Perspectives
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Corporate bonds - bonds related to ’short duration’

For many years, investment in corporate bonds has been one of the ways to achieve a higher return and diversification of portfolios. However, global issue activity from states and companies has never been higher; in addition, interest rates are still low and it is uncertain when this is going to change. In any event, many people see the risk of rising interest rates as more and more onerous.

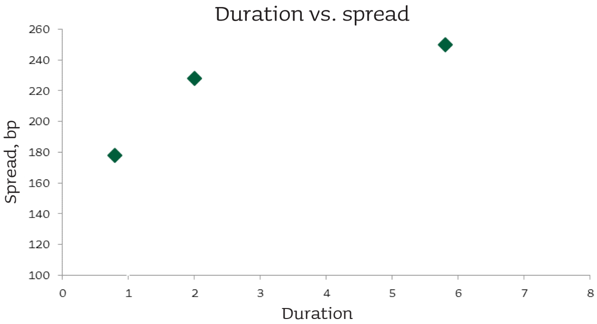
At the same time as interest rates have declined, while the perceived risk of growing interest rates has increased, the last few years have seen investors seeking investments where the risk in case of interest rate increases is more limited. One of the investment sanctuaries used has been investment in corporate bonds with limited duration (short duration bonds).

Below, we address some of the deliberations we recommend before an investor makes a corporate bond investment on the merit of short duration only.

A number of recognised studies assess the possibility of a low-risk anomaly in the credit market. An anomaly which delivers a higher Sharpe ratio, typically through higher rating or short duration. Jyske Capital will be pleased to assist investors by providing academic material covering this subject .

The Challenge

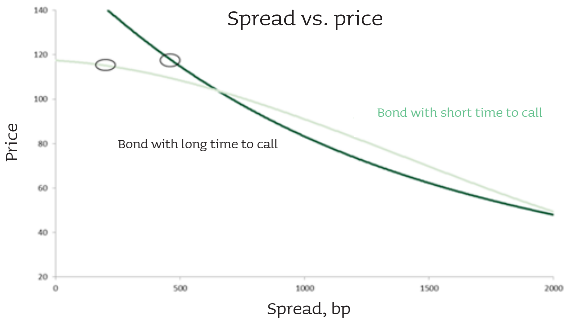
When investing in HY corporate bonds, investors achieve higher interest rates and differentials in most cases, when the duration is increased – illustrated here with three different bonds in the figure. All other things being equal, short duration bonds will thus generate a lower return than long duration bonds. The problem is, however, that the lower expected return is not necessarily accompanied by lower risk.



That short duration bonds are not necessarily 'rewarded' with lower risk is due to the fact that more or less all HY bonds come with a call option, which means that the issuer may choose whether to redeem the debt or leave it as an outstanding until the ultimate maturity date. Roughly speaking, the call decision depends on whether – immediately before the call time – the bond is traded above or below the call price. The call price is typically around 103, and if the market price is above the call price, the issuer will carry out early redemption and refinance the debt.

In a positive scenario, where the interest rate on a company’s bond falls (either because the general interest rate levels are going down, or because the credit quality is improved), the bond price increase will be highest in case of long duration, while the short-term bond is still expected to be redeemed on the first available call date and thus not experience any price increase. In an adverse scenario, where the interest rate on the company's bond increases, the immediate effect will be a modest price drop on the short-term bond and a bigger price drop on the long-term bond. In case of a major increase in interest rates and / or differentials, the price of the short-term bond will, however, fall below the call price quickly. Early redemption is thus not to be expected, therefore the duration will increase, since the bond will not be redeemed until the ultimate maturity date.

The drop in the short-term bond price may thus be much larger than would be expected when looking at duration only. Conversely, the bond price upside is very limited, due to the call option. This effect is illustrated in the figure to the left, where the circles represent the current combination of differential and price.



If an investor goes for short duration corporate bonds only and not other types of corporate bonds, we can see, on the basis of the above, that there is a great risk of losing a disproportionately high amount of upside, while the downside is still significant in a scenario where interest differentials widen.

Concern for general interest rate increases paired with an ongoing desire for corporate bond exposure may be one of the arguments in favour of buying short duration corporate bonds. However, this is not the only solution and we do not currently think it is the most optimal solution.

- We believe that it may in many ways be a better solution to buy a longer-term corporate bond (HY or IG) and cover the duration element by hedging in the form of futures on government bonds. This meets the desire to be 'protected' against interest rate increases, and it may be more efficient than to limit oneself to a universe of issues that allow early redemption within a short time limit.

- In addition, the universe for short duration corporate bonds is also relatively limited; conversely, in a more open universe with longer corporate bonds (HY and IG), investors have the possibility to go more for the right corporate bond issues or the right exposure to the company in question. This is a way not to restrain oneself from buying the right issue merely because of restrictions placed on duration.

Reflections

Many investors have had deliberations and taken initiatives with the purpose of mitigating the effect of a possible increase in interest rates. These initiatives include allocation towards short duration corporate bonds, allocation to bank loans, and orientation towards lower credit quality with a view to obtaining a higher differential (buffer against rising interest rates). A combination of the possibilities is often seen, since shorter duration often means that the investor is being forced to a higher extent of compromise on credit quality, in order to maintain a reasonably attractive interest rate. As for low-rated issues (close to default), increases can thus be observed, when the call date is within the foreseeable future.

We see more attractive and profitable routes to limiting interest rate risk, and in the current market we prefer to use futures to hedge against interest rate risk on a broad portfolio, thereby allowing access to a corporate bond universe which remains wide and where we are not forced to compromise on the selection of company or bond.

Jyske Capital already provides a number of solutions – for example we access the challeges of low expected returns a little differently in our 'All Credit' strategy. In this strategy, position-taking is implemented in the individual companies, so that anomalies and arbitrage options between different instruments from the same issuer are utilised to yield a higher return without increasing credit or interest rate risk. Effective implementation simply means that in this strategy we are able to offer a better risk-adjusted return.

Regulation
Regulation based on EU Regulations directed at banks and insurance companies may lead to a form of regulatory arbitrage, i.e. the regulatory risk weighting may deviate from the immediate return/risk ratio. Such pseudo-arbitrage options may materialise in case of speculative individual positions which deviate on duration, rating, currency or otherwise. In the evaluation of short versus longer duration of portfolios of corporate bonds and based on the current regulatory requirements for banking and insurance, we see no immediate advantages from selecting either short or long duration. Jyske Capital may assist in connection with deliberations and proposals for optimising positions on the basis of regulatory restrictions (including LCR).

Final observations
In a historical perspective, it has been an advantage for investors to access the corporate bond market with a broader approach. Limitation of the investment universe (e.g. restrictions on duration) may easily lead to inappropriate investment decisions, e.g. an investor may assume a higher credit risk to compensate for the lack of a higher interest rate in case of short duration.
In our assessment, the compromise made when solely investing in short duration bonds is too big. We see a noticeable reduction of the return potential and flexibility when the framework for company and issue selection are narrowed. As an active asset manager, we consider flexibility to be a particularly important factor in the current market environment for corporate bonds.

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