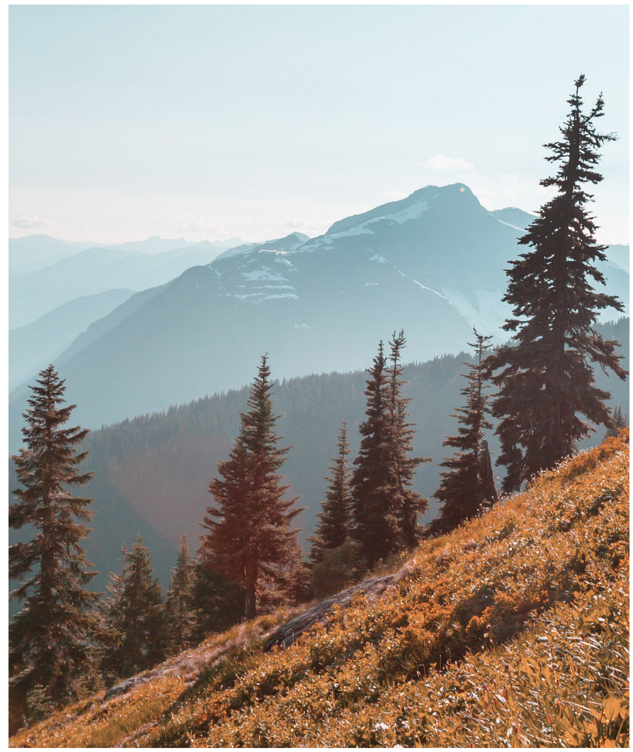
Duration Changes in 2021 Worth a Closer Look



Authors

MATT BUSCONE
CO-HEAD, PORTFOLIO MANAGEMENT,
ACTING CO-CHIEF INVESTMENT OFFICER

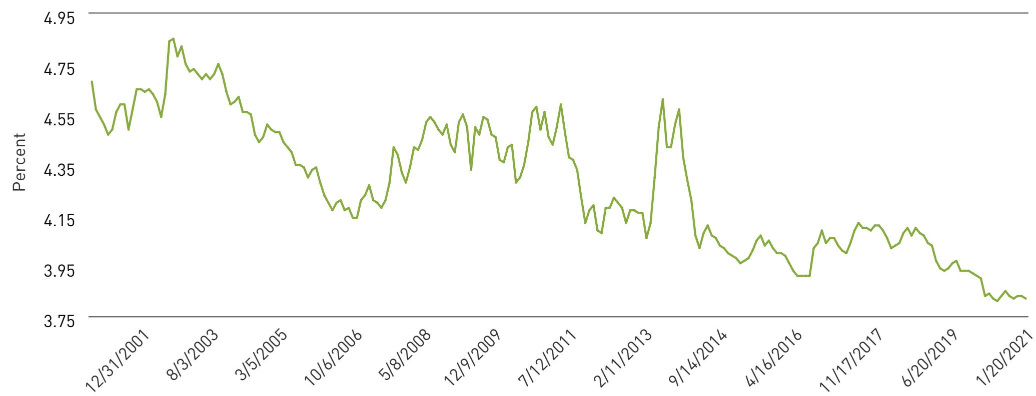
Key Takeaways

- *Duration is a good way to measure the potential effect of interest rate changes on a bond portfolio.*
- *Duration considers several factors including a bond's maturity, yield, coupon and call features and helps to measure its interest rate risk.*
- *As economic growth has soared this year and the rate of inflation has increased, concerns about higher interest rates has brought duration to the front of many peoples' minds while a popular benchmark for municipal bonds has reached its shortest duration in many years.*

As a general rule, the shorter a bond's duration, the less volatile it will be as interest rates rise or fall. For example, a higher duration suggests a bond investment's value will decline as interest rates rise. That is because when interest rates go up, a fixed income security bought in a lower interest rate environment is worth less than a new bond issued at a higher interest rate, and the older bond's value falls. A bond with a longer duration would be preferred if interest rates are expected to fall over the period of time the bond is held, because the bond's value would increase more than comparable bonds with shorter durations due to its higher yield.

Figure 1 illustrates a fairly consistent shortening of duration for the BBG 1-10 Blend (1-12) Municipal Bond Index (the Index) from a peak of 4.85 in 2003 to a low of 3.80 as of January 29, 2021. While it is often difficult to identify any single driver of duration changes, during the last two years we look at increasing levels of taxable municipal supply, issuers using shorter call options and low yields as being significant contributors to the shortening duration of the Index.

FIGURE 1: OPTION-ADJUSTED DURATION



BBG 1-10 Year Blend (1-12) Municipal Bond Index
Source: Bloomberg Barclays Data from December 2001 through January 29, 2021.

At Breckinridge, our intermediate duration portfolios seek to offer a duration that closely resembles a five-year bond as we believe that gives investors a neutral level of interest rate exposure, not too short or too long. While we actively manage duration, we build our intermediate portfolios with exposure to bonds across the 1- to 15-year range of the yield curve in an effort to hedge risks of both falling and rising rates. Our composite duration typically has remained closer to four years.

The last few years have seen the Index's duration shorten more dramatically and persistently. We have chosen not to shorten our portfolios duration as quickly. That decision is based on, among other factors, a positive view of the long-term supply/demand dynamics in the municipal market, the benefit of being slightly long from an income generation perspective and, for long-term clients, the reality that doing so would entail selling longer duration bonds, frequently incurring both capital gains and transaction costs.

We will continue to monitor the indexes that serve as benchmarks across all of our strategies while making active and thoughtful duration-management decisions in an effort to achieve our goals of building or sustaining the income stream. To further explore the differences between benchmarks and actively managed strategies, please see our article, "*When to Bench the Benchmark*."

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