Why Short-Duration Investing May Be a Smart Long-Term Move

October 2016

Neil Dwane
Global Strategist

With extreme monetary policy and political uncertainty making it hard for investors to find returns, Neil Dwane highlights how short-duration bonds offer the potential for higher returns today and reduced volatility when rates rise.

Key takeaways

- Today's low and even negative interest rates make it hard for investors to protect the purchasing power of their savings using traditional bonds
- In response to low rates, some are taking more duration risk, but this could cause a decline in principal value when interest rates rise
- Actively managed short-duration strategies offer flexibility and an attractive blend of return potential and reduced downside volatility
- Active managers can also exploit credit and illiquidity opportunities that exist across the US, Europe and emerging markets

At our recent Investment Forum, we reconfirmed AllianzGI's long-standing view that in today's environment of central-bank repression, investors must take risks to earn returns. Yet while some have indeed enjoyed decent performance from their risk investments in recent years, there is still uncertainty about the changing political landscape and the distorted world of zero and negative interest rates. Negative rates have so far caused many investors to lose money, while merely low rates have failed to help investors adequately protect the purchasing power of their savings.

Allianz Global Investors

The risk of navigating difficult terrain with longer durations

While no one knows for certain how long this environment will last, it is becoming increasingly clear that global economic growth could remain slow and interest rates low for a very long time. This has forced some investors to take more duration risk in the form of owning traditional bonds with maturities of 10, 20 or even 30 years or more. The danger here is that the prices of these long-duration bonds will fall when interest rates rise, thereby causing a loss of capital.

Investors who own traditional bonds with long-term maturities risk watching their prices fall when interest rates rise, causing a loss of capital

Other investors try to mitigate this risk by seeking higher returns from longer-term investments in traditional equities or in illiquid alternatives such as infrastructure equity and debt, which can have investment horizons that stretch out 30 years. While these investments can be attractive alternatives to long-dated traditional bonds, their time horizons may be too risky for those who need shorter-term returns and income potential. After all, this is a marketplace of heightened volatility, elevated asset correlations and low returns warped by monetary policy – an uncertain dynamic that our financial repression thesis suggests could last another decade or more.

Three reasons to consider actively managed short-duration strategies

Regardless of whether investors believe interest rates will remain "lower for longer" or feel a rate hike is imminent – though in our view, rate hikes are still unjustified in most of the world – short-duration investing can offer investors an appealing combination of attractive return potential and reduced downside volatility. Short-duration strategies have a broad opportunity set to capitalize on, including corporate debt, floating-rate notes and government bonds. Active managers know how to navigate this opportunity set to help investors exploit credit and illiquidity opportunities that exist across the US, Europe and emerging markets – without forcing them to take excessive duration risk.

Short-duration investing offers attractive return potential and reduced downside volatility

1 Insightful research gives active managers an advantage

With bond markets distorted by extreme monetary policy, most government bonds offer little in the way of attractive yields, forcing investors to look to the corporate sector for income potential. A strong, active investment process can be a benefit in this sector, as can the addition of insightful research from equity and bond research analysts

Negative Yields Are Spreading Around the World

Central banks have pushed many government-bond yields into negative territory to drive investors into riskier assets

	3M	1Y	2Y	3Y	4Y	5Y	6Y	7Y	8Y	9Y	10Y	15Y	20Y	30Y
Germany	-0.81	-0.65	-0.69	-0.70	-0.67	-0.57	-0.53	-0.47	-0.37	-0.25	-0.10	0.03	0.26	0.48
France	-0.68	-0.63	-0.64	-0.61	-0.54	-0.43	-0.34	-0.27	-0.08	0.07	0.22	0.52	0.79	1.01
Italy	-0.39	-0.24	-0.11	0.00	0.06	0.29	0.46	0.65	0.85	1.07	1.25	1.60	1.92	2.32
Netherlands	-0.77		-0.66	-0.64	-0.62	-0.46	-0.46	-0.37	-0.24	-0.09	0.03			0.55
Belgium	-0.73	-0.63	-0.65	-0.58	-0.54	-0.47	-0.41	-0.32	-0.17	0.00	0.16	0.54	0.63	1.10
Austria		-0.54	-0.61	-0.59	-0.53	-0.48	-0.41	-0.38	-0.31	-0.03	0.12	0.07		0.81
Finland		-0.62	-0.65	-0.61	-0.53	-0.50	-0.42	-0.32	-0.22	-0.12	0.06	0.30		0.56
Switzerland		-0.94	-0.96	-0.97	-0.90	-0.86	-0.79	-0.73	-0.67	-0.60	-0.55	-0.32	-0.18	-0.03
Sweden	-0.75	-0.75	-0.67		-0.55	-0.36		-0.22			0.19			
Denmark	-0.51	-0.70	-0.55	-0.15		-0.36					0.02			0.51
UK	0.33	0.14	0.10	0.11	0.18	0.22	0.32	0.41	0.53		0.75	1.15	1.32	1.47
US	0.30	0.59	0.80	0.91		1.18		1.45			1.62			2.33
Japan	-0.40	-0.35	-0.28	-0.27	-0.25	-0.23	-0.22	-0.22	-0.18	-0.14	-0.07	0.11	0.36	0.46

Chart shows percentage yields of government benchmark bonds. Past performance is not a reliable indicator of future results. Sources: Bloomberg, AllianzGI Global Capital Markets & Thematic Research. Data as of 4 October 2016.

who work together. Their combined analysis can enable portfolio managers to consider the entire capital structure of a company – both debt and equity investments – to find the healthiest balance sheets and the most attractive combination of risk and reward.

2 Enhanced income potential and flexibility mitigates uncertainty about inflation

Short-duration strategies do more than help investors guard against interest-rate hikes. Inflation is another real threat: It can spike unexpectedly, and even low levels can erode the real value of investors' portfolios over time. The flexibility afforded by short-duration strategies can be a helpful addition in times of uncertainty while still providing attractive return potential. Moreover, with new regulations encroaching upon traditional sources of shorter-term capital within banks and money market funds, short-duration strategies offer a useful means of disintermediating these regulatory risks to earn an attractive spread over similar short-duration cash assets.

The flexibility and return potential of short-duration strategies can be helpful for fighting inflation

3 Active managers can optimize the risk/return ratio in changing markets

With their ability to assess changes in interest-rate policies, economies and the health of corporate balance sheets, managers of short-duration portfolios can move up and down the yield curve to optimize return and risk, and to capitalize on credit opportunities that arise in volatile markets. These advantages are only available in actively managed portfolios, as passive indexes are simply static baskets of securities that cannot adapt to changing circumstances.

The hunt for income is growing more urgent

Interest rates are at historically low or even negative levels, and today's already-extreme monetary policies are continuously evolving – including "yield curve control" in Japan and a likely extension of quantitative easing in Europe. That makes hunting for income an urgent priority for many investors, and they will need to look beyond conventional bonds to find it – particularly when inflation can quickly turn low yields into negative returns.

Even if investors do not need to access their investment income today, adding income-generating securities to a portfolio can smooth volatility and supplement capital appreciation over time. We believe investors would be wise to look to active short-duration strategies to earn incremental returns and add diversification while guarding against serious drawdowns on their capital.

About Duration

Duration is a measure of a bond's interest-rate sensitivity expressed in years. If rates were to rise 1 per cent, a bond portfolio with a duration of 10 years would be expected to lose 10 per cent of its value as it adjusts to the new interest-rate environment. By contrast, a 1 per cent rate hike would cause a portfolio with a duration of 1.5 years to lose 1.5 per cent of its value. Duration risk is on the minds of many bond investors because interest rates and yields are so low; eventually, central banks will raise rates, which will cause a loss of capital as the bond's value declines. In times like these, many investors look to shorten the duration of their portfolios to make them less sensitive to interest-rate hikes.

Investing involves risk. The value of an investment and the income from it will fluctuate and investors may not get back the principal invested. Past performance is not indicative of future performance. This is a marketing communication. It is for informational purposes only. This document does not constitute investment advice or a recommendation to buy, sell or hold any security and shall not be deemed an offer to sell or a solicitation of an offer to buy any security. The views and opinions expressed herein, which are subject to change without notice, are those of the issuer or its affiliated companies at the time of publication. Certain data used are derived from various sources believed to be reliable, but the accuracy or completeness of the data is not guaranteed and no liability is assumed for any direct or consequential losses arising from their use. The duplication, publication, extraction or transmission of the contents, irrespective of the form, is not permitted. This material has not been reviewed by any regulatory authorities. In mainland China, it is used only as supporting material to the offshore investment products offered by commercial banks under the Qualified Domestic Institutional Investors scheme pursuant to applicable rules and regulations. This document is being distributed by the following Allianz Global Investors companies: Allianz Global Investors U.S. LLC, an investment adviser registered with the U.S. Securities and Exchange Commission (SEC); Allianz Global Investors GmbH, an investment company in Germany, authorized by the German Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin); Allianz Global Investors Asia Pacific Ltd., licensed by the Hong Kong Securities and Futures Commission; Allianz Global Investors Singapore Ltd., regulated by the Monetary Authority of Singapore [Company Registration No. 199907169Z]; and Allianz Global Investors Japan Co., Ltd., registered in Japan as a Financial Instruments Business Operator; Allianz Global Investors Korea Ltd., licensed by the Korea Financial Services Commission; and Allianz Global Investors Taiwan Ltd., licensed by Financial Supervisory Commission in Taiwan. | AGI-2016-10-05-16515