CIO Portfolio Positioning: Interest rate risk management

Bank of America Merrill Lynch

CHIEF INVESTMENT OFFICE

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The recent increase in bond yields has prompted questions regarding interest rate risk management within the Chief Investment Office (CIO) portfolios. This note provides insight into our interest rate risk management approach. Given current concerns, comments are focused on a rising rate environment. Read more about the CIO's view on the impact of rising rates in our latest **Investment Insights**.

Interest rate risk management

The Chief Investment Office (CIO) takes a multi-layered approach to help protect the portfolios from changes in interest rates.

1. Tactical asset allocation across equity, fixed income and cash (Level 1)

The more we reduce exposure to fixed income, the higher the protection from rising rates. Increasing exposure to cash in lieu of longer-dated fixed income also provides protection, reducing rate sensitivity without increasing overall risk as additional equity might.

In a rising rate environment fueled by a strong economy, the CIO expects equities to perform better than fixed income. Current CIO tactical guidance is 7% underweight fixed Income and 4% allocation to cash in a portfolio with a Moderate Low Tax (Tier 0) investor profile.

2. Tactical asset allocation within fixed income sectors (Level 2)

The lower the emphasis to rate-sensitive sectors and the higher the emphasis to credit-sensitive sectors, the higher the protection from rising rates.

As the Federal Reserve normalizes monetary policy, Treasuries are expected to underperform credit sectors that are more sensitive to the economy. Current CIO tactical guidance is 4% underweight government bonds and 2% overweight corporate bonds in a portfolio with a Moderate Low Tax (Tier 0) investor profile.

3. Selection of investment vehicles

Beyond the elements of the CIO tactical asset allocation, which will be implemented for every portfolio, the selection of particular mutual funds and ETFs may also slightly modify the rate-sensitivity of any portfolio.

Most portfolios have a slightly shorter duration (a fraction of a year) compared to both the fixed income portion of benchmarks and to popular market benchmarks, like the ICE BofAML US Broad or the Bloomberg Barclays Aggregate indexes. But looking only at the duration of fixed income holdings does not capture the substantial impact of items 1 and 2 above on the overall portfolio's rate sensitivity.

Portfolio risk management

Why are the adaptations for rising interest rates not even larger?

During periods of rising rates, it would appear that any significant allocation to securities sensitive to interest rates, like government bonds, would be counterproductive. That indeed would be the case if investors had perfect foresight, which they do not. Instead the CIO relies on long-term Strategic Asset Allocation (SAA) through our **Foundations of Guidance** to guide the portfolio through different investment environments.

The CIO offers portfolios for different Investor Profiles that investors can align with their long-term objectives. The SAA for each profile determines the long-term optimal weight for each asset class or fixed-income sector within the different CIO portfolios. Bonds, which are sensitive to interest rate risk, are the best diversifiers of equity risk. Eliminating bonds or even significantly reducing them, compared to the CIO's strategic guidance, exposes clients to risk in achieving their objectives. For this reason, CIO portfolios continue to hold significant exposure to bonds, albeit less than their benchmarks.

So how do we know when tactical allocation weights are deviating too much from the SAA?

The CIO uses tracking error as the measure of portfolio risk relative to the SAA. Tracking error measures the variability of differences between the performance of a portfolio and its benchmark. To limit the risk of failing to achieve clients' long-run objectives, the CIO will limit portfolio tracking error. Very large departures from strategic allocations could actually shift the risk profile of a portfolio. This is an adverse outcome that the CIO continually monitors and manages.

Conclusion

Advisors and the CIO both play a critical role in helping to manage interest rate risk for clients. The CIO utilizes a multi-layered approach that modifies risk via tactical allocations at the asset class and fixed income sector levels, along with appropriate investment selection. Given current views regarding rates, the CIO is utilizing many tools available to help with protecting portfolios from rising rates without disconnecting portfolios from their underlying Investor Profiles.

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