

Duration: friend or foe?

The case for dynamism in duration management for unconstrained bond portfolios.

Executive summary

- Recent market dynamics, especially the return of inflation in 2021, have undermined duration's effectiveness as a hedge for credit risk, with correlation patterns between credit spreads and government bond yields shifting. We want to own duration when it is likely to act as a good hedge for the credit risk we own.
- Shifting correlations make static duration management in bond portfolios unattractive, particularly when the expected return of duration is low.
- L&G's unconstrained bond strategies adopt a dynamic and flexible approach to managing duration. We reduce duration when we believe investors' inflation fears are likely to dominate their recession fear and returns from duration are likely to be positively correlated with returns from credit.



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When to add duration?

When choosing how much duration to own in a bond portfolio, investors typically look to answer the following questions:

- (1) What will happen to interest rates?
- (2) Are term premiums at attractive levels?
- (3) Can duration act as a reliable hedge for risk exposures (e.g. credit and equity?)

Let's examine each of these:

(1) What will happen to interest rates?

Predicting interest rate moves correctly is extremely difficult and would require a high degree of confidence in forecasts of key macro-economic indicators such as inflation, GDP growth and central bank reaction functions. A lot can go wrong when forecasting large, complex systems, so it's perhaps unsurprising that macroeconomic forecasting has a particularly poor track record. Nonetheless, many investors put great emphasis on their forecasts when determining investment strategies.

Given the poor track record of macro forecasting, we don't think it's wise to let a view on where interest rates will be over the medium term dictate a strategic allocation to duration. However, the overconfidence many investors have in their forecasting ability can [provide us with opportunities to trade against them](#).

(2) Are term premiums at attractive levels?

Are you getting paid to own duration? Term premiums are the expected excess return you expect to receive from a long-dated bond versus putting the money in the bank. The term premium can be thought of as the difference between market participants' expectations of future interest rates and the prevailing market yields on longer-dated debt.

Various methods of estimating term premiums show the same trend: after being negative from 2017–2022, they have been on the rise. However, the relatively small return on offer from owning duration may look unattractive when compared to the volatility of returns.

Term premium trends: upwards, but from a low start



Source: Bloomberg, L&G, as at 31 December 2025

For example, the term premium available on a 10-year US Treasury (using the Adrian Crump & Moench 10 Year Treasury Term Premium as a proxy for term premium) has risen significantly from pre-COVID-19 negative levels, but is still low in absolute terms.¹ Investors with broad universes may decide that a 0.7% annual excess return isn't especially attractive for an asset which has recently had around 5% annual volatility, and might reasonably conclude that the expected return from duration isn't big enough to justify it dominating their portfolios.

(3) Can duration act as a reliable hedge for risk exposures?

Duration has typically been seen as the primary hedging tool for credit risk. This might stem from bond investors' experiences in the decades before the pandemic. Between 2008 and 2020, the correlation between credit spreads and government bond yields was often negative.¹ So when credit spreads widen amid a risk-off environment (leading to negative returns from credit, or negative excess returns), this would typically be accompanied by a decline in government bond yields, cushioning the negative effect from the credit spread widening. Inversely, a risk-on environment would often be characterised by a tightening in credit spreads (positive excess returns) combined with a rise in government bond yields.

However, this correlation fundamentally changed following the return of inflation in 2021 when duration lost its reliable hedge status. This created significant issues for investment strategies relying on duration to perform well when risk assets underperformed – especially for unconstrained bond strategies which typically target smoother return journeys and more convex outcomes than traditional bond strategies.

The changing value of duration as a hedge challenges the assumption that duration is something to 'buy and hold.' In today's world, we believe fixed income investors need an active and dynamic approach to managing duration in portfolios.

To further illustrate, we compare outcomes during different correlation regimes. Between 2011 and 2020, credit portfolios enjoyed strong returns thanks to declining bond yields,¹ driven by an environment of low growth and inflation.

During this period, duration also provided a good hedge for credit exposure. Our research also shows that in periods of significant (10 basis points or more) widening in credit spreads, on average, US 10-Year Treasury yields decreased when looking at both weekly and monthly data.

The table below shows changes in US 10-Year Treasury yield during periods where US credit spreads widened by 10bps or more between 2011 and 2020.

2011 to 2020	
Weekly series	-0.13 bps
Monthly series	-0.22 bps

Source: Bloomberg, as at 31 December 2025

However, all of this changed when inflation picked up in 2021. When we look again at periods of significant credit spread widening but consider data covering 2021–2025 to date, we can see that US Treasury yields still dropped in these moments on a weekly basis, but the opposite happened when looking at monthly series, which suggests that any relief provided by duration has been short-lived.

The table below shows changes in US 10-Year Treasury yield during times where US credit spreads widened by 10bps or more between 2021 and 2025.

2021 to 2025	
Weekly series	-0.13 bps
Monthly series	0.14 bps

Source: Bloomberg, as at 31 December 2025

1. Bloomberg, L&G as at 31 December 2025

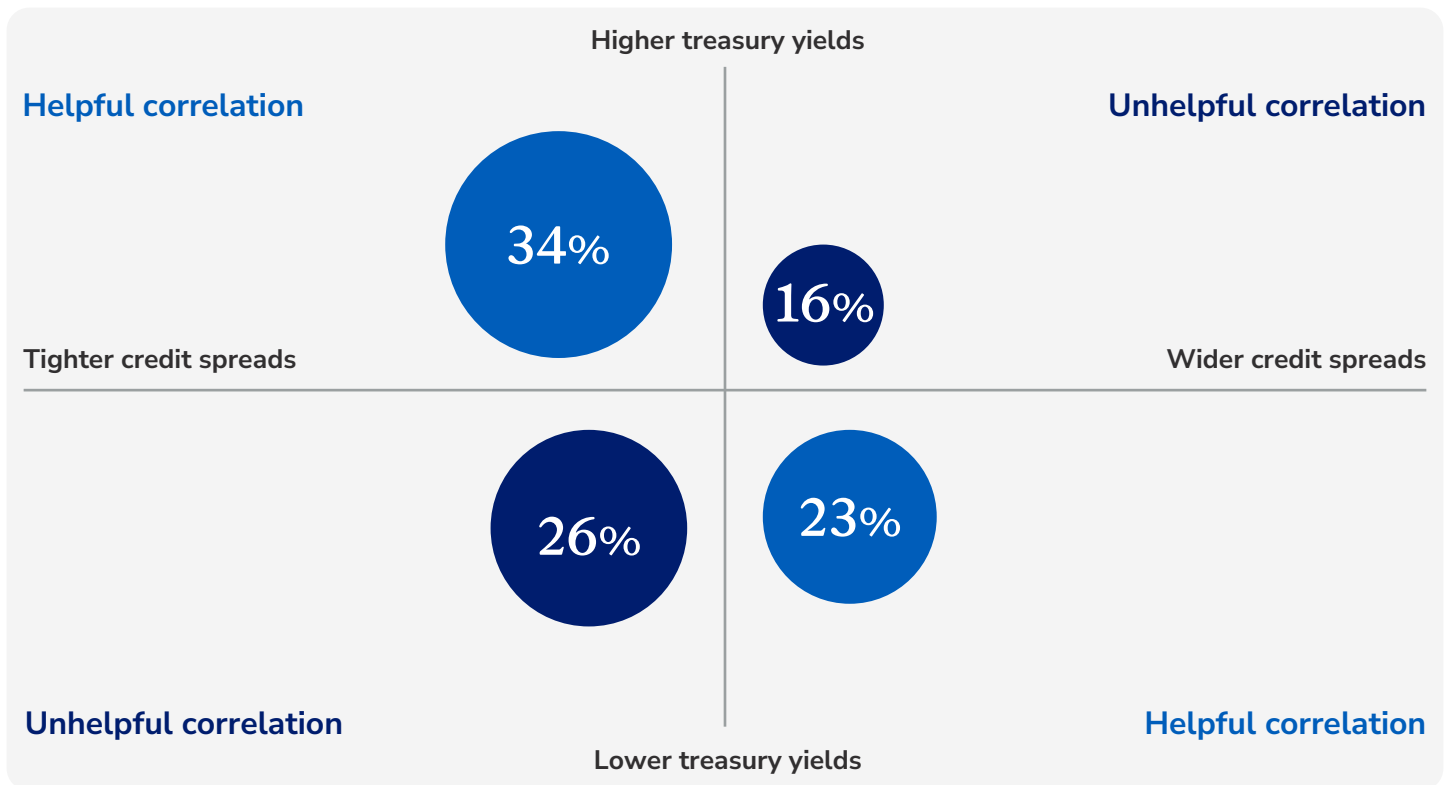
We can use longer data histories to capture outcomes in various macro-economic cycles and inflation regimes.

Using monthly changes in US credit spreads and US 10-year Treasury yields since June 1989, we break down monthly observations in four categories:

- US credit spreads are higher over the month while US Treasury yields are lower (negative correlation, helpful duration for risk mitigation)
- US credit spreads are lower over the month while US Treasury yields are higher (negative correlation, helpful duration for risk mitigation)
- US credit spreads are lower over the month while US Treasury yields are lower (positive correlation, unhelpful duration for risk mitigation)
- US credit spreads are higher over the month while US Treasury yields are higher (positive correlation, unhelpful duration for risk mitigation)

We find that in 42% of monthly observations, the correlation is positive (unhelpful) with duration being an additional source of risk rather than a useful risk dampener.

Monthly correlation dynamics between US credit spreads and US 10-year Treasury yields



Source: Bloomberg, L&G, as at 31 December 2025

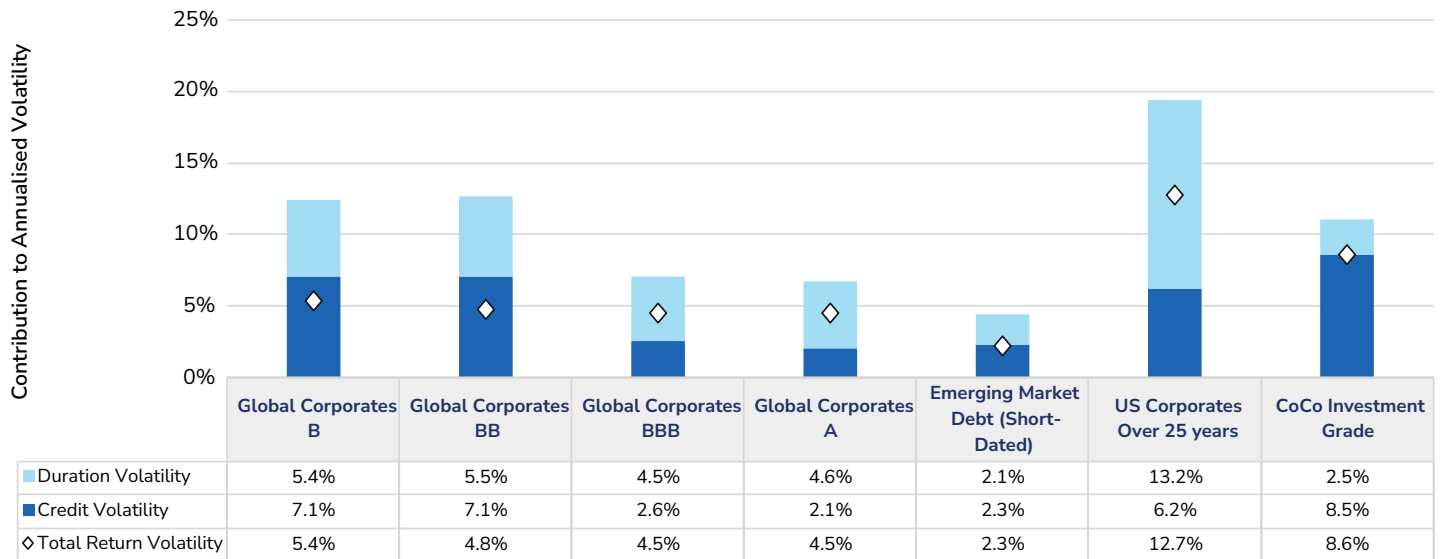
2022 has often been said to be an outlier in the long-term history of bonds; it was certainly in its magnitude, but our analysis shows that correlation dynamics are not static and pose challenges for portfolio construction.

So, having explored the complexities of duration and its correlation dynamics, how can investors manage this exposure in portfolios and what are the potential pitfalls they should consider?

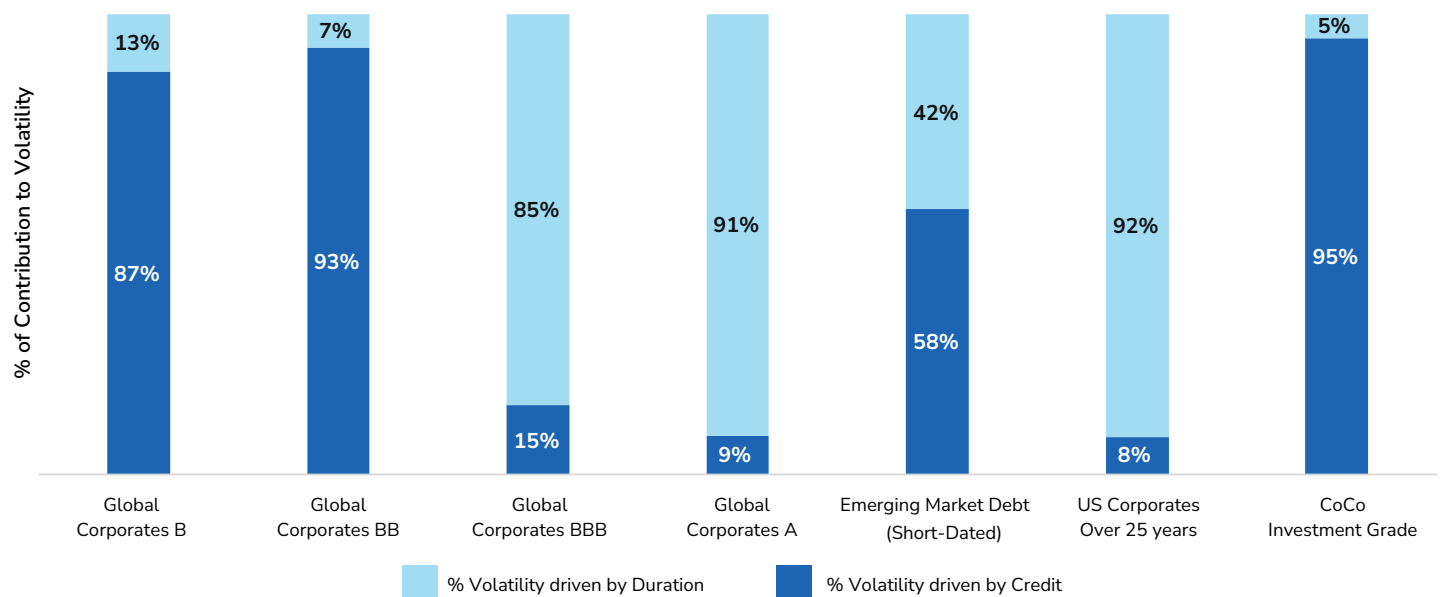
The risks of managing duration to a benchmark in credit portfolios

Choosing the duration that 'comes with' credit - either in a benchmark or in an individual security - can create credit funds that are in fact dominated by duration risk. We can see this by breaking down the drivers of return volatility across different credit benchmarks. A bond's volatility profile and how much of it is driven by duration versus credit risk varies considerably across bond markets. For example, bonds with a maturity of over 25 years face double the return volatility risk from duration than credit risk. In contrast, more credit-sensitive areas such as high yield BB-rated bonds are typically less affected by duration.¹

The drivers of return volatility by credit index



Bloomberg, L&G, as at 31 December 2025



Bloomberg, L&G, as at 31 December 2025

¹ L&G, Bloomberg as at 31 December 2025

Knowing that duration has the potential to increase volatility but offers only limited expected returns, it is important to consider its role carefully in unconstrained portfolios. Duration has recently produced negative returns while contributing to relatively high levels of volatility. The below table presents five-year returns and volatility for major bond indices, showing that markets with higher duration, like global treasuries, experienced volatility and drawdowns comparable to global high yield bonds.

5-year risk and return metrics for key bond indices

	Annualised return	Annualised volatility	Worst return in a single calendar year
Global Treasuries	-0.1%	3.7%	-10.8%
Global Corporates	0.6%	5.0%	-14.1%
Emerging Market Debt	1.5%	4.6%	-15.3%
Global High Yield	4.8%	4.2%	-11.0%

Source: Bloomberg, as at 31 December 2025

We believe that duration needs to be actively managed in a more dynamic fashion. Unconstrained bond strategies in particular – which aim to provide better risk-adjusted returns – should adopt a more responsive and flexible approach.

Actively adjusting our duration exposure in line with evolving macro-economic conditions has been a key driver of the fund's long-term outcomes and how we aim to lower risk. We believe agile duration management is essential for unconstrained bond strategies now and going forwards.

So, how do we do it?

Our framework for managing duration in unconstrained bond strategies

L&G manages a range of unconstrained bond strategies with credit as their core exposure. Credit exposure is used to provide an income and return stream. We want to add duration in a way that creates more convex outcomes than holding credit risk on its own.

Our core principles for managing duration in those portfolios are as follows:

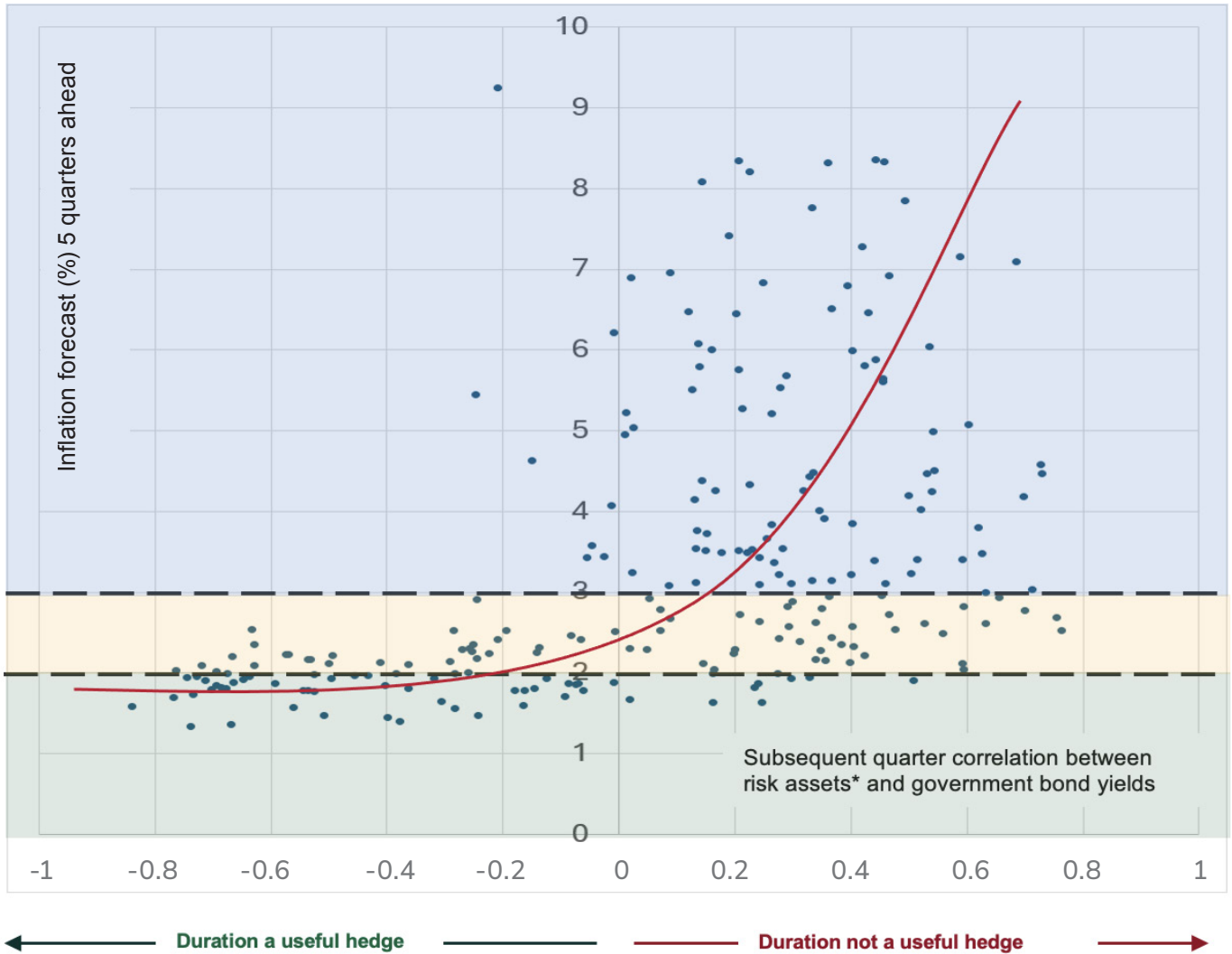
1. Setting duration based on long-term macro forecasts is unlikely to lead to successful outcomes
2. Fear of inflation is key in determining the relationship between duration and credit returns
3. Sizing is very important

Fear of inflation is key

We believe that we can say something useful using forward-looking correlations if we can answer the question 'are investors more likely to be concerned about high inflation or low growth?' The intuition is relatively simple, if investors are concerned about high inflation, we're likely to see both rates and risk assets (credit and equities) produce negative returns. This is because higher inflation necessitates that central banks raise interest rates with the express aim of slowing growth.

The chart below demonstrates the relationship between fear of inflation and the value of duration as a hedge. It shows correlation between risk assets (we use equities to get a much longer time series), and government bond yield since 1964. It highlights that when inflation is expected to be persistently (defined as five quarters) high (above 3%), correlation is positive in the following 90 days for most observations, and when inflation is expected to be low (below 2%), correlation is negative in the following 90 days for most observations. Between 2 and 3%, correlation observations are spread out between positive and negative:

Relationship between expected inflation in 5 quarters time and subsequent risk asset-bond yield correlation



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L&G, Bloomberg, as at 31 December 2025. **Past performance is not a guide to the future. The value of an investment and any income taken from it is not guaranteed and can go down as well as up, and the investor may get back less than the original amount invested.**

*S&P 500 used as a proxy for corporate bond spreads given longer track record.

	Percentage of observations
Expected inflation between 2 and 3%, positive correlation	57%
Expected inflation between 2 and 3%, negative correlation	43%
High expected inflation, positive correlation	92%
High expected inflation, negative correlation	8%
Low expected inflation, positive correlation	18%
Low expected inflation, negative correlation	82%

Source: Bloomberg, L&G, as at 31 December 2025

In periods when inflation is expected to be high for a long time, our framework suggests our unconstrained bond strategies should significantly reduce duration. During periods of persistently low inflation, it recommends we increase duration.

What do we do when inflation is expected to be neither especially high nor especially low – when inflation is in the yellow zone on the chart above? Instead of making the mistake of trying to forecast, we focus on understanding investor beliefs on inflation and growth and how these may change. Acknowledging that forecasting [inflation is a fools game](#), we ask: What do other people believe? Why do they believe it? And how do they change their minds? We will increase duration for situations where a large amount of data is necessary to convince investors that persistently too-high inflation is a significant risk. We will reduce duration when we believe only a very small amount of data is needed to convince investors that inflation will be a persistent risk.

Finally, if inflation forecasts are neither very high nor low and there is no interesting skew in what others believe, we acknowledge that there is persistence in correlation regimes and we will move duration higher if we have observed very low correlations or move duration lower if we have observed very high correlations. Our research using historical data observes that it has been very rare for correlation to flip (from materially positive to negative or materially negative to positive) from quarter to quarter.²

Size matters

Our framework includes provisions for duration sizing according to the amount of credit risk that our unconstrained bond strategies hold. If we expect a negative correlation between duration and credit risk, the amount of duration we hold will increase depending on the amount of credit risk that the strategy holds. Duration positions will be set in proportion to the expected volatility of the credit risk we hold in a particular strategy.

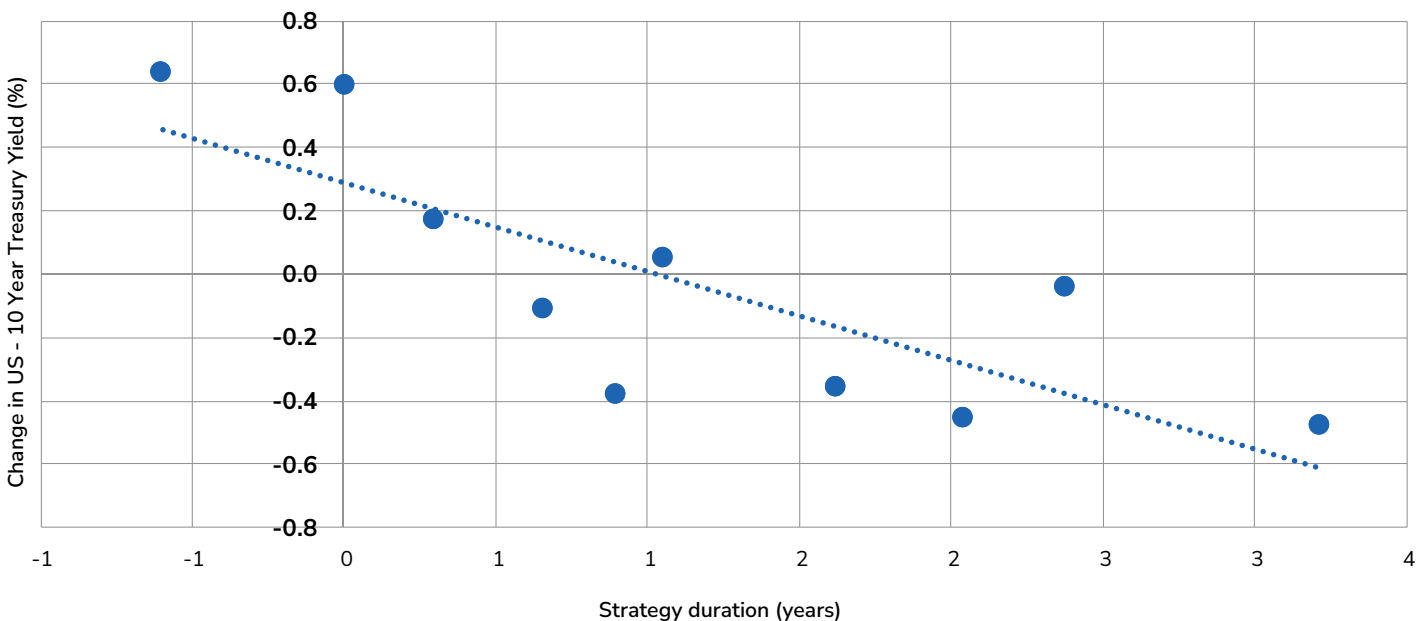
Measuring success

The chart below illustrates how our duration management framework has performed in practice. Specifically, during periods of meaningful US credit spread widening alongside falling Treasury yields (negative correlation), our unconstrained bond strategies have typically held higher duration to act as a cushion against credit market volatility. Conversely, when spread widening coincided with rising yields, duration has been lower.

By evaluating these outcomes, we can refine our approach, continuously assess, and make adjustments to ensure that our strategies remain resilient and well-positioned to navigate fluctuations in credit risk and broader market dynamics.

Measuring the effectiveness of duration as an asset allocation decision

We believe early identification of regime changes is key to generating strong risk-adjusted returns over the long term.



For illustrative purposes only.

L&G, Bloomberg, as at 31 December 2025

² L&G, as at 1 January 2013 to 31 March 2026

Conclusion

Duration can be a powerful hedging tool in times of broader credit market distress. However, it can also be a considerable source of risk for credit portfolios and can cause issues for unconstrained bond strategies that seek to smooth out long-term investment returns.

In our unconstrained bond strategies, we treat duration as an active asset allocation decision rather than a persistent risk exposure. We increase duration when it is likely to act as a good hedge for the credit risk we own most clearly during recessionary, low-inflation environments, and reduce it when inflation fears dominate and duration is likely to behave like an extension of credit risk itself. Outside of these two scenarios, correlation dynamics between credit spreads and government bond yields are the primary drivers of our duration positioning. By acknowledging that duration does not always behave as an effective hedge, our active approach seeks to deploy it selectively and proportionately, with the explicit aim of smoothing returns and improving long-term investor outcomes.

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