FLOATING RATE TREASURIES: TAKING THE MYSTERY OUT OF THE TREASURY'S LATEST SUCCESS

By Rick Harper, Head of Fixed Income and Currency

The U.S. floating rate Treasury note[1] celebrates its fifth birthday in January 2019. The Treasury's newest securities have grown into a $357 billion market, generating robust investor demand and providing the Treasury with needed flexibility in managing the duration of its liabilities. For more than a few investors, however, the securities remain a curiosity.

Q: WHAT ARE FLOATING RATE TREASURY NOTES, AND HOW ARE THEY DIFFERENT FROM TREASURY BILLS AND NOTES?

Floating rate Treasury notes are securities whose coupons are linked to movements in short interest rates. Each day, their coupon rate is reset off the auction yield for the most recent 3-month Treasury Bill[2], plus or minus a fixed spread determined at the securities' initial issuance.

Since auctions for new 3-month Treasury Bills occur once a week, the coupon rate effectively changes weekly. Interest is accrued daily and distributed quarterly.[3]

Like all Treasury securities, they are backed by the full faith and credit of the U.S. government and are exempt from state and local taxes. Each issued note has featured a 2-year final maturity.

This contrasts with Treasury Bills, which don't pay a coupon and are instead issued at a discount to the principal at maturity. Income is generated as the security rises to par at maturity. Treasury notes, on the other hand, pay semiannual coupons and repay the principal at maturity.

All types of U.S. Treasury securities are exempt from state and local taxes.

Q: HOW BIG IS THE MARKET?

Very large and growing. Since the initial auction in January 2014, the outstanding market value for floating rate Treasuries has grown to $357 billion (as of October 31, 2018). At this same point in its genesis (December 2001), the universe for TIPS was only $127 billion. As of October 31, 2018, the Bloomberg Barclays U.S. Treasury Inflation Notes Index had a market value of $1.14 trillion. The index universe for floating rate corporates maturing in fewer than five years is only $477 billion.

[1] Floating rate Treasury note: A debt instrument that is issued by the U.S. government and whose coupon payments are linked to the 13-week Treasury Bill auction rate.
[2] Treasury Bill: A short-term debt obligation backed by the U.S. government with a maturity of less than one year.
[3] Floating rate Treasury notes pay interest quarterly, and the reference index is the weekly stop-out rate from the Treasury's 3-month bill auctions. The security's interest rate is reset daily, although in practice the auction stop-out rate means the rate changes only once a week.

On the issuance side, the Treasury has followed a fairly methodical approach. A new floating rate note (FRN) is auctioned every quarter, with monthly reopenings between each new auction. This has led to a stable investor base with deep liquidity[4].

In terms of demand, the bid-to-cover ratios—interest for the given supply of the notes at auction—have consistently exceeded 3x, similar to ratios associated with bill auctions and much higher than levels corresponding to note and bond auctions.

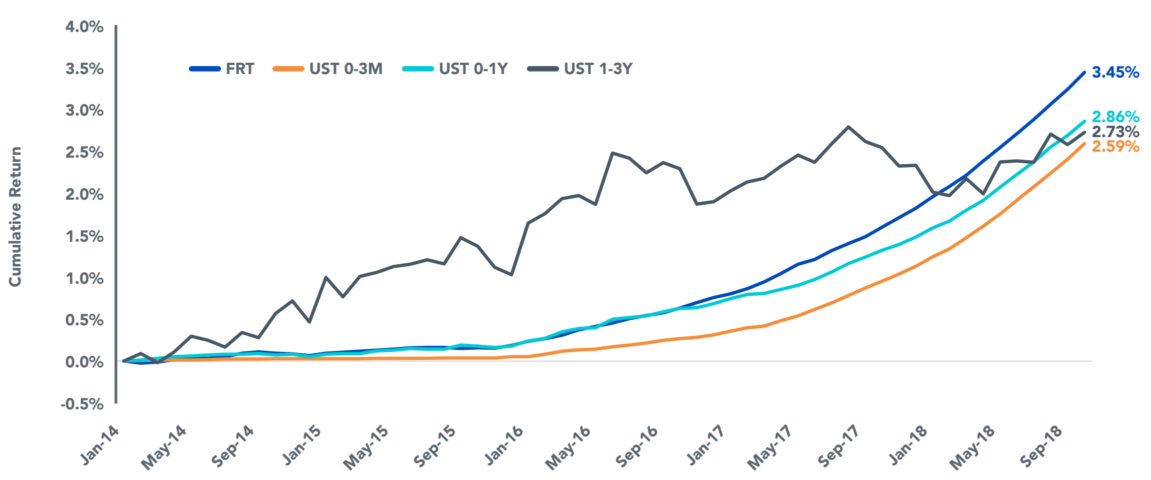
Inception	Treasury Product	Debt Outstanding ($mm) as of 10/31/2018	Bid-to-Cover*
3/1997	TIPS	$1,376,426	2.57
1/2014	FRN	$369,142	3.59

* TIPS bid-to-cover as of 9/20/2018. FRN bid-to-cover as of 10/24/2018.
Source: U.S. Treasury, as of 10/31/18. Treasury Inflation-Protected Securities (TIPS): Bonds issued by the U.S. government. They provide protection against inflation. The principal of a TIPS increases with inflation and decreases with deflation, as measured by the Consumer Price Index. When a TIPS matures, you are paid the adjusted principal or original principal, whichever is greater.

Q: WHAT HAS BEEN THE PERFORMANCE OF FLOATING RATE BONDS RELATIVE TO SIMILAR MATURITY TREASURY BILLS AND NOTES?

Floating rate Treasuries as an asset class have performed well relative to similar short duration products with comparable volatility since inception. However, the performance advantage of FRNs really started to accelerate once the Federal Reserve began lifting interest rates in December 2015.

Cumulative Returns of FRTs, Bills & 1-3Y Notes (1/31/14–10/31/18)



Source: Bloomberg, as of 10/31/18. Past performance is not indicative of future results.

[4] Liquidity: The degree to which an asset or security can be bought or sold in the market without affecting the asset's price. Liquidity is characterized by a high level of trading activity. Assets that can be easily bought or sold are known as liquid assets.

			Rising Rates	
Product	TR 12/31/2014–10/31/2018	Volatility 12/31/2014–10/31/2018	TR 12/15/2015–10/31/2018	Volatility 12/15/2015–10/31/2018
FRT	3.45%	0.20%	3.31%	0.17%
UST 0-3M	2.59%	0.19%	2.55%	0.19%
UST 0-1Y	2.86%	0.18%	2.72%	0.16%
UST 1-3Y	2.73%	0.72%	1.66%	0.77%

* Volatility calculated using full-month periods.
Source: Bloomberg, as of 10/31/18. Past performance is not indicative of future results.

With gradual Federal Reserve tightening likely to continue next year (in our view), investors need to remain cognizant of the interest rate risk embedded in Treasury notes of even 1-year to 2-year maturities.

Q: HOW IS THE FLOATING RATE MECHANISM DIFFERENT FROM MOST FLOATING RATE CORPORATE BONDS?

Most floating rate corporate notes offer coupon streams that are indexed to the 3-month London Interbank Offered Rate (LIBOR)[5] plus some spread in basis points (bps)[6]. Typically, their coupon rates reset quarterly. Income tends to be distributed quarterly as well.

Since corporate floaters reset less frequently than Treasury floaters, they may be less responsive to changes in Fed rates.

With the coming migration of floating rate issuance to a new benchmark by 2021, the Secured Overnight Financing Rate (SOFR) appears to be the most likely candidate to replace LIBOR as the benchmark reference rate. Interestingly, approximately $10 billion in floating rate notes that are linked to SOFR and employ a similar reset mechanism to floating rate Treasuries have been issued.

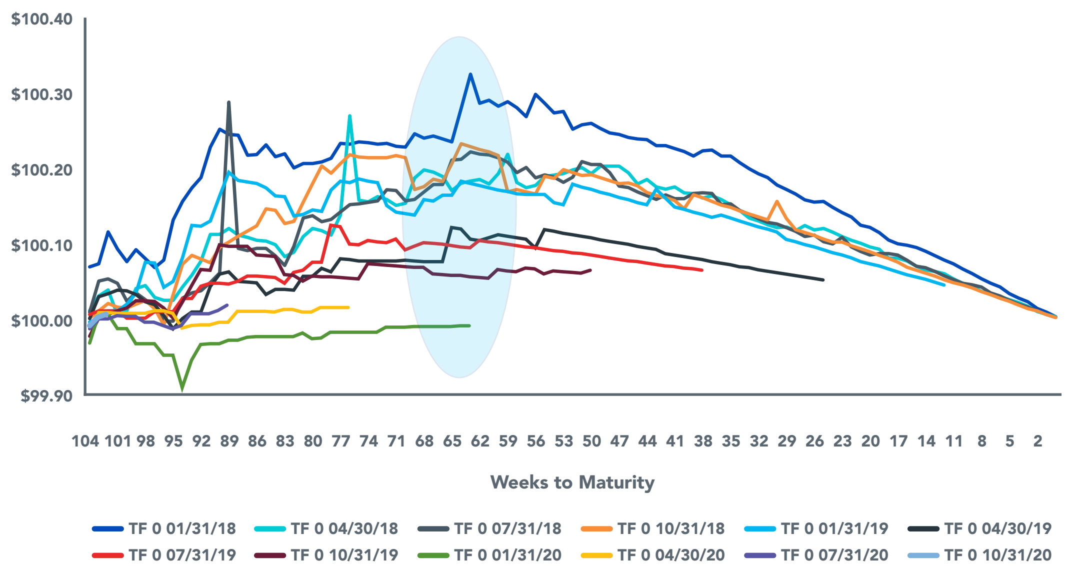
Q: WHY HAS FOCUSING ON FLOATING RATE TREASURY NOTES WITH MATURITIES GREATER THAN ONE YEAR BEEN PRUDENT?

When we designed our Index with Bloomberg, we decided to exclude FRNs with maturities of less than 12 months for the following reasons:

+ **Benefits from Supply/Demand Dynamics within Money Market Funds:** Money market investors who are heavily constrained by maturity restrictions are often interested in purchasing short-term paper right around the 1-year threshold. This dynamic has enabled securities to be removed from the Index at a premium (in larger proportions). At maturity, the floating rates notes are redeemed at par. As illustrated on the next page, the magnitude of the premium varies, but has remained persistent over the last three years.

[5] London Interbank Offered Rate (LIBOR): The average rate that major banks offer to lend to each other for short-term unsecured funds in a particular currency for a particular maturity in the wholesale money market in London. It can range from overnight to one year and is utilized as a benchmark for various loans and in the capital markets.
[6] Basis point: 1/100th of 1 percent.

Price History of Floating Rate Treasuries Issued After 2015



Source: Bloomberg, as of 11/2/18.

+ **Takes Advantage of Any Positive Term Premium for Floating Rate Treasuries with Longer Maturities:** Floating rate Treasuries with maturities of greater than a year have, on average, offered 6 bps more in yield than those securities with less than a year to maturity. Currently, the yield spread is 6 bps.
+ **Mitigates Government Shutdown Anxiety:** While any noise is likely to be short term in nature, anxiety about government shutdowns over the debt limit is an all-too-frequent occurrence for investors in short-term debt. Limiting Index constituents to those with more than a year to maturity diffuses some of this anxiety by mitigating principal risk. With the recent shift in control of the House of Representatives, this periodic headache of government shutdown brinkmanship is probably not going away anytime soon.

Q: CAN FLOATING RATE TREASURY NOTES BE EMPLOYED ACROSS MARKET ENVIRONMENTS AS A LOW-VOLATILITY ASSET?

Yes. Floating rate Treasuries were designed as a cost-effective alternative to the strategy of rolling Treasury Bills, an approach often employed by institutional investors. More frequent resets will lead floating rate Treasuries to outperform Treasury Bills in stable to rising rate environments. However, the opposite will also be true when the Fed is cutting rates. The speed and magnitude of the rise or fall in rates will drive the degree of outperformance or underperformance.

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There are risks associated with investing, including possible loss of principal. Securities with floating rates can be less sensitive to interest rate changes than securities with fixed interest rates, but may decline in value. The issuance of floating rate notes by the U.S. Treasury is new and the amount of supply will be limited. Fixed income securities will normally decline in value as interest rates rise. The value of an investment in the Fund may change quickly and without warning in response to issuer or counterparty defaults and changes in the credit ratings of the Fund's portfolio investments. Due to the investment strategy of this Fund, it may make higher capital gain distributions than other ETFs. Please read the Fund's prospectus for specific details regarding the Fund's risk profile.

Bloomberg Barclays U.S. Treasury Inflation Notes Index: Measures the performance of the U.S. Treasury Inflation Protected Securities (TIPS) market.

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