Treasury Considers Floaters Amid Heavy Skepticism

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Floating Rate notes would be the first new U.S. government debt security since TIPs were introduced in 1997. But would they make sense for your clients?

When Campbell Harvey was an associate professor at Duke University in 1993, he advocated treasury floaters during a time that interest rates hovered around 7.5%.

�I suggested shifting some of the Federal debt to floating rate debt, which would have saved the Treasury $2 trillion to date,� Harvey told Registered Rep.

It�s taken a while but 19 years later the Treasury is catching on.

Treasury Under Secretary for Domestic Finance **Mary Miller** said in her quarterly refunding statement today that she believes there are benefits to issuing floating rate notes (FRNs) and is studying the �optimal terms.�

Unlike a Treasury bond with a fixed coupon rate, an FRN is a bond with a coupon that resets once or twice a year at a rate linked to Treasury bills.

�With a fixed rate Treasury bond you know how much you�re paying out for the maturity of the bond but with floaters the interest payout is unpredictable. It might be 2% or 10% depending on future interest rates. Right now the floating rate coupon would be cheap due to interest rates being a fraction of a percent,� said Harvey. �But if the interest rate goes up to 3% the government will pay out more than if it had locked in the rate of a standard Treasury bond.�

The treasury advisory committee recommended issuing FRNs with a maximum maturity of two years as far back as February.

�With a maximum maturity of two years, there�s some question as to what the index will be. If you�re going to change the price on these quarterly, I would chose the 3 month treasury bill index because it is an index that is familiar, transparent and market driven,� said Mark Stys, chief investment officer with Bluemont Capital, a registered investment advisory firm in Vienna, VA with $160 million in assets under management.

Other indexes under consideration are the **Fed Funds Effective Rate Index** and the **Treasury General Collateral Rate Index.**

But now that interest rates are flat-lining at 1.9%, Harvey�s not so sure treasury floaters are a good idea anymore. �Interest rates are at or near historic lows. It is the wrong time to issue floating rate debt because it introduces unneeded funding risk,� He said.

If introduced, floating-rate notes would be the first new U.S. government debt securities since Treasury Inflation-Protected Securities were introduced in 1997.

�As an advisor you�d have to put FRNs in your arsenal but there�s so many quality floating rate bonds that I don�t think the treasury rates would be remotely competitive. Treasury floaters wouldn�t have investor interest for some time because I don�t think interest rates will go up for a while,� said Paul Schatz, president of Heritage Capital LLC, a Woodbridge, Connecticut registered investment advisory firm with $102 million in assets under management. �Individual investors are much better off investing in Dell computer bonds or Southwest Airline bonds to at least get a yield.� Other alternatives to FRNs include agencies, mortgages and swapping a regular treasury bond.

There were $769 billion of outstanding TIPS notes at the end of March, according to **Bloomberg data**.

�Because TIPS were the safest short term investments when they were introduced, there was record demand for them by money market funds and investors alike. If interest rates pick up these floaters will pay investors a higher coupon,� said Mark Martiak, a senior wealth strategist with Premiere Financial Advisors/First Allied Securities, a Manhattan-based registered investment advisory firm with $350 million in assets under management.

The **benchmark 10-year note yield** remains steady at 1.9 percent today compared to 3.43 percent a year ago. **Three-month Treasury bill rates** were 0.09 percent while the six-monthbill rate was 0.14 percent.

�FRNs may be a good fit for my risk averse clients depending on their objectives. I would ladder the maturities of these floaters to provide income from a cash alternative perspective because they could pay out more than a money market,� says Martiak. �If FRN�s become available, I�d recommend investing a small portion of their fixed income portfolio depending on whether these floaters can supplement my client�s cash holdings.�

Corporate floaters paid about $123 billion in variable interest or 12 percent of the $1.01 trillion company bonds issued in 2011, according to the Securities Industry & Financial Markets Association.

�The vast majority of FRNs will be purchased by institutional investors, money market funds and broker dealers. The institutional investors are pushing for these because there�s less of a need for them to hedge interest rate risk,� Stys told Registered Rep. �They also ease the primary dealer�s distribution concerns because in a rising interest rate environment floaters follow the interest rate increases higher at each index adjustment.�

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