GRANT'S
CELEBRATING 40 YEARS
INTEREST RATE OBSERVER®
Vol. 41, No. 21c
233 Broadway, New York, New York 10279 • www.grantspub.com
NOVEMBER 10, 2023

Rate flotation devices

Yields will fluctuate, approximately said J.P. Morgan, but in which prevailing direction? If, as we expect, bonds have entered a protracted bear market, the direction will be higher, albeit with sometimes-sharp cyclical reversals in trend. Floating-rate notes are the subject at hand.

The very existence of floating-rate Treasury securities was once a well-kept secret; 40 years of persistently declining yields, 1981–2021, seemed to render them pointless. "As recently as the end of 2021," Dhruv Nagrath, director of fixed-income strategy at BlackRock, Inc., tells colleague James Robertson, Jr., "the iShares Treasury Floating Rate Bond ETF (TFLO on the NYSE Arca) was a $300 million fund." Now it holds more than $10 billion.

Ten billion dollars, while not exactly nothing, pales in comparison to the investor stampede into long-dated, fixed-rate securities. In 2023, "across the industry," says Nagrath, "there's been $152 billion of inflows into bond ETFs. And about $102 billion of that has been into Treasury exposures." Assets of the iShares 20+ Year Treasury Bond Fund (TLT on the Nasdaq) have ballooned by 55% and now stand at $41 billion. The influx is all the more striking because, the recent ferocious bond rally notwithstanding, the fund is down on the year by 16%.

Of course, the very speed of the surge in the federal funds rate, to 5½% from zero in just two years, set up the conditions for a reversal in trend. Martin Rees, Britain's Astronomer Royal, once said that, with regard to his confidence in a certain scientific proposition, he wouldn't bet his life on it, but he would bet his dog's. On the *Grant's* expectation of "higher for much, much longer," we are prepared to wager one feral cat.

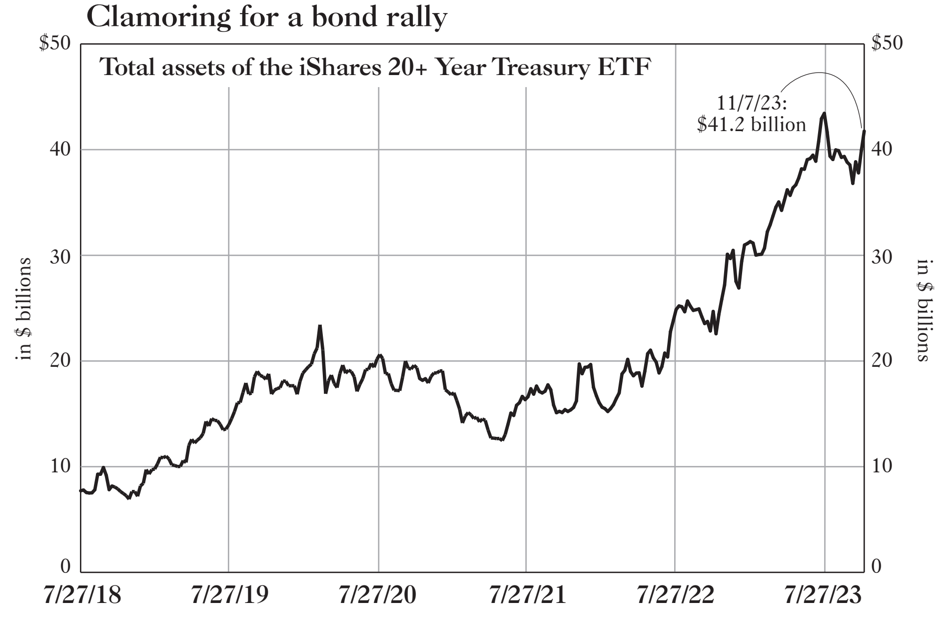
With the knowledge of how little we know, we therefore continue to look for opportunities to profit both by rising and falling rates. Also, on rates that remain the same. The great bear bond market of 1946–81 saw periods of dead calm (e.g., the early 1960s) as well as times of high volatility (e.g., 1979–81). Deeply discounted, long-dated Treasury strips provide asymmetric exposure to falling rates—the speculator has much more to gain from declining yields than to lose from rising ones (*Grant's*, Oct. 27). Historically cheap mortgage-backed securities offer a different kind of exposure to falling rates.

"Variable-coupon notes are the mirror image of orphaned high-convexity long-bond strips," Robertson points out. "With a deeply discounted zero-coupon Treasury, an investor hopes for rate cuts that would deliver significant capital gains. Government-issued floaters, meanwhile, trade close to par with the focus not on capital gains but on steady interest income.

"The appeal of a floating rate in a rising market lies in higher income without capital losses," Robertson goes on. "However, if rates do keep falling, you get a lower coupon but not a big haircut should you sell. Your portfolio is in a sense immunized against interest rate risk with near-zero duration."

The first floating-rate security in the

Clamoring for a bond rally



source: The Bloomberg

United States was a 15-year Citicorp issue that paid 9.7% right off the bat. It reset every six months at 100 basis points above the three-month Treasury-bill rate for the rest of its 15-year life. It debuted in July 1974, and the public roared its approval.

Anyone who lived through 1974 need not be reminded that, by year end, the CPI was climbing at a 12% annual rate. This was the annus horribilis in which "net-nets"—companies valued at less than their net current assets—proliferated on the New York Stock Exchange.

"Sinking-rate notes," the disappointed holders of the floating-rate securities began to mutter, since, at first, the adjusted rate lagged behind market rates. "The experience of the government allowing [sic] extremely high interest rates in attempts to dampen inflation failed," a *New York Times* columnist scolded on Nov. 3, 1974—"and did a lot of damage to financial markets. The effort, it is widely believed, will not be repeated."

"No one knows for sure, of course, how interest rates will move in the future," the columnist acknowledged, before insinuating (as we journalists sometimes do) his own predictive two cents: "Perhaps the most standard forecast is that they will stay high by historical standards but not climb as high as they did last summer." The then-current 9½% funds rate peaked seven years later at more than 19%.

Design improvements in today's floating-rate securities render them less susceptible than their 1970s forebears to interest rate risk. For instance, rate caps are less common, coupons reset more frequently and maturities tend to be shorter. Reinvestment risk remains the same, needless to say—arrival of the long-anticipated recession would likely set in motion a monetary-policy reversal that would drive FRN returns much lower, leaving the prudently hedged investor wondering why he ever listened to the confounded voice of prudence. The next turn in the cycle would remind him why.

Treasury floating-rate notes made their first appearance in 2014. The current series, due October 2025, yields 5.5%, or 60 basis points above the Treasury's 2-year note and 8 basis points over the 3-month bill yield. It resets weekly based on the 90-day bill rate plus a static, auction-determined spread.

The aforementioned iShares Treasury Floating Rate Bond ETF (TFLO on the NYSE Arca), which aims to track the Bloomberg US Treasury Floating Rate Index, delivers a standardized yield of 5.36% after 15 basis points of fees, based on interest earned in the past 30 days. One would buy it, rather than dealing directly with the Treasury, for the sake of not having to roll over one's position every three months.

The relatively small corporate wing of the FRN market is dominated by financial institutions, which issue floating-rate debt to finance their variable-rate assets. Nearly all floating-rate notes carry an investment-grade rating, and coupons are set at a premium to the secured overnight financing rate (SOFR). And because even an investment-grade company lacks the Treasury's taxing power, a credit spread provides an additional fillip of yield.

Corporate FRNs outstanding amount to $209 billion, down from $517 billion in 2018, according to the Bloomberg Floating Rate Note Index, as some companies shrewdly termed out their obligations at the pandemic interest rate lows. A smaller market means less liquidity, especially in times of stress.

Herewith a representative pair of corporate floaters:

• The JPMorgan & Chase Co. single-A-rated, senior unsecured notes of April 2027 trade at 99.65 to yield 6.3%. SOFR plus 88.5 basis points is the base rate.

• The American Express Co. single-A-minus-rated, senior unsecured floaters of October 2026 change hands slightly over par to yield 6.6%. The spread is set at 135 basis points over SOFR.

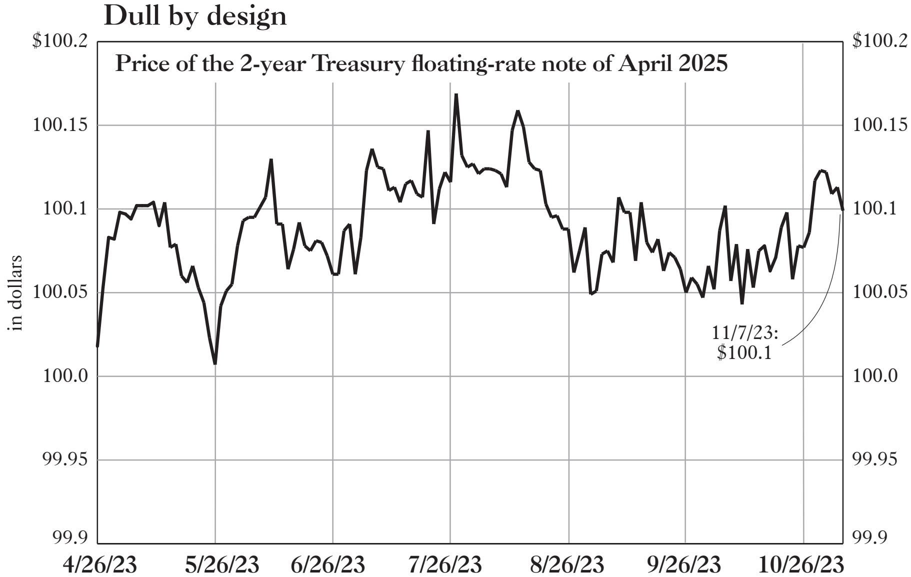
The iShares Floating Rate Bond ETF (FLOT on the Cboe BZX) is not exposed to collateralized loan obligations or leveraged loans as some other floating-rate funds are. The trade-off with floating-note funds, as opposed to floating-loan or multi-asset funds, is greater exposure to financial institutions.

"Yes, there is sector risk with financials," William Sokol, vice president and director of product management at VanEck, tells *Grant's* about floating-rate bond funds. "But generally speaking, these are your big money center banks, your systematically important banks that are highly rated. With CLOs, you are taking more exposure to high-yield corporates through leveraged loans. It's a very different underlying exposure."

In the universe of exchange-traded floating-note funds, the yields on offer after expenses range between 114 and 147 basis points of spread above the 2-year government yield or between 63 and 96 basis points over the 3-month yield. Is that enough? It stands to be wider in the next recession.

FLOT, a BlackRock-sponsored fund, seeks to track the performance of the Bloomberg US Floating Rate Notes 5 Years and Less Index. Largest in its class, the fund holds $7.6 billion in as-

Dull by design



source: The Bloomberg

sets with 59% in floating notes of banks and insurance companies, 18% in supranational issuers and the remainder spread across 13 other sectors. The largest issuers that the fund holds are the International Bank for Reconstruction and Development and The Goldman Sachs Group, Inc.

Credit quality across the portfolio breaks down into 52% single-A-rated bonds, 23% in triple-A, 15% in double-A and 9.8% in triple-B. The fund's standardized yield comes to 6.08% after 15 basis points of fees.

Seeking to replicate the same index as the iShares fund, the SPDR Bloomberg Investment Grade Floating Rate ETF (FLRN on the NYSE Arca) yields 6.05% after 15 basis points of expenses. Top holdings include the floating-rate notes of the International and European Banks for Reconstruction and Development.

The ETF holds $2.5 billion in issuers rated triple-A (25%), double-A (15%), single-A (50%) and triple-B (9.5%). Notes issued by financial concerns make up 59% of the portfolio while those of supranational issuers amount to 19.7%. The rest of the assets are divided among industrials (14.4%), foreign agencies (4.2%), utilities (1.6%) and cash.

Another fund, the VanEck Investment Grade Floating Rate ETF (FLTR on the NYSE Arca), which tracks the MVIS US Investment Grade Floating Rate Index, counts $1.33 billion in assets. Of the bonds held by the fund, 91% come from financial issuers. The top three holdings are JPMorgan Chase & Co., Citigroup, Inc. and Bank of America Corp.

About half of the holdings carry a single-A rating with 28% in triple-B-rated paper and 15% in double-A-rated issuers. FLTR yields 6.38% after deducting 14 basis points of fees.

•