Credit Concepts: Duration

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In the broader discussion of credit investing, there are many terms and ideas to understand. Let's explore the concept of duration and what it means for investors.

What is Duration?

One of the key principles in credit investing is the inverse relationship between interest rates and the price of income investments. When interest rates rise, the fair market value of bonds and loans fall, and vice versa. Duration measures just how sensitive the price is to a change in interest rates. By utilizing duration, it is possible to estimate how much a change in interest rates in either direction will affect the fair market value of the investment. While the two words may seem very similar, maturity and duration are not the same, although longer maturity typically results in higher duration. Where maturity measures the time until principal value is repaid to the issuer, duration measures price sensitivity of an income investment relative to interest rate movements.

How Does Duration Affect Prices?

Generally speaking, duration tells us the degree of interest rate risk of a particular income investment. The higher the duration, the more an investment's price will drop as interest rates increase (or increase as interest rates decrease). You can typically expect a 1% change in interest rates to affect the market price by 1% in the opposite direction, for each year of duration. For example: if a loan fund has a duration of 3 years and interest rates increase by 1%, we would expect the price to decrease by 3%. Conversely, if interest rates should fall by 1%, we would expect the price to instead increase by 3%.

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How to use Duration

All income investments and income funds have a duration. As such, we can use it to differentiate investment choices from one another, all other things being equal. This can make duration a powerful tool in the hands of your financial professional as he or she builds your income portfolio and maintains it over time.

In an investment environment where interest rates are trending upwards, your financial professional may opt to mitigate some interest rate risk by choosing a shorter-duration income fund to reduce the total duration of your income portfolio. The inverse is also true, should rates trend downwards.

Interest rate risk is just one type of risk associated with credit investing and duration is just one component impacting the price of income investments. Be sure to work together with your financial professional to build an investment plan that suits your individual situation and long-term goals.

Risks

As with any investment, there are certain risks associated with credit investing. Credit risk is the risk of nonpayment of scheduled interest or principal payments on a debt investment. Because credit investing can be debt investments in non-investment grade borrowers, the risk of default may be greater. Should a borrower fail to make a payment, or default, this may affect the overall return to the lender. Interest rate risk is another common risk associated with credit investing. Interest rate changes will affect the amount of interest paid by a borrower in a floating rate loan, meaning they move in-step with broader interest rate fluctuations. However, this typically has little to no impact on the underlying value of floating rate debt. Conversely, interest rate fluctuations will have little to no effect on the amount of interest paid by a borrower in a fixed rate loan but will impact the underlying value of the loan if sold before maturity. Further, credit investing has exposure to default risk which makes evaluating the creditworthiness of the borrower especially critical. For these and other reasons, credit investing requires special consideration and is considered speculative and may not appropriate for all investors.

To learn more, please contact your financial professional.

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