Rising interest rates: Be careful what you wish for

Stuart Lingard explains why higher interest rates may not be as beneficial as it first appears for pension funds

The referendum vote to 'Brexit' has only added to the sense that interest rates globally are likely to stay lower for longer. Even in the United States, which is considered further along the economic cycle than many other developed economies, the pace of any moves towards interest rate 'normalisation' remains uncertain. Despite this uncertainty, it seems clear that the path of official interest rates in the US will eventually be upward from here.

> **"While pension schemes should benefit from higher interest rates through a fall in the value of their liabilities, it would not be all good news"**

While pension schemes should benefit from higher interest rates through a fall in the value of their liabilities, it would not be all good news. In addition to long-dated gilts, most schemes typically have global bonds exposure which may be tracking a core benchmark, such as the Barclays Global Aggregate Bond Index. Over the course of this year, that approach has been successful as we have seen core bond yields fall ever lower and benchmarks generate strong returns. However, it is important to recognise the potential risks associated in holding a significant degree of interest rate risk.

In general, for a fixed-income security or portfolio, the longer the duration, the more sensitive it is to fluctuations in interest rates. When rates go up, generally the value of these securities goes down, even more so if they have longer-duration characteristics.

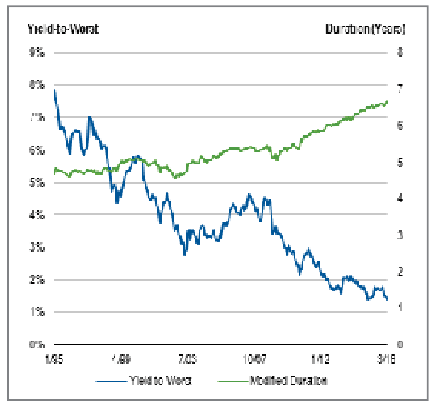
The availability of cheap financing and ample liquidity has prompted a number of governments and companies to lock in longer-term debt at record-low interest rates and because many benchmarks are issuance weighted, as large entities issue more debt, their positions within the benchmark increase. This has the effect of increasing both the benchmark's duration and the investor's exposure to the heaviest debtors. This longer duration means a fixed income strategy tracking an index would be exposed to a higher degree of possibly unintended interest rate risk.

Meanwhile, as the chart opposite shows, the benchmark's overall yield has noticeably declined in recent years as core bond market yields have fallen to record lows in some markets.

So while pension schemes might understandably be wishing for higher interest rates in the UK, the impact on their benchmark-oriented fixed income strategies should be borne in mind. In contrast, fixed income strategies that have flexibility to move away from tightly tracking a benchmark can reduce certain risks, including interest rate risk, while potentially providing additional yield benefits.

Historical Duration of the Barclays Global Aggregate Bond Index and Commensurate Yield Characteristics

Yield-to-Worst and Modified Duration
31 January 1995–31 March 2016



Source: FactSet. **Past performance does not guarantee future results**

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