Opportunities for Short-Term Bonds in a Rising-Rate Environment

4Q 2017

- The Federal Reserve's current cycle of gradually raising interest rates could create attractive opportunities in short-term bonds.
- Short-term bonds — and short-term bond funds — offer investors a chance to benefit from the income generated by higher rates while their short maturity limits their exposure to duration risk.
- Within the short-term bond universe, corporate bonds may offer relatively attractive yields and less interest rate risk
- Income generated by investment-grade and high-yield credits may also act as a cushion against rate-related price declines

LESS SENSITIVITY TO RATE HIKES

Prices for short-term bonds are less sensitive to rising rates than longer-term bonds — that is, they have lower "duration" than bonds with longer maturities. A bond's duration essentially reflects how much impact changing interest rates would have on a particular bond's price. A longer time to maturity tends to increase duration, while a higher coupon/yield reduces duration.

Given these relationships, the current low interest-rate environment is magnifying duration risk for longer-dated bonds relative to short-term bonds.

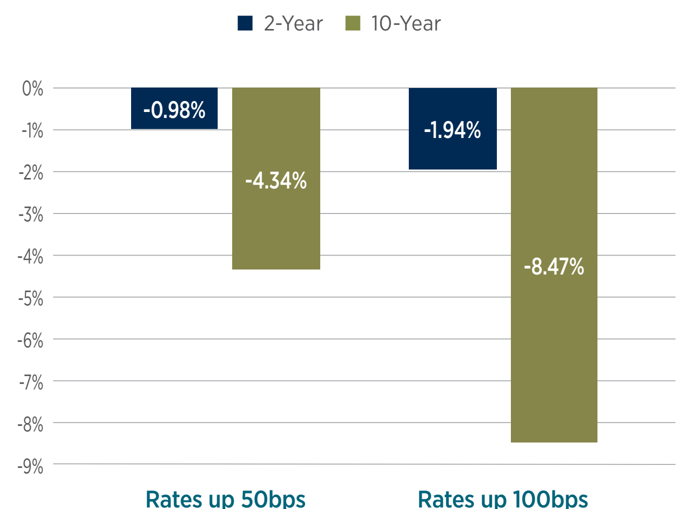
Figure 1 illustrates this heightened sensitivity. An immediate 50-basis-point rate increase would signify a 4.3% drop in the 10-year Treasury's price, and because the 10-year's current yield is so low, its total return would fall into negative territory. A 100-basis-point rate hike would essentially double the price losses. The 2-year Treasury's total return (yield plus price change) would remain slightly positive in the event of a 50-bp rate hike because the bond's yield is a bit higher than the price impact — and total return would be only slightly negative with a 100-bp increase. The shorter time to maturity reduces duration risk relative to the 10-year by allowing investors to capture higher yields when redeploying principal from redeemed bonds.

In our view, slow and steady interest rate increases stand to benefit short-term Treasuries and corporates, just as rate decreases favor longer-term bonds.

FIGURE 1

INTEREST RATE HIKES HAVE LESS IMPACT ON SHORT-TERM BONDS

PRICE CHANGE FOR 2-YEAR AND 10-YEAR TREASURIES



Note: Modified duration is the approximate percentage change in a bond's price for a given change in yield, assuming that the bond's expected cash flow does not change when the yield changes. Calculations based on Treasury yield as of 9/30/2017 | Source: USAA Research

ADVANTAGES OF SHORT-TERM CORPORATES

While corporate bonds cannot match the safety of Treasuries, they have a history of generating higher returns with only slightly more price volatility. This balance between risk and reward largely explains why our portfolios tilt toward a greater exposure to credit.

As shown in Figure 2, over the past decade, short-term corporates have outperformed comparable Treasuries — often by very comfortable margins — in every rolling 5-year period except during the risk-averse depths of the 2008-09 financial crisis.

Active portfolio management, rooted in rigorous credit research, can open still other opportunities to generate additional yield in corporate bonds.

At USAA, the research and analysis of short-term credits by our seasoned team centers on near-term financials, such as balance sheet strength and cash flow, to determine individual bond issuers' ability to cover their operating costs while also meeting their debt obligations.

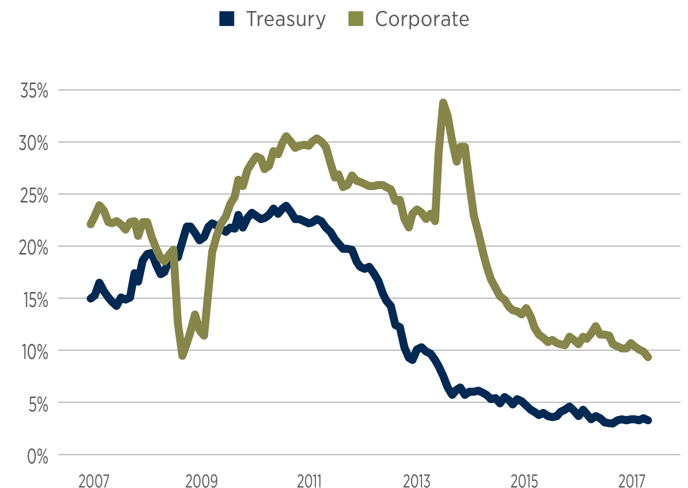
We issue our own ratings on each credit and compare our views to those of the ratings agencies. This process can uncover companies whose bonds carry both investment-grade and high-yield ratings with no meaningful difference in downside risk. It can also reveal time-frame disparities — a rating agency's grade may be based on a company's long-term challenges, while in the short term, its prospects may be strong.

Because we get to know each portfolio holding in detail, we are comfortable holding bonds until maturity. This approach also keeps our turnover low and controls trading costs. But if one of our bond holdings gets significantly bid up in price, we may be willing to sell it to lock in return for our shareholders.

FIGURE 2

SHORT-TERM CREDIT HAS CONSISTENTLY OUTPERFORMED TREASURIES

1-3 YEAR TREASURIES VS. 1-3 YEAR CORPORATE BONDS ROLLING 5-YEAR TOTAL RETURNS



Note: Corporate bonds represented by the Bank of America Merrill Lynch 1-3 Year U.S. Corporate Bond Index
Source: Bank of America, Bloomberg

Investments/Insurance: Not FDIC Insured • Not Bank Issued, Guaranteed or Underwritten • May Lose Value

Fixed income securities are subject to price volatility and a number of risks, including interest rate risk. Interest rates and bond prices move in opposite directions so that as interest rates rise, bond prices usually fall, and vice versa. Interest rates are currently at historically low levels. Fixed income securities also carry other risks, such as inflation risk, liquidity risk, call risk, and credit and default risks. Lower-quality fixed income securities involve greater risk of default or price changes. Securities of non-U.S. issuers generally involve greater risks than U.S. investments, and can decline significantly in response to adverse issuer, political, regulatory, market and economic risks. Fixed-income securities sold or redeemed prior to maturity may be subject to loss.

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