

READY FOR RISING RATES

How managing duration can help preserve the value of fixed income investments during rising interest rate environments



Interest Rate Risk - A Cause for Concern?

One concern for fixed income investors is interest rate risk – the potential for investment value changes due to shifts in interest rates. Interest rates influence a new issue bond's coupon-rate or coupon, which is the amount of annual interest paid to the bondholder. Lower or falling interest rate environments may result in a lower coupon rate. Higher or rising interest rate environments may result in a higher coupon rate, which may be more attractive to many investors.

Part of purchasing a bond is deciding on the term or maturity date (the date the principal investment or purchase price is repaid to the investor and coupon payments stop) and the coupon rate. The coupon rate for a new bond is usually tied to current market interest rates at that time. This is where duration management comes into play. To help reduce the erosion of a bond's market value that may result from rising interest rates, investors first need to understand the concept of duration. Duration represents a bond's sensitivity to interest rate changes and measures how long it takes, in years, for an investor to be repaid the bond's principal value. The longer the duration of a bond, the more a given bond's market value will fall as interest rates rise. This is important to help reduce price volatility in the portfolio and because at the time of principal repayment, an investor may choose to reinvest their principal. New bonds in the current marketplace will likely have different prices and coupon rates than the bond that just matured or was sold. Strategic duration management in a fixed-income portfolio may provide investors more opportunities to take advantage of rising coupon rates. A short-duration strategy during rising rate environments gives investors the opportunity to purchase new bonds with potentially higher coupon rates, which may lead to a greater overall portfolio return.

Strategic Duration Management In Action

During a period of rising interest rates, a fixed income strategy utilizing short duration bonds may be beneficial to investors in order to help reduce market value volatility and to potentially reinvest at higher rates.

Hypothetical Rising Rate Scenario:

Principal and interest can be reinvested more quickly, taking advantage of the higher coupon rates

Two investors are purchasing a new bond for their fixed income portfolio but each investor is utilizing a different duration strategy.

Investor A purchases a 12-year investment-grade corporate bond for \$1000 with a fixed coupon rate of 3%, which reflects the market rate at that time. This bond will pay \$30 in interest every year for the next 12 years - yielding a 3% return on investment.

Investor B purchases the same type of bond as Investor A, but with a 4-year duration. The bond will pay \$30 in interest every year for the next 4 years. When the bond reaches maturity after 4 years, the \$1000 principal paid for the bond is returned. Investor B decides to reinvest that principal and purchase another bond. Interest rates have risen during those 4 years so Investor B now has the option of purchasing a new bond with a higher coupon rate. Investor B purchases a new 4-year investment-grade corporate bond with a fixed coupon rate of 3.5%. This bond will pay \$35 in interest every year for the next 4 years. After this bond reaches maturity, Investor B decides to reinvest in another 4-year investment-grade corporate bond. But interest rates have continued to rise so the coupon rate for the new bond is 4%. For the next 4 years, Investor B earns \$40 in interest every year. When combined, the three bonds paid \$420 in interest - yielding a 3.5% return on investment.

For the same 12-year period, Investor B outperformed Investor A by utilizing a short duration strategy during a rising interest rate environment.

		Coupon Payments														Total Coupon Payments/ Interest Received	Total Return on Investment
		Bond Purchase Price/ Principal Value	Coupon	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Year 11	Year 12		
Scenario 1	Bond 1 (12-year term)	\$1000	3.0%	\$30	\$30	\$30	\$30	\$30	\$30	\$30	\$30	\$30	\$30	\$30	\$30	\$360	3.0%
	Scenario 1 Totals:															\$360	3.0%
Scenario 2	Bond 1 (4-year term)	\$1000	3.0%	\$30	\$30	\$30	\$30									\$120	3.0%
	Bond 2 (4-year term)	\$1000	3.5%					\$35	\$35	\$35	\$35					\$140	3.5%
	Bond 3 (4-year term)	\$1000	4.0%									\$40	\$40	\$40	\$40	\$160	4.0%
	Scenario 2 Totals:															\$420	3.5%

How Crossmark Can Help

At Crossmark Global Investments, our fixed income strategies utilize a conservative approach with a short duration target in a rising rate environment in order to reduce the potential decline in principal value from rising rates. We believe this approach may be more advantageous for investors given the uncertainty in today’s fixed income marketplace.

To learn more about our fixed income products, please visit: crossmarkglobal.com

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