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ACTIVE DURATION FIXED INCOME INVESTING

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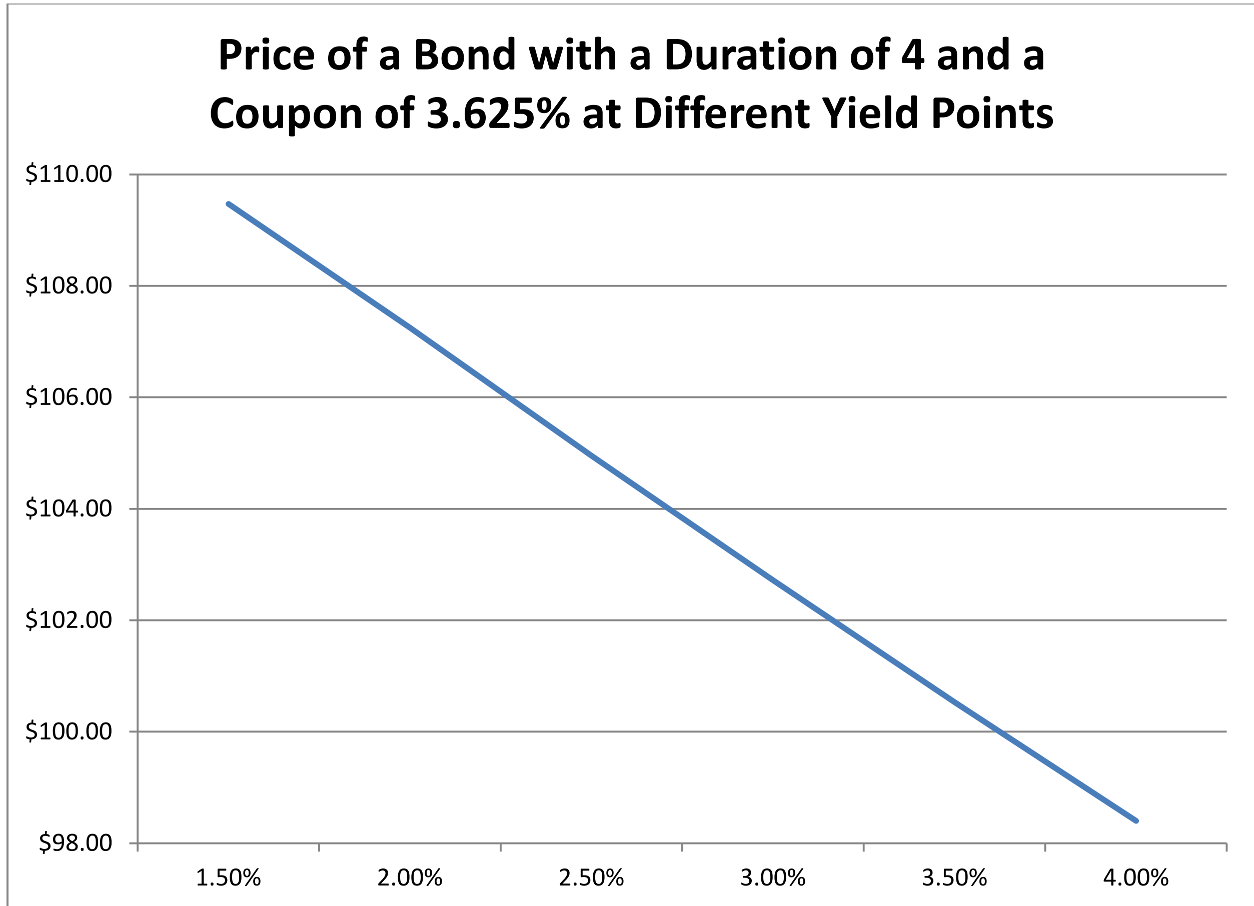
As we wait for and anticipate the end of historically low interest rates, some investors might be tempted to allocate funds to active duration managers in the hope that they can avoid some of the price erosion associated with a return to a more "normal" yield curve. The argument for deploying funds to this active duration style is the fact that a somewhat static duration approach gives a manager little chance of avoiding price erosion when rates do return to a more normal relationship to inflation and other economic indicators.

An active duration approach would give the manager a fighting chance of avoiding some of this price erosion by staying on the short end of the duration curve until rates shift towards a more normal yield curve. When rates finally do shift, the portfolio can then be adjusted to a more normal or average duration profile. The major risk to this strategy would be if rates remain at these historically low levels for another 3-5 years. The income sacrificed as a result of being in shorter maturities would mitigate the advantage achieved by avoiding some of the price erosion in the bond portfolio.

For those investors/consultants that do find an active duration approach to be appealing, we must examine how this process works and what the potential rewards of a successful active duration fixed income management approach are. It is safe to assume most of the fixed income portfolios in question have intermediate duration profiles, (longer duration bond portfolios are often associated with liability driven investing ("LDI") management and would be less likely to consider an active duration approach) and quantifying the risk/reward would be as follows. If one assumes an average duration of 4 for an intermediate maturity portfolio and assumes a normal yield curve for intermediate maturity bonds, the portfolio yield should return to approximately 4.00%. This 4.00% represents the combination of average inflation around 2.00% with an additional 2.00% real return for government bonds.

With current yields on government bonds in the 4-5 year maturity range (duration of approximately 4) of 1.50%, a return to a normal yield environment of 4.00% would imply that 4 to 5 year bond rates would increase by at least 2.50%. Combining the above assumptions suggests potential price only erosion in the range of 10%-12% given a return to a more normal yield curve (as illustrated by the chart

below). If an active manager can even avoid half of the price decline over the next 5 years, the average total return should improve by at least 1.00%, all other things being equal.



We believe that a modified active duration, one which does not allow an active duration manager to position himself anywhere on the yield curve, can significantly lower risk. While we recognize that most accounts maintain a specific index and thus a more static duration profile, (assuming most managers will stay very close to the duration of the benchmark index) an active duration profile with a logical approach towards yield curve management may appeal to certain investors.

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