CAIM | CROWN AGENTS INVESTMENT MANAGEMENT

i3 INSTITUTIONAL INVESTMENT INSIGHTS

# 1.00
# THE BENEFITS OF OWNING DURATION


AUTHOR

ALAN CUBBON, HEAD OF RESEARCH

CROWN AGENTS INVESTMENT MANAGEMENT


JUNE 2024

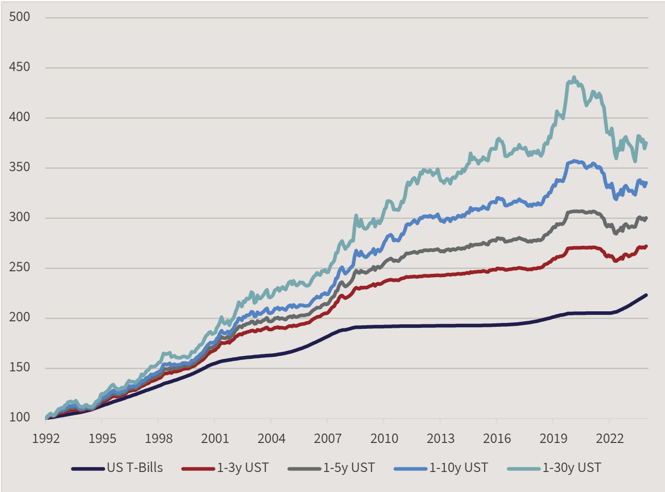
## INTRODUCTION

2022 was a memorably painful year for fixed income investors holding significant amounts of duration, as rates increased sharply from levels close to zero. Does this mean that holding duration is an unwise strategy? We argue below that holding duration is a sound long-term strategy and that, moreover, with yields now back to more "normal" historical levels the pain of 2022 is unlikely to recur any time soon, even as the short-term direction of rates experiences high volatility, yields have recently rebounded close to 2023 highs, and likely actions by the Federal Reserve become less clear. We have focused on US Treasuries, but the arguments can apply equally well to many other developed government bond markets.

## HOLDING DURATION HAS PAID OFF IN THE LONG-TERM

The chart to the right shows total return index levels for US T-Bills and increasing maturities of US Treasury bonds, since the early 1990s. The longer the maturity, the higher the return levels: at all points across the period of more than thirty years.

### Total returns of increasing maturity bands of US Treasuries



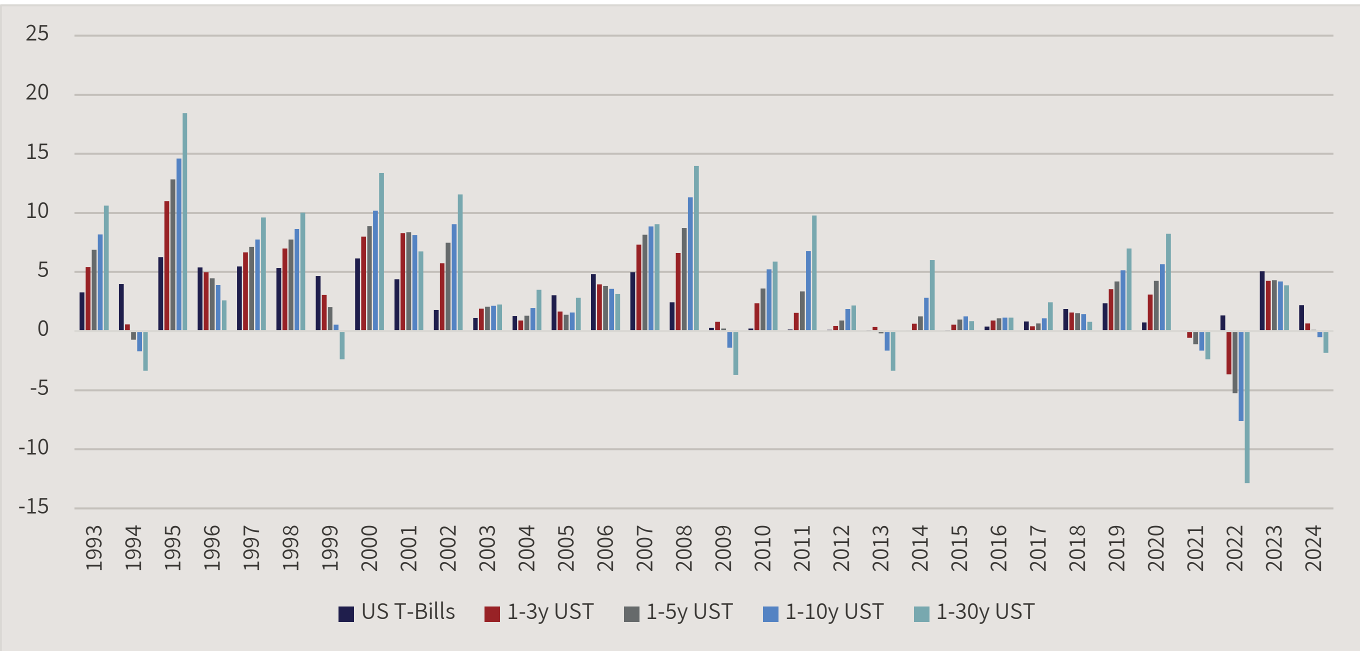

*Index levels, June 1992-May 2023. Based at 100 on 30th June 1992. Source: ICE, June 2024.*

Within this long-term context the impact of 2022 begins to look like nothing more than a bump in the road, at least for all but the longer maturities. The monotonic hierarchy of duration and return remains preserved.

## UNDER-PERFORMANCE HAS BEEN THE EXCEPTION, NOT THE RULE

If we look at the absolute returns of these indices on a year-by-year basis we notice two things. One is how extreme the behaviour of the markets was in 2022. The second is that, 2022 aside, how low-risk US Treasuries have been in terms of capital preservation.

### Year-by-year returns, %



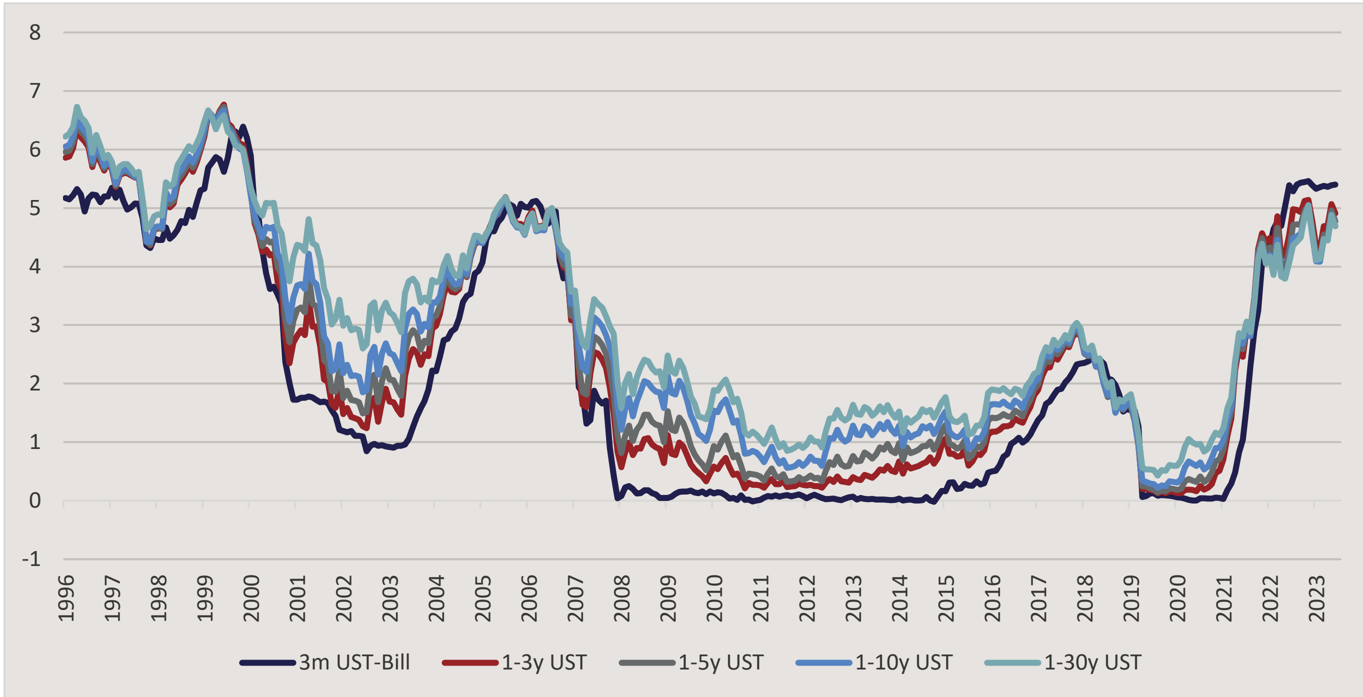

*2024 figures to 31st May. Source: ICE, June 2024.*

The likelihood of negative returns, and capital preservation thereby not being safeguarded, increases with maturity. Bills have never posted a calendar-year return below zero, even during the recent upheavals. The 1-3 year Treasury index has only twice posted negative calendar-year returns: modestly in 2021 and more sharply in 2022. Before the recent market turmoil 1-3y Treasuries had never posted negative returns as far back as these index histories extend. The full maturity, 1-30y, Treasury index has posted negative returns in 7 out of the last 31 years, counting 2024's year-to-date return as a full year. The increased downside risk of lengthening maturity is the price for the higher returns – or, equivalently, the higher returns compensate investors for the increased risks. This balance of shorter-term downside risk and longer-term return is of course the crux of benchmark choice: how much occasional short-term pain can I withstand in my pursuit of higher average returns?

## WHY WAS 2022 SO PAINFUL?

There are two sources of return when holding a US Treasury. One is the "carry": the yield, or interest, one gains by simply holding the bond over a period of time. The other is the "capital gain" (or loss) which is due to changes in prevailing yields (together with moving closer to maturity along the yield curve). If yields rise then bond prices fall, with duration having a multiplier effect. In other words, each basis point rise in yields causes a greater fall in the price of a longer-duration bond than a shorter one. Normally the carry on a bond would be sufficient to compensate for capital losses due to yield rises, but 2022 was not normal. In response to the covid pandemic and the threat to their economies, central banks around the world cut interest rates to close to zero. The chart below shows that short-term rates, as for US T-Bills, have been low before, but covid saw yields close to zero across the maturity spectrum. As a result there was no carry cushion to protect bond-holders from the sharp rise in rates that began in late 2021.

### Treasury yields, %



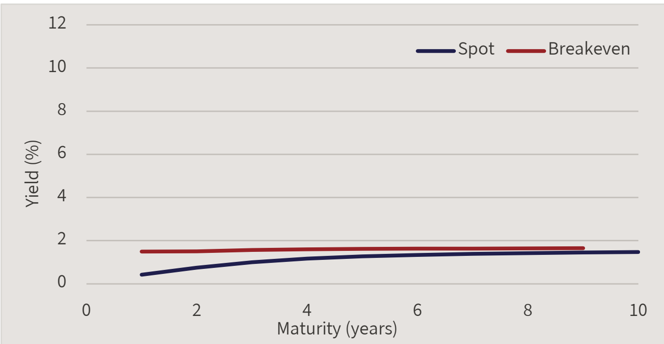

*Source: ICE, Bloomberg, June 2024.*

## THE PAST IS PAST

The rise in rates was painful, but is now likely to be over. Although US rates have, as recently as April this year, rebounded to levels close to the highs of autumn 2023, with warnings of rates staying "higher for longer", there remains a consensus that the Fed will soon embark on a series of rate cuts. And the silver lining from the cloud of 2022 is that the carry cushion has been restored. Even if rates were to repeat the rises of 2022 – hopefully an extremely unlikely occurrence – the re-established carry cushion would mean that this would not be as painful as 2022. The charts below show spot and breakeven yield curves as at the end of 2021 and the end of May 2024. As long as yields rise no further over the next year than the red curve there will be sufficient carry cushion to outweigh the capital losses and returns will be positive. At the end of 2021 cushions were very small: for a holder of a two-year bond to make money one-year rates had a cushion of 107 basis points. At the end of May that cushion was 500 basis points.

Clearly, any discussion of the attractions of holding duration should focus on where we are now rather than where we were at the end of 2021.

### Spot and breakeven yield curves, %, as at the end of 2021 and June 2024





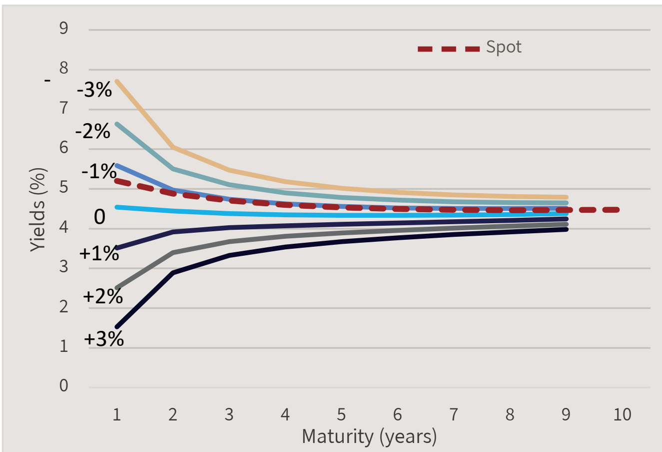
*Source: CAIM, ICE, June 2024.*

## THE CURRENTLY INVERTED US CURVE IS ALSO ANOMALOUS

Thus far we have not discussed the inverted shape of the current US yield curve. Right now, investors gain higher yields from holding shorter-maturity US Treasuries than longer. However, as with the low yields of 2021, the current situation is an historical anomaly that we do not expect to persist (as discussed in the next section). Prior to the current inversion which commenced in July 2022 we did experience periods where the yield of the 1-3y UST index were higher than those of the 1-10y, but the largest difference was just 12 basis points in late 2000, at the time of the "dot-com" crash. In the period to July 2022 for which we have data such an inversion occurred in only 31 months out of 307, with an average yield difference of just 6 basis points. Differences since July 2022, of up to 49 basis points, are historically unprecedented. Again, the previous short-term nature of this phenomenon should be borne in mind when weighing the strategic benefits of duration. Although an inverted curve may yet persist for a while longer, history tells us that it will disinvert in due course.

Moreover, although short-term rates are attractive, investments in such maturities will, by definition, require reinvestment before too long: at which point rates could conceivably be significantly lower. Longer-term investments, though offering lower yields, have the potential for much higher capital gains. The chart below shows how far yields have to move from current levels (end of May 2024) in order to generate whole percent extra returns above prevailing one-year yields. An investment in a 10-year Treasury would only have to see 9-year yields fall by 23bp to out-perform 12-month cash by 1% over the next year. Of course, a back-up in yields – of 4bp – would mean a similar level of under-performance. Nevertheless, the fact remains that if you believe yields are likely to fall over the next year, investing in longer-term maturities becomes increasingly attractive.

### Spot and 1y horizon yield curves, %, for chosen levels of out-performance of cash




*Source: CAIM, ICE, June 2024.*

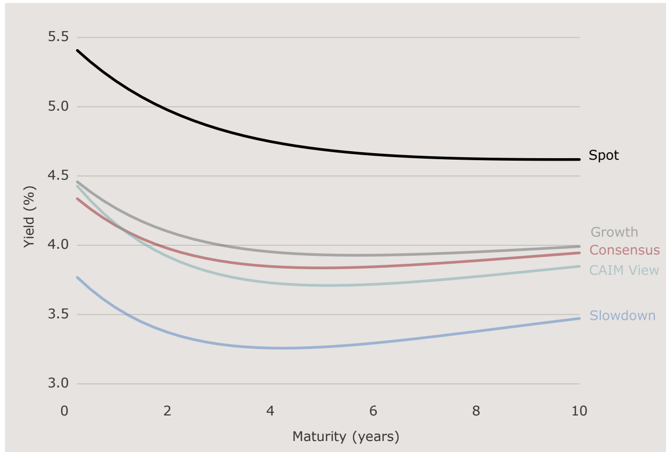
## CAIM'S MARKET VIEWS

The three charts below show our forecasts for possible evolutions of the US Treasury curve over the next twelve months, and the corresponding returns at each year's maturity along the curve, up to ten years.

The first chart shows the current curve and projected curves we forecast according to how the market may evolve under potential "regimes" over the next year. The "CAIM view" curve shows our view of the most likely curve 12 months from now.

### Spot and forecast Treasury curves a year from now

***Scenario Curves, June 2024***

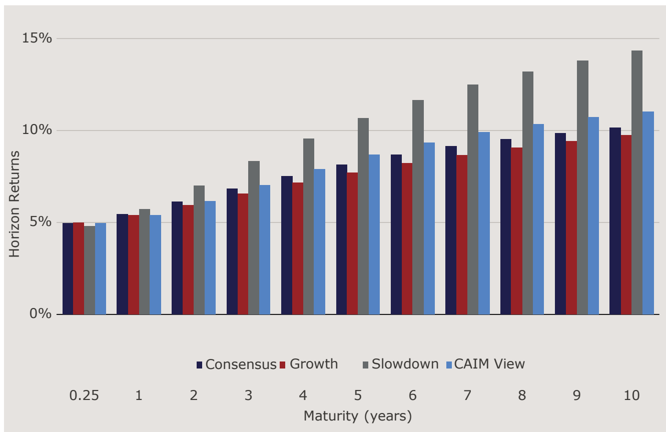



*Forecasts are not a reliable indicator of future performance.*

The second chart shows the corresponding returns from holding bonds of each maturity under each scenario, including CAIM's house view in light blue. Under each of the four scenarios we consider representative of the range of outcomes for the next year, forecasted returns increase with maturity (and duration!).

### Across each scenario returns increase with maturity

***Scenario Horizon Returns***

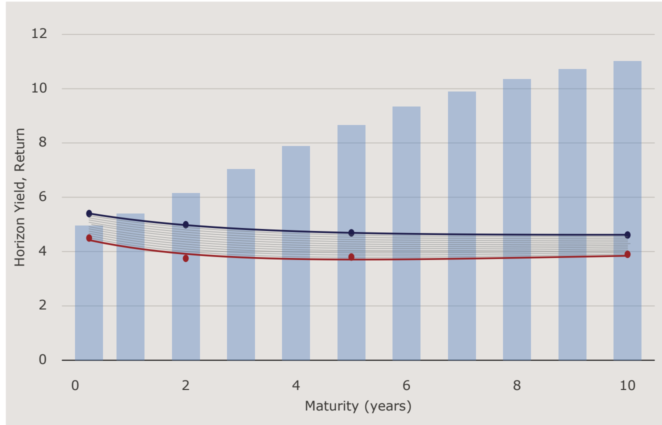



*Forecasts are not a reliable indicator of future performance.*

The final chart shows the details of the curves and returns within our house view scenario. Note that although we are projecting forwards twelve months (and we also make longer-term forecasts), we will revisit our forecasts at least quarterly and, if necessary, more often as market moves unfold.

### Our house 12-month yield and return forecast

***Scenario: "CAIM View" curve path and horizon returns***




*Forecasts are not a reliable indicator of future performance.*

## CONCLUSION

Owning duration has paid off over longer-terms, but occasionally has come at the cost of short-term pain. An extreme example of this occurred in 2022 when rates rose sharply from levels close to zero, which provided no "carry cushion" to the accompanying capital losses. Nevertheless, such episodes need to be viewed in a historical context and should not give rise to precipitate action such as investing purely for the short-term, or altering benchmarks designed for long-term strategic purposes. The events of 2022 are now, thankfully, receding in the rear-view mirror and due to a restored carry cushion any similar rate rises, however unlikely, would be much less destructive.

## ABOUT CAIM

CAIM is a UK-regulated specialist investment manager with a particular focus on managing foreign exchange reserves on behalf of central banks globally. We can trace our roots back to **1749**, when our predecessor organization was originally established by the British Crown. CAIM and our former sister organization Crown Agents Bank (CAB) have via our predecessor organizations offered financial services to our clients since **1833**. We began managing money for the world's first sovereign wealth funds in the **1960s**, and CAIM's oldest current management account dates to the early **1980s**. CAIM offers comprehensive investment solutions tailored to our clients' specific needs, and structures portfolios to maximise expected returns while constraining expected downside risk.

CAIM is a wholly-owned subsidiary of UK-based and UK-regulated Momentum Global Investment Management (MGIM) which is in turn a subsidiary of Momentum Metropolitan Holdings (MMH), a financial services group listed on the Johannesburg Stock Exchange.



i³ CAIM

## DISCLAIMER

CAIM CROWN AGENTS INVESTMENT MANAGEMENT

The Rex Building
62 Queen Street
London, EC4R 1EB

www.caiml.com