FLOATING RATE SECURITIES

WINTRUST WEALTH MANAGEMENT

Floating rate securities can be an attractive investment for investors concerned about rising rates.

Investors who believe that interest rates may rise, and are dissatisfied with low short-term rates, may consider a floating rate investment. Also known as "floaters," these fixed income investments provide interest income based on widely used short-term rates plus an additional percentage.

Floating rate securities adjust periodically ("float") depending on how the short-term rate they are tied to moves. Floaters can be linked to almost any benchmark and pay interest based on a variety of formulas. Basic floaters, though, pay a coupon equal to widely used interest rates plus a fixed spread.

Floaters are issued by government-sponsored enterprises (GSEs), such as the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Bank system and corporations, as part of their overall funding strategy. They are most suitable for investors who buy and hold them to maturity. However, some investors may find it necessary to sell their floating-rate investments before maturity. Investors may sell them at prevailing market prices, which may be more or less than the original amount invested.

How floaters are structured

Once the reference rate is chosen (such as T-Bill, LIBOR or prime rate), the issuer will add an additional amount, or spread, that it is willing to pay beyond the reference rate. This spread is usually described in basis points (a basis point is one one-hundredth of one percent, or 0.01%) and is added to the reference rate to determine the overall coupon. For example, a floater may be issued with a spread of 40 basis points above the three-month T-Bill rate. If the T-Bill rate is 2% when the floater is issued, its initial coupon will be 2.40%.

Spreads on floaters are based on a variety of factors, including the credit quality of the issuer and when the bond will mature. Please be aware that floaters typically pay less interest than fixed-rate notes that mature at the same time.

How coupon rates are determined

The most important factor to understand with floating rate securities is their underlying benchmark, or reference rate. Typical reference rates include:

- **U.S. Treasury Bill Rate (T-Bill).** The prevailing rate at which short-term Treasury Bills, issued and backed by the U.S. Government, are trading.
- **London Interbank Offered Rate (LIBOR).** The rate used in the short-term, international interbank market.
- **U.S. prime rate.** The interest rate that U.S. banks charge their largest commercial investors. Investors receive an additional amount, called a spread, above the reference rate on the floater.

Other factors to consider

Something else to keep in mind with floaters is how often the interest rate is adjusted to reflect the current reference rate, which is called the "reset frequency." A floater's interest payment (coupon) can reset daily or once a year. Typically, coupons reset each time the issuer makes an interest payment, and then remain constant until the next one.

If the floater resets between coupon payments, the issuer pays interest based on the average coupon resets since the previous interest payment. For example, a floater that resets each month and pays quarterly coupons would reflect the average of the three monthly resets that occurred in the previous quarter. A floater may be either non callable or callable. If callable, it can only be called by the issuer before maturity. Floaters have a variety of maturities, although most are issued with maturities of 10 years or less.

POTENTIAL BENEFITS

Protection from rising-interest risk

Investors who believe rates will soon rise may hesitate to "lock in" a long-term fixed rate. On the other hand, rates offered by short-term investments may be less attractive. Floaters offer an alternative because they pay a spread above current short-term rates and also allow investors to take advantage of future rate increases.

Steadier values when interest rates vary

When interest rates rise, the value of fixed-rate bonds tends to fall; likewise, when interest rates fall, the value of fixed-rate bonds tends to rise. As a result, a bond's value changes to make up for the difference between the fixed coupon rate and varying interest rates. The coupon rate on a floater resets when market rates change, so its price will generally fluctuate less than comparable fixed-rate bonds.

RISK FACTORS

Interest rate risk

While the market value of a floater is relatively insensitive to changes in interest rates, the income received is, of course, highly dependent on the level of the reference rate over the life of the investment. Total return may be less than anticipated if interest-rate expectations are not met.

Credit risk

As with any fixed-income investment, there is a risk that the issuer will be unable to meet its payment obligations. Credit ratings reflect the issuer's financial health and should be taken into account when considering a purchase of floaters. In addition, because the spread beyond the reference rate is affected by the issuer's credit rating, changes in this credit rating can also affect the market value of the investment.

Understanding Caps and Floors

Many floaters are issued with a cap, a floor or both.

- A cap is the maximum interest rate the issuer will pay, regardless of how high the reference rate may go. A cap protects the issuer from rising interest rates.
- A floor sets the minimum rate that will be paid, even if the coupon's reference rate is lower. A floor protects investors from declining income.

The following table[1] illustrates the difference between two floaters that pay a spread of 40 basis points above the reference rate. As you can see, one has a 4% cap and 2% floor, and the other does not have a cap or a floor:

Reference Rate	4% Cap/2% Floor	No Cap/No Floor
1.00%	2.00%	1.40%
2.00%	2.40%	2.40%
3.00%	3.40%	3.40%
4.00%	4.00%	4.40%

Call risk

If a callable floater is called by the issuer before maturity, the investor may be unable to reinvest funds in another floater with comparable terms. The investor should be prepared to hold it until maturity in case the floater is not called.

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