While rising interest rates may present challenges to bond investors, history shows that a diversified fixed income portfolio can weather difficult periods remarkably well. First, the interest income generated by a bond portfolio tempers volatility in a rising interest rate environment unlike other asset classes such as equities. Second, when interest rates rise in response to an improving economy and higher inflation expectations, credit sensitive sectors, such as corporate bonds, generally outperform lower risk sectors such as Treasuries. Corporate profitability and consumer confidence tend to increase as the economy improves, which is positive for risk assets. Lastly, broad portfolio mandates, such as the Bloomberg Barclays Aggregate, include allocations to short-term securities which generally experience lower price declines than longer-term bonds. In addition, active management can help to further mitigate the negative impact of rising interest rates by managing the portfolio's duration, adjusting the yield curve positioning and diversifying risk.

Strategies for a Rising Interest Rate Environment

1. **Duration Management**
   Duration is a measure of the price sensitivity of a bond to a 100 basis point parallel shift in the yield curve. Portfolios with shorter average durations will typically experience greater stability when rates rise than those with longer durations. However, determining what sectors and yield curve segments have the largest contributions to the overall portfolio duration is a key risk management factor often overlooked in passively managed portfolios. In addition, the duration calculation contains several important limitations that should be understood:

   - *Assumes an instantaneous 100 basis point parallel shock in interest rates* – In reality this rarely occurs as short, intermediate and long-term rates react differently to changes in various economic factors.
   - *Assumes credit spreads remain constant* – Typically, when interest rates rise due to improving economic conditions, tighter credit spreads help cushion the negative impact of lower prices.
   - *Based on movements in the U.S. Treasury curve* – Bonds issued by non-U.S corporations and government entities may be more sensitive to the interest rate changes in their local markets rather than U.S. Treasuries.
   - *Duration is most useful for estimating relatively small changes in interest rates* – Large rate changes require a convexity adjustment, particularly for securities with call and put options.

2. **Yield Curve Positioning**
   Our forecast for the shape of the yield curve plays a key role in determining how we position our portfolios across the maturity spectrum. By emphasizing specific maturities of the yield curve we can potentially capitalize when interest rates fall or defend our portfolios from adverse rate movements. For example, if a steep yield curve is anticipated we may utilize a bullet strategy, where the portfolio is concentrated around a single segment of the curve. However, if a flatter yield curve is expected, a barbell strategy is more likely, where a portfolio is divided between short and longer-term bonds. Either of these strategies can be implemented without altering the overall portfolio duration.

3. **Diversification**
   The bond market, similar to the stock market, consists of many different types of securities that exhibit unique risk and return characteristics. Credit-sensitive sectors such as corporate bonds, municipal bonds, and mortgage-backed securities offer a yield premium or spread over Treasuries that can provide a cushion during rising rate environments. Higher risk sectors such as high-yield bonds, non-agency mortgages, and emerging market debt provide a substantial yield advantage over government securities and generally have low correlations to the broader fixed income market. Other sectors such as bank loans and floating-rate notes benefit from higher interest rates as their coupon rate resets every 30–90 days. Diversifying by issuer, sector, credit rating, maturity, and coupon can help enhance total returns and reduce portfolio volatility.

Fixed income is an essential component of a conservative portfolio, providing a consistent income stream, capital preservation, and diversification benefits. It is impossible to predict when interest rates will rise, by how much and over what time period, so for most investors we believe keeping a longer-term view, regardless of the outlook for interest rates, makes the most sense.

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