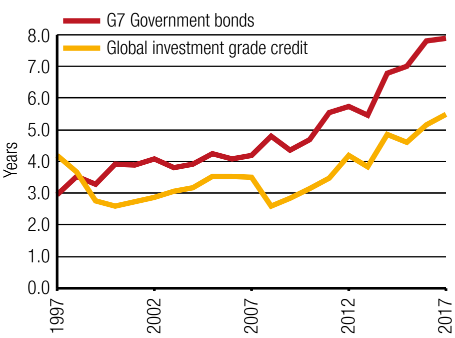
AN ACTIVE APPROACH to bond market duration risk

Mark Benbow of Kames Capital warns of the growing duration risk within the global bond market and how clients should be mindful of increasing risk by default, rather than by design.

One of the biggest concerns that bond investors face right now is duration risk – the potential for a rise in interest rates to create a fall in bond prices. Given that the duration of government and corporate bond benchmarks has been rising for the past 20 years (chart 1), investors are wise to be mindful of this risk.

Chart 1: Historical duration of government bonds and investment grade credit



Source: Bloomberg as at 30 June 2017

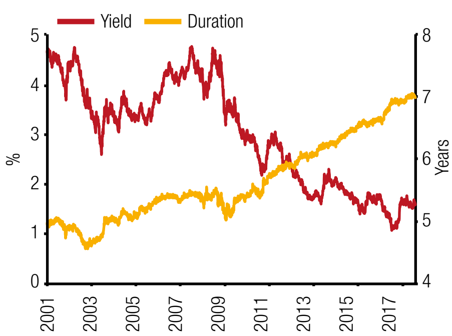
We've experienced a long-term trend of falling bond yields, thanks in part to the extremely accommodative monetary policy that's been implemented globally by central banks since the Financial Crisis. As yields have continued to fall, the behaviour of debt issuers has started to change. Many are taking advantage of this low-rate environment to lock-in an all-time low cost of debt for as long as possible. In June Argentina issued a bond with a maturity of 100 years, just three years after its last default. Is 8% a tempting enough income to lend to Argentina for 100 years, considering the five defaults it has faced in the last century alone?

The merits of individual issuers aside, the importance of this change in behaviour is that as issuers borrow for longer periods, the level of duration in bond benchmarks rises.

This is at the same time as lower yields are forcing investors into lower-rated or longer-dated bonds to generate income within their portfolios. The demand for yield in the market is proving insatiable at this stage of the cycle. Factors such as rising pension deficits and the need for retirement liability-matching have driven the demand for longer-dated bonds as yields continue to fall.

This is a noteworthy combination: ever-lower yields means more supply (and greater demand) of longer-dated bonds, but for investors' bond portfolios it can mean more duration risk for less return potential. We illustrate this in chart 2.

Chart 2: Yield and duration of Barclays Global Aggregate Index



Source: Bloomberg as at 30 June 2017. Yield reflects 'yield-to-worst'. Duration is 'option-adjusted duration'.

What does this mean for investors?

Anyone invested passively in the index faces a particular risk from following this trend. They are being forced into longer and longer duration than desired in response to the changing characteristics of bond markets.

Indeed, many bond fund managers are being dragged longer in duration as their underlying benchmark duration has increased, thereby exposing their clients to additional interest rate risk by default rather than by design.

At Kames Capital we don't believe the composition of indices is the basis for successful investing. Our highly active approach means we do not simply chase benchmark duration. Instead we have the freedom to focus on the best money-making ideas when building portfolios.

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