. Don't shift to cash, which could soon have you lagging both income-generating bonds and inflation. And, don't expect to time the end of the interest-rate cycle, either. Even the most seasoned bond managers can't do that.

Also, don't fall prey to the lure of floating-rate bank loans. Neither of their selling points—floating rates and seniority in the capital structure—is what it seems.

Loan coupons float, or adjust, based on movements in LIBOR. But they're continuously callable, and they're being called in massive numbers. Nearly three-quarters of outstanding bank loans were refinanced or repriced in 2017. That's led to lower—not higher—coupons, despite the Fed having raised interest rates six times over the past two-and-a-half years.

As for seniority, more than half of today's loan issuers have no unsecured bond debt on their balance sheets. That means default recovery rates are likely to be much lower than in the past.

Oh, and the quality of those loans has been getting worse. "Covenant-lite" deals lacking basic protections for lenders now represent more than 70% of the market. This suggests that default risk is far higher than many investors realize.

2) Lift a barbell. This approach balances interest-rate risk and credit risk in a single strategy run by one manager who alters the exposures to each as valuations and conditions change. This kind of strategy should help minimize risk by preventing investors from reducing duration too much and, conversely, from tilting too far into credit.

What's more, while the interplay between interest rates and credit is always important, there are times when that interplay becomes the most important risk for investors to manage. This typically happens when a central bank's attempt to slow a credit cycle is the key factor driving interest rates and bond yields higher. That's what we believe is happening today.

3) Diversify, diversify, diversify. Diversification is an essential defensive strategy at this stage of the credit cycle. The key is to keep your horizons broad and be choosy. Today, blending exposure to attractive high-yield bond sectors—European banks, US energy companies—with positions in select emerging-market debt and US securitized assets offers a good mix of credits that generate high levels of income.

For investors who want an attractive floating-rate option, look no further than credit risk–sharing transactions (CRTs), a new type of securitized asset, backed by mortgages and issued by the US federal housing agencies. CRTs offer protection against rising rates without the downsides of bank loans. Unlike bank loans, they aren't callable for the first 10 years, and their returns have outpaced loans during periods when rates were rising. In addition, underlying credit quality is higher than on bank loans: mortgage lending standards today are tight, and borrower fundamentals are strong.

Higher-yielding assets occupy a riskier segment of the global bond market, making them vulnerable to drawdowns during an economic downturn or a market correction. But by spreading exposure across multiple regions and sectors, investors can reduce the potential damage that a large drawdown or spike in default rates might have in any single sector. And, by providing access to diverse sources of income and return, a global, multi-sector strategy maximizes opportunities at the same time that it minimizes concentration risk.

From Surviving to Thriving

Take heed of the role of risk-mitigating assets in your overall portfolio: when return-seeking assets show volatility, risk-mitigating assets react positively. That’s precisely what we’ve observed lately and why most investors need to hold both return-seeking assets and risk-mitigating, fixed-income assets. This behavior is also a sign, along with the flatter yield curve, that we are likely further advanced in the rate-rise cycle than some investors and market commentators fear.

Above all, remember that for most investors, rising interest rates benefit bond investments over time. If the duration of your portfolio is shorter than your investment horizon, rising rates will help you, no matter how big the rate increase.

In fact, with the right strategies in place, rising rates can help keep your entire asset allocation afloat.

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