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Swapping out of U. S. Treasuries for Emerging Market Stocks; what is the Risk?

Source Credit:
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Current Thinking, backed by sound analysis, is giving way to The Proposition that:

Treasuries – that is, U.S. government bonds – are as risky as Emerging Market Stocks.

When I say emerging market stocks, that's exactly what I mean… Russia, Brazil, China, South Africa, India, Mexico, Malaysia, Thailand and Indonesia… bona fide emerging markets.

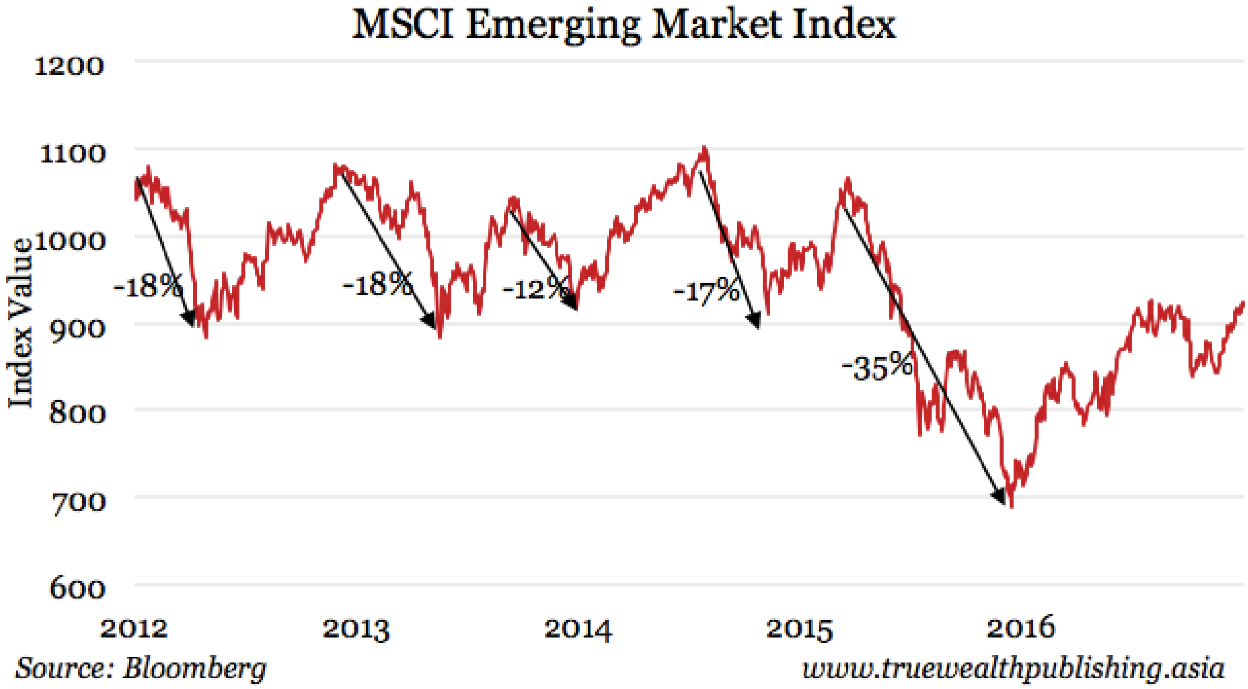
And, when I say Treasuries, I mean U.S. government bonds… backed by the full faith and credit of U. S. Government (and with no leverage).

So, how can these two asset classes possibly be equally risky?

Emerging Market Stocks are widely acknowledged to be one of the most volatile asset classes you can own.

Just look at the performance of MSCI's emerging market benchmark index in the chart below. It fell by 35 percent from April 2015 through early 2016.

In fact, since 2010, emerging markets have experienced corrections of 18 percent (twice), -12 percent, -17 percent, and -35 percent… it's been a rough ride.



Let's look at the Vanguard Group. Founded in 1975 by Jack Bogle, and with nearly US$3 trillion under management, it's one of the biggest global fund management companies. Vanguard offers a suite of very low-cost ETFs, across a range of asset classes. They are one of the biggest in FTF listings. In trying to assist individual investors, the company designates a risk level to each ETF. All ETFs are categorized from 1 through 5, with 1 being the least risky, and 5 being the riskiest.

First, let's look at Vanguard's FTSE Emerging Markets ETF (New York Stock Exchange, ticker: VWO). With roughly US$61 billion of assets, its top 5 country allocations are as follows: China, Taiwan, India, Brazil and South Africa. Not surprisingly – given the volatility of emerging markets overall – Vanguard rates this as a risk level 5 ETF.

Now, let's take a look at one of their U.S. Treasury ETFs for comparison. The ticker is EDV on the New York Stock Exchange. As mentioned, it is composed purely of U.S.

Government bonds. It currently holds 77 of them. It’s pretty cheap as well, charging an annual expense ratio of only 0.07 percent. And, it’s also designated by Vanguard as a Risk level 5 ETF… the highest possible.

Why is that Risk level assigned to this Treasury ETF? Because it’s the Vanguard Extended Duration Treasury ETF. The focus here in the Funds “Duration”.

This ETF holds “Separate Trading of Registered Interest and Principal of Securities”, otherwise known as STRIPS. First introduced in 1985, STRIPS are U.S. Treasury bonds that have carved out the interest and principal payments into individually tradeable securities. For example, a 30-year Treasury can be broken down into 60 semi-annual interest payments, and a single principal payment at maturity. STRIPS (IOs and POs) are zero-coupon bonds (bonds that don’t pay interest but are issued at a discount to face value). And, what Vanguards Extended Duration Treasury ETF does is focus on long-dated zero-coupon bonds (STRIPS). STRIPS normally mature at terms up to 30 years.

The truth is most investors simply don’t spend much time on fixed income (i.e. bonds) at all. They view their Portfolio of bonds as more or less passive commitments; this is furthest from the truth as to their perceptions of risk. How much airtime do CNBC and Bloomberg devote to fixed income versus the equity market? It’s fractional.

As a result – in part based on our experience with our own fixed income clients – a large number of Bond and Bond ETF investors do not have a good understanding of fixed income risk. But, credit and interest rate risk are two of the biggest risks that investors need to consider.

Credit risk is easy enough to understand. We intrinsically understand the difference between lending to the U.S. government by buying their bonds versus buying those issued by, say, an Australian mining company.

But, when it comes to interest rate risk, things become a little less clear. The duration of your bond portfolio is a key determinant of how much risk you’re exposed to.

Duration, which is measured in years, tells you how long it will take for the interest payments generated to repay the invested principal. Duration will indicate the approximate change in price of a bond for a given change in interest rates.

Because zero coupon bonds offer the entire payment at maturity, they always have durations equal to their maturities. So, therefore their durations are higher than coupon bonds. If your bond duration is **5 years** and interest rates rise by 1 percent, the price of the bond falls by approximately 5 percent (and vice versa).

The duration of say the iShares 7-10 Year Treasury Bond ETF (New York Stock Exchange; ticker: IEF) is around **7.63 years**. And the Vanguard Extended Duration Treasury ETF (New York Stock Exchange; ticker: EDV) has a whopping Duration of **24.5 years**!

So, for every 1 percent move in interest rates, you can expect roughly a 25 percent price move in your (EDV) ETF.   Yikes!

That's why a portfolio of U.S. Treasuries can be just as risky as Emerging Market Stocks.

With the U.S. Federal Reserve in the midst of raising rates, it's worthwhile checking out the duration of your fixed income portfolio – and making sure you know how much interest rate risk you have on the table. Because, just because something's a bond, it doesn't mean it's any less risky than – say – Emerging Market Stocks or low priced Small Caps or even IPOs.

Royce Equity Management can hel p with a portfolio review to aid in your rebalancing between Interest Rate Risk and opportunities in Emerging Market Equities; Particularly Equities in SE Asia as well as new IPO opportunities.

Please Contact your Royce's representative for athorough risk evaluation and our latest Equity Investment Opportunities.

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