The Problem With "Rising Rate" Strategies

In recent weeks I’ve heard quite a few people comment that they’re looking for “rising rate strategies”. It’s a seductive concept; interest rates are almost assuredly headed higher. The debate about tapering rages on, and clearly the bull market in bonds is over. Serial Quantitative Easing will transform to the Fed’s exit strategy from its $3.5 trillion balance sheet.

Unfortunately, it’s not that simple. Long positions in a bond bull market have several sources of return. In addition to the capital gain that falling rates create, the holder of a leveraged long position further benefits from positive carry in that the cost of funding the position through the repo market is less than the interest rate earned on the bond. There’s also “rolldown”, in that a ten year security held for a year will be priced as a nine year security, and with a positively sloped yield curve the lower nine year rate causes some additional drop in the yield. Three sources of return make a bull market with a positive yield curve a great environment for leveraged investors.

By the same token, bond returns in recent years have been very strong.

Rising rates present a significant challenge for investors. The past four years’ return on the Dow Jones Corporate Bond Index (all investment grade bonds) is 18%, 9%, 9% and 12% respectively (from 2009-2012). Since each year has provided investors with a return substantially above prevailing interest rates, a significant portion has come from capital gains through bond yields falling and the rolldown effect described above. Clearly, since yields are now rising, capital losses will eat into interest income and it’ll be challenging

for investors to break even. So far this year the Dow Jones Corporate Bond Index is -3.7%.

But just because bonds are likely to be a poor investment doesn't mean they're a good short. It's a tempting proposition, but being short means that positive carry becomes negative carry and rolldown also works against you (since a shorted bond will roll down the still positive yield curve to a lower yield over time, notwithstanding the effect of generally high rates).

Here's an example. Suppose an investor shorts a $1million ten year security with a 4% yield, and expects to hold the position for a year. Short term rates at 0% mean that the short will pay away the 4% coupon on the bond with no meaningful offsetting credit from cash (since cash rates are so low). This will cost $40,000. The slope of the yield curve is around 0.20% per year, so the ten year security's market yield can be expected to fall by approximately this amount over the course of a year, absent any overall shift in rates. This will cause a further loss of about $15,000 to the short.

The net result is that yields need to rise to around 4.55% over a year for the short position to be profitable. Anything less, and the combination of negative carry and rolldown will render the position unprofitable.

This is the significant hurdle facing any strategy that seeks to profit from rising rates. They're already expected to rise, so profiting from a forecast of rising rates requires that they rise more than is already priced in to the yield curve. If rates move irregularly higher, it'll be very hard to profit from that. A better approach is to look for investment strategies across all asset classes that ought to be robust during a rising rate environment, but that don't require rising rates to work.