AN INTRODUCTION TO U.S. FLOATING RATE TREASURY NOTES

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The U.S. Treasury recently made headlines when it auctioned off the first floating rate Treasury bond in its history.[1] This was also the first new class of issuance by the Treasury since it issued Treasury Inflation-Protected Securities (TIPS) in 1997. As another means for the Treasury to fulfill growing investor demand and diversify its sources of funding, we believe that issuance and investor adoption of floating rate Treasuries are poised to increase over the next several years. By comparison, the last new product issued by the Treasury has grown to become a $750 billion market since 1997.[2] **Bond Basics: What Is a Floating Rate Treasury Note?** For many investors, exposure to bonds generally starts and stops with fixed income securities, which customarily pay a fixed rate of interest and refund the principal balance at maturity. However, floating rate notes are slightly different. Although floating rate Treasuries make payments to holders each quarter, the size of these payments is based on a rate that is reset daily in reference to a rate that is determined weekly. This reference rate is based on the high yield determined at the weekly 13-week Treasury bill auction, which is generally held every Monday. Therefore, if yields on the Treasury bill auction rise week to week, investors could receive greater compensation than with a fixed coupon payment from a traditional fixed income investment. This reset frequency should also mitigate price fluctuations in floating rate notes compared to fixed income bonds of similar maturities. Given that these securities are issued by the U.S. government, they could serve as reference benchmarks for a variety of floating rate issuers in the same way that U.S. Treasury bonds serve as interest rate benchmarks for all other U.S. dollar-denominated fixed income issuance. But there is never a free lunch in financial markets. At today’s levels, investors will likely receive lower coupon payments than with fixed coupon bonds of a similar maturity. However, in the current market environment, we believe that the opportunity cost of protecting against higher rates is low and the margin for error in navigating a rising rate environment is continuing to narrow. **What Role Can Floating Rate Treasuries Play in Investor Portfolios?** With interest rate risk on the minds of many investors so far in 2014, we believe that floating rate Treasury securities represent an effective way for investors to help reduce their exposure to rising interest rates, while generating income payments that are backed by the full faith and credit of the U.S. government. Whereas other investments may also pay a rate of interest that resets each month or quarter, those securities are exposed to credit risk or the risk that the borrower will not be able to meet its financial obligations. The Treasury decided to offer this floating rate option as an alternative to rolling three-month Treasury bills every quarter. This can help investors by reducing transaction costs and extends the holding period of their investments but not their interest rate sensitivity, which will hinge on the frequency of the reset (effective maturity of one week). As the market matures, floating rate note issuance is expected to be expanded to include notes with different terms to maturity.[3] From an operational perspective, floating rate Treasuries can be an important addition to the investment opportunity set available to today’s investor. [1]Source: U.S. Department of the Treasury, 1/29/14. [2]Source: Barclays, as of 12/31/13. [3]Source: J.P. Morgan.

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Fixed income investments are subject to interest rate risk; their value will normally decline as interest rates rise. In addition, when interest rates fall, income may decline. Fixed income investments are also subject to credit risk, the risk that the issuer of a bond will fail to pay interest and principal in a timely manner or that negative perceptions of the issuer's ability to make such payments will cause the price of that bond to decline. 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 they may decline in value. The issuance of floating rate notes by the U.S. Treasury is new and the supply will be limited. Fixed income securities will normally decline in value as interest rates rise.

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DEFINITIONS

U.S. Treasury Bond : a debt security issued by the United States government.

Treasury Inflation-Protected Securities (TIPS) : Bonds issued by the U.S. government. TIPS 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.

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.

Interest rates : The rate at which interest is paid by a borrower for the use of money.

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