

ETFs for Rising Interest Rates

BI Credit Strategy, North America Dashboard



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1. Hedged ETFs, Floaters Can Ease Rate Risk As Interest Rates Rise

(Bloomberg Intelligence) -- The rise in interest rates, which began in July on signals that global central banks were less willing to extend accommodative policies, has gained momentum after the U.S. presidential election on potentially laxer fiscal policy by the new administration. Additionally, the Federal Reserve indicated it expects three policy-rate hikes in 2017. With the Bloomberg Barclays U.S. Corporate Bond Index duration (LUACMD) near the highest levels in decades, the management of rate risk for credit portfolios gains importance.

[Table of Contents](#)
[Topics](#)

[Rate-Hedged ETFs](#)
[Floating Rate Notes](#)

Several ETFs offer credit exposure but address rising rates, including interest-rate hedged ETFs and floating-rate-note funds. While such products have drawbacks, they have been proven to outperform historically. (01/26/17)

Topics

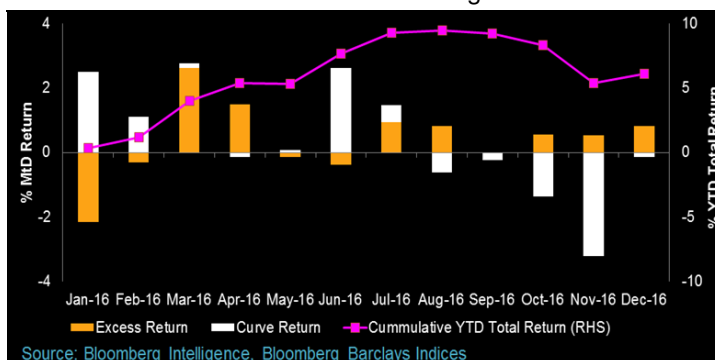
Rate-Hedged ETFs

2. Corporate Bonds Boosted by Excess Returns Despite Rising Rates

Despite lower total returns for U.S. corporate bonds in 2H due to rising interest rates, excess returns -- those exceeding Treasuries benchmarks -- have stayed positive as credit spreads tightened. While the U.S. 10-year note's yield climbed over 110 bps from a record-low close of 1.36% in July, credit spreads tightened 30 bps, as gauged by the Bloomberg Barclays U.S. Corporate Bond Index. Managing rate risk gains importance as the Fed moves toward monetary policy normalization, with three hikes expected in 2017.

The average high grade debt duration is more than seven years, as measured by the index. This is the longest index duration since inception as corporate issuance moved up the yield curve to longer maturities. (01/26/17)

Excess vs. Curve Return: U.S. High Grade Index

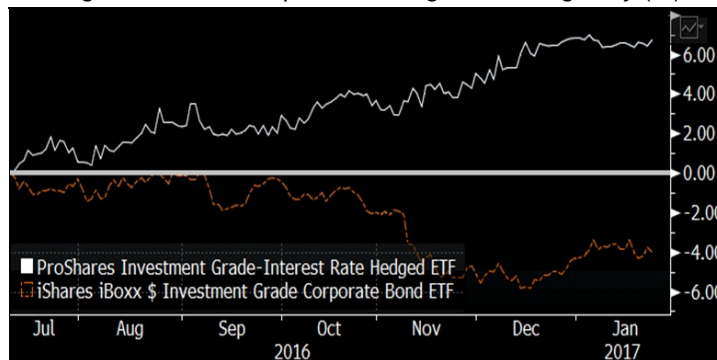


3. Hedging Strategies Outperform as Treasuries Risks Are Reassessed

Interest-rate-hedged ETFs take a long position in a corporate bond portfolio with a concurrent duration-matched short position in U.S. Treasury futures. They thereby provide U.S. corporate high grade exposure while addressing the risk of rising interest rates. The ProShares Investment Grade-Interest Rate Hedged ETF (IGHG), the largest of such funds by assets, has outperformed the iShares iBoxx \$ Investment Grade Corporate Bond ETF (LQD), the largest high grade ETF, by almost 11% since July 8.

Securities Impacted: Other interest-rate-hedged ETFs offering U.S. corporate high grade exposure include the iShares Interest Rate Hedged Corporate Bond ETF (LQDH) and the Deutsche X-Trackers Investment Grade Bond Interest Rate Hedged ETF (IGIH). (01/26/17)

High Grade ETF Exposure: Hedged vs. Long Only (%)



4. BlackRock's Rate-Hedged Junk ETF Grows 1,000% Since Election

Assets have ballooned 10-fold for the iShares Interest Rate Hedged High Yield Bond ETF (HYGH) since the U.S. election, to \$208 million from \$21 million. Investors are using the ETF to hedge against rising yields and expected rate hikes by the Federal Reserve in 2017. HYGH provides junk-bond exposure, while targeting a duration of zero years with an embedded hedge from shorting Treasury futures. The ETF has gained 4.3% since the election, about double most long-only high yield debt ETFs. (01/26/17)

Assets Jump in BlackRock's Rate-Hedged Junk ETF

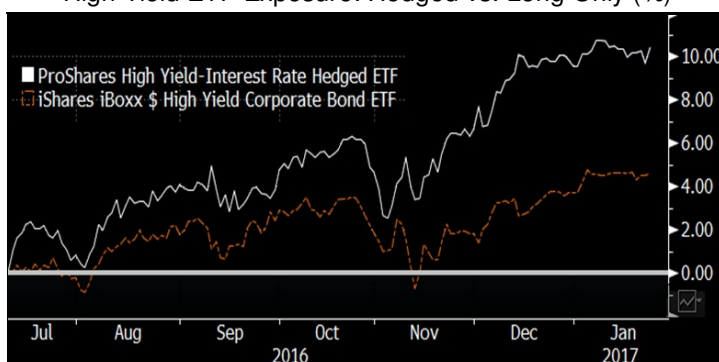


5. High Yield Exposure With Lower Rate Risk: Rate-Hedged ETFs

The ProShares High Yield-Interest Rate Hedged ETF (HYHG) is the largest exchange-traded fund by assets offering U.S. corporate high yield bond exposure with a concurrent duration-matched short position in U.S. Treasury futures to hedge interest-rate risk. The ETF has outperformed the iShares iBoxx \$ High Yield Corporate Bond ETF (HYG), the largest long-only high yield ETF, by about 5.8% since July 8, as the Treasury 10-year note's yield climbed more than 110 bps from a record-low 1.36%.

Similar products include the iShares Interest Rate Hedged High Yield Bond ETF (HYGH), the WisdomTree Interest Rate Hedged High Yield Bond Fund (HYZD) and the VanEck Vectors Treasury-Hedged High Yield Bond ETF (THHY). (01/26/17)

High Yield ETF Exposure: Hedged vs. Long Only (%)



6. Rate-Hedged ETFs' Recent Outperformance Resembles 2015 Rate Rise

Interest-rate hedged ETFs have outperformed unhedged peers during the recent increase in yields. Hedged ETFs were similarly favored in 1H15, when yields rose 100 bps. The iShares Interest Rate Hedged Corporate Bond ETF (LQDH) beat its unhedged version (LQD) by 4.6 percentage points in that period, while the iShares Interest Rate Hedged High Yield Bond ETF (HYGH) was up 3.3% vs. 2.4% for its unhedged counterpart (HYG). Since the U.S. election, LQDH is beating LQD by 3.4 points and HYGH tops HYG by 1.9 points. (01/26/17)

Hedged vs. Unhedged During 2015 Rate Climb

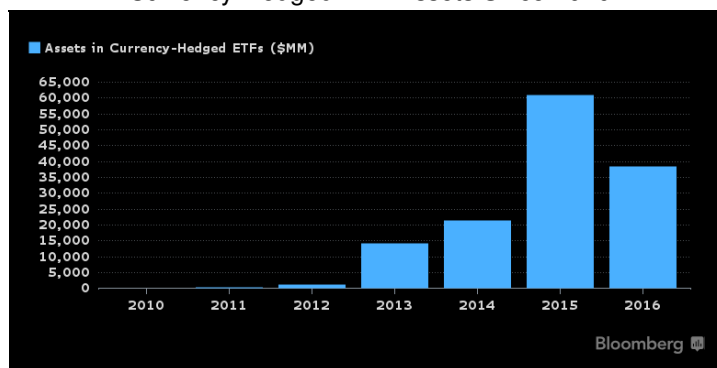


7. Rate-Hedged ETF Growth May Follow Path of Currency-Hedged Peers

Interest-rate hedged ETFs resemble currency-hedged ETFs, in that they provide a desired exposure while eliminating something undesirable. Currency-hedged ETFs take long positions in a country or region's stocks, while hedging out the currency via forward contracts. Such funds began beating their unhedged peers when central banks in Japan and Europe ramped up bond buying, and they grew to \$60 billion from nothing in three years. They've underperformed lately, though, and have recorded outflows.

Many issuers of currency-hedged ETFs also launched interest-rate-hedged products. Both provide ways to invest around changing interest rates. (01/26/17)

Currency-Hedged ETF Assets Since 2010



8. As Rates Rise, So Does the Cost of Hedging for Rate-Hedged ETFs

To hedge out interest-rate risk, rate-hedged ETFs short long-dated Treasury futures. The catch is that the coupon payment is part of the short, so all of these products have an embedded cost that drags on performance. The drag is about 2.7% a year, based on current yields, but would go up with rates. That would mute returns, while still providing a credit spread premium. Despite this headwind, rate-hedged ETFs have shown they can outperform unhedged peers in a rising rate environment. (01/26/17)

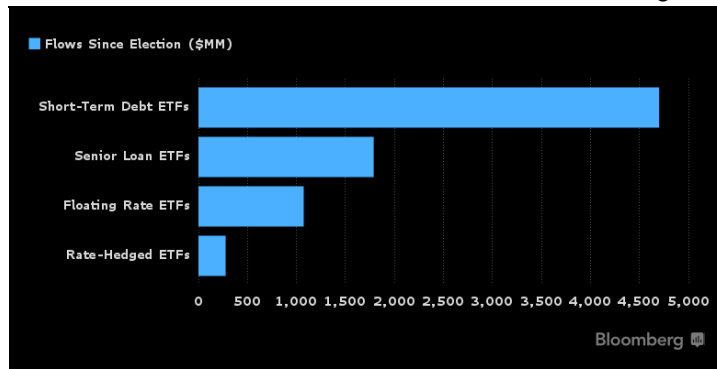
Cost of Hedge Is Close to Long Treasury Yield



9. Rate-Hedged ETFs Trail Floaters, Short-Term Debt as Rate Tools

Many types of ETFs can be used to position a portfolio for rising interest rates. With yields climbing since the U.S. election on Nov. 8, investors have overwhelmingly chosen to use short-term debt ETFs to lower their portfolio duration. Short-term debt ETFs have taken in almost \$5 billion in the period, while senior loan ETFs received \$1.7 billion and floating-rate debt ETFs added \$1.1 billion. Interest rate-hedged ETF inflows trailed at \$277 million, still almost doubling their assets. (01/26/17)

Short-Term Debt ETFs Favored for Rate Positioning



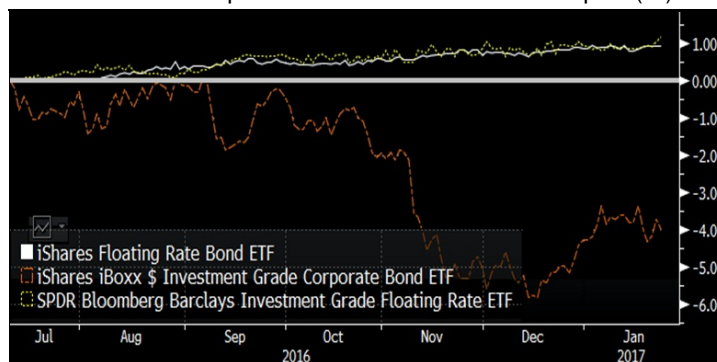
Floating Rate Notes ETFs

10. Floater ETFs Provide Credit Exposure With Lower Rate Risk

Floating-rate notes are another way to get U.S. high grade exposure with lower interest-rate risk. Floater coupons reset when market interest rates change, so prices of these securities fluctuate significantly less than fixed-coupon bonds with similar maturities. The iShares Floating Rate Bond ETF (FLOT) provides ETF investors with corporate high grade floater exposure and has outperformed the fixed-coupon-focused iShares iBoxx \$ Investment Grade Corporate Bond ETF (LQD) by almost 5% since July 8.

Peer Comparison: The SPDR Bloomberg Barclays Investment Grade Floating Rate ETF (FLRN) is a similar product that also tracks the Bloomberg Barclays Capital US FRN < 5 Years Index. FLOT assets total \$4.35 billion vs. \$765 million for FLRN. Expense ratios are similar at 15 bps for FLRN vs. 20 bps for FLOT. (01/26/17)

Credit ETF Exposure: Floaters vs. Fixed Coupon (%)



11. Floating-Rate Note ETFs Tilted Toward Financial-Sector Exposure

Financial institutions' debt accounts for 55% of the iShares Floating Rate Bond ETF's market value vs. 33% of the fixed-coupon-focused iShares iBoxx \$ Investment Grade Corporate Bond ETF. While floater ETFs can provide credit exposure with lower interest-rate risk, the credit-risk profile for the broad floating-rate note market is different from its fixed-coupon counterpart. Banks tend to issue more floating-rate notes since many of their assets, including loans and deposits, are also linked to variable rates.

Methodology: Type PORT <GO> and load the iShares Floating Rate Bond ETF (FLOT) as portfolio and iShares iBoxx \$ Investment Grade Corporate Bond ETF (LQD) as the benchmark. Under "Holdings" tab, click "Allocations" to view a sector breakdown, based on the "Bloomberg Barclays Level 2" classification schema. (01/26/17)

Credit ETF Exposure: Floaters vs. Fixed Coupon



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