

Caselet #34—Three Bearish Customers

Learning Outcome Statement

After completing this caselet, students and trainees should be able to calculate forward yields and formulate duration targets based on the combination of expectations and forwards.

Caselet #34

Renowned Darla Moore School of Business graduate and bond analyst, Ms. Jane Gotzrox is meeting with her intern prior to holding a joint portfolio strategy session for three clients – none of whom could afford her time alone.

All three clients have a one-year investment horizon, all three have a ‘bogey’ of the on-the-run 5-year, all are permitted to own only 1s, 5s and 10s, and none is currently permitted to use leverage.

“Sparky,” she says, ‘the world is quite strange today.”

“Notice in the yield curve below that although the overall slope is fairly steep, 4s and 5s have the same yield, as do 9s and 10s. Why should that matter?”

US yield curve:

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<thead>
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<tbody>
<tr>
<td>1s</td>
<td>2%</td>
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<tr>
<td>2s</td>
<td>3%</td>
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<tr>
<td>4s</td>
<td>4%</td>
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<tr>
<td>5s</td>
<td>4%</td>
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<tr>
<td>9s</td>
<td>5.75%</td>
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<tr>
<td>10s</td>
<td>5.75%</td>
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<tr>
<td>30s</td>
<td>7%</td>
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“Well, Ms. Gotzrox. Since your customers are only allowed to buy 1s, 5s or 10s, I guess that means that we do not have to include rolldown in the analysis.”

“Sparky, that is a great answer. Your skills are coming along nicely. Waytago.”

The strategy session begins and the clients file in. The clients are:

- **Our Lady of Perpetual Bearishness (OLPB).**
- **No-Ledge Associates.**
- **Berndt Oowt Partners.**

All three portfolio managers expect interest rates to rise over the coming year. They also expect the yield curve to shift parallel to itself so that yields will rise by the same amount.
• *OLPB* expects yields to increase by 34bp.
• *No-Ledge* expects an increase of 55bp.
• *Berndt* expects an increase 77bp.

Upon hearing these expectations, Ms. Gotzrox, who always comes to meetings well-prepared, shoots investment advice to the portfolio managers,

“*OLPB*, sell 5s and buy 10s. Yes, you heard me right; even though you expect yields to increase, extend duration.”

“No-Ledge, sit on your index or move to 1s or move to 10s. I really don’t care what you do”

“*Berndt*, get to 1s today and don’t look back.”

Then she turns to her intern. “*Sparky,*” she says, “give these managers the analytical evidence that they need to justify their actions to their Boards.”

“*Sparky*, let me give you a hint. To make money in fixed income markets, you must disagree with the forwards – and be right? What does that make your first task, eh?”

“Make your notebook extra pretty on this one, *Sparky,* you will want to show it to potential employers – it’s that important!”