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Pure rate hedge

Evan Lorenz writes:

A drought is the time to buy flood insurance, not when a hurricane is barreling through town. Yet, even as investors contort themselves into knots over the surging prices of just about everything, the cost of long-term hedges on moderately higher interest rates is, in the words of Harley Bassman, "crazy cheap." In preview, *Grant's* is bullish on the Simplify Interest Rate Hedge ETF (PFIX on the New York Stock Exchange), a new fund to protect against an unscripted rate rise.

Bassman, as long-term readers know by now, is a volatility and rates expert extraordinaire and the creator of the MOVE Index, the VIX for bonds. He is also, as of Feb. 3, a managing partner at Simplify Asset Management and one of the portfolio managers of the PFIX, which, as he divulges in a May 11 bulletin, is the single largest line item in his personal account.

The just-launched PFIX is, like its namesake sponsor, shorn of complexity: It starts life at a $50 share price. That $50 buys around $25 worth of 7-year Treasurys and $25 worth of 7-year forward 20-year payer swaptions with a strike price of 4.25%.

This may sound like a mouthful, but it's essentially a put option on the 20-year Treasury exercisable in May 2028 if that security yields 4.25% or more compared with the 2.2% quoted today. Owing to the low level of implied volatility on this instrument, each PFIX share embodies a put option on roughly $1,000 worth of notional value. The fund will charge an annual fee of 0.5%.

Why are these options so cheap? For one, investors have resigned themselves to the idea that the Federal Reserve, the European Central Bank and their confreres will squash any uptick in rates and stop any bear stock market by printing more money. "All these vols have come down and flattened out," Bassman tells me. "And the reason why is Western society and the Fed, they all have basically locked down all risk."

Then, too, certain foreign investors—especially insurers in Taiwan—like bonds issued by name-brand American companies, albeit at yields higher than the ones on offer today. Wall Street accommodates that demand by packaging the debt with an array of options.

Unfortunately, there are no natural buyers for the longer-term options. Insurers and pensions yearn for higher rates, not hedges against them. Retail investors, lacking International Swaps and Derivatives Association credentials, couldn't buy the options even if they wanted to. Hedge funds are focused on the next quarter, not what happens seven years from now.

The Simplify strategy isn't the first ETF to crack the ISDA retail nut. That honor goes to the Interest Rate Volatility and Inflation Hedge ETF, which is in business to profit from higher inflation and a wider difference between the 10-year and 2-year points on the over-the-counter interest rates market yield curve. IVOL on the Big Board is the ticker; since inception two years ago, the fund has generated a 23.6% total return (see the issue of *Grant's* dated May 17, 2019).

To deliver the goods, IVOL invests 85% of its assets in Treasury inflation-protected securities, with the balance in a mix of cash and options. Shareholders profit when the consumer price index rises and/or when the yield curve steepens; they fare less well when inflation flattens. Nor would they cheer if the Federal Reserve decided to pin down long-term rates through so-called yield-curve control.

The PFIX, in contrast, is geared purely to changes in interest rates, regardless of the shape of the curve. If, in two years, yields increased by 100 basis points, according to Bassman's model, the shares would trade at $70.55. In contrast, an investor shorting $50 worth of 20-year Treasury futures on the Chicago Mercantile Exchange (and rolling that position quarterly) would be sitting on a position worth $53.77. If rates surged by 200 basis points over the next 24 months, Bassman's model tells him, the PFIX could be worth $114.58 a share versus $58.60 for the investor who shorted the CME futures.

Structuring hedges for rising rates isn't as easy as it seems. In 2008, Harvard University began an ambitious expansion program in Allston, a Boston neighborhood near its main Cambridge campus. To lock in its borrowing costs, the university used swaps. The contracts would have paid off if rates had risen, but they reciprocally required Bill Gates's alma mater to make heavy payments if rates plunged—which they did. By 2012, Harvard paid $1.25 billion to exit the position after four years of Fed-administered QE and ZIRP.

If, by May 2028, the 20-year Treasury yields less than 4.25%, the most the fund can lose is the roughly $25 per share it paid in option premiums. Along the way, Bassman and his investors will pocket the coupon on the 7-year Treasury, which is priced to yield 1.28% today, less the aforementioned 0.5% annual fee.

"We know that interest rates are still near all-time lows; we also know that the price for uncertainty (implied volatility) is also near a forever low," Bassman writes. "We know there has been massive monetary expansion from the Fed; and we know that there has been a fiscal impetus funded by deficit spending only rivaled by the battle for Western Civilization (World War II). Finally, we know that the Fed does not want deflation, and we are fairly sure they would like a higher inflation rate."

What we don't know is whether this mélange of facts will lead to higher, sustained price rises and untethered interest rates. "I hope I'm wrong," Bassman tells me. "Rates at 5% is not going to be happy times for anybody, financially. I mean your average person might be happy. Your pension fund might be happy. But people who own financial assets, they aren't going to be happy.

"Look at the cap rates," Bassman continues. "Go call your friends and ask them where Class A office buildings are trading [in terms of cap rates]; 3%? 3.5%? Rates go to 4%, the cap rate, still 3.5%, goes to 5%. Now take a look at the long-term lease contract of a Class A office building in one of the prime places.…What's the value of that if you take the cap rate from 3.5% to 5.5%? It's a massive number."

"This product," Bassman winds up, "really isn't for guys who were superbearish on rates. Guys who were superbearish on rates have already sold all their bonds. This is for people who actually aren't bearish on rates but are terrified of what might happen if they're wrong."

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