Investor Blind Spots in Short-Duration Bond Funds

Extraordinary central bank intervention that followed the financial crisis produced a prolonged environment of low yields and muted volatility. Increasingly, investors turned to short-duration strategies seeking higher returns than those of money market funds. As a result, the overall short-duration category experienced dramatic inflows, with investors allocating roughly $187 billion to funds in the ultrashort, short-term investment-grade, and short-term-municipal categories from December 2009 to June 2013 (see Exhibit 1, below).

EXHIBIT 1: Strong investor interest in short-duration bond funds helped drive total assets higher.

Higher-yielding strategies with commensurate volatility attracted flows

Although investors gravitated toward the short end of the yield curve, presumably in order to avoid interest-rate volatility, they purchased higher-yielding funds that had other sources of volatility.

In hindsight, the three funds that garnered the largest inflows were at the higher end of the standard-deviation-of-return spectrum for the five years ending June 2013 (see Exhibit 2, page 2). They took in 42% of total asset flows during the period. Within the $285 billion Morningstar Short-Term category at the end of June 2013, they represented 35.2% of total assets.

KEY TAKEAWAYS

- In the exceptionally low-yield environment of the past three years, investors have gravitated to short-duration funds in search of higher returns relative to money market funds.
- Within the ultrashort and short-duration categories, fund composition can vary widely, resulting in diverging risk-and-return characteristics.
- Unanticipated “blind spots” can occur when investors unknowingly buy short-duration funds without consideration as to whether the associated interest-rate and spread risks are aligned with their objectives.
- As with any bond strategy, credit risk, interest-rate risk, and liquidity risk can have a significant impact on performance and volatility. Short-duration funds should not be considered money market alternatives.
A blind spot?

With this allocation of assets, did investors knowingly or unknowingly increase their exposure to volatility? If they lacked a clear view into how the funds allocated assets in terms of duration and sector—key determinants of a security’s performance and volatility—their investing exposed them to a blind spot.

Funds within the short-duration category are not homogeneous. For inclusion in the category, funds can have durations ranging from 1.5 to three years. In addition, they can have allocations to a broad range of asset classes, including corporate bonds, mortgages, and high-yield securities. Each fund manager employs his or her own distinct investment style, which can involve concentrated allocations in certain securities or diversified portfolios.

Some in the industry have marketed ultrashort and short-duration funds as money market alternatives. It is important to recognize that these funds invariably take more risks compared with money from 1.5 to three years. In addition, they can have allocations to a broad range of asset classes, including corporate bonds, mortgages, and high-yield securities. Each fund manager employs his or her own distinct investment style, which can involve concentrated allocations in certain securities or diversified portfolios.

EXHIBIT 2: Investors purchased funds with higher volatility.

EXHIBIT 3: Even within the short-term category there can be wide dispersion of returns.

EXHIBIT 4: Short-term bond investors can experience periods of volatility similar to Q2 2013, when 71% of assets in the category underperformed the quarter’s –0.7% median return.
market funds, which have strict SEC credit, maturity, and liquidity requirements intended to support a stable $1 net asset value.*

Considering the wide dispersion of risk-and-return outcomes
For an investor who decides to allocate assets to a short-duration strategy, there is a spectrum of fund offerings to consider. Variations in management style influence a fund’s sector allocation, credit quality, and level of interest-rate risk, all of which translates into meaningful diversity in risk-and-return characteristics within the short-duration fund category (see Exhibit 3, page 2, top right).

Did investors understand the risk of price fluctuations that accompanied reaching for yield? Blind spots can become apparent as market actions result in unanticipated portfolio behavior. For example, market volatility in 2008 contributed to a broad range of short-duration fund returns, from a high of 7.8% to a low of −31.9%. Even in 2009, when the tide was turning, the range was still broad, with a high of 30.1% and a low of −8.8%.

Over a longer period, most short-duration funds have generated positive returns (see Exhibit 4, page 2, bottom). More recently, in the second quarter of 2013, uncertainty created by Federal Reserve comments regarding monetary policy put downward pressure on bond prices. During the period, 71% of short-duration assets had a negative return lower than the median return of −0.7% (see Exhibit 4, inset chart). This performance may have revealed some short-duration investors’ blind spot: taking more investment risk than they intended in the process of searching for yield.

Know what you own
Duration
For investors wanting to limit exposure to rising rates, short-duration bond strategies may help them meet their objectives. Within the category, the duration choice should be the primary consideration for investors, since interest-rate risk is a dominant factor in return outcomes and for volatility.

Looking at short-duration fund assets by duration, the majority of assets were at the longer end of the duration range at the end of June. The upward sloping one- to three-year segment of the U.S. Treasury yield curve may have enticed investors to reach for yield and thereby accept higher total-return volatility (see Exhibit 5, above left). For some, this may have been expected and appropriate. For others, perhaps not.

Sector
Another factor contributing to return and volatility outcomes is sector exposure. A comparison of sector allocations for the three largest funds versus the most commonly used index—the Barclays 1–3 Year Government Credit Index—illustrates a significant variance (see Exhibit 6, above right). For example, an average of the funds’ allocations shows an exposure to corporate bonds that...
was more than two times greater than that of the benchmark. Also, more than 80% of the funds are allocated to sectors with credit exposure—mortgage-, commercial-, and asset-backed securities, and corporate bonds. A manager’s success investing in credit positions and avoiding bonds with increasing risk of default is essential to delivering portfolio return with low volatility.

In order to avoid the pitfalls of “blind spot” investing in the short-duration universe, investors should consider the trade-off of return and price volatility relative to their objectives. In other words, an investor’s tolerance for risk as well as their return expectations should be in alignment with a fund’s characteristics.

**Importance of research and portfolio construction**

After identifying the desired short-duration strategy that is appropriate based on their objectives, investors should evaluate a manager and the manager’s investment process with some of the following features in mind:

<table>
<thead>
<tr>
<th>Feature</th>
<th>Description</th>
</tr>
</thead>
</table>
| Choice of Sector Allocation and Security Selection | • Sector decisions are a significant driver of potential returns.  
• Security selection can add value through fundamental research and by experienced, opportunistic trading. |
| Quality of Research | • An extensive research team can help broaden the opportunity set of securities and support strong issue selection.  
• Research is critical across all areas of risk, including taxable credit, municipal credit, sovereign, along with macroeconomic and quantitative analysis. |
| Caliber of Risk Management & Measurement Tools | • Taking risks carefully aligned with an investment mandate can translate into returns that are consistent with investor expectations.  
Volatility spikes can reveal investor blind spots. |

In the short-duration bond universe, portfolio composition can be focused on one sector—credit, mortgages, high yield—or be highly diversified across several asset classes. Each bond market segment presents different risk and reward potential (see Exhibit 7, above right). The onus is on the investment team—managers, analysts, and traders—to assess the diverse risks being actively managed relative to a fund’s overall objective. Taking advantage of opportunities in short-duration spread sectors can require a significant depth and breadth of resources to be successful.

**Investment implications**

Asset flows into short-duration fixed income funds that began in a low-for-long rate environment could easily continue as the market begins its transition to higher rates in the medium to longer term. These funds may meet the needs of investors who wish to maintain a fixed income allocation that can provide a competitive yield relative to money market funds and stronger NAV stability than longer-duration bond funds.

There is a wide choice of short-duration funds available to investors. The market volatility during the second quarter of 2013 illustrated the impact that changes in interest rates and exposure to spread sectors can have on short-duration fund returns, depending on how they are constructed and managed. To avoid investing with potential blind spots, investors need to know what they own, and align their risk tolerance with a fund’s underlying investment approach.
It is not possible to invest directly in an index. All indices are unmanaged. Investing involves risk, including risk of loss. Decrease. Interest rates can cause the price of inflation-protected debt securities to increase and risk of default than investment-grade bonds. Increases in real income security sold or redeemed prior to maturity may be subject to loss.

Fixed income securities also carry inflation risk, liquidity risk, call risk and default risks for both issuers and counterparties. Any fixed income security sold or redeemed prior to maturity may be subject to loss. In general the bond market is volatile, and fixed income securities carry additional information concerning your specific situation. Investment decisions should be based on an individual’s own goals, time horizon, and tolerance for risk.

Past performance is no guarantee of future results. Neither asset allocation nor diversification ensures a profit or guarantees against a loss. In general the bond market is volatile, and fixed income securities carry interest rate risk. (As interest rates rise, bond prices usually fall, and vice versa. This effect is usually more pronounced for longer-term securities.) Fixed income securities also carry inflation risk, liquidity risk, call risk and credit and default risks for both issuers and counterparties. Any fixed income security sold or redeemed prior to maturity may be subject to loss. High yield/non-investment-grade bonds involve greater price volatility and risk of default than investment-grade bonds. Increases in real interest rates can cause the price of inflation-protected debt securities to decrease.

Investing involves risk, including risk of loss. It is not possible to invest directly in an index. All indices are unmanaged.

Before investing in any mutual fund, consider the investment objectives, risks, charges, and expenses. Contact Fidelity for a prospectus or, if available, a summary prospectus containing this information. Read it carefully.

*An investment in a money market fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although the fund seeks to preserve the value of your investment at $1.00 per share, it is possible to lose money by investing in the fund. Interest rate increases can cause the price of a money market security to decrease.

Views expressed are as of the date indicated, based on the information available at that time, and may change based on market and other conditions. Unless otherwise noted, the opinions provided are those of the authors and not necessarily those of Fidelity Investments or its affiliates. Fidelity does not assume any duty to update any of the information.

These materials are provided for informational purposes only and should not be used or construed as a recommendation of any security, sector, or investment strategy. Please consult your tax or financial advisor for additional information concerning your specific situation.

Index definitions

Barclays 1–3 Year Government Credit Index includes Treasuries, government-related issues, and corporates with maturities of one to three years.

Barclays 1–5 Year Government Credit Index includes Treasuries, government-related issues, and corporates with maturities of one to five years.

Barclays 1–5 Year Treasury Index includes public obligations of the U.S. Treasury with maturities of one to five years.

Barclays 1–5 Year Credit Index includes investment grade, U.S. dollar-denominated, fixed-rate, taxable corporate bonds and non-corporates including foreign agencies, sovereigns, supranationals and local authorities. Maturities range from one to five years.

As of June 30, 2013, the Morningstar Ultrashort fund category had 50 portfolios represented with an average duration of 0.73 years. For the same period, the Morningstar Short-Term fund category had 112 portfolios represented with an average duration of 2.17 years, and the Morningstar Muni National Short category had 47 portfolios represented with an average duration of 2.31 years. Standard deviation shows how much variation there is from the average (mean or expected value). A low standard deviation indicates that the data points tend to be very close to the mean, whereas a high standard deviation indicates that the data points are spread out over a large range of values.

Endnotes

1 Includes actively managed funds in the Morningstar short-term and ultrashort categories. ETFs and index funds are not included.

2 Source: Fidelity Investments.

If receiving this piece through your relationship with Fidelity Financial Advisor Solutions (FFAS), this publication is provided to investment professionals, plan sponsors, institutional investors, and individual investors by Fidelity Investments Institutional Services Company, Inc. If receiving this piece through your relationship with Fidelity Personal & Workplace Investing (PWI), Fidelity Family Office Services (FFOS), or Fidelity Institutional Wealth Services (IWS), this publication is provided through Fidelity Brokerage Services LLC, Member NYSE, SIPC. If receiving this piece through your relationship with National Financial or Fidelity Capital Markets, this publication is FOR INSTITUTIONAL INVESTOR USE ONLY. Clearing and custody services are provided through National Financial Services LLC, Member NYSE, SIPC.