Floaters for the Win

Reviewing the Fixed Income Landscape and Introducing Floating-Rate Notes (FRNs)

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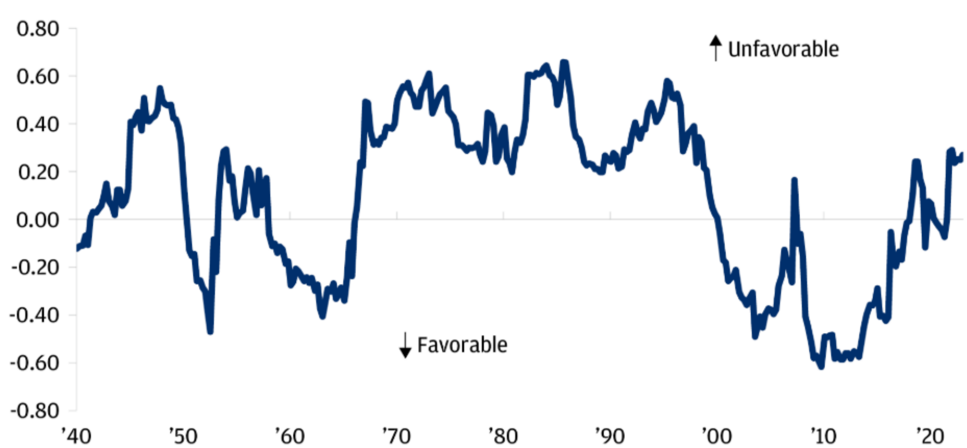
In the world of finance, the term "fixed income" conjures images of stable bonds generating consistent returns. Yet, this characterization only scratches the surface of the rich and evolving bond market landscape. Floating rate bonds, a dynamic and increasingly relevant sector of the fixed income market, defy traditional expectations with their adjustable coupons, designed to rise and fall with prevailing interest rates. While fixed coupon bonds have garnered the bulk of investors' focus over time, tides are turning as investors begin to recognize the potential of floating rate notes (FRNs) in an uncertain economic climate.

Interest in floating rate bonds started to perk up as rates hit zero-bound and investors started to think about what might happen if the precepts of the last forty years were upended. As the allure of locking in historically low interest rates fades and the once obscure risk of duration moves to the forefront, investors are naturally looking beyond traditional fixed income options.

Fixed Income is widely expected to be negatively correlated with equities and therefore represent a core component of traditional asset allocation models. This negative correlation arises from two factors: 1) the tendency for investment dollars to shift into low-risk assets during periods of volatility and 2) prices of bonds with fixed rate coupons increase as interest rates fall. However, during the most recent cyclical rise in interest rates in 2022, bonds and stocks experienced a positive correlation which called into question many of the assumptions behind traditional asset allocation models.

After 20 years of favorable stock-bond correlation, it flipped during the recent inflation shock

Rolling 5-year correlation between changes in P/E multiples and changes in 10-year Treasury bond prices



Sources: S&P, Robert Shiller. Data as of September 30, 2023. Positive correlation: when stocks and bonds move in the same direction. Negative correlation: when stocks and bonds move in different directions.

Source: JP Morgan Private Bank, [Bonds may play a renewed role in your portfolios – are you ready?]

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Amidst the shifting landscape of fixed income investing, investor interest in a relatively new financial innovation, floating rate notes (FRNs), has grown rapidly in recent years. Having been around for over a thousand years in fixed coupon form, it was only in the last century that FRNs entered the scene, offering a fresh approach to fixed income investing.

History of FRNs

Floating rate bonds emerged in the 1970s during a period of significant interest rate volatility and high inflation which had made it difficult for companies to raise funds in the bond markets. Prior to this innovation, virtually all bonds carried fixed interest rates, exposing bondholders to substantial interest rate risk in volatile environments. The introduction of floating rate notes (FRNs) represented a paradigm shift in debt markets which allowed interest rate risk to be shared more equally between lenders and borrowers.

The first floating rate bonds were issued by the Italian company ENEL in 1970[1] in the Eurobond market where new financial innovations were often tested due to less regulatory restrictions. In 1974, Citicorp issued $850 million in FRN in the Eurobond market[2] demonstrating for the first time that FRNs could be issued at scale. This innovation quickly spread to the US market as financial institutions and corporations recognized the benefits of matching their floating rate assets with floating rate liabilities. The Federal Home Loan Bank was among the first US domestic issuers to utilize FRNs in significant size and banks became regular issuers of FRNs to fund their floating rate loan books.

Deregulation in the US financial markets during the 1980s facilitated greater innovation in the domestic FRN market led by financial institutions and government sponsored entities. Additionally, as interest rate volatility increased under the Volker Fed, investor demand for FRNs remained strong. Once inflation was reigned in and interest rates began to fall, FRNs gained popularity amongst corporate issuers seeking to avoid locking in high borrowing costs.

The 1990s saw relatively stable monetary policy and a decline in FRN issuance as investor demand shifted back towards fixed rate debt. However, financial institutions continued to utilize FRNs for asset-liability management and there were several important developments in international markets: Italy started issuing floating rate treasury certificates in 1991 and Japan entered the FRN market in 2000.

[1] Bank of England Quarterly Bulletin September 1984

[2] Dufey, G., & Giddy, I. H. (1994). "The Evolution of Instruments and Techniques in International Financial Markets." SUERF Papers on Monetary Policy and Financial Systems, No. 21. The Société Universitaire Européenne de Recherches Financières (SUERF).

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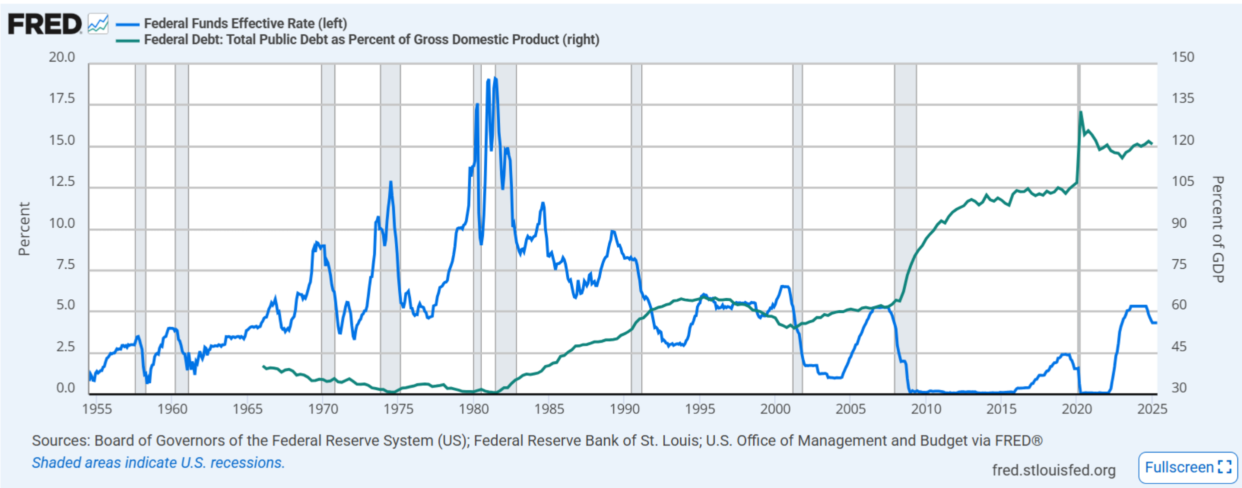
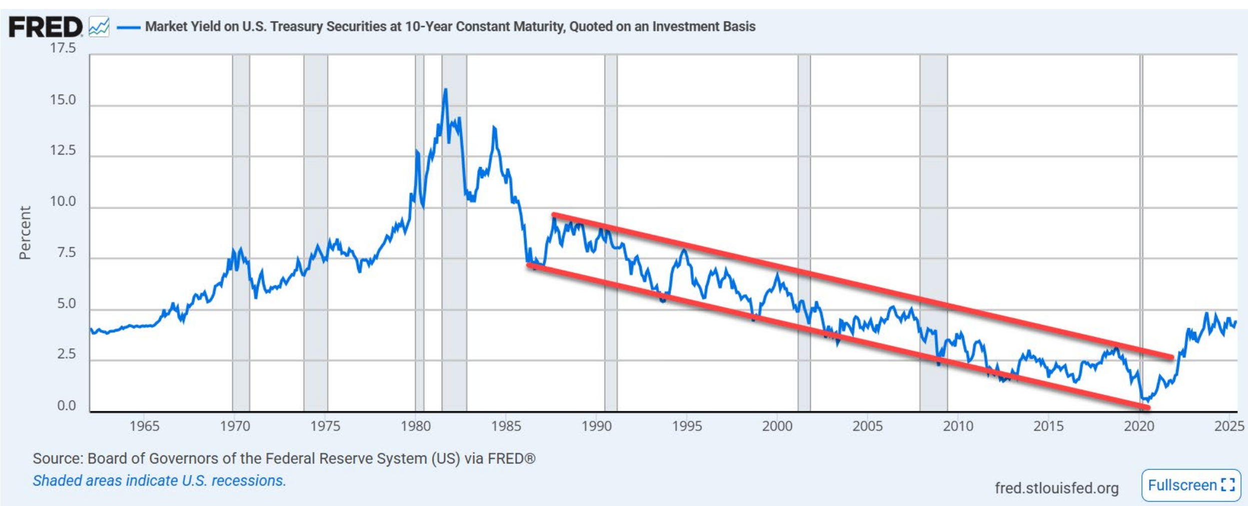
The Global Financial Crisis in 2008 saw the Fed Funds rate drop to zero percent and stay there for a prolonged period which reduced investor demand for FRNs. As the low-rate environment persisted, investor concerns about rising debt levels and inflation sparked renewed interest in the FRN market and in January 2014 the US Treasury began issuing FRNs.



Source: Federal Reserve Bank of St. Louis http://www.stlouisfed.org/

2023 saw the sharpest rate hiking campaign in Federal Reserve history; longer-term interest rates broke out from their secular downtrend which further fueled investor demand for FRNs. Today, there are more floating rate bond investment options available to investors than ever, but FRNs remain a small and often overlooked part of the bond market.



Source: Federal Reserve Bank of St. Louis http://www.stlouisfed.org/

Today's Bond Market Landscape

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According to Bloomberg data, the US bond market is currently $51.6 trillion in total outstanding with just over $2 trillion in FRNs. The market is made up of different issuer types with the US Treasury being the largest followed by Mortgage-Backed Securities, US Corporations, Municipals, and Government Agencies.

There are several popular bond market indices that investors use to track the bond market such as the Bloomberg US Aggregate Bond Index which serve as the primary benchmark index for most bond funds.

	Fixed	Floating	Total	Pct Floating
Treasury	$27,982,938,000	$674,350,000	$28,657,288,000	2.4%
MBS	$9,813,857,000	$458,029,000	$10,271,886,000	4.5%
Corporate	$8,889,581,536	$380,214,005	$9,269,795,540	4.1%
Municipal	$1,739,333,850	$11,158,350	$1,750,492,200	0.6%
Agency	$931,190,062	$758,414,620	$1,689,604,682	44.9%
	$49,356,900,448	**$2,282,165,974**	**$51,639,066,422**	**4.4%**

Source: Bloomberg data as of 8/15/2025

By definition, fixed income indices are almost exclusively fixed rate and market weighted. The return of 0% Fed Funds rates and a flood of stimulus, post-Covid, allowed mortgage, corporate and government buyers to extend duration and borrow money at generationally low interest rates. Given these attributes, these indices will remain long duration and low yielding for many years.

As we have seen throughout history, investor demand will drive the patterns of bond issuance. Recently, the most rapid growth in floating rate issuance has been in the CLO market. This growth has been driven by:

a) The popularity of private credit and leveraged buyouts
b) Leveraged loans, which underpin the CLO market are quicker and easier to obtain relative to high yield fixed rate debt
c) CLOs provide the best overall price execution to leveraged borrowers
d) CLOs also provide a regulatory arbitrage to investment grade buyers

To date, investors have not been concerned about the credit risk in CLOs as default rates have remained historically low and investors have been drawn to the yields offered by CLOs and the floating rate coupons. However, if we experience an increase in default rates, we could see investors move out of credit-oriented FRNs into sectors with less credit risk such as treasuries, agencies, and MBS.

ETFs are an efficient and popular vehicle that provide investors with access to new and varied investment opportunities. These vehicles are increasingly opening corners of the financial markets that used to be difficult or impossible for average investors to access. There are several popular bond market ETFs from the largest bond managers but there are far fewer options that provide exposure to purely floating rate securities.

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Ticker	Name	Focus	AUM (BLN)	Inception Date
USFR	WisdomTree Floating Rate Treasury Fund	US Treasury Floaters	$19.01	2/4/2014
FLOT	iShares Floating Rate Bond ETF	Investment Grade Corporates	$9.13	6/14/2011
FLRN	SPDR Bloomberg Investment Grade Floating Rate ETF	Investment Grade Corporates	$2.79	11/30/2011
FLTR	VanEck IG Floating Rate ETF	Investment Grade Corporates	$2.54	4/25/2011
FLBL	Franklin Liberty Senior Loan ETF	Senior Loans	$1.20	5/30/2018
LONZ	PIMCO Senior Loan Active ETF	Senior Loans	$0.69	6/8/2022
FLRT	Pacer Pacific Asset Floating Rate High Income ETF	Senior Loans	$0.53	2/18/2015
SEIX	Virtus Seix Senior Loan ETF	Senior Loans	$0.31	4/24/2019
MBSF	Regan Floating Rate MBS ETF	Agency MBS	$0.16	2/28/2024

Source: Bloomberg data as of 8/15/2025

There are just over 30 floating rate bond ETFs in the US with AUM totaling over $90 billion which is a tiny subset of the more than 800 bond ETFs with approximately $1.7 trillion in AUM. Most of the floating rate ETFs focus on corporate issues due to the higher yield and benign credit risk environment experienced recently.

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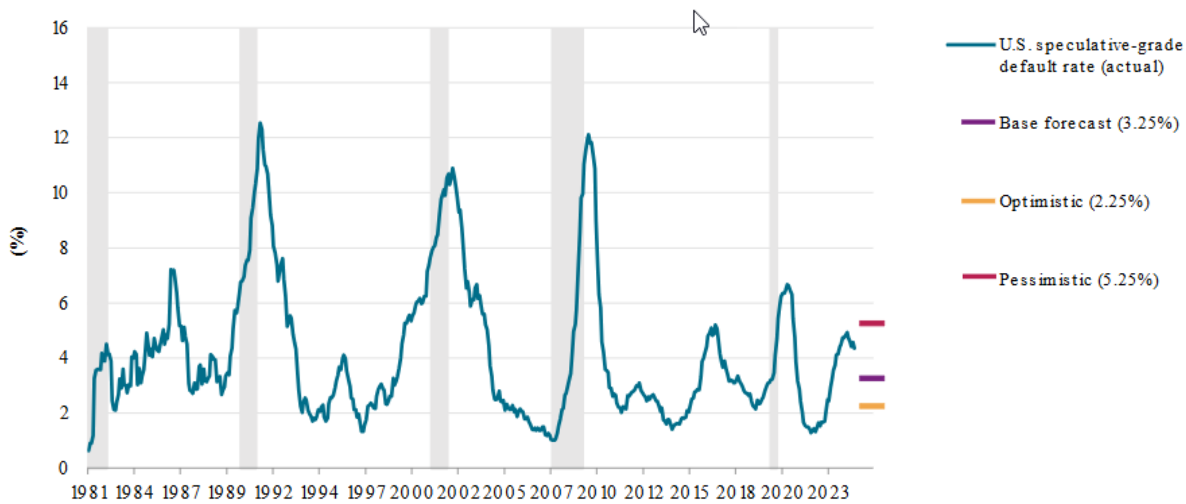
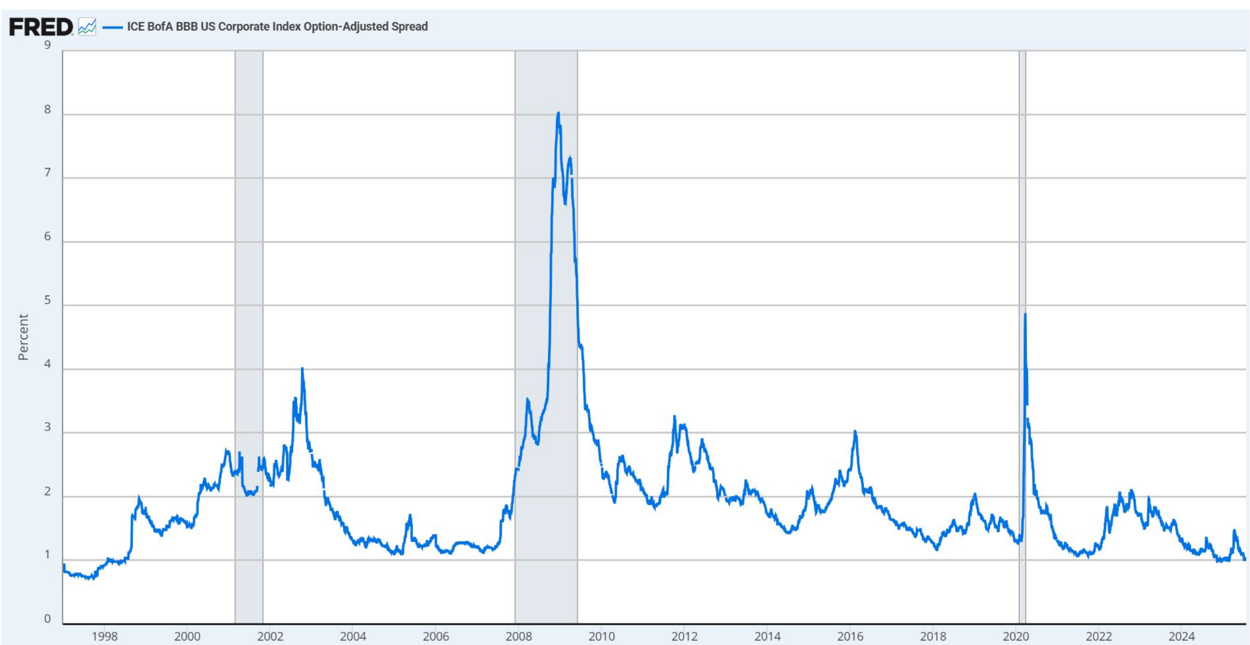
Chart 1

U.S. speculative-grade default rate expected to hit 3.25% by September 2025



Note: Shaded areas are periods of recession as defined by the National Bureau of Economic Research. Sources: S&P Global Ratings Credit Research & Insights and S&P Global Market Intelligence's CreditPro®.

This benign credit risk combined with buyout equity markets has made bonds tied to corporate credit risk such as CLOs and corporate bonds attractive investments over recent years. Expectations are for this favorable environment to continue, and the additional risk premium offered by these investments reflects these expectations and is currently trading at historically low levels.



Source: Federal Reserve Bank of St. Louis http://www.stlouisfed.org/

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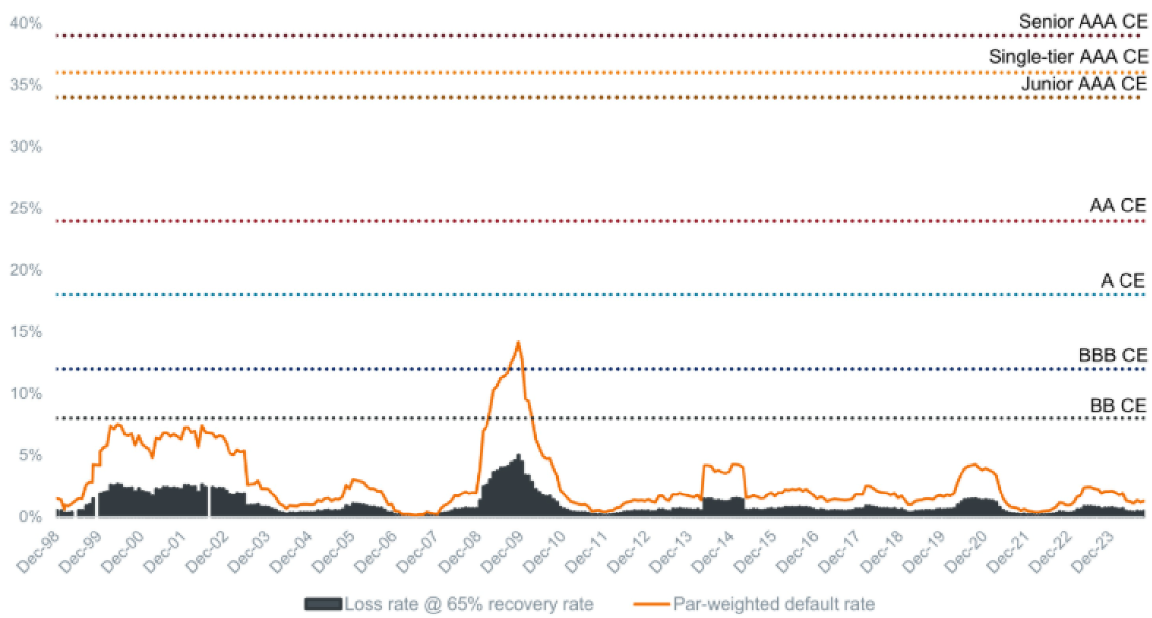
Within the floating rate bond market, CLOs have traditionally offered the highest risk premiums which made them attractive investment options for investors who desired additional yield without taking on too much risk. Recently, AAA-rated CLO spreads have converged with the spreads for Agency MBS bonds which carry no credit risk. While both investments are deemed to have low risk, MBS are issued by GNMA which are backed by the full-faith and credit of the US Treasury or by Fannie Mae or Freddie Mac which are effectively guaranteed by the US Treasury. CLOs invest in below-investment grade or non-rated loans to highly leveraged private companies, often backed by private equity firms. Based on historical default and recovery rates rating agencies allow managers to issue the AAA tranche of these CLOs, which are the top 60% slice of the stack, even though the underlying credit of their portfolio is below-investment grade.

Exhibit 2: Loan defaults vs. CLO credit enhancement (CE)

All AAA tranches remain loss remote, with 34%-39% CE.



Source: Janus Henderson Investors, J.P. Morgan, LSTA, as of 31 December 2024. Loan defaults based on S&P/LSTA Leveraged Loan Index data. Loss rate assumes a 65% recovery rate, consistent with historical data. CE represents the level of losses a tranche can withstand. **Past performance does not predict future results.**

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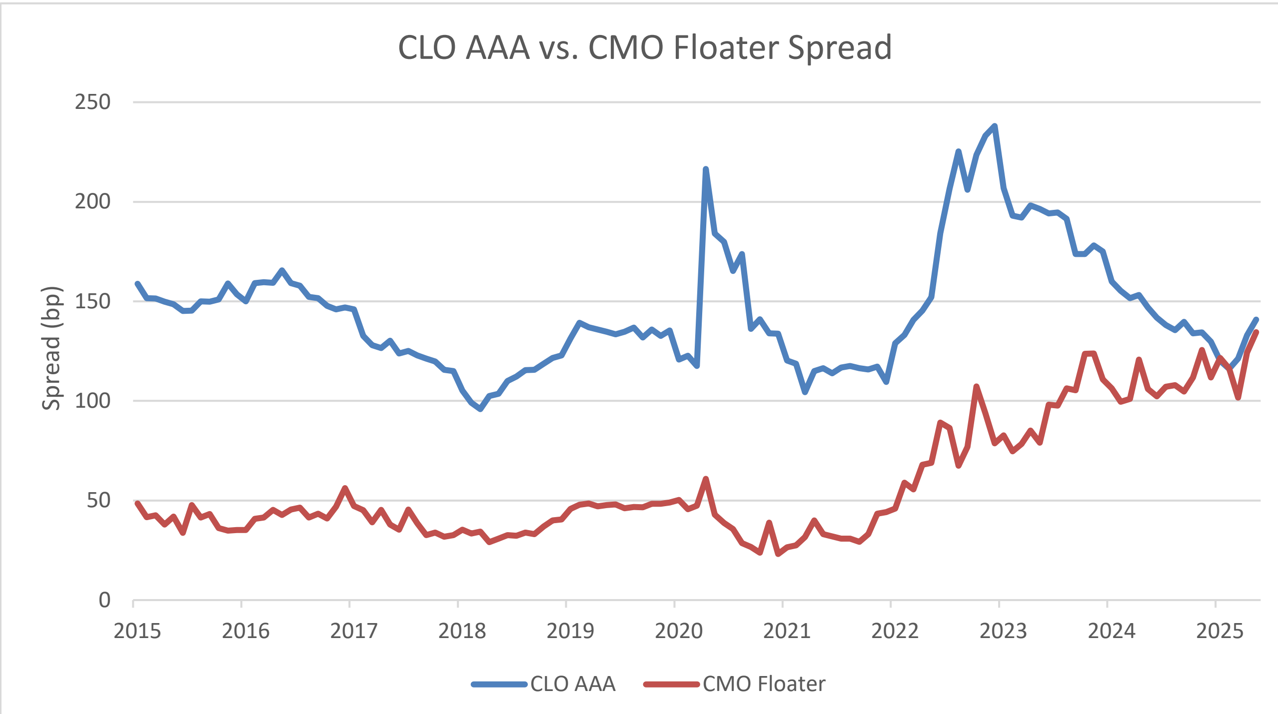
While AAA CLOs are seemingly well-protected from losses, the prices of AAA CLOs can exhibit greater volatility due to the highly leveraged nature of their holdings and their capital structure; these structures are often referred to as "leverage-on-leverage."



Source: Goldman Sachs Research as of 6/10/2025

Currently AAA CLOs spreads trade on top of Agency floating rate MBS that carry a full-faith and credit guarantee from the US Treasury. The floating rate portion of the MBS market has been the fastest growing segment of the MBS market, making up a majority of monthly issuance, after the Fed's most recent rate-hiking cycle. Despite this growing interest in floating rate MBS from investors total floating rate CMO issuance totaled just over $143 billion in 2024 well less than the $451 billion in CLO issuance which demonstrates the continued dominance of credit products.

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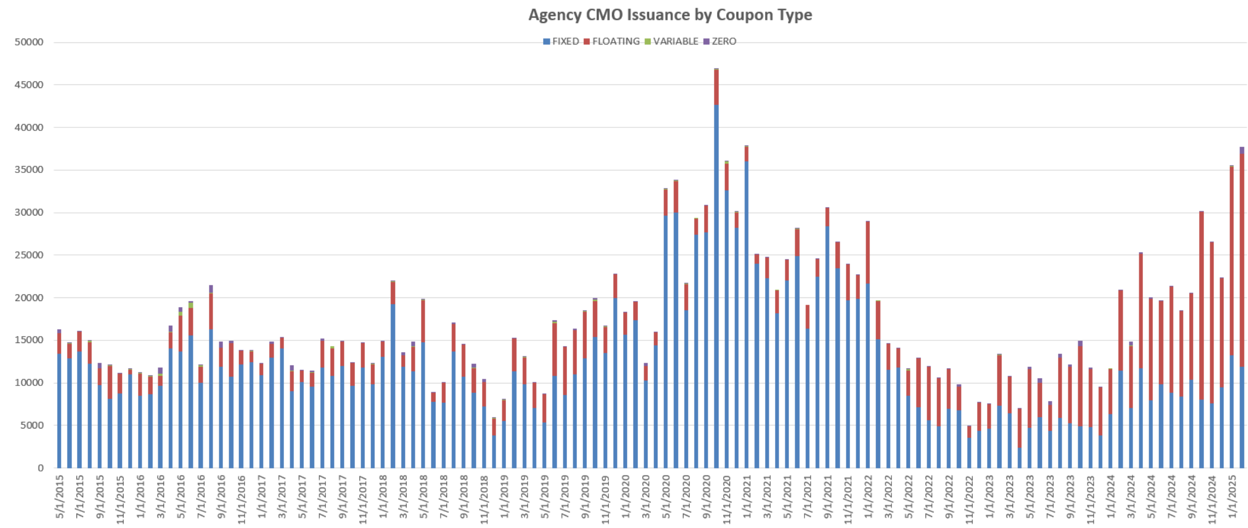

Source: Bloomberg Intelligence as of 5/31/2025

Conclusion

Regan Capital expects to see increasing demand for FRNs as investors are still licking their wounds from historic fixed income losses in 2022 and are looking to immunize their portfolios from interest rate volatility. The current bond market landscape is made up of primarily fixed rate bonds, with FRNs making up less than 5% of the aggregate bond market. As interest rates potentially rise and volatility increases, issuers may struggle to raise capital through traditional fixed rate issuance and may increasingly turn to the FRN market to raise capital. As the FRN market grows in popularity, liquidity and pricing are likely to improve, which creates a unique opportunity for investors to enter the market in the early innings of secular growth.

FRNs outperform during periods of rising interest rates but can provide outperformance during different yield curve environments as well. Recently, FRNs have outperformed as the Fed has lowered interest rates as the market expected more cuts than the Fed delivered; this resulted in a steepening of the yield curve which favored FRNs. FRNs can also outperform after the yield curve inverts and before it steepens because of the additional yield that FRNs earn during this time which is referred to as "positive carry." It is only when long-term interest rates are declining enough to offset the positive carry of floaters that FRNs underperform their fixed-rate counterparts. This is reflected in the duration risk of the fixed income market.

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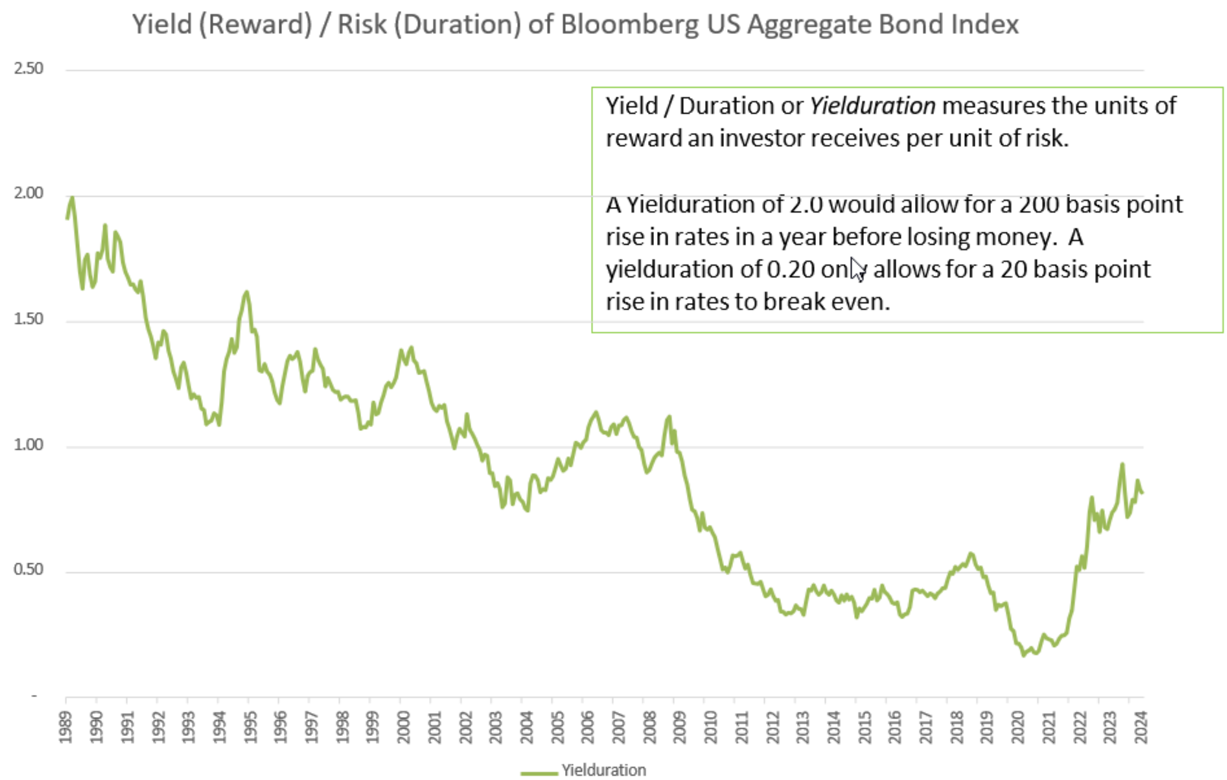

Source: Bloomberg data as of 12/31/2024

After a 40-year trend of falling interest rates, interest rate volatility, and credit risk, the bond market was oriented towards the winners of the last cycle: fixed-rate bonds with credit risk. During the next cycle, the new winners are unlikely to be the same as the last cycle and with current market pricing offering little to no advantage for investing in fixed-rate, credit-backed bonds, floating-rate MBS offer a unique investment opportunity to take less risk and increase your odds of outperforming.

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