

## PERSPECTIVES

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## Rising Rates: Short-Term Pain for Long-Term Gain?

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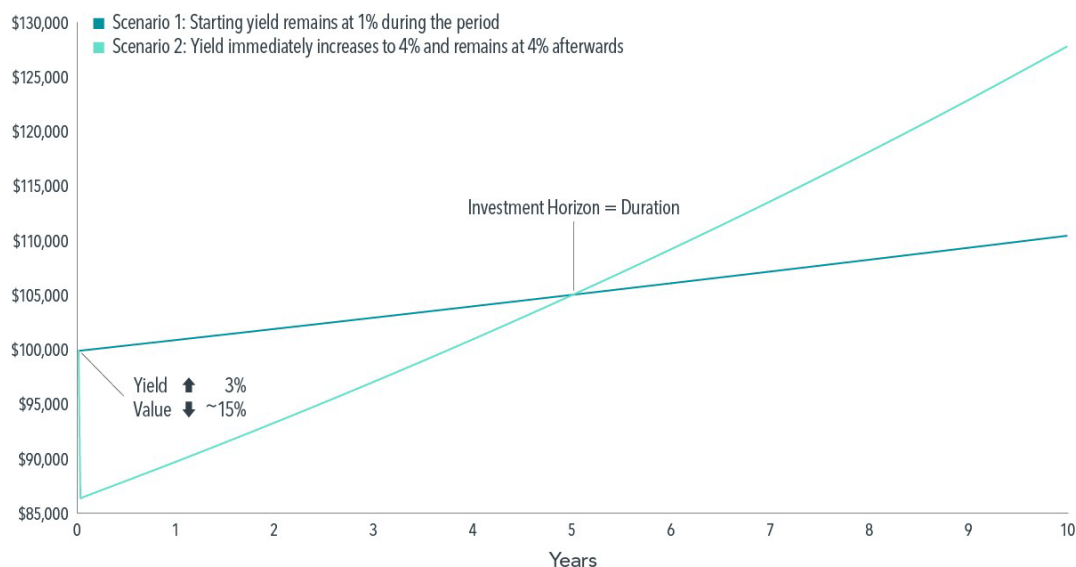
Investors have likely noticed the improved opportunity set in fixed income due to higher yields. And yet some investors may be hesitant to take advantage of higher yields because of concerns about future increases in yields. Some may even be considering reducing their bond exposure after this year's negative returns for fixed income.<sup>1</sup> The good news? If yields do keep rising, investors seeking higher expected returns may still be better off maintaining the duration of their fixed income allocation.

Rising yields impact fixed income portfolios in several ways. On the one hand, longer-duration portfolios may experience larger immediate losses from increased yields relative to shorter-duration portfolios. On the other hand, higher yields may lead to higher expected returns. Investors can think of this tradeoff as a pit stop in a Formula 1 race. The pit stop immediately causes the driver to fall back. However, fresh tires may help the driver win the race if there are enough laps left to catch the leader.

**Exhibit 1** illustrates this using two scenarios for a \$100,000 fixed income allocation with a five-year duration. Scenario 1 experiences a constant yield of 1% during the period. Scenario 2 is faced with a sudden spike in yield from 1% to 4% on Day 1 and sees its value immediately drop to a little over \$86,000. However, the higher-yield environment accelerates Scenario 2's recovery: With a 4% yield rather than the previous rate of 1%, Scenario 2's portfolio value overtakes Scenario 1's within five years—the time horizon determined by the duration of Scenario 2.

**Exhibit 1****Recovery Race**

Growth of a \$100,000 fixed income allocation with a five-year duration



*For illustrative purposes only.*

Data presented are based on mathematical principles, are not representative of indices, actual investments, or actual strategies managed by Dimensional, and do not reflect costs and fees associated with an actual investment. Growth of wealth assumes a constant duration and flat yield curve for simplicity.

For Scenario 2, the approximate 15% drop in value seen in year 0 is based on a hypothetical yield increase from 1% to 4%, resulting in an immediate decline in value. The drop in value can be approximated by multiplying the assumed five-year duration by the yield increase.

Fixed income securities are subject to increased loss of principal during periods of rising yields.

Source: Dimensional.

When faced with uncertainty, investors should focus on the things they can control. Research tells us that trying to outguess the market by holding on to cash, or shortening duration, with the expectation of future yield increases may not help you achieve your long-term goals.<sup>2</sup> Markets quickly incorporate new information about higher interest rates and inflation.<sup>3</sup> Investors who maintain appropriate asset allocations, even after increases in bond yields, may have a more rewarding investment experience in the long run.

**Duration:** A measurement of the sensitivity of the price of a fixed income investment to changes in interest rates. Generally, high-duration bonds will have greater sensitivity to changing interest rates than lower-duration bonds.

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1. The Bloomberg Global Aggregate Bond Index (hedged to USD) returned -12.1% from January 1, 2022, through September 30, 2022.
  2. Mingzhe Yi, "[All Eyes on the Fed? A Look at Federal Funds Rate, Bond Return, and Term Premium](#)," Insights (blog), Dimensional Fund Advisors, March 15, 2022.
  3. Wes Crill, "[Light at the End of the Inflation Tunnel](#)," Insights (blog), Dimensional Fund Advisors, June 10, 2022; "[Markets Appeared to Be Ahead of the Fed](#)," Insights (blog), Dimensional, June 16, 2022.
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