For global professional / qualified / institutional clients and investors and US retail clients and investors

Liquidity Perspectives—2Q19

Shorter duration bond funds: finding a sweet spot on the curve

Overview

- Ultra short duration and low duration bond strategies fill the gap between money market funds and traditional short term bond strategies
- As monetary policy continues to shift around the world, interest in these shorter duration bond strategies is likely to continue to grow
- These strategies can potentially
  - Lower the duration of a core bond allocation and reduce interest rate risk
  - Offer more yield vs. money market funds while maintaining liquidity
  - Reduce volatility in a portfolio

Take another look

Shorter duration bond strategies (ultra short and low duration) can be used as a stand alone investment or be seen as a building block within a broader liquidity approach. These strategies can play a role in most market environments because they seek higher yield than bank deposits or traditional money market funds while still maintaining a shorter duration and lower volatility of principal compared to longer duration funds.

Shifts in policy and rising rates

In a rising rate environment, shorter duration strategies can benefit from the maturing and reinvestment of very short duration securities—potentially mitigating reinvestment risk and price risk. If a portfolio is made up of securities that will come due as interest rates rise, it means the portfolio's yield will basically "follow the central bank" or the prevailing rates in the market, and will be reinvested at higher rates. Additionally, most securities in a shorter duration strategy are generally held to maturity and are expected to return the full value of the principal invested.

In a low interest rate environment, as we have seen in the years following the financial crisis, money market funds and other short duration investments in most developed countries offered low, and in some cases negative, yields. However, policies have been shifting.

In the US, the Federal Reserve raised its target federal funds rate by 25 basis points for the first time since the financial crisis in December 2015. Now after a total of nine rate hikes the range is 2.25%-2.50%, which has made money market funds, ultra short bond funds and low duration bond funds in the US all more attractive as their returns have risen in response to the higher overnight rate. In contrast, the European Central Bank has left the interest rates on the main refinancing operations, marginal lending facility and deposit facility unchanged at 0.00%, 0.25% and -0.40% respectively, while at their March 2019 meeting they affirmed that net asset purchases under the net asset purchase programme would not continue after 2018. In the UK, the Bank of England raised its benchmark rate to 0.75% from 0.5% back in August 2018, the first increase since 2009 and it has remained unchanged.

Taking a "shorter duration" route

Shorter duration strategies, which can be referred to as ultra short or low duration, fill the gap between the investment/risk horizon of money market funds and short term bond strategies. Most money market funds' returns are constrained by regulations on their investment guidelines, while most low duration strategies are relatively less constrained and do not need to follow the respective money market fund regulations, such as the SEC's Rule 2a-7 and European Securities and Markets Authority's (ESMA) Money Market Fund Regulation (MMFR). Shorter duration bond strategies generally extend their duration beyond typical money market fund durations, with weighted average maturities generally from 12 months to under six months and sometimes as low as 90 days. With the ability to buy securities that money market funds are not allowed to hold, shorter duration strategies are often able to pick up additional yield. These strategies seek to consistently provide higher yields than money market funds with less volatility than traditional (longer maturity) short term strategies.

Shorter duration strategies generally invest in short duration investment grade corporate debt, mortgage-backed securities, asset-backed securities, floating rate notes and cash equivalents, with the aim of meeting their duration target while maintaining very high credit quality. An important component of many shorter duration strategies is active management and rigorous credit risk management. Just as shorter duration typically reduces interest rate risk, investing in debt of higher credit quality can reduce the potential for volatility that may arise due to credit events and which is generally associated with lower credit quality securities.

These types of shorter duration, higher credit investments may provide a hedge against credit risk while providing market liquidity. Investment managers need to have the capability to carefully assess and monitor the liquidity and credit quality of the securities they invest in if they aim to minimize the net asset value (NAV) volatility of their portfolios.

A good fit

Since cash needs are frequently multitiered, a broader liquidity portfolio can be structured accordingly. For operating cash, which is cash to meet daily and very short-term needs, money market funds are appropriate. However for an investor with some flexibility, one who can give up the intraday liquidity of a money market fund, a shorter duration strategy may provide sufficient liquidity for their reserve cash—or balances set aside to take advantage of certain periodic opportunities or to meet other needs—with higher return on their investment. For strategic cash needs, when an investor has an investment timeframe of about one to five years, shorter duration strategies are now being considered because when yield curves are flat or inverted (i.e. due to market uncertainty; change in Fed policy), the pickup in yield may require taking on additional duration.

Additionally, for any investor who has a core fixed income allocation, dedicating part of that to a shorter duration strategy can reduce the overall duration exposure of a core bond portfolio or liquidity allocation. Investors can use a shorter duration strategy to match the duration of their portfolio more closely to their expected future cash needs or liabilities.

Even investors who are looking to manage their equity exposure due to increased volatility, or who may want to "sit on the sideline" or "keep some powder dry" are considering lower duration, lower volatility shorter duration strategies.

Price risk, reinvestment risk

Investors in fixed income securities face two primary risks: price risk and reinvestment risk.

For example, as interest rates rise, the market price of a bond falls in order to account for the fact that its interest payments are lower than prevailing interest rates. However, such a discount, or loss, is only realized should the owner sell the bond prior to it maturing. Most low duration strategies aim to hold all or most of their investments to maturity and have the full principal returned to them. Likewise, in a rising rate environment it is beneficial to reinvest proceeds from maturing bonds at the new higher rates. A longer duration bond can lock owners into lower rates and will likely trade at a discount. An shorter duration strategy that invests in securities that mature in a very short timeframe can help to address reinvestment risk.

It is important to keep in mind that if a shorter duration investment vehicle is a mutual fund, although it is managed to have a low volatility of principal, a shorter duration fund's NAV may at times move. The overall performance of a shorter duration strategy or fund should be viewed in the context of total return, which is the change in net asset value plus interest income.

A growing market, a growing opportunity

As economic growth and monetary and fiscal policies continue to shift around the world and given increasing volatility in global markets, interest in shorter duration bond strategies will likely continue to expand. Meanwhile investors are finding them useful on a number of fronts in any environment.

Ultimately, an ultra short duration or low duration investment is a core fixed income allocation that may reduce the interest rate risk of a bond allocation and may be an effective tool for managing overall duration and volatility in a portfolio while still providing comparatively attractive returns.

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