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Returns to convexity

James Robertson, Jr. writes:

A zero-coupon strip of the Treasury 1.875s of 2051 trades at 25 cents on the dollar, down 60% from its high in the meme-stock and crypto-confetti year of 2021.

This publication has observed that bond cycles, once begun, tend to persist. The prior bear bond market took the 10-year Treasury yield to 15.7% in 1981 from 2% in 1946, but the path was far from straight and violent countertrend rallies shook out many a weak-pawed bear. In the false bull market dawn of spring 1980, the 10-year yield fell by 400 basis points.

Bearish on bonds for the long haul *Grant's* may be, but we're also alert to the possibilities of a sharp countertrend rally. Then again, we are bound to admit, so is approximately everyone else. Thus, in the 21 days to Oct. 11, per Vanda Research, a record $574 million flowed into the iShares 20+ Year Treasury Bond Exchange-Traded Fund (TLT on the Nasdaq). Anyway, long-dated, high-convexity government bonds provide asymmetric leverage on falling rates. Agency-backed mortgage-backed securities present another way to play the next interest rate downdraft.

"If," Paul Singer, founder of Elliott Investment Management, L.P., told the *Grant's* conference-goers early this month, "you are truly interested in risk management, you must hedge all the time."

We write in the spirit of that motto, homing in, first, on the opportunities in convexity, a term connoting asymmetric investment payoffs. Positive convexity, the good kind, in this case means you gain more on a fall in interest rates than you'd lose on a rise in interest rates.

The principal-only strip of the aforequoted 1.875s offers positive convexity. A 200 basis-point decline in yield would deliver a 73% rise in price, to 43.37 from 25, whereas a 200 basis-point rise in yield would produce a 42% decline in price, to 14.51 from 25.

The 1946–81 bear bond market served up seven recessions over its 35-year life. Interest rates do not invariably descend in a business cycle downturn—the world monetary crisis of 1931–32 made a memorable exception—but that's the form. Betting on that form, one might seek out the worst-performing, longest-duration bond of the preceding selloff. On the Interactive Brokers trading platform, the 1.875s strips require a minimum investment of $1,000. The market's quoted at 24.92–25.77, with $13 million bid for and $10 million offered.

Mortgage-backed securities bearing 5% and 6% coupons promise another means to profit from a reversal in bear-market trends. Guaranteed by Fannie Mae, Freddie Mac or, in the case of Ginnie Mae, by the Treasury itself, the bonds carry little or no credit risk while paying a decent spread above Treasurys. The rub is prepayment risk—the inalienable right of every American mortgagor to cash in on falling rates.

The Freddie Mac 6.05s of 2033, for instance, priced on Monday, trade slightly below par to yield 6.08%, a 120 basis-point spread above the 10-year Treasury.

The forthcoming Simplify mortgage-backed securities exchanged-traded fund (*Grant's*, Oct. 13) will select and hold mortgage bonds at prevailing high yields. Unlike legacy MBS funds, Simplify dodged the bullet of low-yielding, pandemic-variety mortgages. In an update to its registration, the fund is slated imminently to trade under the ticker MTBA.

"Let me tell you what's going to happen," Harley Bassman, bond quant par excellence, told the audience at the *Grant's* event. "The Fed's going to cut rates. I'm not sure when they're going to cut rates. And when they do, they're going to yank that curve down. And when they do that, you're going to see these mortgage bonds go north relative to everything else. I mean, everything else might go down also, but they'll go down by less. They're going to tighten up by over two points. They have to because that's all a mortgage bond is—a Treasury minus a call [option]—and the cost is going down. That's it."

That's the creator of PFIX, the Simplify Interest Rate Hedge ETF, talking (*Grant's*, May 14, 2021).

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