

Floaters

Is There a Secondary Market?

Floaters are most suitable for purchasing and holding to maturity. However, investors may find it necessary to sell their floating-rate investment prior to maturity. Floaters may be traded in the secondary market, which provides an opportunity for investors to sell them at then prevailing market levels, which may be worth more or less than the original amount invested.

What are the Risks of Floating-Rate Investments?

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 upon the level of the reference rate over the life of the investment. Total return may be less than anticipated if future 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 serve as a measure of the issuer's financial health and should be taken into account when considering a purchase of floaters. In addition, because the spread paid in excess of the reference rate is determined in part by the issuer's credit rating, changes in this credit rating can also effect the market value of the investment.

Call Risk

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

Call your financial consultant:

***Ask how Floating-Rate Securities
can be part of your investment future today!***

Member Firm Name

**A Guide to
Understanding
Floating-Rate Securities**

Floaters

What are Floating-Rate Investments?

A floating-rate investment, also known as a “floater”, is an investment with interest payments that *float* or adjust periodically based upon a predetermined benchmark. While floaters may be linked to almost any benchmark and pay interest based on a variety of formulas, the most basic type pays a coupon equal to some widely followed interest rate plus a fixed spread. Only this type of floater will be discussed in this brochure.

How are Floaters Structured?

The most important determinant of a floater's performance is the underlying benchmark, or reference rate. Reference rates typically used as benchmarks include U.S. Treasury Bills (T-bills), the London Interbank Offered Rate (LIBOR), the Prime Rate or some other short-term interest rate. Once the benchmark is chosen, the issuer will establish an additional “spread” that it is willing to pay in excess of the reference rate. This spread is generally expressed in basis points (*a basis point is one one-hundredth of one percent or .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 2.00% on the day the floater is issued, its initial coupon will be 2.40% (2.00% + 0.40% = 2.40%). The spread for any particular floater will be based on a variety of factors including the credit quality of the issuer and the time to maturity. It is important to note that since short-term rates are usually lower than long-term rates, the initial coupon of a floater is typically lower than that of a fixed-rate note of the same maturity.

Another important component of a floater's structure is the reset frequency — how often the interest rate is adjusted to reflect the current reference rate. A floater's coupon can reset as often as daily or as infrequently as once per year. It is quite common for the coupon to reset each time an interest payment is made, and then remain constant until the next coupon payment date. If the floater resets more frequently than interest is paid, the coupon payment will reflect the average of each reset since the previous interest payment. For example, a monthly reset/quarterly pay floater's interest payment would reflect the average of the three monthly resets that occurred in the previous quarter.

A floater may be issued as either non-callable or as callable. If issued as callable, it can be called **only by the issuer** prior to maturity. Floaters have a variety of maturities, although most are issued with maturities of 10-years or less.

Understanding Caps and Floors

Many floaters are issued with either 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, and therefore protects the issuer from escalating interest costs. Conversely, a *floor* sets the minimum rate that will be paid even if the coupon determined by the reference rate were lower, and protects the investor from declining income. The following table illustrates the difference between two floaters that pay a spread of 40 basis points above the reference rate; one with a 4% cap and 2% floor, and one without a cap or floor:

<u>Ref. Rate</u>	<u>With Cap/Floor</u>	<u>No Cap/Floor</u>
1.00%	2.00%	1.40%
2.00%	2.40%	2.40%
3.00%	3.40%	3.40%
4.00%	4.00%	4.40%

Floater Advantages

Benefit from Rising Interest Rates

Investors are sometimes reluctant to “lock-in” a current fixed rate for the long term because they believe rates will rise in the future. However, rates available on short-term investments may be lower than the investor is willing to accept. Floaters offer an alternative which pays a spread above current short-term rates and also enjoys the benefit of future rate increases.

Limited Price Sensitivity to Interest Rates

Fixed-rate bonds tend to decrease in value when interest rates rise and increase in value when rates fall. The bond's value changes to compensate for the difference between its fixed coupon rate and current interest rates. Because a floater's coupon rate changes when market rates change, its price will fluctuate far less than fixed-rate bonds of similar maturity.

Who Invests in Floaters?

Investors who believe that interest rates may rise and are dissatisfied with low short-term rates may consider a floating-rate investment.

Who Issues Floaters?

Both Government Sponsored Enterprises (GSEs) and corporations issue floaters as part of their overall funding strategy.