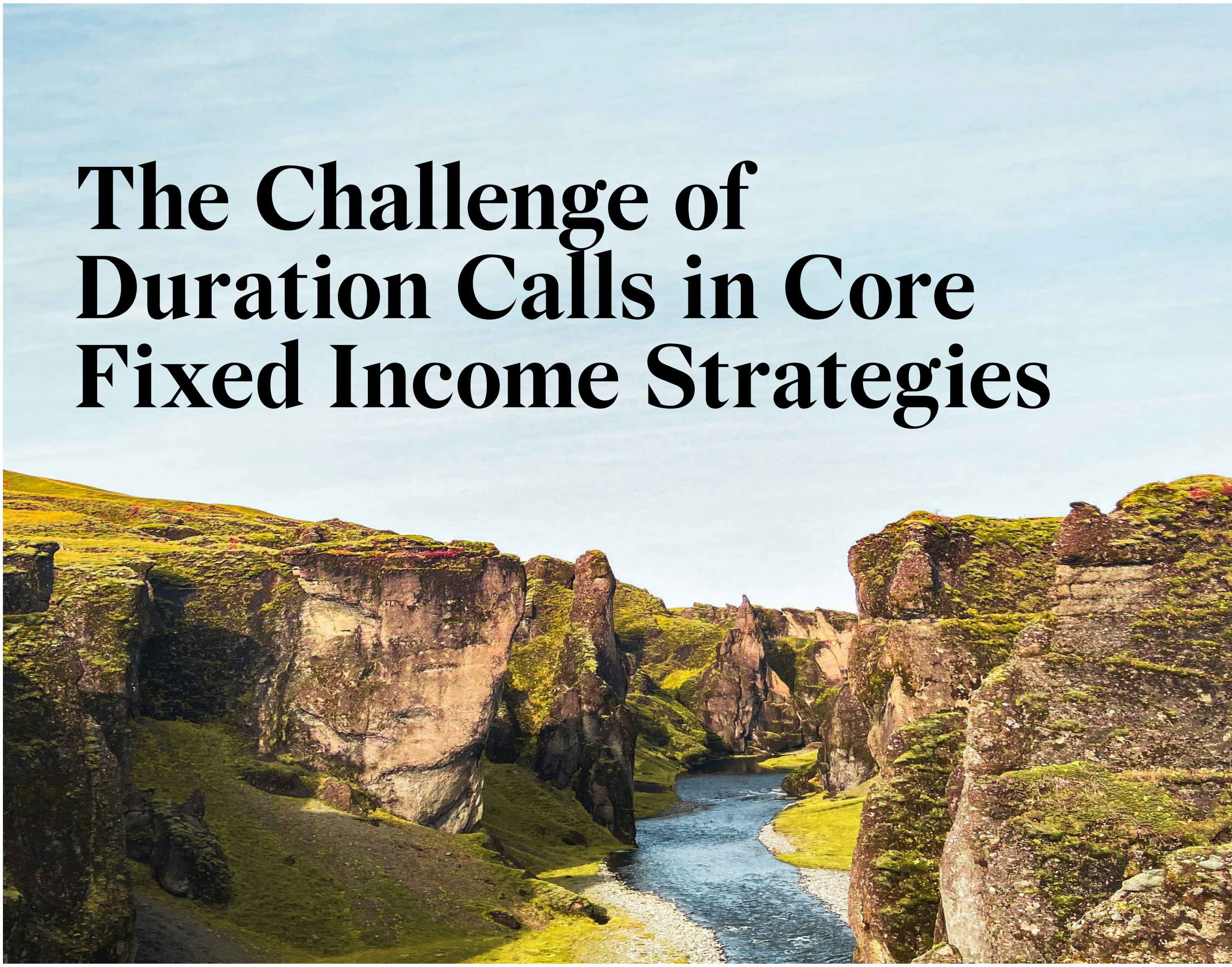
MANAGER INSIGHT

The Challenge of Duration Calls in Core Fixed Income Strategies



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Interest Rate Strategies

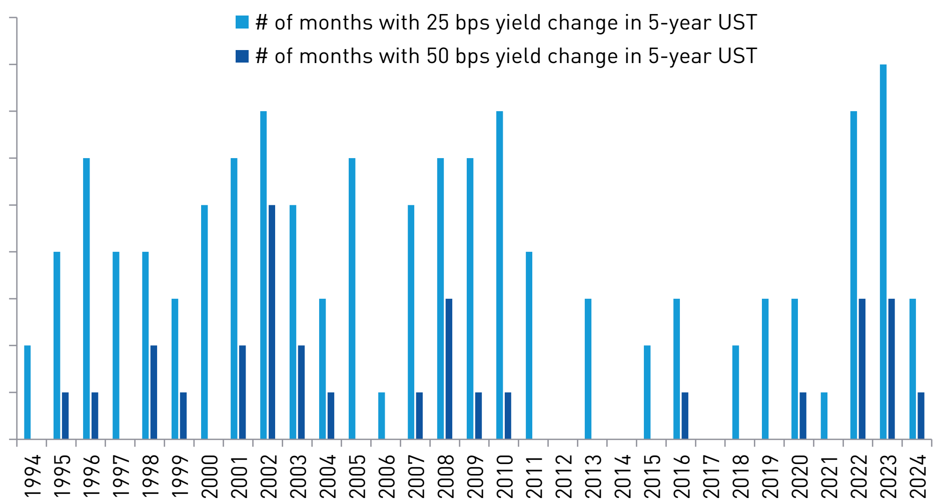
Bond portfolio managers looking to source incremental return over a benchmark often implement strategies such as asset class rotation, security selection or duration-based investing. Rates markets can offer opportunities to potentially generate additional returns because interest rates move daily. In this way, using duration or interest rate positioning based on a prediction of where interest rates may go in the future, can be a very effective tool in our view. Further, duration strategies can vary in magnitude and when combined with significant interest rate changes, the impact on alpha potential can be meaningful.

Rate Moves

The capricious expectations that can swirl around interest rates can contribute moves in the rates market that are often significant, frequent and, at times, compelling. During the past 30 years, the 5-year US Treasury yield has had 119 monthly moves of greater than 25 basis points (bps) and 30 monthly moves of 50 bps or more. The 10-year US Treasury has had 112 monthly moves of 25 bps or greater and 22 monthly moves of 50 bps or greater. See both of the charts below.

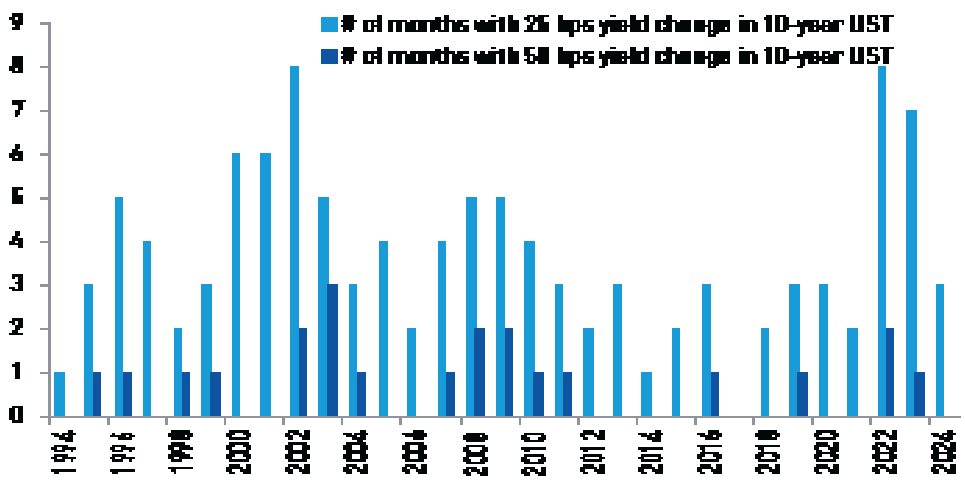
MONTHLY MOVES IN 5-YEAR TREASURY YIELDS

Source: Barclays, 31 July 1994 to 31 July 2024.



MONTHLY MOVES IN 10-YEAR TREASURY YIELDS

Source: Barclays, 31 July 1994 to 31 July 2024.



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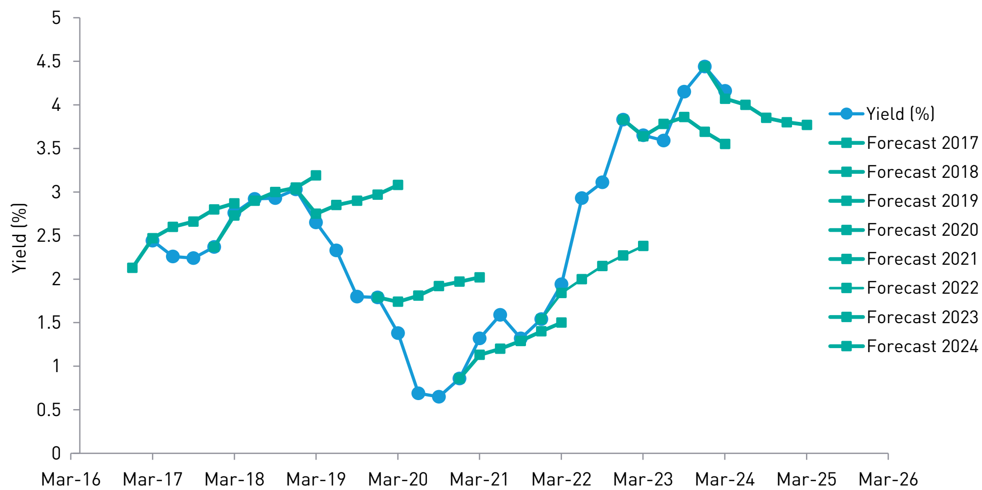
Past market performance is no guarantee of future results.

Policy Expectations

If interest rates can be such a robust opportunity set for bond investors, why wouldn't every manager use this approach? Unfortunately, the path of future interest rates is notoriously hard to predict. Consider the wild ride monetary policy expectations have taken so far in 2024. Markets had priced in six Fed cuts heading into 2024. After the Fed's September cut, expectations are for an additional cut by year end.[1] As the chart below shows, the gap between rate expectations and reality is not just a 2024 phenomenon.

ROLLING 5 QUARTER MEDIAN FORECASTS OF 10-YEAR NOTE YIELDS IN THE PHILADELPHIA FED'S QUARTERLY SURVEY OF PROFESSIONAL FORECASTERS: 2017 - PRESENT

Source: Philadelphia Federal Reserve Bank, as of 9 August 2024.



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Seeking Consistent Alpha

In our view, the vagaries of the rates markets can sometimes make them a very challenging opportunity set from which to profitably extract value, particularly for core fixed income managers who must mind a benchmark-aware risk-return objective. While there can be effective duration calls, there will also be ineffective duration calls. Success will vary and in our view this can speak to a manager's skill for this particular alpha lever. For core managers, who prioritize seeking consistent alpha, an investment process focused on security selection and sector rotation may offer comparatively better risk/return prospects.

[1] *Source: Cuts priced into market from 13 December 2023: https://www.cnbc.com/2023/12/13/fed-interest-rate-decision-december-2023.html.*

Here is one reason why. Based on historical moves, we calculate that a duration call of 0.5 years on the Bloomberg Aggregate Index duration of 6.1 years can represent approximately 45 to 50 bps of tracking error. As a result, ineffective duration calls can materially impact a portfolio's alpha potential—in some cases, eroding a large share of alpha or worse, depending on the size of the duration positioning and the move in rates. Keep in mind that the typical alpha objective for a core fixed income portfolio can range between 50 and 100 bps per year over a market cycle.

Mixed Results

Layering the vagaries of interest rate expectations on a responsive rates market can create a shaky platform from which to make duration decisions. In a benchmark-aware strategy, the use of duration as an alpha generator can have mixed results. In our view, expertise in sector rotation and security selection may increase a core fixed income manager's ability to deliver steady returns above the benchmark return.

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Important Disclosures

Past market performance is no guarantee of future results.

Market conditions are extremely fluid and change frequently.

Any investment that has the possibility for profits also has the possibility of losses, including the loss of principal.

There is no guarantee that the investment objective will be realized or that the strategy will generate positive or excess return.

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