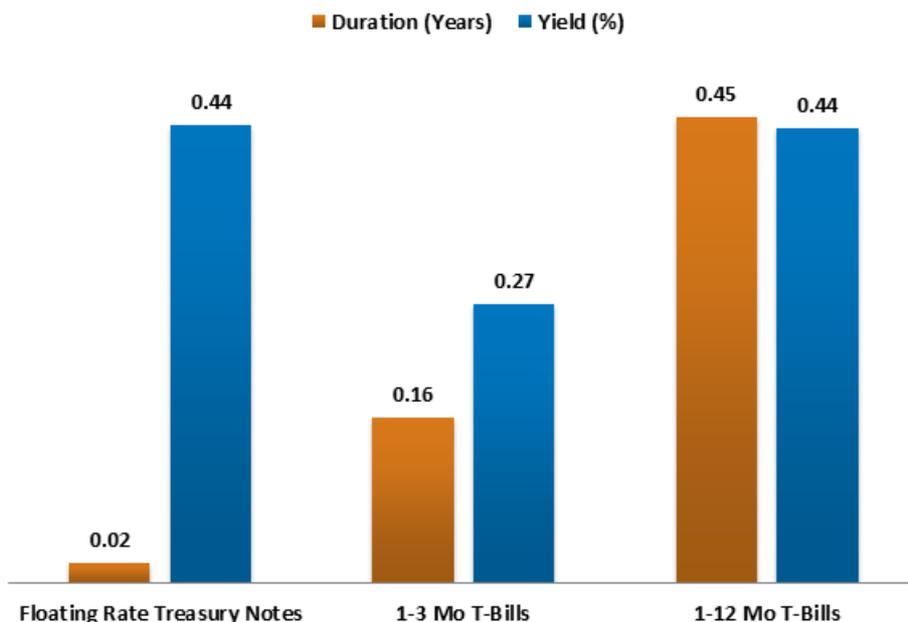


AS THE FED CONTINUES TO HIKE, WHAT'S YOUR BEST BET FOR SHORT TERM FIXED INCOME?

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The U.S. Treasury rarely issues a new type of security, but in January 2014 it issued the first [floating rate Treasury note \(USFRN\)](#). While investors are familiar with the concept of [floating rate bonds](#) issued by corporations, USFRNs are the first to be backed by the full faith and [credit](#) of the U.S. government. So far, the notes themselves have had a paltry [yield](#), averaging roughly 0.13% over the past two years.¹ However, since the [Federal Reserve's \(Fed\)](#) rate hike in December 2015, the yield on those notes has more than tripled to 0.44%.² When considering where to park assets for short-term [liquidity](#), investors should consider U.S. floating rate notes as an alternative to other commonly used strategies. USFRNs have a two-year [maturity](#), and the yield is reset weekly to the yield of the most recent 13-week [Treasury bill](#). As 13-week bills are auctioned each week, the yield on USFRNs resets as well. Therefore the risk that an investor would be locked into a two-year bond at a certain yield lasts for only a week, which is effectively the [duration](#). Historically, investors have used strategies tracking short-term Treasuries for their liquidity needs. While all Treasury securities are considered liquid and secure, not all provide the highest level of income for the same level of risk. All invest in highly liquid, high-quality, short-term instruments that are issued and payable in U.S. dollars, but as the chart below shows, the yields on each are pronounced different. Given that many of these vehicles are accessed in pooled funds, subtracting expense ratios of 0.15% can make the difference in yields that much more pronounced. **Short-Term Fixed Income (1/31/2016)**



Source: Bloomberg, 1/31/16. Past performance is not indicative of future results. You cannot invest directly in an index.

In the above chart: [Floating Rate Treasury Notes](#) are represented by the Bloomberg U.S. Treasury Floating Rate Bond Index. [1-3 Month Treasury](#)

Bills are represented by the Barclays U.S. Treasury Bills Index: 1-3 Months. **1-12 Month Treasury Bills** are represented by the Barclays Short Treasury Index. Even though the credit quality may be similar in these strategies, the maturity and duration can be quite different. The duration on USFRNs is one week, or 0.019, considerably lower than that of one- to three-month T-bills and one- to 12-month T-bills, as shown above. The yield and duration characteristics alone make USFRNs a better investment over other short-term fixed income alternatives from a risk/reward standpoint. Many investors employ a common strategy of [rolling](#) their Treasury Bill holdings every quarter. Investing in USFRNs, enables the investor to avoid the cost of eight purchases of T-bills over a two-year period. Not only does the investor reduce transaction costs, but USFRNs typically offer a [spread](#) over three-month Treasury Bills as compensation for holding the investment longer. Over the past 30 years, the average spread of the [Federal Funds Rate](#) over three-month Treasury Bills has been about 0.24%. Over the past two years, however, it has been roughly 0.08%. Currently, the Fed governors' median projection of the Fed Funds Rate is 1.375% by year-end. The market is a lot less confident that the Fed will raise rates that aggressively and is estimating the rate at 0.55% by December.³ Using the Fed's projections, and the historical spread between the two rates, USFRNs could yield anywhere between 1.135% and 1.295% by year-end. Using the market's estimation, it could be anywhere from 0.30% to 0.46%. Compared to one- to three-month and one- to 12-month Treasury Bills, U.S. floating rate notes have similar credit quality, lower [interest rate risk](#) and the same to higher yield. Since the Fed is more likely to increase interest rates than to decrease them, investors should consider using U.S. floating rate notes as part of their short-term bond or cash allocations. ¹Source: Bloomberg, 1/31/16. ²Source: Bloomberg, 1/31/16. ³Sources: Fed Funds December 2016 Futures contract, Bloomberg, 1/31/16.

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DEFINITIONS

Floating Rate Treasury Note : a debt instrument issued by the U.S. government whose coupon payments are linked to the 13-week Treasury bill auction rate.

Floating Rate Security : A debt instrument with a variable interest rate usually tied to a benchmark rate such as the US Treasury Bill Rate or the London Interbank Offered Rate.

Credit : A contractual agreement in which a borrower receives something of value now and agrees to repay the lender at some date in the future.

Yield : The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

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 asset.

Maturity : The amount of time until a loan is repaid.

U.S. Treasury Bill : A short-term debt obligation backed by the U.S. government with a maturity of less than one year.

Duration : A measure of a bond's sensitivity to changes in interest rates. The weighted average accounts for the various durations of the bonds purchased as well as the proportion of the total government bond portfolio that they make up.

1-3 month U.S. Treasury Bill : A short-term debt obligation backed by the U.S. government with a maturity of less than 3 months.

1-12 month U.S. Treasury Bill : A short-term debt obligation backed by the U.S. government with a maturity less than 12 months.

Rolling : trading out of a security that is close to maturing and into the same or similar security with a later maturity date.

Spread : Typically refers to a difference between a measure of yield for one asset class and a measure of yield for either a different subset of that asset class or a different asset class entirely.

Federal Funds Rate : The rate that banks that are members of the Federal Reserve system charge on overnight loans to one another. The Federal Open Market Committee sets this rate. Also referred to as the "policy rate" of the U.S. Federal Reserve.

Interest rate risk : The risk that an investment's value will decline due to an increase in interest rates.