

Not all bonds fall when interest rates rise

Published on: 3 March, 2023 | Author: Investment Team

With interest rates rising, bond prices have fallen. Bond prices move inversely to interest rates: they rise when interest rates fall, and they fall when interest rates rise (as now).

Since November our strategies have had meaningful exposure to a different type of bond in lieu of equity, namely Floating Rate Notes (FRN). FRNs, unlike conventional bonds, have a floating coupon that adjusts with changes in short term interest rates. Higher interest rates are actually good for the holder of these notes as illustrated in the table below:

	At issue	At 1st Coupon Reset	At 2 nd Coupon Reset
Reference Interest Rate	1%	2%	4%
Fixed agreed spread (or premium)	3%	3%	3%
Coupon Paid	4%	5%	7%

Longer term clients will know that during periods such as now (2011 and 2020) we have allocated to company credit as the pricing has allowed us to generate equity like returns without taking on equity market risk. The opportunity in a diversified basket of FRNs at present is on a par with historic longer term equity market returns for three reasons:

1. they generate floating income as shown above. FRN coupons reset in line with central bank interest rates. As interest are expected to remain higher, the running yield available is significantly higher than equity market dividends currently.
2. They exhibit low duration. FRNs exhibit very low, sometimes no duration. This means that their capital value does not fall like conventional bonds when interest rates rise. This stable capital value is important when you are relying on the yield to generate returns.
3. Current wide credit spreads. Due to the economic uncertainty around, credit spreads, the premium you are paid for lending to a company, are higher than at any time in the past decade other than during the Pandemic.

In the current environment we see an asset such as this as a very interesting alternative to equities. It is not a well-known asset but again illustrates why at Tacit we allow ourselves to invest wherever our research highlights an opportunity. This flexibility is vital during periods such as now when market distortions lead to valuation anomalies, which allow us to generate higher returns in the future without just buying equities to generate returns.

Important Information: Any views, insights, or commentary are for general information only, do not constitute personal investment advice or research, and are intended for UK residents. They may not be appropriate in all jurisdictions. While

sourced from information we believe to be reliable, we make no guarantee as to accuracy or completeness. Past performance is not a guide to future results, and the value of investments can go down as well as up.

Regulatory Disclaimer: Tacit Investment Management is the trading name of TIML Limited (No. 9228395), part of Tacit Holdings Limited (No. 10611211). Both companies are incorporated in England and Wales, with the registered office at 14 Hanover Square, London W1S 1HN. TIML Limited is authorised and regulated by the Financial Conduct Authority (FCA ref. 670184) and approves and issues this communication under Section 21 of the Financial Services and Markets Act 2000. Please note, tax and estate planning services are not regulated by the FCA.