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Viewpoint

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The Benefits of Active Management When Rates Are Rising

With a Fed rate increase likely imminent after nearly seven years of a near zero federal funds rate, investors are concerned about investing in the current environment. We discussed rising rates and the benefits of active management with PIMCO managing director Jim Moore.

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Dr. Moore is a managing director in the Newport Beach office. He is head of the investment solutions group and leads our global team of pension solutions strategists. Prior to joining PIMCO in 2003, he was in the corporate derivative and asset-liability strategy groups at Morgan Stanley and responsible for asset-liability, strategic risk management and capital structure advisory work for key clients in the Americas and Pacific Rim. Dr. Moore also taught courses in investments and employee benefit plan design and finance while at the Wharton School of the University of Pennsylvania, where he earned his Ph.D. with concentrations in finance, insurance and risk management. He has 21 years of investment experience and holds undergraduate degrees from Brown University.

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Q: What insights can you give investors who are concerned about rising rates?

Moore: First of all, it's important to consider the Federal Reserve's objective and where it is in the process of pursuing it. The Fed has been keeping rates very low for a prolonged period of time, waiting for the economy to show signs of economic growth and stronger labor markets, and, of course we have seen an ongoing recovery and declining unemployment.

Considering the Fed's experience back in 2013, when it began hinting at increasing policy rates and the market reacted with the "taper tantrum," we are fairly confident that it will take its time when it finally does begin to hike. This is likely to be the slowest, most gradual, most telegraphed rate hike in the history of the Federal Reserve. We expect them to start with a very small increase and then watch how the economy and markets react. If all goes well enough and the market absorbs the change without incident, they would then take another step.

From an investor's point of view, in this environment an important thing to keep in mind is the benefits of active management. Once the Fed rate hike cycle begins, the yield curve will not necessarily move uniformly and line up with what the Fed does at the front end.

Investors need to consider relative pricing and relative risk trade-off along the curve in order to decide where they want to be positioned, and where they will

get the best return for each unit of risk. An active manager can pick spots on the yield curve where they see risk/return characteristics as more favorable as opposed to simply replicating the allocations of an index.

Q: What does this mean from a global perspective?

Moore: Unlike the U.S., many other areas of the world are in holding or easing cycles: Europe is behind the curve relative to the U.S. with slower growth and lower inflation, Japan is committed to easing to try to keep the economy growing, China is easing given the slowdown there, and some emerging market countries are easing as growth slows in response to the Fed and the slowdown in demand from China for their exports. Active managers can take account of non-U.S. bonds as offshore rates are either stagnant or moving in the opposite direction, potentially adding value.

Q: What would you say to investors who are allocating to mostly cash?

Moore: I would point out that there's an opportunity cost to that approach. If you look at a five-year bond currently, it's at about 1.5% versus near zero or negative rates for cash, so there is an opportunity cost to staying in cash. Investors should evaluate what their liquidity needs are – cash has a place for those who prize liquidity and may need to deploy those funds in the near term, but timing rates is a very difficult pursuit. For example, many who got spooked with the taper tantrum moved to cash and never got back into longer maturity bonds before rates fell again in 2014. If they had held course, they would likely have been better off. Investors need to also be conscious of their time horizon. For the long-term investor, rising rates would actually be a good thing! Sure there is short-term pain as longer maturity bonds suffer some capital loss, but as coupons reset higher, the longer duration portfolio has a higher yield.

Also, while rates may be low by historic standards, they are higher in the U.S. than in other high quality sovereigns. Since the supply of investment capital flows across borders, investors need to realize they cannot look at the U.S. fixed income market in isolation.

Q: PIMCO's New Neutral thesis envisions more frequent periods of market volatility. What does this mean for investors?

Moore: We're entering a period that we think may be more volatile as the Fed slowly reduces its influence. In choppy markets, many investors who get spooked may look to sell, and with new regulations limiting the capital and liquidity provided by banks, market participants are looking for other liquidity providers. This can be advantageous to active investors who have the balance sheet to pick up additional liquidity premia and who can take advantage of opportunistic prices. So rising rates can be a boon for those who are in a position to provide

liquidity to markets. While a hiking cycle can lead to rough patches, it can create more opportunity for an active manager to add value.

Despite investors' concerns about owning bonds in a rising rate environment, it's important to remember that bonds always have and always will play a key role in a diversified investment portfolio. Investors can look to active managers to take that allocation and direct it in a more intelligent way by looking at all aspects of the bond market from top to bottom.

And, for an investor with a long horizon, higher rates mean the yield on bonds in the future will be higher, as I mentioned previously. So if rates do move up faster, that can work to their advantage if they continue to keep their longer-term objectives in mind.

Finally, active managers can spot structural inefficiencies in the market that are created by indexes and other buyers whose objectives create short-term pricing biases and use those as opportunities to identify better priced or higher yielding, quality securities.

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