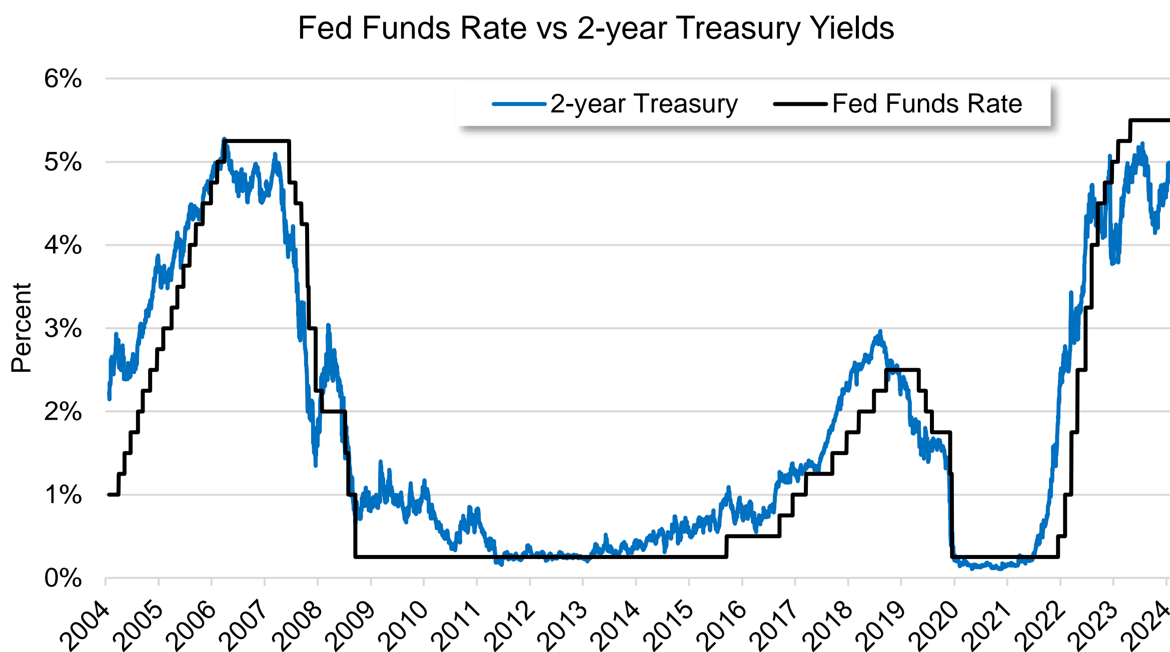
Navigating Yield Environments: The Case for Short Duration Funds

The recent non-consensus move higher in interest rates has brought the 2-year U.S. Treasury to a yield back above 5%. This brought our attention to the yield differentials between short duration strategies and money markets. We have highlighted that the elevated yields available in money markets created a hurdle return for fixed income investors, raising the question around owning duration. We have stressed that with duration comes price volatility, but also return potential. With the yield differentials between money markets and short duration strategies approaching zero, and many short duration strategies still yielding more than money markets, we believe it is time to revisit the advantages of short duration strategies.

We believe short duration funds offer competitive and potentially advantageous return profiles compared to money market funds, even amidst an inverted yield curve environment and the uncertainty associated with current monetary policy. Short duration strategies typically invest in debt securities with slightly longer maturities than those in money market funds, providing them with incremental duration. This can lead to better total return performance when we move into rate cutting cycles.

Currently, money market funds and short duration funds offer similar yields. While we have been skeptical of the market's view of future rate cuts from the Fed, due to the economy's resilience, we believe that the next move from the Fed will likely be an easing of rates. But the most important question is when?

What we find interesting is that investors can now earn incremental yield in short duration strategies over money market funds. With the carry/yield differential low, when the Fed eventually initiates interest rate cuts, short duration funds may benefit from yields moving lower due to their available duration, resulting in potentially higher returns. Conversely, money markets may likely experience lower returns as the Fed engages in taking rates lower. Historical data highlights that when the Fed engages in an easing campaign, short duration funds outperform money market funds.



Source: Smith Capital Investors, Bloomberg 4/25/2024

In addition to the future return differences between money market funds and short duration strategies, recent amendments to money market liquidity requirements have introduced new fee considerations for investors. The SEC has increased the minimum liquidity requirements for institutional prime and institutional tax-exempt money market funds, which imposes liquidity fees during periods of high redemptions. These fees are designed to protect remaining shareholders from dilution and ensure that redeeming shareholders bear the costs associated with their redemptions. During rate-cutting cycles, money market investors are potentially exposed to liquidity fees, whereas there are typically no liquidity fees for the short duration funds.

In summary, short duration funds can offer attractive yield profiles with incremental duration compared to money market funds amidst interest rate reduction phases. Additionally, evolving liquidity requirements for money market funds may impose restrictions on certain investors. Let us know if you'd like to delve deeper into this topic or how we can serve your investment needs.

Let's talk! – Smith Capital Investors

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