FIXED INCOME: STAYING A "FLOAT"

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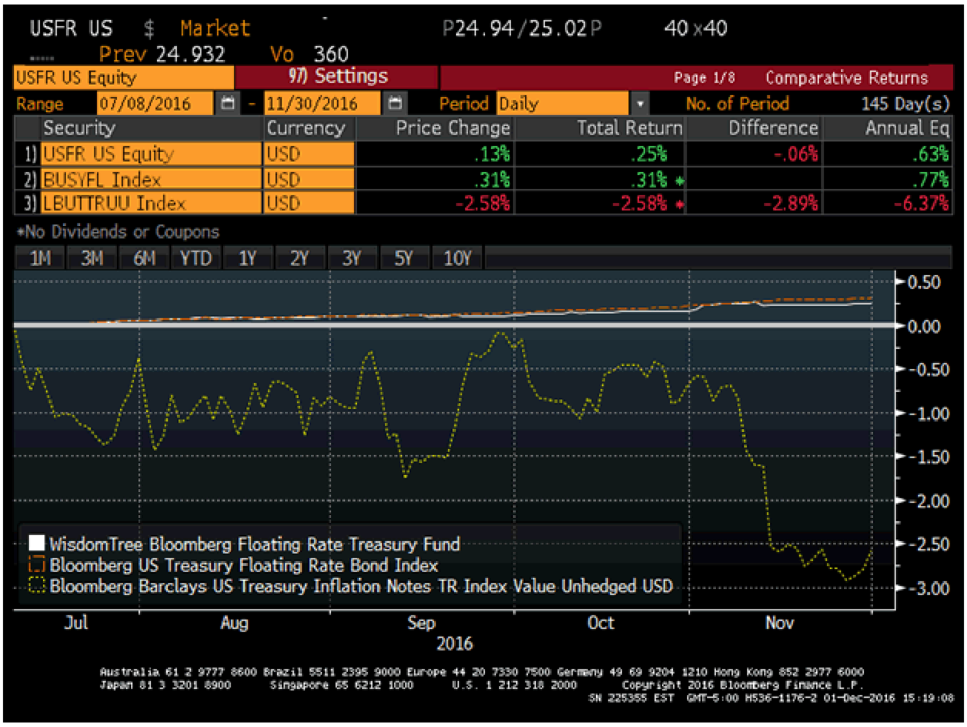
In what will no doubt be viewed as a gross understatement, the dynamics have certainly changed within the fixed income universe following the U.S. presidential election. However, how investors go about adjusting their portfolio to these changing conditions can certainly vary.

The surge in U.S. Treasury (UST) yields since election day has been of historical proportions in terms of the timing and magnitude of such a move. Yet, taking it one step further, the UST yield has now risen more than 100 basis points (bps) since hitting its all-time low on July 8 of this year. As a result, interest rate risk has been brought front and center into the fixed income investment discussion.



Source: Bloomberg, as of 12/01/2016. Past performance is not indicative of future results.
You cannot invest directly in an index.

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Please click here for the standardized performance of the WisdomTree Bloomberg Floating Rate Treasury Fund (USFR).

One strategy investors have employed is to reallocate their holdings to inflation-protected vehicles. Indeed, the argument for such an approach is that higher interest rates are a function of heightened inflation, and by that reasoning, that fixed income investors can help insulate their portfolios from rising rates by placing funds into these inflation-protected vehicles. In fact, looking at flows into U.S. inflation-protected exchange traded funds (ETFs) over the last quarter highlights how this strategy has been utilized. To provide some perspective, as of this writing, U.S. inflation-protected ETFs have taken in roughly $3.6 billion quarter-to-date. It is interesting to note that $2.5 billion, or more than 70% of these inflows, have occurred in the month of November alone, no doubt a reflection of the "rate anxiety" that has occurred post-election.

So, how have U.S. Treasury Inflation-Protected Securities (TIPS) held up since early July? After examining the yield performance, investors may be a bit surprised by the results. To illustrate, the five-year maturity has witnessed a nearly 50-bp back-up in yield while the 10-year TIPS registered an almost 60-bp increase in yield during this time frame. In other words, real yields actually rose as well.

This begs the question: Is this the optimal strategy to shield one's fixed income portfolio from the potential for rising rates? In our opinion, we believe there is an alternative approach investors should explore: floating rate products. Investors looking to mitigate potential interest rate exposure may wish to examine the benefit of floating rate Treasury securities (FRNs). The U.S. Treasury began issuing two-year FRNs in January 2014. The yield is reset weekly based on a reference rate that is determined at the weekly three-month Treasury bill auction. As a result, they have the potential to reset interest rates more frequently as short-term yields drift higher. The WisdomTree Bloomberg Floating Rate Treasury Fund (USFR), which seeks to track the price and yield performance of the Bloomberg U.S. Treasury Floating Rate Bond Index, offers investors a vehicle to follow this type of strategy.

Conclusion

For the first time this year, it appears as if global investors have finally agreed upon one thing: the Fed will lift the target range on Fed Funds by a quarter point at next week's FOMC meeting. Given the relatively high odds of a rate hike and the potential for additional increases in the Fed Funds Rate in 2017, some "Fed protection" seems warranted. Against this backdrop, due to the weekly reset feature of Treasury FRNs, we feel that by utilizing a floating rate product such as USFR, investors may be better able to insulate their bond portfolios than with a more traditional fixed income investment.

For standardized performance and the most recent month-end performance click here NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

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DEFINITIONS

Treasury yield : The return on investment, expressed as a percentage, on the debt obligations of the U.S. government.

Basis point : 1/100th of 1 percent.

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

Inflation : Characterized by rising price levels.

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

Rate Hike : refers to an increase in the policy rate set by a central bank. In the U.S., this generally refers to the Federal Funds Target Rate.

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.

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

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.

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.

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.

Bloomberg U.S. Treasury Floating Rate Bond Index : A rules-based, market-capitalization-weighted index engineered to measure the performance of floating rate U.S. Treasury notes.

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.