TRENDS IN FIXED INCOME

Duration Risk: Then vs. Now

April 2024

EAGLE | Asset Management

Why duration risk is different in the new environment

If you ask investors why their portfolios hold fixed income, many of their answers will focus on two things: diversification from equities and striving to generate a high level of income. The diversification from equities has historically come from interest rate sensitivities – that is, how prices of fixed income assets change as interest rates fluctuate. When the economy is strong, which historically has resulted in positive equity performance, the expectation is that rates will rise. Higher rates negatively affect bonds because bonds issued at lower rates become less valuable in higher-rate environments. Conversely, in a falling-rate environment, when the economy is weaker and equity markets are often down, bonds provide both income from coupons and principal appreciation from the increasing value of bonds issued at higher rates. Thus, including both fixed income and equities in a portfolio typically results in at least part of the portfolio performing well in any market environment and highlights diversification.

The recent rising-rate environment was different. Following the Global Financial Crisis, interest rates remained at historical lows for nearly a decade, producing low levels of coupon income from fixed income bonds issued during that period. To generate higher income, investors needed to take on greater risk, either through lower credit or more interest rate sensitivity. The inflation shock in 2021 forced the Federal Reserve to raise rates into an already slowing economy, attempting to curb the growth in economic activity that causes inflation. Decreased forecasts for consumption and increased rates causing lower forecasted profitability meant that equities performed poorly. Fixed income also performed poorly because it wasn't generating the coupon income needed to offset the devaluation of bonds during the rising-rate environment, which had historically provided the shock absorber to offset paper losses.

We find it helpful to think about duration risk in terms of how many years of yield it takes to offset a 1% rise in interest rates. At the 2% to 2.5% rates generally prevalent over the last decade, investors extending duration needed multiple years of income generation to offset a loss caused by a 1% rise in rates. But at current rates, which are double or triple what was available in the decade before the pandemic, extending duration typically results in a bond investor needing less than a year to recoup principal losses from yield.

Years of Yield to Compensate for 1% Rate Shock

Present Yield of Portfolio

Duration of portfolio	1.0%	1.5%	2.0%	2.5%	3.0%	3.5%	4.0%	4.5%	5.0%	5.5%	6.0%	6.5%	7.0%
2	1.00	0.80	0.67	0.57	0.50	0.44	0.40	0.36	0.33	0.31	0.29	0.27	0.25
3	1.50	1.20	1.00	0.86	0.75	0.67	0.60	0.55	0.50	0.46	0.43	0.40	0.38
4	2.00	1.60	1.33	1.14	1.00	0.89	0.80	0.73	0.67	0.62	0.57	0.53	0.50
5	2.50	2.00	1.67	1.43	1.25	1.11	1.00	0.91	0.83	0.77	0.71	0.67	0.63
6	3.00	2.40	2.00	1.71	1.50	1.33	1.20	1.09	1.00	0.92	0.86	0.80	0.75
7	3.50	2.80	2.33	2.00	1.75	1.56	1.40	1.27	1.17	1.08	1.00	0.93	0.88
8	4.00	3.20	2.67	2.29	2.00	1.78	1.60	1.45	1.33	1.23	1.14	1.07	1.00

Source: Eagle research.

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It is understandable that many investors who were stung by the increase in yields would be wary of taking on additional interest rate risk. But it's important to recognize that the environment has changed: Fixed income is back to providing levels of income that can serve as a shock absorber during periods of falling rates (and presumably, economic stress). As noted in the chart above, investors taking on additional interest rate risk have the ability to be compensated notably quicker than they had been in the past. The blue box indicates rates that were typically available from the Global Financial Crisis until early 2022, and the gold box indicates yields seen during 2023 and the start of 2024. For these reasons, we believe that, depending on an investor's individual situation, taking on additional interest rate sensitivity can help to benefit investor portfolios without taking the levels of risk that were seen previously.

Risks associated with Fixed Income investing:

Many investors consider bonds to be "risk free" investment vehicles. Historically, bonds have indeed provided less volatility and less risk of loss of capital than has equity investing. However, there are many factors that may affect the risk and return profile of a fixed-income portfolio. The two most prominent factors are interest-rate movements and the creditworthiness of the bond issuer. Bonds issued by the U.S. government have significantly less risk of default than those issued by corporations and municipalities. However, the overall return on government bonds tends to be less than these other types of fixed-income securities. Investors should pay careful attention to the types of fixed-income securities that comprise their portfolio and remember that, as with all investments, there is the risk of the loss of capital.

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Definitions

Duration incorporates a bond's yield, coupon, final maturity, and call features into one number, expressed in years, that indicates how price-sensitive a bond or portfolio is to changes in interest rates. Bonds with higher durations carry more risk and have higher price volatility than bonds with lower durations.

Interest rate sensitivity is a metric used to reflect how much the prices of bonds or other fixed income securities will rise or fall as interest rates change. Securities with more interest rate sensitivity have prices that will move by larger degrees than those with less sensitivity.

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Eagle Asset Management, a boutique in the Raymond James Investment Management family, provides a broad array of fundamental equity and fixed-income strategies designed to meet the long-term goals of institutional and individual investors. Eagle's multiple independent investment teams have the autonomy to pursue investment decisions guided by their individual philosophies and strategies.

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