Ways to Hedge Interest Rate Risk

By: www.ProfitableInvestingTips.com

Throughout the last year interest rates went up as the US Federal sought to curtail inflation. Although inflation was the highest in forty years, many investors and businesses persisted in their belief that higher rates would be temporary. **Silicon Vally Bank** was just one of the institutions that were casualties of rate increases. Because managers at SVB did not expect rates to keep going up, they purchased long term bonds in early 2022 when interest rates were much lower than they became by the spring of 2023. The value of their bonds plummeted as rates went up which, in turn, effectively reduced their reserves. When there was a run on the bank SVB collapsed. There were ways to hedge interest rate risk which SVB did not take advantage of.

How to Hedge Interest Rate Risk - Bond Ladders

Investors commonly include bonds as well as stocks in their portfolios. The rationale is that bonds will retain their dollar value even if the stock market falls. When rates are on the rise a common tactic is to use a **bond ladder**. Bond ladders are interest rate investments like US Treasuries, bank CDs, or high grade corporate bonds. The ladder part refers to have a set of staggered yields. Longer term bonds pay a higher interest rate and shorter term bonds provide protection against being locked in when rates go up. Always having a bond or two that will soon mature gives the investor access to cash when they need it.

Ways to Hedge Interest Rate Risk With Options

The basic idea behind options is that a person pays a premium for the right to buy or sell something like a stock or to protect against interest rate changes. By using interest rate management options the buyer gains protection in a debt obligation. They are commonly used to provide protection with floating rate loans like adjustable-rate mortgages. An interest rate cap is a grouping of interest rate call options. An interest rate floor is a set of interest rate put options. A way to reduce the cost of buying protective interest rate options is to use a collar. A collar is buying a cap and selling a floor at the same time. One provides protection and the other reduces the cost of that protection. These tactics work for short term interest rate risk.

Hedging Interest Rate Risk With Futures

Interest rate futures allow traders to speculate on interest rate changes. Futures prices move inversely to the rate of interest. They are also used to protect against the effects of rising interest rates. Such contracts are not tied in any way to a person's or business's bonds or debts. Rather they are a way to hedge by "betting" on interest rate movement in such a way that the futures contract will help make up for losses incurred due to interest rate changes. Like with options, the buyer pays a premium for this type of insurance.

Forwards As Interest Rate Hedges

The point of a forward rate agreement is to set an interest rate for a future transaction. These are over-the-counter contracts between two parties. Buyers of these contracts are called borrowers and sellers are called

lenders. Both are hedging against an unwanted or unfavorable increase or decrease in interest rates depending on their point of view. When these contracts mature and the rate has gone up, the buyer pays the difference between the interest rate specified in the contract and the interest rate of the day and the seller receives the difference.

Hedging Interest Rate Risk With Swaps

Swaps are used to hedge risk when paying interest. A plain vanilla swap is set up when one party is paying a fixed rate and the other is paying a variable rate. In a swap, the two parties exchange futures sets of cash flows.

Hedges for Long Term Interest Rate Risk

The best protection when rates are going up is paying attention to what is going on and why. When inflation hit its highest in four decades it should have been abundantly clear to folks like Silicon Valley Bank that the Fed was going to raise rates. The period of continually low rates following the Financial Crisis was going to end and not return for the foreseeable future. At a minimum someone like SVB could have staggered the yields on their bonds and minimized their risk on the long end. Better yet they could have only purchased short term securities until the direction of rates was clear. To the extent that they might have chosen to use options, futures, swaps, or forwards, these instruments could have provided short term protection from losses.

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