INVESTMENT MEMO

FLOATERS: PARTICIPATING IN THE UPSIDE OF HIGHER RATES

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MERGANSER TODAY

The Merganser team has been investing in investment grade floating rate securities since the 1980s and has developed a deep understanding of this niche asset class.

With front-end rates anchored at record low levels, yield starved fixed income investors are searching for ways to earn incremental income. A few options include: extending duration by moving out the yield curve, going down in credit quality, or introducing alternative (less liquid) vehicles such as private credit. Institutional investors who favor capital preservation, liquidity and higher quality parts of the market may be surprised to learn of another alternative – investment grade floaters. In this paper, we'll explore floating-rate securities in greater detail and highlight some of the associated benefits in a rising rate environment.

FLOATING RATE MECHANICS

Within investment grade fixed income, most floating-rate securities ("floaters"), have a coupon that resets periodically (typically measured in days or months, not years) based on a reference index. The most commonly referenced indices are one-month and three-month London Interbank Offered Rate ("LIBOR") and the Secured Overnight Financing Rate ("SOFR"). The result of this structure is that the price of such a security has little interest rate sensitivity since the coupon adjusts with changes in the reference index (with a small lag). Many investors find this to be a valuable feature during periods of rising rates. Examples of sectors that contain high quality floaters include Treasuries, prime loans, corporate bonds, Government Sponsored Entity ("GSE") debentures, GSE-backed mortgage-backed securities ("AMBS"), municipal debt, sovereign debt, asset backed securities ("ABS"), and non-agency commercial mortgage-backed securities ("CMBS"). For illustrative purposes in this memo, we will focus on corporate debt, but the same general principles apply for other asset types.

As a general rule, fixed-rate instruments will return a known fixed coupon plus par upon maturity (assuming no default), regardless of the interest rate path. Stated differently, the return over the life of a fixed coupon security is known with near certainty, but the timing of those returns month-by-month is not. Conversely, the ultimate total return of a floating-rate security is not known since the timing and size of cash flows are dependent on the path of interest rates.

Investor demand for floaters has been modest over the past few years since the Fed stepped in to support the economy at the onset of the pandemic. Further, floater issuance is somewhat subdued as corporations have been terming out debt by issuing longer dated bonds that lock in low interest rates for many years. As the Fed's liftoff date approaches, we expect demand for floating-rate securities to build, and it is reasonable to expect issuance to increase as well. Corporate floating-rate issuance was approximately $69 billion in 2021, only 5% of total investment grade issuance. Floaters were 5% of all ABS issuance as well, *We believe the floating-rate market can present opportunities that nimble active managers can turn to their advantage.*

representing approximately $13.2 billion of total market value. In recent years, there have been dramatic increases in floating-rate issuance within both Agency and Non-Agency CMBS, with 22% and 62% of total issuance in 2021, respectively.[1] Although the size of the floating-rate market relative to the traditional fixed-rate market can present capacity concerns, we believe it can also present opportunities that nimble active managers can turn to their advantage.

THE "OTHER" FLOATING RATE CLASS

For many investors, the primary association with floating-rate strategies is the leveraged loan (or bank loan) market. This association is understandable given the increased prominence and size of this market following the financial crisis along with its exclusively floating-rate structure. However, the similarities to the investment grade floating-rate bond universe quickly dissipate beyond the resetting of coupons. Of the differences between the two investments, the following aspects are the most important considerations for investors:

- Credit Risk: The bank loan market is predominately loans to below investment grade-rated corporations. Given the volatility of the underlying fundamentals of junk borrowers compared to investment grade borrowers, bank loans tend to perform substantially worse than investment grade floating-rate bonds during periods of macroeconomic shock. During 1Q 2020, bank loan prices declined as much as 20% while investment grade floating-rate bonds fell as much as 3.87%. By the end of 2Q 2020, the investment grade floating-rate notes returned to positive total returns for the year while Bank Loans remained more than 4.5% down YTD.[2]

- Liquidity Risk: Bank loans are not securities and therefore do not trade in a manner comparable to traditional fixed income, with settlements taking as much as 20 business days versus the standard two days (or shorter) for traditional investment grade fixed income.

- Interest Rate Risk: Unlike traditional investment grade floating-rate bonds, most bank loans contain a provision for the coupon to be fixed up to a certain level of the reference rate (typically 1%). With rates currently near zero, this coupon "floor" introduces interest rate risk as rates rise because coupons do not adjust higher until this floor is breached. With standard loan terms, this can be a substantial drag on total returns.

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FIXED VS. FLOATING COMPARISON

The table below shows representative characteristics for a fixed-rate security and floating-rate security issued by a single issuer with the same maturity.

EXHIBIT 1: FIXED VS. FLOATING RATE CHARACTERISTICS

	COUPON	YIELD AT ISSUE	DURATION	MATURITY
2-Year Fixed	0.75%	0.75%	1.95 yrs	11/3/2024
2-Year Floating	SOFR+23	0.28%	0.00 yrs	11/3/2024

Source: Bloomberg as of 11/3/2021

1. Floating rate new issue data: ABS (J.P. Morgan Securities), Corporates (Barclays), CMBS (Wells Fargo Securities)
2. S&P/LSTA US Leveraged Loan 100 Index and Bloomberg US Floating Rate Note Index

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The divergence in yield and duration of the two securities underscores the trade-offs between fixed- and floating-rate bonds. The fixed-rate security has a higher yield than its floating-rate counterpart at new issue. The increase in yield is due in large part to the increased interest rate risk exposure. When interest rates rise, the price of the fixed coupon bond will fall and offset the higher initial coupon. The investor in a floater will receive a lower yield at issuance as rates are held down by the Fed but will benefit as rates rise. The coupon will automatically adjust higher as the reference index increases and the price will suffer only small declines absent spread widening compared to its fixed-rate counterpart.

SCENARIO ANALYSIS

Scenario analysis can be helpful in deepening the understanding of performance dynamics associated with floating-rate bonds versus their fixed-rate counterparts. Using the same securities shown above, the following analysis illustrates the total return profile of the two-year fixed-rate security versus the two-year floater.

EXHIBIT 2: FIXED VS. FLOATING RATE RETURNS

	ACTUAL TOTAL RETURN	EXPECTED TOTAL RETURN		
	SINCE ISSUE TO 1/31/2022	YEAR 1	YEAR 2	ANNUALIZED TR
2-Year Fixed	-0.77%	-0.12%	1.64%	0.76%
2-Year Floating	-0.06%	0.59%	1.70%	1.14%

Assumptions: Forward rates as of 1/31/2022, pricing source Bloomberg

While initially priced to provide similar returns by maturity, the significant changes in rate expectations since November 2021 caused the balance to shift decisively in favor of the floating-rate security, which provides cumulative returns more than 65 basis points (bps) ahead of the fixed-rate bond. The floating-rate note's added stability of principal in response to volatile rate conditions is also attractive for investors who value more predictability in their fixed income portfolios. Clearly, if rates remain static through maturity, the fixed-rate security has the superior return profile due to the greater coupon income. If rates rise by 100 bps immediately after one year, a floating-rate coupon is preferable due to the lower duration and increase in carry.

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As shown above, floaters are superior immediately after rate increases because the duration of the fixed coupon bond leads to a fairly significant drop in value. Over the remaining time to maturity, the fixed-rate investor still receives the coupon, and over time the bond price slowly pulls back to par, which results in total return converging with the original yield to maturity at purchase. Regardless of what happens to interest rates, the total return of the fixed-rate security will equal its purchase yield if held to maturity. The floater, on the other hand, not only receives a higher coupon over the remaining two years of the investment, but its price remains close to par, resulting in a hold-to-maturity total return that is greater than the original purchase yield.

A boutique approach to the floating-rate space by a smaller, more specialized manager is particularly warranted.

CONCLUSION

At Merganser, our portfolios contain a combination of fixed-rate and floating-rate securities, and we are constantly evaluating the relative value of each. As the current rate cycle evolves, we believe investors would be well served by dedicating a portion of their investment grade portfolio to high quality, floating-rate securities. Assuming rates continue to rise, investment grade floaters will provide a more stable total return profile and benefit from increased levels of income relative to fixed rate securities. Relative to the widely followed bank loan market, these securities are higher quality, do not contain the same floor provisions and enjoy stronger liquidity in different market environments. Finally, we believe the transition away from LIBOR demands an active approach to portfolio management and an ability to identify and source sufficient supply of transition appropriate securities. As such, a boutique approach to the floating-rate space by a smaller, more specialized manager is particularly warranted as investors seek ways to maintain investments in high quality bonds while also benefiting from rising rates.

CONTACT INFORMATION

Merganser Capital Management
99 High Street
Boston, MA 02110
www.merganser.com

Consultant Relations & Business Development
P: 617.528.4863
info@merganser.com