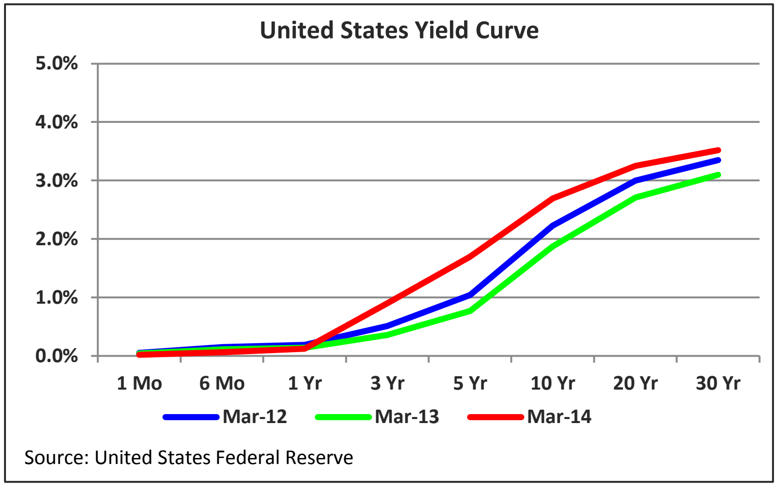
MARKET MICROSCOPE – Fixed Income Portfolio Duration

What is portfolio duration, and why is it so important?

Duration is one of the most important characteristics of a fixed income investment strategy. While portfolio duration is expressed as a number of years, it really represents a measure of how sensitive a bond portfolio is to a given change in interest rates. Specifically, the value represents the change in value that we should expect if interest rates change 1%.

For example, if a portfolio has a duration of 4 years then if interest rates ***decrease*** by 1% we would expect the value of the portfolio to ***rise*** 4%. Importantly, the opposite is also true - If interest rates ***rise*** 1%, we would expect the value of the portfolio to ***decrease*** 4%.

Chart covers January 1, 1962 through March 26, 2014.



As we can see from the chart on the left, for most of the past 30 years interest rates have been declining, with the 10-year Treasury rate reaching a low of roughly 1.40% in 2012. However, in May 2013 rates began to climb, with the 10-year rate rising approximately 1.25% in just a few months. Not coincidentally, the Barclays Aggregate Index suffered a loss of -2.02% for the year 2013. This was only the third time since 1976 that the Aggregate Index had a negative return for a calendar year, the others being 1994 (-2.92%) and 1999 (-0.83%).

As of 3/27/14, the Barclays Aggregate Bond Index had a portfolio yield of 2.37% and an effective portfolio duration of 5.19 years. We at Alpha do not pretend to know exactly where market interest rates will be at a specific point in the future, however it would seem likely that interest rates will eventually trend upward to a more historically “normal” level. If this occurs, investors with bond portfolios that have a higher duration value could see more negative returns in their future.