

PERSPECTIVES

HERE'S AN IDEA TO POTENTIALLY ENHANCE YOUR CASH RETURNS

January 11, 2016

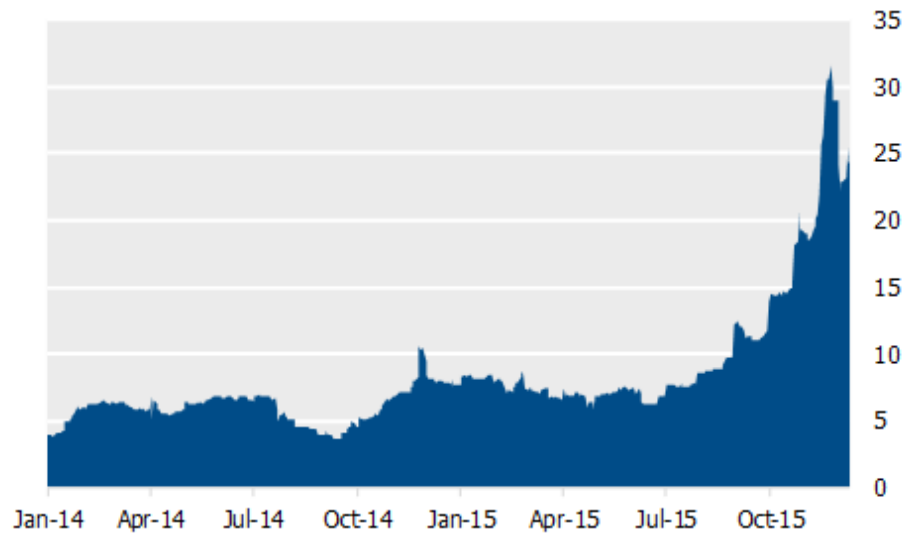
Topics: [Taxable Portfolio Management](#) / Contributors: [David G. Eichhorn, CFA](#)



Returns will be hard to come by in 2016. That is perhaps the least controversial prediction we can offer for the New Year. Though modest, we do have one suggestion for potentially improving an investor's overall return: consider substituting Treasury Floating Rate Notes (FRNs) for T-bills/Short Term Investment Fund.

FRNs have several features that make them attractive as cash equivalents. They are Treasury quality, have near zero duration, and, because their index rate resets every week based on the auctions of 3-month Treasury bills, respond quickly to changes in short term interest rates. Interestingly, they have been trading at a substantial discount to T-bills, with yields reaching as much as 30 bps above 3-month T-bills in the last few weeks, though they have traded in the low-to-mid 20 bps more recently.¹

Exhibit I: Floating Rate Bargain? FRN Yield Spread Over 3-Month T-bill, bps



Source: Bloomberg, through 1/8/16. The spread is between the yield of the two-year on-the-run Treasury floating rate note and the on-the-run 3-month Treasury bill.

In theory, this spread between FRNs and T-bills reflects two (typically opposing) forces. First, FRN buyers should generally receive a liquidity premium spread, because FRNs have longer maturities and higher transaction costs than T-bills. Second, FRN buyers should generally pay a term premium (FRN rates reset with the weekly T-bill auction, but based on a longer term T-bill). Notwithstanding these forces, however, the main driver of the T-bills/FRN spread may be the unique role played by T-bills in the market. Whether for regulatory or institutional reasons—for example, money market funds limited to holding less than one-year securities—investors may be driven toward buying T-bills without considering their FRN cousin, thus creating a “specialness” for T-bills, resulting in lower yields.

The bottom line is that—if you can bear a modest liquidity give-up relative to T-bills—we believe that FRNs currently offer a good opportunity for picking up a little extra yield.

Exhibit II: Treasury FRN Characteristics

- Introduced in January 2014
- Auctioned monthly, with new bonds issued on a quarterly basis and reopenings of the on-the-run on the remaining months; next auction is expected on January 27, 2016
- Maturities range up to 2 years
- The FRN index rate resets every week based on the auctions of 3-month T-bills
- FRN spread at purchase can be thought of as the incremental yield earned relative to the underlying reference instrument (3-month T-bills)
- Currently, FRNs trade in a 1-3 bps bid/offer spread

Source: Bloomberg, US Treasury.

¹ Technically, this yield difference is known as the discount margin, but we will refer to it as the spread for simplicity's sake.

Disclaimer: By accepting this material, you acknowledge, understand and accept the following:

This material has been prepared by NISA Investment Advisors, LLC ("NISA"). This material is subject to change without notice. This document is for information and illustrative purposes only. It is not, and should not be regarded as "investment advice" or as a "recommendation" regarding a course of action, including without limitation as those terms are used in any applicable law or regulation. This information is provided with the understanding that with respect to the material provided herein (i) NISA is not acting in a fiduciary or advisory capacity under any contract with you, or any applicable law or regulation, (ii) that you will make your own independent decision with respect to any course of action in connection herewith, as to whether such course of action is appropriate or proper based on your own judgment and your specific circumstances and objectives, (iii) that you are capable of understanding and assessing the merits of a course of action and evaluating investment risks independently, and (iv) to the extent you are acting with respect to an ERISA plan, you are deemed to represent to NISA that you qualify and shall be treated as an independent fiduciary for purposes of applicable regulation. NISA does not purport to and does not, in any fashion, provide tax, accounting, actuarial, recordkeeping, legal, broker/dealer or any related services. You should consult your advisors with respect to these areas and the material presented herein. You may not rely on the material contained herein. NISA shall not have any liability for any damages of any kind whatsoever relating to this material. No part of this document may be reproduced in any manner, in whole or in part, without the written permission of NISA except for your internal use. This material is being provided to you at no cost and any fees paid by you to NISA are solely for the provision of investment management services pursuant to a written agreement. All of the foregoing statements apply regardless of (i) whether you now currently or may in the future become a client of NISA and (ii) the terms contained in any applicable investment management agreement or similar contract between you and NISA.