Short Duration Strategies are Worth a Look

InvestEd | July 2021

The Federal Reserve (Fed) and the federal government have unleashed massive monetary and fiscal stimuli over the past year, leading to a low rate environment. By extension, this environment caused many investors to ponder ways to generate positive returns, particularly those that operate in the world of fixed-income. Below, we discuss the current economic environment and what we believe may be a viable option for some investors.

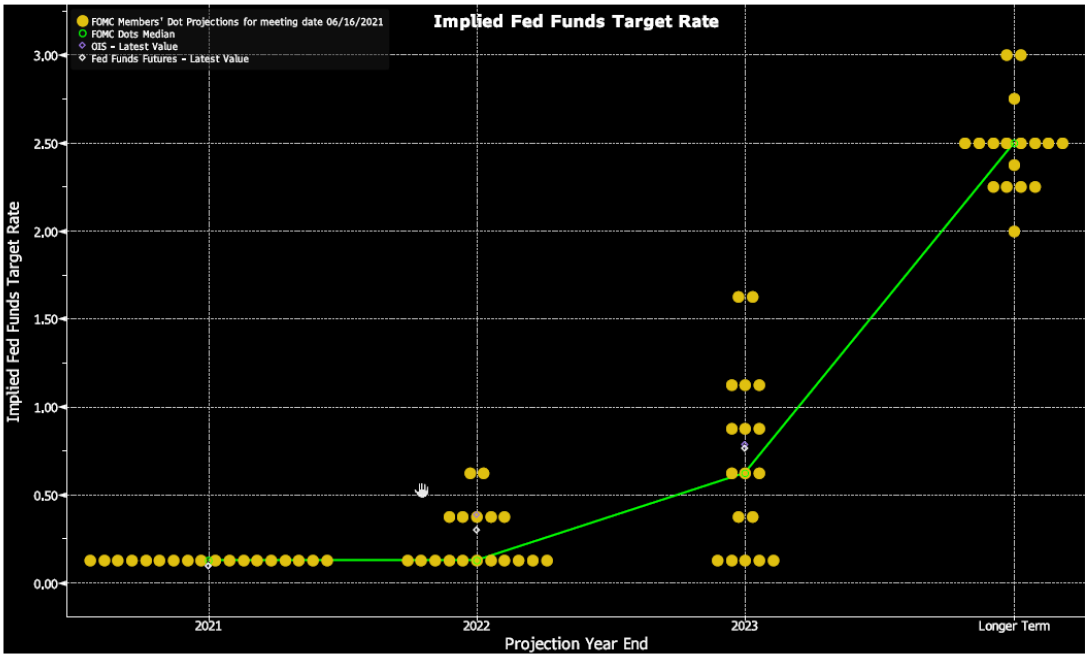
The Backdrop

The Fed continues to provide unprecedented levels of monetary support. At the same time, the federal government has committed more than $5 trillion of fiscal stimulus since the spring of 2020 — both in an effort to support economic growth in the aftermath of the COVID-19 induced recession. The absolute level of yields across the curve remain near historic lows after last year's "flight-to-quality" — a term that describes investor preference for safe-haven investments, which tend to drive high-quality bond yields lower — causing many investors to explore strategies that can be implemented to generate positive returns.

The Current Environment and Outlook for Interest Rates

In March 2020, the Fed reduced the overnight lending rate, or Federal Funds rate, to near-zero. This was done to help mitigate the economic damage wrought by COVID-19 and, ultimately, led to historically low-interest rates in money funds, money market instruments and cash pools. This accommodative monetary policy, coupled with the trillions of dollars that the U.S. Congress has committed to stimulate the economy, has led to increased inflation expectations.

Despite the increasingly optimistic outlook shared by economists and strategists and the prospect for elevated inflation levels, the monetary policymaking body remains adamant that a near-zero fed funds rate will be appropriate in the near term. While only some Fed officials anticipate the Federal Open Market Committee (FOMC) will raise short-term rates in 2022, the majority of Fed officials do not see a rate increase until late 2023 (see dot plot below). With this guidance, the market's current expectation is that we are not likely to see a marked increase in rates until sometime in 2022 and that "cash rates" (interest rates earned on daily liquidity or close to daily liquidity) could remain anchored near 0% for another year or two.



Source: Bloomberg Consensus Forecast.

*Note that in anticipation of higher economic growth and inflation, economists expect market rates to move higher further out the curve (especially outside of three years in maturity). The yield curve (the difference between short-term and long-term rates) is also expected to widen or rise as the front end remains anchored close to zero and the long end moves higher.

Rate	Market Yields %	Q2 21	Q3 21	Q4 21	Q1 22	Q2 22	Q3 22	Q4 22	Q1 23	Q2 23	Q3 23
U.S. 30-Year	2.18	2.31	2.45	2.53	2.58	2.65	2.71	2.77	2.85	2.96	3.00
U.S. 10-Year	1.57	1.64	1.79	1.88	1.95	2.02	2.08	2.17	2.25	2.35	2.42
U.S. 5-Year	0.91	0.86	0.99	1.05	1.12	1.18	1.26	1.36	1.41	1.51	1.58
U.S. 2-Year	0.20	0.19	0.25	0.31	0.38	0.46	0.55	0.65	0.74	0.85	0.95
U.S. 3-Month Libor	0.12	0.19	0.22	0.25	0.27	0.30	0.35	0.39	0.55	0.60	0.69
Fed Funds Rate - Upper Bound	0.25	0.25	0.25	0.25	0.25	0.30	0.30	0.35	0.40	0.50	0.60
Fed Funds Rate - Lower Bound	0.00	0.00	0.01	0.01	0.02	0.03	0.05	0.08	0.17	0.25	0.35
2 Year - 10 Year Spread	1.37	1.45	1.54	1.57	1.57	1.55	1.53	1.52	1.50	1.50	1.46

Source: Bloomberg, as of June 16, 2021.

So, what can investors do with excess cash (funds not anticipated to be utilized in the near term)? While low duration funds are not an alternative for meeting daily liquidity needs, low duration investments/strategies may indeed be an attractive option for some.

What Is a Low Duration Strategy?

There is no one standard definition of "low duration," however, it is often used when referring to portfolios that have an average duration between one and three years. These strategies strive to maintain a high average credit quality and a high level of liquidity to meet unanticipated cash needs. Another important aspect of these portfolios is their relatively low volatility compared to longer duration portfolios, which supports the portfolio's ability to responsibly meet unforeseen liquidity needs and help achieve above-average risk-adjusted returns over cycles.

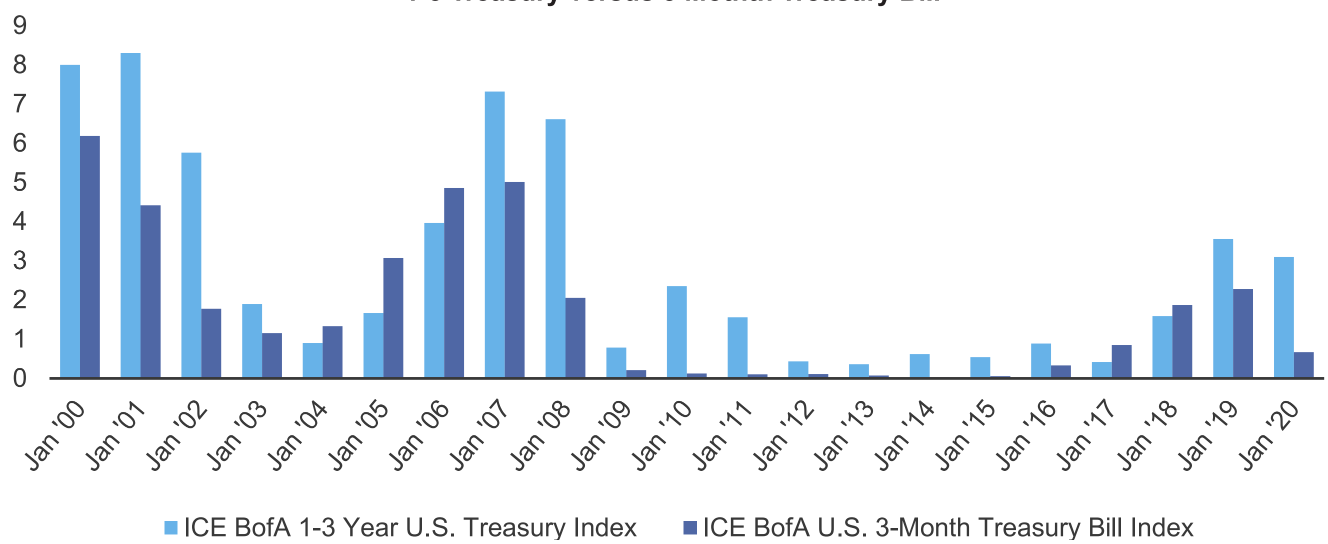
While these strategies may include investments in money market instruments such as Treasury bills, commercial paper and certificates of deposit, they typically invest in individual securities with durations between one and five years. They may also include Treasury notes, agency debentures, corporate notes and securitized products such as asset-backed securities (ABS) and mortgage-backed securities (MBS). A common benchmark for such a strategy might be the ICE BofA 1-3 year U.S. Treasury or a similar duration Government/Credit alternative which would allow active portfolio managers to take advantage of dislocations or market opportunities that arise.

Taking advantage of securities that extend beyond traditional money market and short-term vehicles creates increased alpha opportunities (potential excess returns over applicable benchmarks). Additionally, interest rate risk has historically been low relative to longer-term bond funds, helping to produce strong risk-adjusted returns. In summary, these strategies look to preserve capital and increase risk-adjusted returns while maintaining a degree of liquidity.

An Overview of Historic Returns

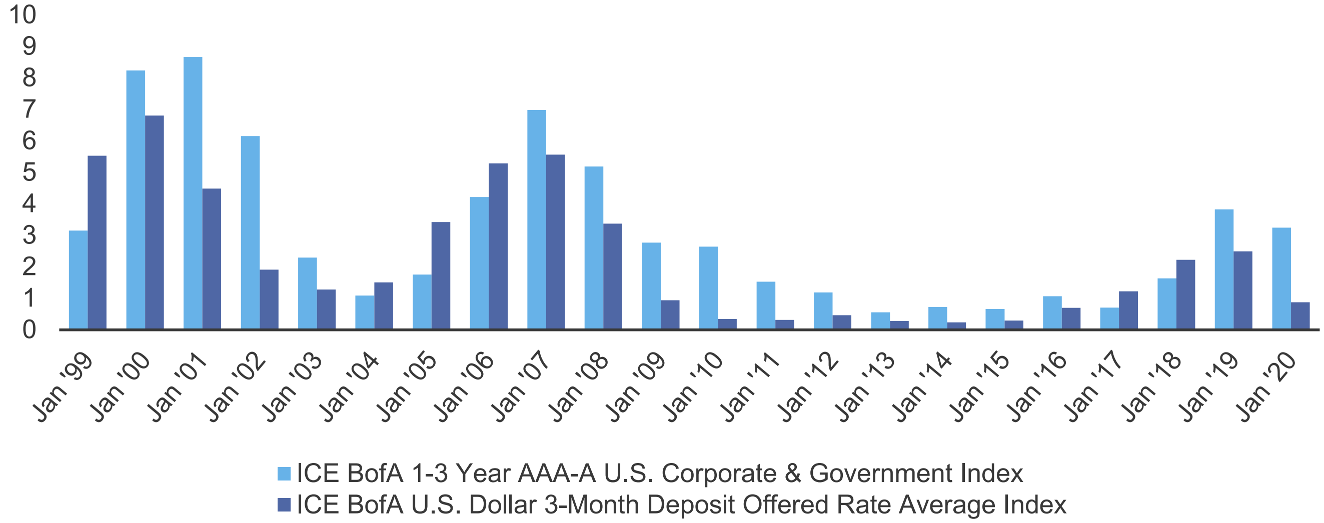
Historically, returns on short duration securities have been higher, at times substantially, than that of money market funds and local government investment pools (LGIPs). Depending upon monetary and fiscal policy, the return differential can and will vary through market and interest rate cycles. Since 2000, the annualized return on the 1-3 year Treasury index has been higher than the 3-month Treasury Bill by more than 100 basis points (bps). Meanwhile, the annualized return for the ICE BofA 1-3 year Government/Credit index has been higher by almost 100 bps compared to the 3-month LIBOR (a proxy for money market funds). Historically, neither the ICE BofA 1-3 year Treasury nor Government/Credit indices have produced a negative return in a calendar year, according to Bloomberg. That said, past performance does not, of course, guarantee future performance and/or results.

1-3 Treasury versus 3 Motnth Treasury Bill



Source: Bloomberg.

1-3 G/C versus 3 Month LIBOR



Source: Bloomberg.

	1-3 Year Treasury	3 Month Bill	Difference in Returns
1 Year	3.10%	1.51%	1.59%
5 Year	1.90%	1.20%	0.70%
10 Year	1.30%	0.64%	0.66%
20 Year	2.60%	1.51%	1.09%

Returns are annualized for periods greater than 1 year.

	1-3 Year G/C	3 Month LIBOR	Difference in Returns
1 Year	3.24%	0.87%	2.37%
5 Year	2.09%	1.50%	0.59%
10 Year	1.51%	0.91%	0.60%
20 Year	2.82%	1.85%	0.97%

Returns are annualized for periods greater than 1 year.

Philosophy and Process for Managing Short Duration Portfolios

At PFM, our short duration portfolios are managed on a total return basis – taking into account not only the income that is generated but also changes in the portfolio's fair market value. We believe inefficiencies and opportunities can exist within specific areas of the fixed-income market due to several factors including mispricing, liquidity and bias). Utilizing rigorous analysis and a disciplined process, we seek to take advantage of these inefficiencies and opportunities through active portfolio management, which has the potential to lead to attractive risk-adjusted returns over cycles.

We start with a comprehensive and broad view of the macroenvironment or a "top-down" approach. We consider domestic monetary and fiscal policy, the outlook for consumers' health and spending, corporate fundamentals (business cycle), the regulatory environment, global economic growth and much more. A top-down view helps develop strategies for our duration decisions, yield curve positioning and structure of a security (bullet versus securities with embedded call features — MBS, for example). It also provides some input for the sectors we believe will have better performance potential. We then use a "bottom-up" approach to identify specific securities that have attractive yields and total return potential.

We invest in high-quality securities that offer an attractive yield on a relative basis. We utilize Treasuries, agencies, supranationals, investment-grade (IG) credit and securitized products (ABS and agency CMBS/CMBS). Depending on market conditions, we will look to change our sector allocation and swap out of specific securities once we believe the relative total return (combination interest received and change in market value) has been maximized. We work to minimize the portfolio's expected volatility and maximize overall returns.

At PFM, we also identify appropriate risk parameters for our short duration strategy. We use a quantitative and qualitative approach for managing risks associated with certain sectors and specific securities. Our decisions implemented into our clients' portfolios adhere to their specific guidelines and needs.

Final Thoughts

If same-day liquidity or access to a substantial amount of the portfolio within a short period of time is not a necessity, investing in a short duration strategy may be an appropriate alternative. Working with your PFM client manager, a specific plan can be developed based on your cash flow needs, guidelines and risk tolerances.

Stay Tuned

In the coming weeks, we will weigh in with additional insights and observations with regard to short duration strategies.

For more information about this report, please reach out to your PFM representative or James Sims at simsj@pfmam.com.

To learn more or discuss in greater detail, please contact us:

James Sims, CFA
Managing Director
simsj@pfmam.com