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The New ‘Rising Rate’ ETFs

Are Bond ETFs Designed to Insulate Investors From Rising Interest Rates a Good Idea?

By: Joe Light - April 11, 2014

Asset managers have created exchange-traded funds for just about every investment trend—from commodities to emerging markets to mortgage-backed securities. The latest idea: bond ETFs designed to insulate investors from rising interest rates.

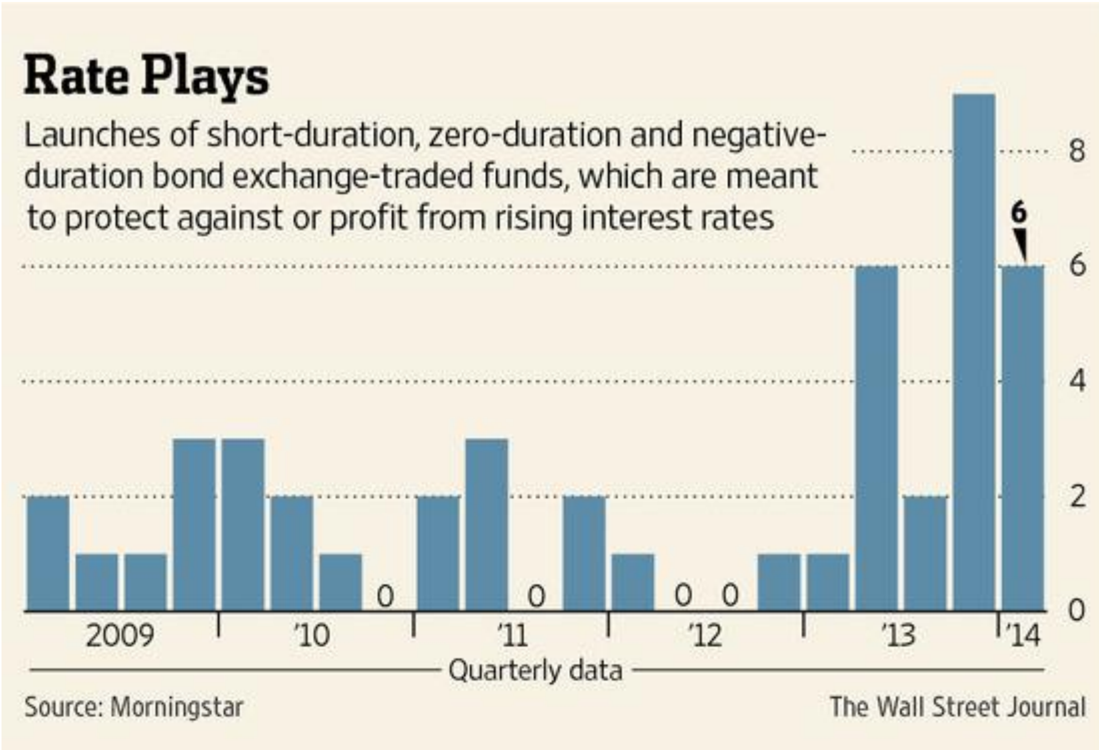
Companies including BlackRock BLK -0.72% and WisdomTree Investments WETF +0.60% have launched or filed plans for at least 17 such ETFs in the six months through March, according to investment research firm Morningstar. That is as many as in the prior three years combined, and the new ETFs now hold about $430 million. They come on the heels of a stellar year for actively managed bond mutual funds that use similar strategies to hedge interest-rate risk.

If successful, the new bond ETFs, some of which are known as "zero duration" or "negative duration" ETFs, would be an important driver for an industry whose product engine has slowed. In 2013, fund companies launched 158 ETFs, the fewest since 2009.

Zero-duration funds and ETFs typically buy longer-term bonds but then "short" Treasurys or use Treasury futures contracts to counterbalance losses that would have otherwise occurred if rates rose. Negative-duration funds take the strategy a step further and seek to make money if rates rise, though they lose money if rates fall. Bond prices move in the opposite direction of yields.

"Duration" is a measure of funds' sensitivity to interest rates. The price of a fund with a duration of five years, for example, would fall 5% if interest rates rose one percentage point immediately, before factoring in yield.

Yet experts caution that some of the funds carry risks that investors may not anticipate and have costs that aren't readily apparent.



Fears of further bond-market losses are on the mind of many small investors.

The Barclays U.S. Aggregate Bond Index, a broad index of corporate and government bonds, lost 1.92% last year, its worst loss since 1994.

"It's probably the main question we get from clients: 'How will you protect me from rising rates?'" says Jason Gunkel, a senior financial analyst at Sherpa Investment Management in West Des Moines, Iowa, which manages about $370 million.

During economic downturns, interest rates tend to fall, which helps traditional investment-grade bond funds rise in price. On the other hand, many of the new ETFs use "short" strategies that cause them to either not move in price or to fall in price when rates fall.

That could lead to unpleasant surprises for investors who expect bond funds to protect them during a stock-market drop, says Dave Nadig, chief investment officer at fund tracker ETF.com.

The new ETFs tend to have annual expense ratios of less than 0.5%, or $50 per $10,000 invested, compared with about 0.3% for typical bond ETFs.

However, depending on how the fund or ETF hedges its interest-rate exposure, certain costs might not appear in the expense ratio, Mr. Nadig says. If a mutual fund shorts Treasurys to hedge interest-rate risk, the cost of taking the short position gets included in the fund's expense ratio, he says. However, if the fund or ETF uses derivatives, the cost isn't included and is instead embedded in the fund's performance, he says.

The shorting expenses of interest-rate-hedged funds is directly tied to the yields that Treasurys pay, which means the costs of the funds will rise if interest rates do, Mr. Nadig says.

The complexity of the funds makes some financial advisers wary.

"We're concerned that some of these negative-duration funds are highly complex and have characteristics that aren't easily discerned," says Antonio Caxide, chief investment officer at Hamilton Capital Management in Columbus, Ohio, which manages $1.3 billion.

In addition to the zero-duration and negative-duration ETFs, recently launched funds include more-conventional ones that hold short-term bonds, and "floating rate" funds, whose yields can rise with interest rates.

BlackRock's iShares unit, the largest manager of ETFs, hopes to launch a zero-duration investment-grade corporate bond ETF and a zero-duration high-yield bond ETF in the second quarter, pending Securities and Exchange Commission approval.

Since September, the New York-based company already has launched five ETFs that target short-term or floating-rate bonds. One such ETF, iShares Short Maturity Bond, NEAR +0.02% has garnered more than $200 million since its September launch. The fund, which has an annual expense ratio of 0.25%, has returned 0.45% this year through Thursday.

WisdomTree in December launched four zero-duration and negative-duration funds that use derivatives to protect against interest-rate risk or to profit from rate increases.

It remains to be seen whether the new funds, most of which still have little in assets, will catch on. However, investors have shown a huge appetite for bond funds that won't be damaged by rate increases.

"Interest rates will rise," says John Otte, a 63-year-old writer in Urbandale, Iowa, who says he plans to retire in a couple of years and recalls large bond losses when interest rates spiked in the 1970s and 1980s. "It's inevitable."