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Floating-Rate Bonds: Switching One Risk for Others

Floating-rate bonds (FRB) and FRB funds are attracting investors searching for more income and capital protection. Strong performance has compounded the attraction. The primary benefits of FRBs seem compelling, but there are risks: credit risk, liquidity risk, concentration risk and valuation risk. In this piece, we address each.

Floating Rate Bond Risks:

Credit Risk: Issuers tend to be non-investment grade, increasing the potential for default.

Liquidity Risk: The market for FRBs has grown significantly, but remains vulnerable to "shocks."

Valuation Risk: Recent demand has pushed prices for FRBs up, leaving less of a margin of safety for long-term investors.

Little Diversification Benefit: Returns for FRBs have moved more in line with stocks vs. other bonds.

What is a Floating Rate Bond?

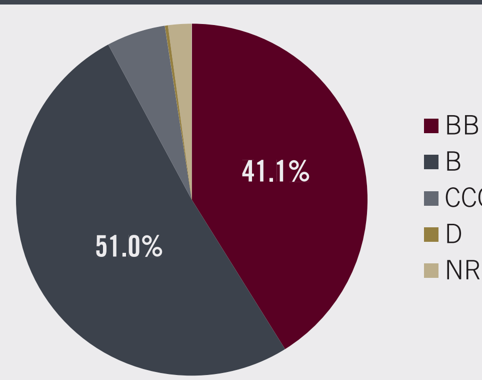
Unlike traditional bonds, FRBs do not have a fixed rate coupon. Instead, their rate fluctuates or floats based on the market (often the quarterly London Interbank Offered Rate or LIBOR) plus a spread. As a result, FRBs tend to be less vulnerable to interest-rate fluctuations. Many believe FRBs can help preserve principal, while offering above-average yields—especially if rates rise.

Typically, FRBs are issued by banks or other financial firms to companies. These loans are often pooled and sold to investors. FRBs are fairly senior in terms of a company's capital structure. That means FRB holders have a high priority claim on company assets in the event of bankruptcy. However, it does not protect against the *potential* for default.

Swapping Interest-Rate Risk for Credit Risk

In essence, FRB investors are exchanging one risk for another; they are minimizing interest-rate risk, but exposing themselves to greater credit risk. While there are investment-grade (IG) publicly issued floating rate bonds, they are a small segment of the IG market and largely purchased by institutional investors. Today, the FRB market for individual investors is essentially synonymous with bank loan funds.[1] And as shown in the credit profile of the Barclays U.S. High Yield (HY) Loan Index, a proxy for bank loans (Exhibit 1), more than 92% of the market is BB or B rated (the rest is CCC or worse). Keep in mind that anything below BBB- is considered non-investment grade or "junk."

Exhibit 1: FRB Market, Synonymous with High Yield, Reflects Credit Risk
Barclays U.S. High Yield Loan Index Credit Profile



Source: Barclays U.S. High Yield Loan Index, as of 3/31/2014. NR means not rated. Credit ratings provided by Barclays Capital.

Given their higher credit risk, it's not surprising that default rates for FRBs are significantly higher than investment-grade bonds—3.4% vs. 0.1%.[2]

[1] Bank loans are privately negotiated transactions. Unless individuals are accredited investors, they only could purchase bank loans via a mutual fund.

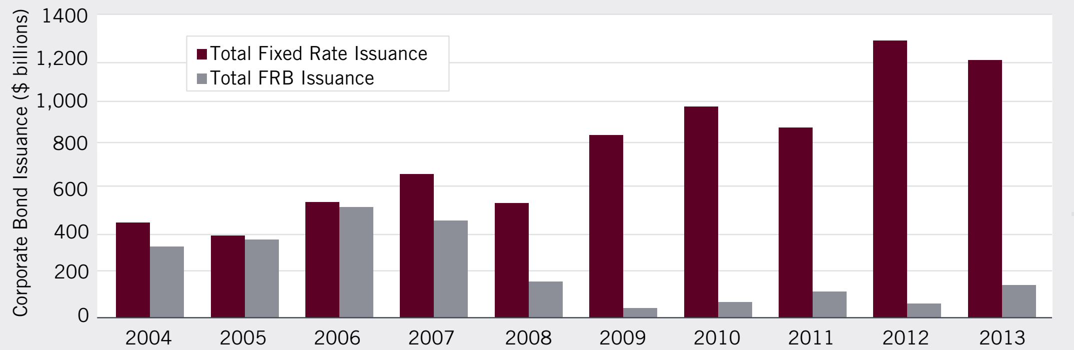
[2] Bennyhoff, CFA., Donald G. and Yan Zilbering. "A Primer on Floating-Rate Bond Funds." Vanguard. September 2013. Average annual default rates between 1996 and 2012.

Supply/Demand Disparity May Create Liquidity Risks

Assets in FRB funds nearly doubled in 2013, growing from $71 billion to $140 billion—including $62 billion in new money, according to Morningstar data. Although FRB issuance has grown the last few years, it pales in comparison to fixed-rate bond issuance, as shown in Exhibit 2.

FRB issuance lags fixed-rate issuance creating a potential supply/demand imbalance.

Exhibit 2: FRB Issuance Lags Fixed-Rate Issuance Creating a Potential Supply/Demand Imbalance



Source: SIFMA and Thomson Reuters, as of 12/31/2013.

In 2013 alone, FRB issuance was about $152 billion vs. $1.2 *trillion* for fixed-rate bonds. The lack of a deeper FRB market could create liquidity issues during a period of market stress and send prices tumbling. While past performance does not guarantee future results, FRBs were hit hard during the financial crisis in 2008/2009—FRB funds averaged losses of 29%, underperforming the Barclays U.S. Aggregate Bond Index by 34%.[3]

Potential Limits on Interest Rate-Risk Protection

Investors need to be aware of the potential disconnect between long- and short-term interest rates. Investors may look at the climb in 10-year U.S. Treasury rates in 2013 and assume (incorrectly) that coupons for floating rate notes will soon reset at higher rates as well. While the 10-year Treasury yield rose 1.27% in 2013, 3-month LIBOR fell 0.07%; longer-term yields don't always move in sync with shorter-term yields and FRBs may not always provide the protection against interest-rate risk investors seek.

In addition, some FRBs have features called floors and caps that may limit investor participation as rates fluctuate. Floors are a minimum level of interest to be paid. For example, if the floor were 2% for an FRB and the market rate plus spread were only 1%, the FRB would pay 2%. That sounds good, but if the market rate rose to 1.75%, the value of the FRB would decline (bond prices move in opposite directions of rate changes), but the interest rate would remain 2%. In this case, an investor would not realize a benefit of higher rates until those rates exceeded the floor. And, until then, the investor would be susceptible to short-term losses in the value of the FRB.

Conversely, some FRBs have caps, an upper limit on how much interest it will pay, regardless of how high interest rates go. While less of an issue relative to credit and liquidity risk, floors and caps are components of FRBs investors may wish to investigate.

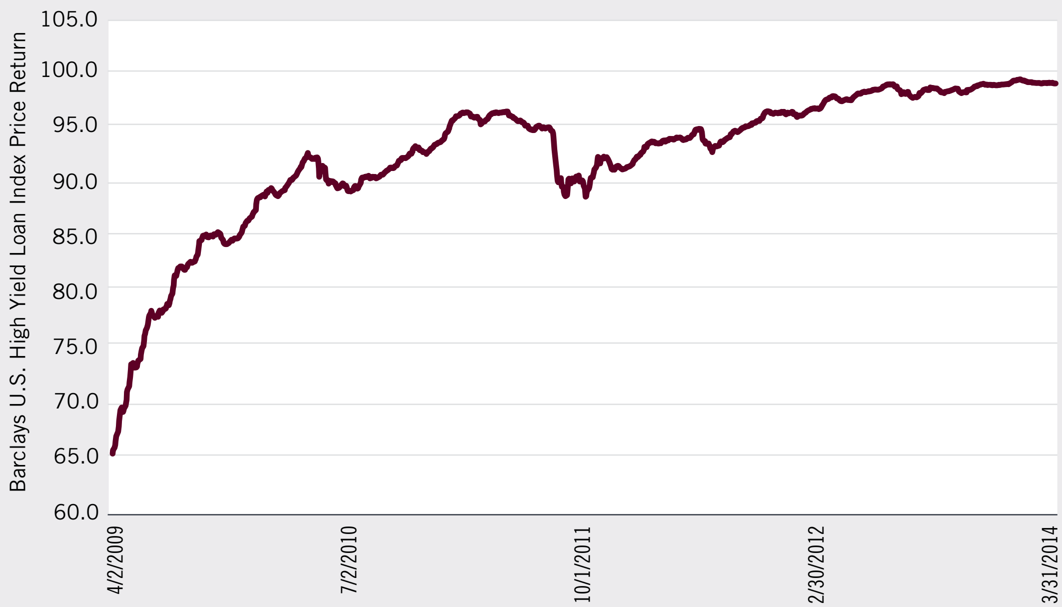
[3] Larry Swedroe, "Sell, Don't Buy, Floating-rate Note Funds" *Seeking Alpha*, December 31, 2013.

FRB Valuations Not Attractive

Strong recent returns for FRBs have pushed their prices higher—perhaps too high for investors seeking current yield *and* meaningful appreciation potential. Exhibit 3 shows the price appreciation of the Barclays U.S. HY Loan Index, up more than 40.0% in the last five years.[4] In our view, such rapid gains reflect investors overpaying for interest-rate risk protection and, as a result, mispricing the credit component of these instruments. At these prices, we believe investors are overpaying for yield and putting themselves at risk for a pullback.

Strong, recent gains for High Yield Loan Index may create greater risk for pullback.

Exhibit 3: Strong, Recent Gains for High Yield Loan Index May Create Greater Risk for Pullback



Source: Barclays U.S. High Yield Loan Index, as of date 3/31/2014. Past performance is not a guarantee of future results. One cannot invest directly in an index.

Little Diversification Benefit

Some investors looking to FRBs to diversify their exposure to stocks may be disappointed. Exhibit 4 shows the high correlation of 0.62 between the Barclays U.S. HY Loan Index and S&P 500 Index (based on monthly returns). The correlation between the Barclays U.S. Aggregate Index (a broader bond index) and the S&P 500 index over the same period was 0.05, significantly lower.

Exhibit 4: High Yield Loan Index Shows Higher Correlation with Stocks vs. U.S. Aggregate Index
Correlation Based on Monthly Returns, January 1, 2006 to March 31, 2014

	S&P 500 Index
Barclays U.S. High Yield Loan Index	0.62
Barclays U.S. Aggregate Index	0.05

Source: Barclays, as of 3/31/2014.

[4] Price return for this index is calculated using daily prices. Any loan balance that is paid down is assumed to have been paid down at par.

The Barclays U.S. Aggregate Bond Index is an unmanaged index consisting of U.S. dollar-denominated, fixed-rate, taxable bonds. The U.S. Aggregate Bond Index is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM passthroughs), ABS, and CMBS. The U.S. Aggregate rolls up into other Barclays flagship indices such as the multi-currency Global Aggregate Index and the U.S. Universal Index, which includes high yield and emerging markets debt. The U.S. Aggregate Index was created in 1986, with index history backfilled to January 1, 1976. The index is a total return index which reflects the price changes and interest of each bond in the index.

The S&P 500 Index with gross dividends is an unmanaged, market capitalization weighted index that measures the equity performance of 500 leading companies in leading industries of the U.S. economy. The index includes 500 leading companies in leading industries of the U.S. economy, capturing 80% coverage of U.S. equities. This index includes dividends and distributions, but does not reflect fees, brokerage commissions, withholding taxes, or other expenses of investing.

The Barclays U.S. High Yield Loan Index, also known as the Bank Loan Index, provides broad and comprehensive total return metrics of the universe of the syndicated term loans. To be included in the index, a bank loan must be dollar denominated, have at least $150 million funded loan, a minimum term of one year, and a minimum initial spread of LIBOR +125. The London Interbank Offered Rate (LIBOR) is an interest rate at which banks can borrow funds, in marketable size, from other banks in the London interbank market. The LIBOR is fixed on a daily basis by the British Bankers' Association. The LIBOR is derived from a filtered average of the world's most creditworthy banks' interbank deposit rates for larger loans with maturities between overnight and one full year. Source: Investopedia.com.

Margin of safety: The discount of a security's market price to its estimated intrinsic value.

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