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Floaters: Why and When

With the Federal Reserve keeping rates on hold at extraordinarily low levels, fixed income money managers have difficult choices to make: buy what the Fed buys and keep duration long in order to capture yield further out the curve, go further out the risk or liquidity curve, or look ahead and realize that rates have nowhere to go but up and position the portfolio accordingly. Institutional investors who choose the latter approach, or are otherwise focused on the short end of the curve, can find capital preservation, liquidity, and incremental total return in bank deposits, money market funds, floating-rate portfolios, and short duration investment grade portfolios. A key component of many of these products is floating-rate securities.

Most floating-rate securities, or "floaters", have a coupon that resets periodically (typically measured in months, not years) based on a reference index. The most commonly referenced indices are one-month and three-month LIBOR. 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). Obviously, this is a valuable feature during a period of rising rates. Some types of high quality floaters available today include prime loans, corporate bonds, GSE debt, municipal debt, sovereign debt, and certain asset backed securities (ABS). For illustrative purposes in this memo we will focus on corporate debt and ABS, but the same general principles apply for other asset types.

It is worth a reminder that fixed-rate instruments will return par upon maturity (as long as there is no default) regardless of the interest rate path. Stated differently, the return over the life of a fixed coupon security is known with certainty, but the timing of those returns month-by-month are not known. The ultimate total return of a floating-rate security is not known since the actual cash flows are dependent on the path of interest rates.

Investor demand for floaters has been modest over the past few years as the Fed has communicated that it will maintain current monetary policy for an extended period of time. 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. Corporate floating-rate issuance was approximately $40 billion in 2012, only 4% of total investment grade issuance[1]. The ABS market is much smaller, but a higher percentage of issuance has floating-rate coupons. Floaters were 32% of all ABS issuance in 2012, which represents approximately $62 billion of total market value[2].

[1] Bank of American Merrill Lynch

[2] JP Morgan

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As demand for floating-rate securities builds, it is reasonable to expect issuance to increase as well. In fact, even the US Treasury is considering the issuance of floating-rate Treasury notes.

The table below shows representative characteristics for two fixed-rate securities and two floating-rate securities of similar maturity.

Table 1 shows the representative characteristics for two fixed-rate securities and two floating-rate securities with similar maturites.

Table 1 - Fixed vs. Floating

Security Type	Coupon	Yield as of 12/31/2012	Duration
Corporate A/AA Rated 3 Year Maturity			
Fixed-Rate	1.00%	1.03%	2.93
Floating-Rate	3 Month LIBOR + 20 basis points	0.81%	0.25
Credit Card AAA Rated 3 Year Maturity			
Fixed-Rate	0.54%	0.57%	2.75
Floating-Rate	1 Month LIBOR + 13 basis points	0.35%	0.08

Source: Bloomberg, Merganser

In each instance above, the fixed-rate security has a higher yield than its floating-rate counterpart. The increase in yield is due in large part to the increased interest rate risk exposure. Clearly, if investors choose not to "fight the Fed," they are rewarded with higher yields by extending duration using a fixed-rate security. That strategy will maximize total returns until interest rates rise. 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 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.

The trade-offs are clear, but the question remains, which security is better? The answer is also clear in a rising rate environment, it's only a question of time.

Scenario Analysis*

The following scenario analysis illustrates the total return profile of a three-year fixed-rate security and a three-year floater in two cases: no change in interest rates, and a 100 basis point upward shift in rates after one year.

Table 2 illustrates the total return profile of a three-year fixed-rate security and a three-year floater in two cases: no change in interest rates, and a 100 basis point upward shift in rates after one year.

Table 2 - Changes in Rates

	No Interest Rate Change	Increase of 100 basis points at 1 year	
Corp A/AA Rated 3 Year	Annualized Total Return to Maturity	Annualized Total Return at 1 Year	Annualized Total Return to Maturity
Fixed-Rate	1.03%	-1.19%	1.03%
Floating-Rate	0.81%	0.81%	1.48%

*For the purposes of all analysis in this Memo, we assume parallel shifts in the yield and LIBOR curves, no spread changes, and no reinvestment of coupon income.

Clearly if rates don't rise for three years, the fixed-rate security has the superior return profile due to the higher amount of coupon income. If rates rise by 100 basis points immediately after one year, a floating rate coupon is preferable. Immediately after the rates rise, floaters are superior because the duration of the fixed coupon bond leads to a fairly significant drop in value immediately after the increase in rates. Over the remaining time to maturity, the fixed-rate investor still receives the coupon, and over time the bond price pulls back to par, which results in total return converging to the yield to maturity at the time of purchase. Regardless of what happens to interest

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rates, the total return of the fixed-rate security will equal its yield if held to maturity. The floater, on the other hand, not only ends up receiving a higher coupon over the remaining two years of the term of the security, but it has also held its value, resulting in a hold-to-maturity total return that is greater than the yield to maturity at purchase.

This is a rather simple scenario analysis that is helpful in understanding the drivers of total return and relative value of fixed-rate and floating-rate securities. The key determinants of relative value in a real-world assessment of value are the timing and magnitude of potential interest rate increases. In short, the floater is preferable if rate rises are sooner or larger, the fixed-rate security space is preferable if rate rises are later or smaller. We calculated the total return of the two securities shown in Table 2 under two different interest rate scenarios to determine when the rate rise would need to happen over the 36-month term in order for the floating-rate security to have the higher total return.

- Scenario one—50 basis point increase: If the 50 basis point increase happens at any time within the first 21 months, the floater is superior.
- Scenario two—100 basis point increase: If the 100 basis point increase happens at any time within the first 28 months, the floater is superior.

These are still simple examples, and much will depend, among other things, on the relative coupons of the two securities, the forward path of rate increases, and the nature of the reset. In general, if an investor believes rates are going higher over the next two years or so, floating-rate product offers a compelling total return profile.

Alternatives

This type of scenario analysis can help investors prioritize goals, better understand interest rate sensitivity and compare floaters to other alternatives in the short duration sector. Also relevant are the recent and proposed legislative changes to bank deposits and money market funds.

Bank deposits currently have close to zero total return prospects and the risk associated with the deposits has recently increased. The FDIC insurance plan, the Transaction Account Guarantee program insuring deposits above the general limit of $250,000, expired last month. For large institutional investors, this effectively means bank deposits over the minimum move from a government guarantee to bank credit risk.

Money market funds have been struggling with regulatory uncertainty since the Reserve Fund broke the buck in the fall of 2008. Proposed legislative changes, including a floating NAV and clawback features, have made this investment less attractive to many investors. This is particularly true given the lack of any meaningful total return in the product.

Floating-rate portfolios are a viable alternative to bank deposits and money market funds. There is minimal interest rate sensitivity and liquidity in the investment grade space is robust. This type of portfolio makes the most sense for investors who are very loss sensitive over periods measured in months, have uncertain timing needs for their capital, and are willing to forgo incremental return potential relative to a short term bond portfolio in a low and stable rate environment. At the time of publication, a portfolio that represents a blend of corporate and ABS floating-rate securities had a yield of between 60 and 75 basis points. As the above scenario analysis demonstrates, this type of portfolio is particularly compelling if an investor believes the Fed will raise rates within the next two years.

Cash enhancement and short term bond portfolios have fixed-rate benchmarks at the short end of the curve, typically the 6-Month T-bill, 1-Year T-bill, and 1-3 Year US Treasury. These portfolios have very short durations and invest in a wide variety of securities with both floating- and fixed-rate coupons. The typical yields for these

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portfolios in today's interest rate and spread environment can reach or exceed 100 basis points depending on client guidelines. Investors willing to introduce a modest amount of interest rate sensitivity benefit from the diversification of a broader range of securities and the potential of a higher yield.

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. However, accounts with a traditional duration benchmark of 1-year or greater are limited in the amount of floating-rate exposure that can be introduced. In order for the manager to maintain compliance with portfolio-level duration benchmarks, any increase in floater exposure would need to be offset with a longer duration fixed-rate coupon security. Clients desiring a higher percentage of floating-rate securities as the interest rate cycle evolves may wish to consider adjusting guidelines to include a floating-rate benchmark (such as LIBOR), or introducing a new separate account.

Given the combination of low returns and changes in both FDIC insurance and the money fund industry, we believe investors in these products can do better. Floating-rate portfolios have relatively compelling yields and react favorably in a rising interest rate environment. Floating-rate and short duration bond portfolios are both viable and compelling alternatives that combine meaningfully higher total return prospects, liquidity, and high quality underlying assets.

For more information on Merganser Capital Management and our investment strategies, please visit www.merganser.com.

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