SN VALUATION
SN CAPITAL SN CONSULTING SN ENGLISH

Sung Nam

April 1, 2013

Negative Duration

Read an article from PIMCO, where the seasoned investment professional explained the history of the fixed income market from 1970s to the present. When rates were low, people invested in government bonds because they were safe and collected the coupon, or interest payments over the life of the loan. However, as inflation started to rise, and bank deposits returned 20% over 3 months, the investors left the fixed income market. Yet, with Volcker in the 80s, inflation was tamed down and for the past 20 years, have followed a downward trend. However, with the volatility in the market over the previous decade, investors have been desiring more absolute return. As the trend turns and rates, along with inflation rises, we may see investors flocking back to equities, real estate, commodities, also known as the Great Rotation, FRNs, inflation linked bonds, real estate and etc, will become the prime investment vehicles within the credit space.

He also mentioned negative duration, which implies as rates increase, the price will increase as well. Normally, we think of duration in years, instead of the correct view of sensitivity to interest rate movements reflected in the price. Fixed rate bonds have a positive duration, which means as rates increase, the price decreases. Yet, floating rates can adjust, and as interest rates rise, the coupon will rise as well, thereby increasing the value of the bond. So, if interest rates rise, the FRN's will appreciate in value, thereby safeguarding investors from interest rate risk.

Courtesy: http://www.thisisthegreenroom.com/2009/frns-negative-duration/

"Floating rate notes (FRN's) can exhibit a curious property called negative duration.

An FRN is a bond whose coupon is not fixed, but rather changes each year (or each reset period, to be specific). For example, the coupon might be quoted as L+100, meaning 100 bps above than Libor. A familiar if infamous example is an adjustable rate mortgage.

Fixed-coupon bonds bear interest rate risk, because higher interest rates make their coupons and principal worth less due to heavier discounting. Conversely, lower rates make the bond appreciate. Since FRN coupons reset to higher interest rates, FRN's have no interest rate risk (actually, they have a little bit of risk, since coupons are set based on Libor at the beginning of the coupon period, but not paid until the end of the period). In the absence of credit risk, they should always trade at or above par."