

Protecting Your Fixed Income Asset Allocation in a Rising Rate Environment

BOND YIELDS HAVE STEADILY DECLINED OVER MOST OF THE PAST THIRTY YEARS. ALTHOUGH IT IS POSSIBLE RATES COULD DECREASE FURTHER, WE BELIEVE IT IS MORE LIKELY THEY WILL RISE OVER THE NEXT YEAR OR TWO.

This communication explores the potential outcomes of a rising rate environment on the bond market, and how Glenmede has positioned client portfolios to minimize the impacts and take advantage of emerging opportunities. With the scenario of rising rates, there is a silver lining: if we position ourselves correctly, we can invest in higher-income securities.

Typically, central banks respond to an economic recovery by raising short-term interest rates in order to ward off inflation and/or slow economic growth. In anticipation of such changes, longer-bond yields may rise rather quickly, reshaping the entire yield curve.

In some ways, high-quality bonds can, over the long term, be unaffected by credit risk. Provided an issuer does not default, investors are repaid at maturity regardless of rate activity. However, in response to interest-rate fluctuations, market values of bonds can change in the interim. If rates rise, bond values fall given that investors can purchase newly issued bonds with higher-paying coupons.

Glenmede's fixed income approach is one of risk aversion and high credit quality. Interest-rate risk (the sensitivity of a bond to interest-rate changes) can be reduced by managing the portfolio's duration. By raising or lowering the duration of a portfolio, we change the average maturity of the holdings. If rates increase by 1%, a portfolio of four-year-duration bonds will fall in value by approximately 4%. Likewise, if interest rates decline 1%, a portfolio's value will increase by approximately 4%. At Glenmede, our strategy has been to maintain lower-than-average interest-rate risk (duration) with sizeable exposure to shorter maturities. For taxable and tax-exempt portfolios, the average duration is approximately 3.5 years.

Within taxable bond portfolios, we have also controlled risk through a significant allocation to higher-coupon corporate securities. The corporate bonds held are high-quality, liquid benchmark issues (benchmark meaning the size of the security is a billion-dollar issue). These corporates, in our view, have been purchased at an attractive spread to U.S. Treasuries (additional yield) and have higher-than-average coupons. We believe that when treasury yields rise, prices of these securities will not show equivalent price depreciation.

This fixed income update is intended to be an unconstrained review of issues, topics and considerations of possible interest to Glenmede's clients and is not intended to be applicable to any one particular client. Actual investment decisions for particular clients are made in light of applicable considerations and may be different from the views expressed here. Likewise, actual portfolio performance may differ from the results discussed. Clients are encouraged to discuss the applicability of any topic or view contained in any Glenmede publication, especially Insights, with their Glenmede representative.

Similarly, many of our tax-exempt portfolios have been purchasing “kicker bonds.” Kicker bonds are premium coupon bonds with shorter call dates. This structure keeps the portfolio’s income generation high without substantially increasing interest-rate risk. Should rates move higher, we believe these bonds will not fall in value by as much as bonds with comparable maturities. Kicker bonds may not be suitable for all accounts as they trade at high dollar prices.

By keeping the duration low, and being overweight in corporate and municipal sectors, Glenmede has added an additional layer of protection in advance of rising rates. In addition, many portfolios have embedded high-paying coupons, attractive acquisition yields, and unrealized capital gains. Most economists are calling for a slow, gradual increase in rates. Our strategy of higher-coupon securities, defensive structures, and shorter portfolio durations should protect returns if interest rates move higher.

It is quite reasonable to ask, “Why not sell everything now if rates are expected to go higher and cheaper bonds can be purchased later?” First, we do not know for certain if/when, or to what extent, rates will rise. We believe neither a repeat of the debt crises nor another substantial drop in rates is likely. Bonds are, however, one of the few assets in a portfolio that will do well if a deflationary scenario was to unfold.

In addition, the cost of liquidating securities is not inconsequential. For taxable accounts, there could be severe tax consequences. More importantly, unlike the equity markets, except for the most liquid treasury bonds, some bonds do not trade easily. Selling seasoned securities could prove counterproductive. Current portfolio holdings could be hard to replicate and not easily found in the marketplace. Compounded with the political climate and minuscule cash yields, owning a high-quality, low-duration bond portfolio could still provide attractive, stable returns.

The table on page 3 delineates the impact of different rate scenarios for typical taxable and tax-exempt portfolios. The total return of a bond is the sum of two factors: the price return and the income earned during the course of a year. In most of these rate scenarios, a fall in the market value of a bond portfolio is nearly or completely offset by the income earned over the course of the year.

Your relationship manager, in addition to our fixed income team, is available to further discuss any of the ideas mentioned here. Finally, we conclude with our original thought: a dramatic increase in bond yields, while somewhat painful in the short term, allows us the opportunity to reinvest at higher income-producing levels.

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Bond Returns and (Parallel) Interest Rate Shifts

Taxable Portfolios

Duration of 3.5 years, benchmarked to the Barclay's Intermediate Gov't/ Credit Index

	Unchanged	Up 50 bps	Up 100 bps	Up 150 bps	** Forecasted Economic Consensus
Income Return	2.47%	2.47%	2.47%	2.47%	2.47%
Price Return	0.54%	-1.06%	-2.61%	-4.14%	-1.33%
*Total Return	3.01%	1.41%	-0.14%	-1.67%	1.14%

Duration of 4.5 years, benchmarked to the Barclay's Aggregate Index

	Unchanged	Up 50 bps	Up 100 bps	Up 150 bps	** Forecasted Economic Consensus
Income Return	3.30%	3.30%	3.30%	3.30%	3.30%
Price Return	0.32%	-1.67%	-3.72%	-5.84%	-1.85%
*Total Return	3.62%	1.63%	-0.42%	-2.54%	1.45%

Tax Exempt Portfolios

Duration of 3.5 years, benchmarked to the Barclay's Municipal 1-10 Year Blend

	Unchanged	Up 50 bps	Up 100 bps	Up 150 bps	** Forecasted Economic Consensus
Income Return	1.98%	1.98%	1.98%	1.98%	1.98%
Price Return	0.33%	-1.23%	-2.78%	-4.30%	-1.64%
*Total Return	2.31%	0.75%	-0.80%	-2.32%	0.34%

Duration of 3.8 years, benchmarked to the Barclay's Municipal 1-10 Year Blend

	Unchanged	Up 50 bps	Up 100 bps	Up 150 bps	** Forecasted Economic Consensus
Income Return	2.02%	2.02%	2.02%	2.02%	2.02%
Price Return	0.37%	-1.26%	-2.88%	-4.51%	-1.74%
*Total Return	2.39%	0.76%	-0.86%	-2.49%	0.28%

*Total return assumptions include 12 month horizon, using 50/50 allocation between instantaneous yield curve shift and roll down with cash reinvested at money market rate.

** Forecasted Economic Consensus of yield curve flattening approximately 75 bps 1-year forward, Muni Curve Flattening approximately 50 bps 1-Year forward. Source: Bloomberg

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