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Back to Basics

Rolling Down the Curve

By Tom Slefinger, Senior Vice President, Director of Institutional Fixed Income Sales at Balance Sheet Solutions, LLC. Tom can be reached at tom.slefinger@balancesheetsolutions.org.

One of the easiest and time-tested strategies for making money investing in bonds is called "rolling down the yield curve." As long as shorter-term bonds yield less than longer-term bonds, this strategy is effective. Rolling down the yield curve can significantly enhance returns versus buying a shorter-maturity security, or staying in overnight funds.

What is Roll Down?

Simply put, as a bond ages toward maturity, each year it produces lower yields – thus, *rolling down the curve*. As its yield falls, the value of the bond rises.

The Timing is Right

Since May, yields have risen and the Treasury yield curve has steepened significantly. Meahwhile, short-term cash equivalents are yielding historic lows – near 0%. The following graph shows that the yield on the five-year Treasury has risen by 100 bps (from 0.65 to 1.65%) since early May. As yields have risen, the yield curve has steepened with the spread between the two-year Treasury and the five-year Treasury widening from 44 bps to 136 bps as the time of this writing (January 2014), the highest level since 2011. Thus, the combination of extremely low yields on overnight funds, coupled with the recent steepening of the yield curve, creates an attractive opportunity to extend and *roll down the curve*.

Five-Year Yields and Spreads Look Attractive

Continued…

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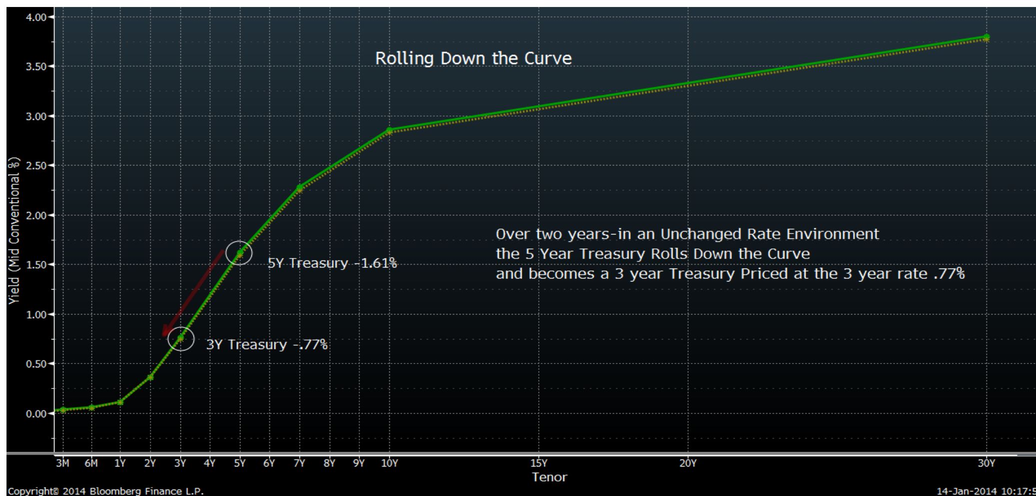
How Do You Know What Bonds to Buy?

The yield curve is not a straight line with yield decreasing evenly over time. When selecting bonds to implement a *rolling down the curve* strategy, attempt to locate bonds in the steepest areas of the yield curve. To over-simplify, you want the biggest change in yield over the shortest amount of time. Currently, the yield curve provides opportunities in both short and intermediate maturities, with the short end providing a unique opportunity to implement this strategy.

The next graph depicts opportunity five-year maturities for this strategy. Under this scenario, a five-year Treasury, held for 24-months, would appreciate in price as the bond *rolls down* towards a lower portion of the yield curve (in this case from 1.61% to 0.77%). In essence, a the five-year bond will appreciate in value as yields decline. This is due to the passage of time, thereby providing a cushion in the form of a higher total return.

Take a Ride on the Yield Curve



An Example of Rolling Down the Curve

The following chart plots the total return of a five-year Agency bullet, over a two-year time horizon, under varying interest rate scenarios: ranging from -100 to +300 bps.

In an unchanged rate/curve scenario, the total return (income, price and roll-down) of a five-year Agency, over a 24-month time horizon, would be 5.99%. The income return of 3.52% represents 58% of the total return. The difference between the income return and total return is attributable to the roll-down effect. ***In fact, the roll down amounts to 2.46%, or 42% of the total return (see yellow-highlighted are). This is the power of rolling down the curve!***

The roll-down strategy may also help protect principal in a rising interest-rate environment. As highlighted in red in the following Agency chart, even if rates rise 100 bps from current levels, the total return on the five-year Agency would be 2.97%. It would produce an income return of 3.54% and a price decline of -3.02%. However, once again, the roll-down return of +2.46% mitigates much of the price decline.

What Could Go Wrong?

This strategy works best when the yield curve remains upward sloping, and rates remain the same (or rise less than the markets are predicting). Conversely, if yields rise by the full amount the markets predict, the benefits of this strategy could be zero. Also keep in mind that the longer the maturity of the bond, the smaller the increase in interest rates needed to turn the *rolling down the yield curve* strategy into a losing investment. As shown in the next chart, if rates rise in excess of 200 bps over the next 24 months, the five-year bullet will show a negative total return.

Five-Year Agency
Total Return Analysis, 24-Months Aged

Issuer Name	Coupon	Maturity	Price	YTW	Scenario	Income	Price	Roll	Total Return	Ending Eff Dur	Ending Price
FNMA	1.875	02/19/2019	100.543	1.763							
					DN100	3.524	3.139	2.465	9.127	3.011	105.970
					NO CHANGE	3.525	0.000	2.465	5.990	2.994	102.814
					UP100	3.543	-3.029	2.465	2.979	2.977	99.769
					UP200	3.562	-5.953	2.465	0.074	2.960	96.829
					UP300	3.580	-8.775	2.465	-2.730	2.944	93.991

Summary

On numerous occasions, the Fed has stated its intention to leave short-term interest rates unchanged until 2015, at the earliest. With inflation declining well below what the Fed finds acceptable, it is conceivable that the Fed could leave the Fed Funds rate unchanged through 2016 – if not beyond. So while the easy money from the 30-year secular bull market has been made, staying in cash still remains an unattractive strategy.

In the context of the economic backdrop and the conviction that the Fed will remain on hold for quite some time, we believe that the front end of the yield curve is providing an attractive opportunity for credit unions to enhance income. As we discussed in the latest WRV, given the slope of the curve we believe 5 year agency bullets offer the best combination of yield and roll down. In the short duration space we feel that this may be one of the best risk-return strategies for credit unions in the market today.

More Information

For more information about credit union investment strategy, portfolio allocation and security selection, please contact the author at *tom.slefinger@balancesheetsolutions.org or* 800-782-2431, ext. 2753.

Tom Slefinger, Senior Vice President, Director of Institutional Fixed Income Sales, and Registered Representative of ISI, has more than 30 years of fixed income portfolio management experience. He has developed and successfully managed various high profile domestic and global fixed income mutual

funds. Tom has extensive expertise in trading and managing virtually all types of domestic and foreign fixed income securities, foreign exchange and derivatives in institutional environments.

At Balance Sheet Solutions, Tom is responsible for developing and managing operations associated with institutional fixed income sales. In addition to providing strategic direction, Tom is heavily involved in analyzing portfolios, developing investment portfolio strategies and identifying appropriate sectors and securities with the ultimate goal of optimizing investment portfolio performance at the credit union level.

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