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Quant Focus

Why most portfolios are short interest rate volatility

How long swaption positions may provide useful hedges for equity, credit

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Quantitative Strategies

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We are taught that micro and macro risks are different. And yet, the data shows that long swaption straddle positions appear to be decent hedges for credit and equity benchmark drawdowns. We examine the evidence and what might explain this.

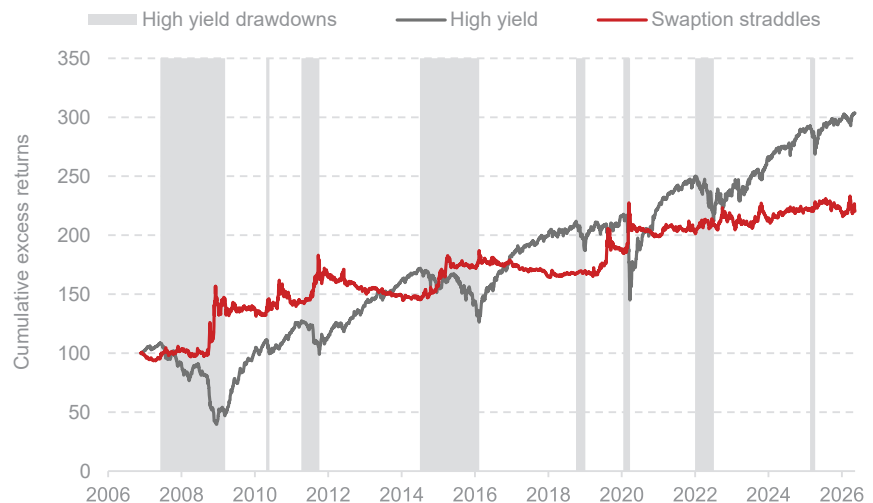
The blind spot of standard valuation—assuming interest rates are known

- Discounted cash flow (DCF) analysis, the Black-Scholes formula, the CAPM, the Fama-French framework all make a key assumption—that interest rates are known and not subject to change, ie non-stochastic
- Research and practice confirm that this assumption fails to hold in the data and may lead to a material misunderstanding of risk and return drivers
- While the impact of stochastic interest rates is small in short-expiry options, it is large when expiries are longer, especially when valuing the underlying equity and credit assets that are contingent on cash flows decades ahead

Portfolios are materially short interest rate volatility, and swaptions can help

- As investors seek to manage total portfolio risk, it is worth considering that all major asset class benchmarks are short interest rate volatility, even when they are designed to be explicitly duration-neutral
- For example, long swaption positions (shown in red below) can offset high yield credit exposure (shown in gray below), even when the credit exposure is stripped of duration risk. And unlike the usual suspects (e.g. buying equity index puts or CDS protection), swaptions have far less negative carry

Chart 1: Long swaption positions have gained during credit drawdowns, without the usual bleed

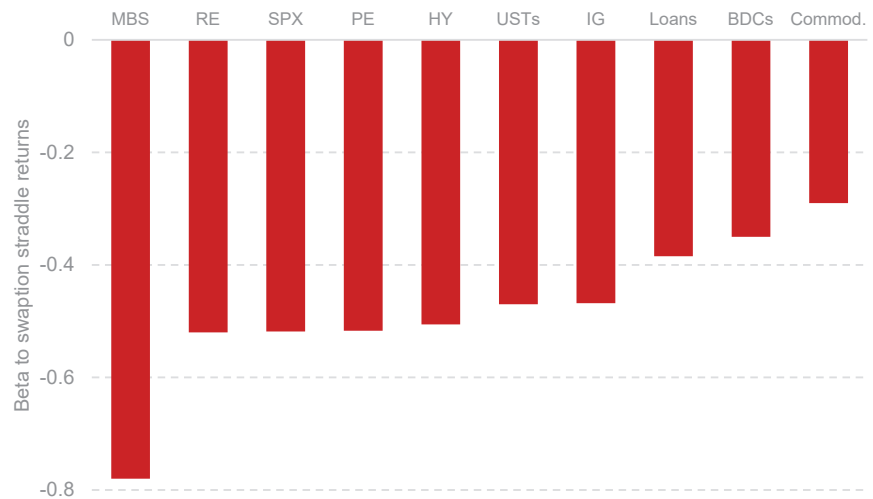


Source: Nomura. High yield series reflects duration-adjusted excess returns, ie just credit spread duration and carry.

The blind spot—equity and credit are short interest rate volatility

The interest in taking a “total portfolio approach” (TPA) to asset management is well intentioned. While traditional asset allocation would assign credit and equity to different asset classes, they clearly share exposure to a common corporate risk factor. But what TPA implementations typically ignore is that all major risk factors have short exposure to interest rate volatility. It is not only US agency MBS. In the chart below, we show betas of portfolio benchmarks to long positions in swaption straddles, which are delta-neutral but long gamma and vega with respect to interest rates.

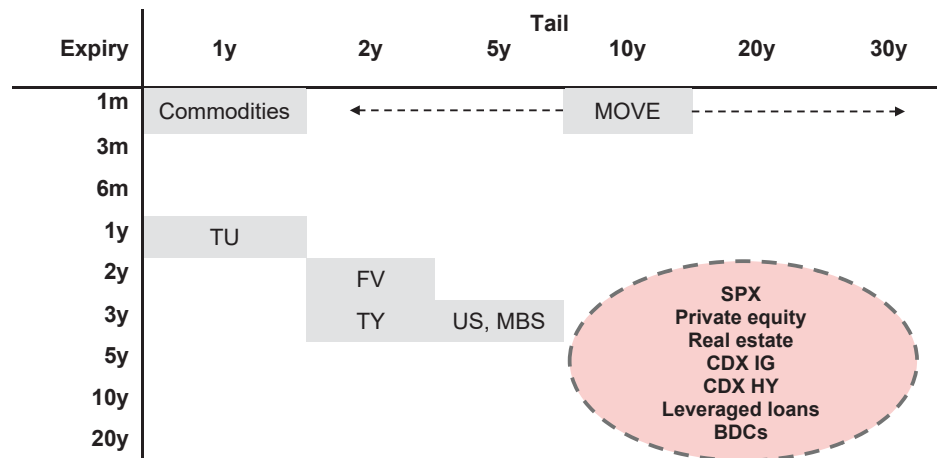
Chart 2: Mainstream portfolio assets have negative beta to long swaption straddle returns



Source: Nomura

Furthermore, while US MBS prepayment risk can be approximated by the 3y5y point, equity and credit risk cluster in the lower right, at longer expiries and forward tenors or “tails”, such as 5y20y, as shown in the table below. This has nothing to do with callability, as neither CDS nor equity exposure is callable in any conventional sense.

Chart 3: Equity and credit is more exposed to “lower-right” swaptions, with long expiries and tails

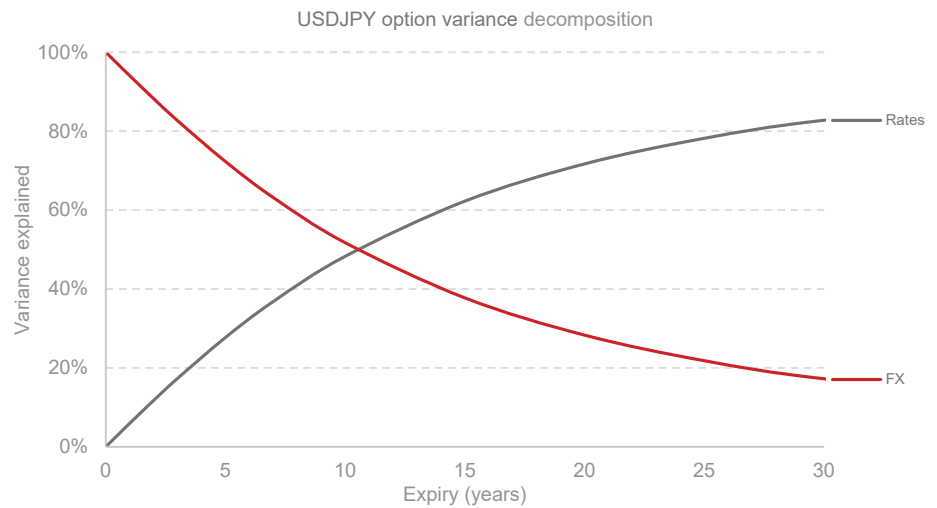


Source: Nomura.

Rates volatility drives long-term risk, regardless of asset label

What could possibly explain the connection between lower-right swaption straddles and corporate risk? It is fair to say most option traders in equity or FX can and do ignore interest rate volatility at expiries less than six months, where most listed options trade. But traders who manage long-expiry option books are aware that interest rate variance comes to dominate the total variance of an option, even if the option on paper is based on an equity or FX underlying. In the chart below, we show a common phenomenon in the long-dated FX options market—that interest rate volatility crowds out FX volatility as expiries lengthen.

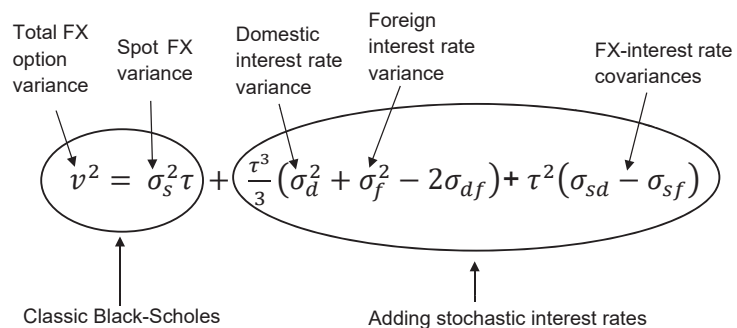
Chart 4: Long-expiry FX options are mainly driven by the volatility of interest rates, not FX



Source: Nomura, Hilliard, J. E., Madura, J., & Tucker, A. L., 1991. Currency Option Pricing with Stochastic Domestic and Foreign Interest Rates. *The Journal of Financial and Quantitative Analysis*, 26(2), 139–151, equation 20.

Next we provide some intuition for why this happens. In classic Black-Scholes, interest rates are constant, and the total variance of the option scales linearly with time to expiry as a function of spot FX variance, shown on the left side of the equation below. If interest rates are stochastic, total option variance also depends on the terms on the right hand side. Notice that the scaling of these variance and covariance terms with time is not linear, but quadratic and cubic. Hence, even if interest rate variance is relatively small in spot terms, it scales with expiry far faster than FX variance.

Chart 5: The scaling of Interest rate variance in time to expiry is cubic or quadratic, not linear

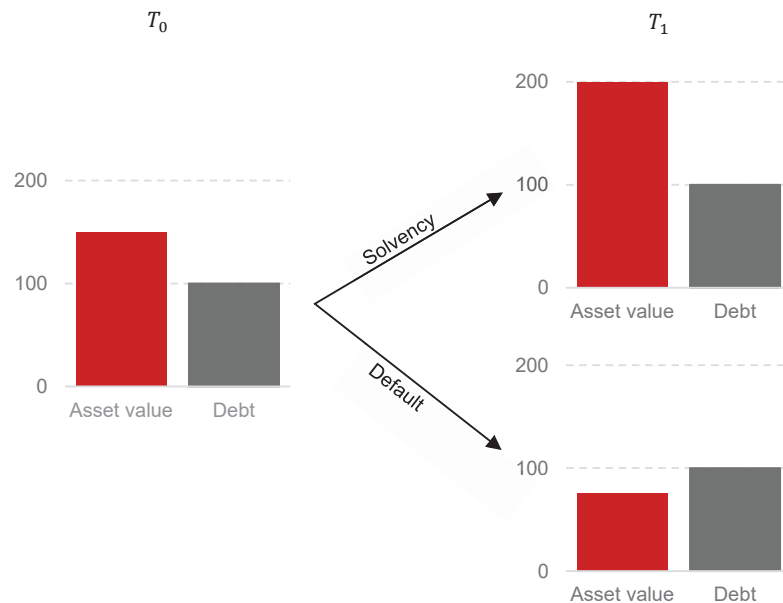


Source: Nomura, Hilliard, J. E., Madura, J., & Tucker, A. L., 1991. Currency Option Pricing with Stochastic Domestic and Foreign Interest Rates. *The Journal of Financial and Quantitative Analysis*, 26(2), 139–151, equation 20.

Credit and equity are short long-dated options, hence rates vega

The same logic behind the FX example applies to equities and credit. The early work of Black, Scholes and Merton showed that option pricing could be applied with some modifications to equity and credit, which are contingent claims on the asset value of the firm. A credit or equity investor will suffer losses if the asset value of the firm goes below the level of its debt, as shown below. In this sense, they are short a put option on the value of the firm, where the strike is the level of debt.

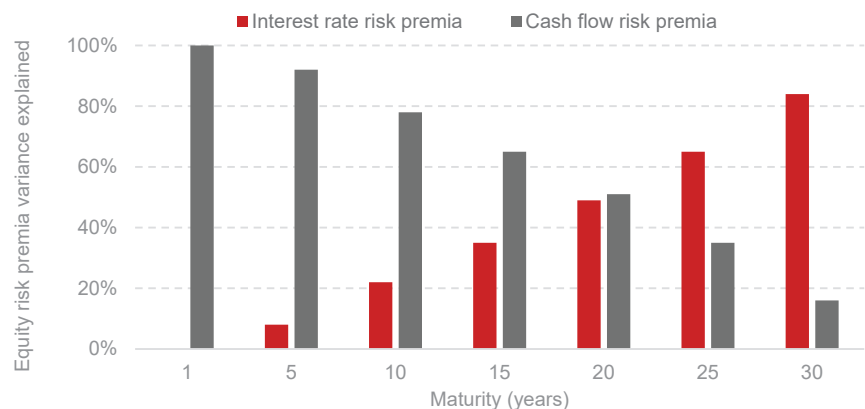
Chart 6: Credit and equity investors are short puts on the value of the firm's assets



Source: Nomura

Going one step further, the asset value of a firm is a function of cash flows going out many years. Recent research has shown that 80% of US equity market risk is attributable to cash flows beyond 10 years in the future. As with the FX option example, interest rate variance should be expected to dominate the variance attributable to corporate dynamics alone as horizons get longer. This intuition is also confirmed by recent academic research, illustrated below.

Chart 7: Interest rate variance dominates corporate cash flow variance as horizons extend



Source: Nomura, Andrews, Spencer and S. Gonçalves, Andrei, 2025. From Bonds to Dividend Strips: Decomposing the Equity Premia Term Structure, Figure 1(d), Kenan Institute of Private Enterprise Research Paper Forthcoming.

In sum, swaptions might be useful hedges for credit and equity

We started by showing that long positions in swaption straddles have gone up during major drawdowns in high yield credit. We then noted that major asset class benchmarks, including equity, bonds, loans and CDS, also show short beta to long positions in swaption straddle returns. In effect, every major benchmark is short interest rate volatility, and the short beta is most evident in the “lower right” part of the swaption surface, where both expiries and forward tenors are longer term.

We then examined why this might be the case, noting that interest rate variance has little impact in options where expirations are less than six months, as is the case in most listed option markets. However, interest rate variance does play an important role as expirations get longer. Many options on FX or equity underlyings may in effect be dominated by interest rate variance as expirations get longer.

Both equity and credit assets can be viewed as portfolios of short put options, with expirations stretching many years into the future, on the underlying asset value of firms. This asset value is itself dependent on cash flows many decades into the future. Some academic studies estimate 80% of US equity risk is driven by cash flows beyond the 10 year horizon.

Hence, given equity and credit are exposed to long-expiry options on long-horizon cash flows, it makes sense that most portfolios are materially short interest rate volatility. Long positions in swaptions can help provide balance.

For more information about the performance drivers of swaptions, especially why their carry and total return properties are attractive, please see our 2023 piece, “Swaptions for the long run.”

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