How should bond fund investors manage interest rate risks?

At the start of the year, the market was overshadowed by an imminent rate hike by the US Federal Reserve. Bond investors were worried: any interest rate increase would translate into falling bond prices. When the UK voted to leave the European Union in June, market uncertainties went through the roof. The market is speculating that central bankers, including Fed officials, will respond with further monetary easing and rate-cut exercises. In this highly uncertain environment, how should bond fund investors manage interest rate risks?

Duration reflects interest rate sensitivity

To assess how a bond or bond fund reacts to shifting interest rates, members can turn to an indicator called "duration". For example, a bond with a duration of five means that for every 1% increase in interest rate, the bond price will fall by 5%, and vice versa.

Bond yields can stay above zero despite rate hikes

Increasing interest rates do not necessarily trigger negative yields in bonds. Bond yields can be divided into two parts: changes in bond price and interest income. If interest income is more than enough to offset the drop in bond price, the bond can still contribute positive yields. Professional fund managers can help you shorten the duration of your bond portfolio to curb any negative impact arising from interest rate increases. In contrast, when interest rates trend down, bond prices tend to shoot up. Under this situation, fund managers can increase duration to amplify the positive effects of falling rates on bond prices.

Dollar cost averaging techniques minimise risks

Although interest rates are a determinant factor affecting bond performance, they are not the only factor at play. MPF adopts a dollar cost averaging approach to investment, which means when prices drop, your fixed monthly contribution can buy a larger number of fund units; when prices pick up, fewer fund units will be bought. This method effectively mitigates the impact of short-term volatility.

Invest according to your own objectives and risk appetite

As ever, the asset allocation of MPF should be based on your own investment objectives and level of risk tolerance, not the prevailing market situation. Evaluate whether the bond fund you are holding still suits your objectives. If yes, continue to hold the investment. An old adage holds true in the world of investment: "Doing nothing is doing something".

Tactical asset allocation

Asset allocation is the single most important factor that affects long-term investment returns. Therefore, your investment portfolio should not stray far from your predetermined strategic asset allocation. However, if you think the market will go a certain way in the medium term, you may consider capturing the trend with tactical asset allocation. For instance, assume you have set an equity-bond ratio of 20:80 in your strategic asset allocation. If you foresee subpar bond performance in the medium term on the back of a rate hike, you could adjust the ratio to 30:70. Tactical asset allocation in general should not deviate too much from strategic asset allocation, but a deviation of 10% or below is acceptable.

In conclusion, members should adhere to their investment strategies despite the evolving market environment, except when changes in personal circumstances necessitate portfolio adjustments. For example, when retirement approaches, members should gradually move their nest eggs from high-risk assets, such as equities, to lower-risk assets, such as bonds.