Commentary Managing interest rate risk: A challenge for bond managers

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An axiom of fixed income investing is the principle that interest rates and bond or note prices have an inverse relationship. When rates rise, prices fall, and vice versa. Given that, it would seem reasonable that a portfolio manager who feared an impending increase in in interest rates would want to consider hedging his or her investments. A variety of hedging contracts might be used for this purpose, including futures contracts, swaps, and options. All could reduce the duration of the combined position relative to the original duration before the implementation of the hedge. As reasonable as this strategy may appear on its face, a closer look is warranted.

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Unlike any other asset class, baring default, the prices of fixed income instruments will necessarily converge to their par values at maturity. In other words, when managing fixed income assets, we should be operating with an appreciation of the fact that, for most of these instruments, price perturbations are temporary. Ultimately, the final values at maturity would

be known with certainty, such that any deviations from that final value would self-cancel. No other investment category has this attribute, save transactions that include forward contracts with stipulated forward sales prices.

To be fair, this orientation fails to recognize that the instrument in question may *have* to be liquidated prior to its natural maturity date, or, more drastically, the debtor could default. In both cases, prior price perturbations might not be reversed. This consideration justifies segmenting the consideration of risk in fixed income portfolios into two categories: Elements that would be expected to be held for maturity versus those that would be (could be) liquidated before maturity. The nature of risk for these two investment categories is palpably different, thus justifying different risk metrics and risk mitigation strategies. In both cases, interest rate volatility will foster price volatility; but in one case these value effects would be temporary with subsequent reversals, while in the other case, the value effects could end up being permanent.

The critical point is that it doesn't make sense to hedge a price effect that will reliably self-correct on its own accord. Here's why: Consider the manager who institutes a hedge in anticipation of rising rates. In all cases, again, barring default, the underlying bond positions will generate known gains or losses over their lives, equaling the differences between starting prices as of the time the hedge is initiated and final (known) par amounts. In contrast, the performance of any derivative will be independent of the change in values of the exposure being "hedged."

On the basis of this understanding, it would seem prudent to hedge only if you were confident (and correct!) in your expectation that the derivative would generate a gain – a highly problematic expectation. The irony of this situation is that what would appear to be a risk mitigation strategy in the short run actually serves to add to the overall risk exposure in the longer run. In this case, adding a derivative position to a traditional fixed income portfolio might more appropriately be considered to be a speculation, rather than a hedge, which presents an issue in connection with any formal disclosures that an investment manager might be required to make. Intuition and experience suggest to me that many such disclosures tell only half of the story in their characterization of their derivatives use.

This cautionary note notwithstanding, it *would* be reasonable to hedge fixed rate instruments when part of an overall portfolio of assets and liabilities. In this situation, harmonizing the

durations of the assets and liabilities is legitimate and understandable, as is typical for depository institutions that rely on shorter-term deposits to fund longer-term fixed rate assets. On the other hand, hedging fixed rate investments on their own, intending to offset value changes due to changing interest rates, without consideration of the broader, asset/liability context, might serve to mitigate some income volatility in the short run with considerably less desirable earnings outcomes over the longer term.

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