3 Reasons Why Investors Should Consider Adding Duration

Holding bonds with longer maturities may seem counterintuitive in today's environment. See why it could make sense.

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In a world in which investors are reluctant to part with CDs paying more than 5%, and where even short-term Treasury bills are offering some of the most attractive yields seen in years, why would investors think now's a good time to add duration[1] to fixed-income portfolios?

Adding duration, after all, means investing in securities that have more interest-rate risk. A "higher-for-longer" interest-rate environment is generally perceived to be problematic for preserving the value of long-term fixed-income returns.

That said, here are three reasons why investors may want to consider adding duration at the moment:

1. Markets anticipate the Federal Reserve's (Fed's) actions
2. Many bonds are selling at a discount[2]
3. Global uncertainties may push rates down and bond prices up

Key Points

- In previous Fed hiking cycles, intermediate-duration bonds outperformed short-duration bonds and cash one year after the Fed's last rate hike.
- While 2022 and 2023 were certainly roller-coaster years for bondholders, higher yields have also created an attractive entry point for new investors.
- The economy appears resilient at the moment—especially in the US. But unforeseen changes in the outlook here and abroad could motivate investors to turn to bonds to help manage risk.

1. Markets Anticipate the Fed's Actions

The Fed hasn't moved its federal funds rate,[3] currently between 5.25% and 5.50%, since July 2023. Based on its own most recent dot plot,[4] there's a consensus among Federal Open Market Committee (FOMC) members that the Fed is currently sitting on its peak target rate. Treasury yields have fluctuated since the last rate hike, based on the market's anticipation of cuts in 2024 and uncertainty of not knowing when, or how many, cuts will actually take place.

However, we do know that the average length of time for Fed pauses, as seen over the past five hiking cycles, has been 11 months. During these cycles, history shows that intermediate-duration bonds outperformed short-duration bonds and cash over the following 12 months—even without a rate cut (**FIGURE 1**).

FIGURE 1: Intermediate Duration Has Outperformed Short Duration and Cash One Year After the Fed's Last Rate Hike
Performance (%) of Bond Indices vs. Cash After Fed Cycles Ended (1995-2019)

Bonds vs. Cash by Duration	Avg.	2/1/95-2/1/96	3/25/97-3/25/98	5/16/00-5/16/01	6/29/06-6/29/07	12/19/18-12/19/19
Intermediate	11.55	16.82	11.15	13.95	6.74	9.08
Short	7.60	10.37	7.33	10.54	5.57	4.21
Cash	5.51	6.41	5.94	6.99	5.57	2.63

As of 12/31/23. **Past performance does not guarantee future results.** Indices are unmanaged and not available for direct investment. Intermediate duration is represented by the Bloomberg US Aggregate Bond Index. Short duration is represented by the Bloomberg US Government/Credit 1-3 Year Index. Cash is represented by the ICE BofA US 3-Month Treasury Bill Index. Please see page 3 for index definitions.
Source: Bloomberg

How is that possible without a rate cut? Typically, the market anticipates Fed action before it has a chance to make any changes. Ten-year Treasury rates have been, on average, 1.31% lower from the last hike until the Fed's first rate cut (**FIGURE 2**). This is a clear indication that waiting for the Fed to act heightens the risk of missing the actual market move.

FIGURE 2: 10-Year Treasuries Have Fallen Between the Last Rate Hike and the First Rate Cut

Change in 10-Year Treasury Yields for the Past Five Hiking Cycles (1995-2019)

Date of Last Fed Rate Hike to Date of Initial Rate Cut	Starting 10-Year Rate	Ending 10-Year Rate	% Change
2/1/95-7/6/95	7.66%	6.03%	-1.63%
3/25/97-9/29/98	6.76%	4.57%	-2.20%
5/16/00-1/3/01	6.42%	5.16%	-1.27%
6/29/06-9/18/07	5.20%	4.47%	-0.72%
12/19/18-7/31/19	2.76%	2.02%	-0.74%
Average Rate Change			**-1.31%**

Data Source: Bloomberg, 12/31/23.

The Fed has held rates steady for an average of 11 months over the last five hiking cycles.

2. Many Bonds Are Selling at a Discount

The past couple of years have been maddening for bond investors as rates came off historic post-COVID-19 lows. Ten-year Treasury rates hit an all-time low of 0.51% on 8/4/20. Since then, as recently as October 2023, the 10-year note touched as high as 5% for the first time since 2007. This move helped create cumulative losses of approximately 15% for investors in high-quality bonds. Investors were able to recoup a portion of the losses as the markets experienced a significant 100-basis-point[5] rally before year end, with the Bloomberg US Aggregate Bond Index (the Agg) finishing up over 5% for calendar-year 2023.

While it certainly has been a roller-coaster ride recently for bondholders, it's created an attractive entry point for new investors. The average price for bonds in the Agg was a little more than $91, and the yield to worst[6] was 4.53% as of 12/31/23. If those numbers are compared to bond prices at the end of 2021, when average prices stood at $104 and the yield to worst hovered around 1.75%, it's not difficult to see why opportunities in high-quality fixed income may still exist.

In a higher-for-longer scenario, newly issued bonds with higher coupons will be added into bond funds and ETFs, while older bonds that trade at a discount will accrete back to par.[7] Even if the fixed-income market were to remain flat, a 5% return would be a welcome total return for fixed-income investors.

3. Global Uncertainties May Push Rates Down and Bond Prices Up

Keep in mind, investment-grade bonds[8] typically experience minimal defaults. The Agg consists of high-quality fixed-income assets with three main components (**FIGURE 3**).

FIGURE 3: Three Largest Components of the Agg

US Treasuries	41.64%
Agency Mortgage-Backed Securities	26.62%
US Corporates	24.86%
Total	**93.12%**

Data Source: Bloomberg, 12/31/23.

Downward-trending rates have typically signaled some sort of market turmoil. In these instances, high-quality bond funds with longer duration have historically shown an ability to provide diversification relative to equities and potentially provide upside for investors. The US economy has continued to show resilience in labor markets and in consumer behavior. However, any number of headwinds at home (commercial real estate, declining consumer balance sheets, slower lending) and abroad (Israel-Hamas war, Russia-Ukraine war, Chinese economic woes, UK/eurozone economic contraction) could create uncertainty about the long term, which could eventually push rates lower and bond prices higher.

Summary

Adding duration may seem counterintuitive, given that the Fed has yet to definitively lay out plans to cut rates. However, current valuations are attractive and could stay that way even if the market ends up mired in a higher-for-longer state. The market generally makes its move before the Fed and the public can react. While the economy appears resilient at the moment—especially in the US—unforeseen changes in the outlook here and abroad could motivate investors to turn to bonds to help manage risk.

Duration: Why It Matters

Duration is the measure of a bond's sensitivity to interest-rate changes. The statistic is measured in years, and the longer the duration, the more sensitive a bond is to rate moves—up or down. Conversely, the shorter the duration, the less sensitive to rate changes.

Short-duration bonds generally have maturities between six months and five years. Intermediate-duration bonds generally have maturities between five and 10 years. Long-duration bonds have maturities between 10 and 30 years.

Talk to your financial professional to help you construct a bond portfolio that's right for you.

Bloomberg US Aggregate Bond Index is composed of securities that cover the US investment-grade fixed-rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities.

Bloomberg US Government/Credit 1-3 Year Index is an unmanaged index comprised of the U.S. Government/Credit component of the U.S. Aggregate Index.

ICE BofA US 3-Month Treasury Bill Index is comprised of a single issue purchased at the beginning of the month and held for a full month. At the end of the month that issue is sold and rolled into a newly selected issue.

[1] Duration is a measure of the sensitivity of an investment's price to nominal interest-rate movement.

[2] Bond discount is the amount by which the market price of a bond is lower than its principal amount due at maturity. A bond issued at a discount has its market price below the face value, creating a capital appreciation upon maturity since the higher face value is paid when the bond matures.

[3] The federal funds rate is the target interest rate set by the Federal Open Market Committee. This target is the rate at which commercial banks borrow and lend their excess reserves to each other overnight.

[4] Dot plots are well known as the method that the Fed uses to convey its benchmark federal funds interest rate outlook at certain Federal Open Market Committee (FOMC) meetings. FOMC members place dots on the dot plot denoting their projections for future interest rates in subsequent years and in the longer run.

[5] A basis point (bps) is a unit that is equal to 1/100th of 1% and is used to denote the change in a financial instrument. The basis point is commonly used for calculating changes in interest rates, equity indices and the yield of a fixed-income security.

[6] Yield to worst is a measure of the lowest possible yield that can be received on a bond that fully operates within the terms of its contract without defaulting.

[7] In finance, accretion refers to the accumulation of the additional income an investor expects to receive after purchasing a bond at a discount and holding it until maturity. Par is the face value of a bond, which defines its maturity value and the dollar value of coupon payments.

[8] Investment-grade (IG) bonds are believed to have a lower risk of default and receive higher ratings by the credit rating agencies, namely bonds rated Baa (by Moody's) or BBB (by S&P and Fitch) or above. These bonds tend to be issued at lower yields than less creditworthy bonds.

Important Risks: Investing involves risk, including the possible loss of principal. • Fixed-income security risks include credit, liquidity, call, duration, event and interest-rate risk. As interest rates rise, bond prices generally fall. • Mortgage-related and asset-backed securities' risks include credit, interest-rate, prepayment, and extension risk. • U.S. Treasury securities are backed by the full faith and credit of the U.S. government as to the timely payment of principal and interest. • Diversification does not ensure a profit or protect against a loss in a declining market.