The New Bond King Is…The 2-Year Treasury Note!

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I had the pleasure of working for over a decade for the greatest bond investor of all time – Bill Gross. Recently, with another Bill -- Ackman -- publicly going short the bond market and then covering the short and advertising the exploit in a tweet, many market commentators crowned him the new Bond King. A few years ago, when the original Bill departed PIMCO, one Jeffrey Gundlach was crowned the Bond King, albeit briefly.

> "My vote today for Bond King is not a person; it is a modest little risk-free Treasury security which we know as the Treasury 2-Year Note. No more Bond, James Bond. For now, it is Note, James Note (an inside joke of old-school fixed income traders). Let me explain why."

First, the yield. The 2-year Treasury that was auctioned last week has a nice round coupon of 5% and came in at a slight discount to its par value at a price of 99.89. The bond will mature in exactly two years (October 31, 2025), at a value of 100, and will deliver a yield of just above 5%, guaranteed, each year, for the next two years. So, investors will get their money back from the Federal government and will also get 5% income per year. Not bad compared to a regular savings account, and unlike the bank, the Feds won't go belly up. Yes, inflation will take a bite, but hopefully only a small nibble considering the short holding period.

The duration of this note is about 1.9, and what that means simply is that if yields rise 1% (from 5% to 6%), the price of the bond will fall by 1.9%; i.e. from roughly 100 to 98.10 (actually a little bit less, only to about 98.15, because of what is called "convexity" which we will not spend time discussing, albeit every Treasury bond has it, and its good for investors who own the bond).

Now, here is the punch line: every Treasury note, or bond, is an option in disguise and that's what gives it secret superpowers. It might make sense to explore why. Recall that an option is a right, not an obligation, to buy or sell something at a pre-determined price in the future for a premium. A Treasury bond walks, talks, and acts like an option because holding a Treasury bond gives the holder the right, but not the obligation, to convert the bond to cash when needed. And amongst Treasurys with coupons on them, the most liquid is the one with the lowest duration, i.e., a freshly minted 2-year Treasury. So, if one believes that we are heading toward a market correction, another geopolitical crisis, or any number of other black swans that keep me up at night, then earning 5% a year while having the right to liquidate and convert to cash sounds quite compelling.

There is another way this lowly note rules and behaves like an option. Recall that when we own an option, the most we can lose is the option premium we pay, but we can have potentially unlimited gains. At a minimum owning an option provides the owner with the potential of much larger gains than losses. Let's look at what we can make or lose on this note. Let us assume we bought this 2-year note and held it for one year. At the one-year point we have many possibilities of where yields can be, so what might we make or lose? We can do this calculation in our heads if we assume just for computational ease that the duration is 2, not 1.9.

If the yields in the market do not change, the price stays where it is (close to 100), and we collect the 5% coupon. If yields rise 100 basis points (1%), we still make the 5% coupon, but we give up no more than 2%, so we are still ahead by about 2% to 3% (the actual computation is more complex because the maturity of the note shortens, so one has to adjust for the fact that it becomes less risky as we get closer to maturity). On the other hand, if yields fall by one hundred basis points, we make not only our 5% coupon, but at least another 2%, so more than 7% total return. Running this computation for other scenarios, we see that before maturity, for us to have a negative mark-to-market loss, yields must rise by close to 2%. But on the other hand, if yields drop by 2% or more, we can make a total return of over 10%. And just so that there is no confusion, if we hold this note to maturity, we get our 5% per year and our principal back, no questions asked. So, our minimum total return is 5% per annum if held to maturity.

"So, come back full circle: (1) we cannot lose more than what we invested, (2) we can make a lot more than what we can lose, (3) we get paid a nice yield."

Nothing here requires fancy math or a computer. This is bond math at its absolute best. And yes, I have spent my whole career trading options, and the mathematics of bonds is similar to the mathematics of options, so the analogy is rooted in a deeper connection.

The astute reader might be a little dissatisfied – if bonds are options, what are they options on? Good question. Bonds are options on deflation, i.e., on falling rates.

"So, if one believes, like I do, that we are entering a period of maximum danger in the global economy and markets because of long-term rates going up, then a sharp breakage is possible. I hope it does not happen, but if it does, I would like to be prepared and ready. If you believe, like I do, that the Fed would have no choice but to pivot to cutting rates if there is a serious breakage in the financial markets, then a good idea is to (1) have ample liquidity, (2) not take too much credit risk where someone can default on me and refuse to pay. The humble 2-year note gives me both of these, and as discussed above, an income of 5% on top while we wait, i.e. the possibility of an asymmetric option like gain. And yes, if there is continued inflation, the 5% yield might not be enough. But due to the short maturity, we can reset and do it again in 2 years."

Humble and modest, looking out first and foremost for its investors…this is why I think – with apologies to the two Bill's and Mr. Gundlach -- the 2-year is the new Bond King, or should I say the Note King?

Important Disclosures

Vineer Bhansali, Ph.D. is the Founder and Chief Investment Officer of LongTail Alpha, LLC, an SEC-registered investment adviser and a CFTC-registered CTA and CPO. Any opinions or views expressed by Dr. Bhansali are solely those of Dr. Bhansali and do not necessarily reflect the opinions or views of LongTail Alpha, LLC or any of its affiliates (collectively, "LongTail Alpha"), or any other associated persons of LongTail Alpha. You should not treat any opinion expressed by Dr. Bhansali as investment advice or as a recommendation to make an investment in any particular investment strategy or investment product. Dr. Bhansali's opinions and commentaries are based upon information he considers credible, but which may not constitute research by LongTail Alpha. Dr. Bhansali does not warrant the completeness or accuracy of the information upon which his opinions or commentaries are based.

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