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A Corporate Treasurer's Guide to Investment Challenges

How to Weather a Rising Interest Rate Environment

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Introduction

It has been more than a decade since the last interest rate tightening cycle. As we dust off this report written more than ten years ago for corporate treasurers on how to weather a rising rate cycle, we are struck by how little we needed to revise its content despite a vastly different cash investment landscape today.

What's Different and What's Not

Despite a few false starts, it appears that in a few weeks the time may finally be here for the Janet Yellen Fed to start increasing interest rates. While the short-term investment community aches to break the spell of the near zero interest rate policy (ZIRP), higher rates can be an unpleasant experience if not taken seriously.

All else being equal, higher rates result in immediate unrealized losses in existing holdings. Credits may see more losses than government securities because of inherently higher risks. This normally isn't a big concern if one intends to hold securities to maturity, assuming that the terms are short and credit quality is high. However, it may be problematic if one has to sell assets prior to maturity and turn unrealized losses into realized ones. These risks remain the same from one rate tightening cycle to the next.

What's different in this cycle is that unprecedented quantitative easing to combat deflationary forces has left global central banks with unusually large balance sheets. In the U.S., the effectiveness of the fed funds rate as the main tool to lift all other rates is in doubt, as deposit-rich banks have little need to borrow in the fed funds market. Though the U.S. economy appears healthy, the same cannot be said about Europe and China. The Fed's tightening will come in contrast with more qualitative easing in these regions. The Fed's decision to reinvest cash proceeds from its treasury and agency mortgage bond holdings while raising rates also complicates matters.

Therefore, when this tightening cycle starts, it will likely be at a more measured pace with few increases at smaller increments. The implications of a slower increase in rates for cash portfolios may be significant. One may expect lower duration risk, a flatter yield curve and perhaps even less credit widening than in past cycles.

With those familiar and new factors in mind, we are issuing our revised guidance for corporate treasury professionals on how to prepare for a rising interest rate environment. Following are several portfolio management techniques available to help diminish the risk presented by higher interest rates. In fact, when managing *portfolio duration*, *yield curve* *positioning* and *security selection* properly, rising interest rates can add value, particularly for short duration or held-to-maturity portfolios.

Duration Management

Though it is difficult to predict with precision how quickly and to what extent interest rates will shift, we believe investors should resist moving all fixed income assets into an overnight vehicle for fear of losses from higher rates. In moving all assets to deposits or money market funds, investors are likely to substantially reduce portfolio yield as they give up the higher yields provided by instruments with longer maturities. Moreover, the loss in yield could be greater if the pace of interest rate increases turns out to be more conservative than the market initially predicted.

In our opinion, the key is to strike a logical balance between reduction in duration to protect principal and investment in higher yielding securities. An investor should assess his or her tolerance for potential unrealized market value losses and decide on a targeted portfolio duration. For example, a portfolio with a12-month duration may stand to lose 1% of its value when rates move higher by 100 basis points. However, it is important to note that when an investor holds a security to maturity, any unrealized losses will be erased as the bond approaches its final maturity date. Once the targeted duration is established, an investor may then select investments that take advantage of the higher yields further out on the curve.

Yield Curve Positioning

When interest rates start to rise, not all bonds behave the same. Market expectations may cause yields on shorter bonds to rise more than longer bonds, or vice versa. An informed portfolio manager should be able to take advantage of the changing shape of the yield curve and increase the potential to achieve higher yields without changing the overall portfolio duration and its corresponding interest rate risk.

For example, a well-managed short-duration portfolio with an appropriate structure of maturities will allow for reinvestment opportunities as rates steadily rise. As individual bonds mature, the proceeds may then be used to invest at higher absolute yields. Alternatively, certain maturities along the curve may provide more incremental yield pick-up than bonds that are either shorter or longer. Lastly, a breakeven analysis of a money market fund yield can also provide valuable insight into which maturity buckets to utilize.

Security Selection

The ability to select the appropriate mix of securities is another method to control interest rate volatility. Some well-established bond investments are specifically designed to reduce interest rate risk. With a good understanding of their credit quality and relative yield attractiveness, an investor may add return without taking on additional interest rate risk. Examples of such investments include:

- TIPS
  A Treasury Inflation Protected Security, commonly referred to as "TIPS", is a U.S. Treasury issued bond that has its redemption value indexed for inflation based on the Consumer Price Index (CPI) readings. Since its redemption value will never fall below its face value, while earning a premium over inflation, TIPS may be a good weapon against higher interest rates.

- Floating Rate Securities
  A floating rate security (also referred to as floating rate note, or FRN) is an instrument whose coupon rises when the underlying reference rate (usually U.S. LIBOR or U.S. Treasury Bills) rises. They may provide additional yield opportunities relative to U.S. Treasury securities without taking on interest rate risk.

- Corporate Bonds
  Short duration corporate bonds of high credit quality typically provide incremental yield relative to U.S. Treasuries. This extra yield may help cushion the principal loss associated with rising interest rates.

- Foreign Government Securities
  U.S. dollar denominated, high-grade foreign government bonds, such as those issued by G-7 nations, may also provide interest rate protection, particularly when the markets view higher U.S. interest rates as being at least partly due to trade and fiscal deficits. In this scenario, yields of foreign government bonds should rise slower than U.S. securities.

Investors need to be cognizant of the risks associated with higher interest rates. However, Capital Advisors Group believes it is unwise to simply hide your cash in a money fund in a rising rate environment. Instead, a prudent, short-duration investment strategy can help to mitigate the risk of increasing rates, while allowing more flexibility to take advantage of improving yields.

About Us

Capital Advisors Group, Inc. is an independent investment advisor specializing in institutional cash investments, risk management, and debt financing.

Drawing upon almost a quarter of a century of experience through varied interest rate cycles, the firm has built its reputation upon deep, research-driven investment strategies and solutions for its clientele.

Capital Advisors Group manages customized separate accounts that seek to protect principal and maximize risk adjusted returns within the context of each client's investment guidelines and specific liquidity needs. Capital Advisors Group also provides FundIQ® money market fund research, CounterpartyIQ® aggregation and credit analysis of counterparty exposures, risk assessment on short-term fixed income securities and portfolios, and independent debt financing consulting services.

Headquartered in metropolitan Boston, Capital Advisors Group maintains multiple U.S. regional offices.

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