

When Fixed Income Isn't

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SmartMoney

For bond investors, preparing for higher interest rates doesn't always have to be complicated. If rates must rise, find something that will rise with them.

Wall Street already has. It's called a variable-rate or floating-rate bond. These bonds have been around for years, but they typically play second fiddle to fixed-rate bonds. The latter are retirement mainstays because, as their name suggests, they have predictable income streams, paying the same amount every six months until the bond matures.

But last year, for the first time, investment-grade corporate issuers sold more floating-rate bonds than those paying fixed interest. And floating-rate bonds are on track to outpace fixed-rate bonds again this year. Unlike fixed-rate bonds, whose interest payments are set at a specific level, floaters are sold with interest that periodically resets, or floats, at a level linked to some benchmark. Traditionally rates have been linked to Libor—the London interbank rate charged on loans between large international banks.

Lately, however, issuers have been using other benchmarks, such as U.S. Treasury debt. If that rate rises, so does your interest payment, which keeps the bonds trading around face value, unlike traditional issues, whose price falls as rates increase. It's not surprising, then, that floaters are becoming more available in what is expected to be a period of rising rates.

Since last June, the Federal Reserve has almost tripled its short-term benchmark interest rate to 2.75%. As the rate continues to increase, floaters will pay holders ever-rising interest. "That allows you to effectively have an increasing amount of income through time that you won't have with a fixed-income security," says Anton Pil, global head of fixed income at J.P. Morgan Private Bank.

Not all variable-rate bonds are guaranteed to offer rising interest payments because short-term rates are going up. Some issuers, such as Sallie Mae and John Hancock, have issued bonds whose payments are tied to inflation. Although rising inflation usually leads to higher rates, the two don't always move in lockstep. During the stagflation of the 1970s, prices for many goods and services rose, but the economy was weak; inflation-linked bonds would have been attractive in that kind of environment.

Floating-rate bonds aren't without drawbacks. Most notably, when rates fall, so do the interest payments. Floaters also typically start out paying a lower interest rate than similar fixed-rate bonds to compensate issuers for the risk of higher payouts down the road. Variable rates won't protect investors from credit risk. If the issuer runs into financial problems, the price of a bond will drop, as was the case for bonds of auto maker General Motors when it issued a recent profit warning.

A middle ground for investors who want to know what their interest payments will be while gaining protection against rate increases is so-called step-up bonds. Interest payments on these periodically increase according to a predetermined schedule, regardless of the rate environment.

But again, there's a tradeoff. Issuers typically have the right to buy back the bonds before maturity, and they typically do so if rates fail to rise.

Floater often require minimum investments of \$10,000 or more, but smaller increments are available in retail note programs. These securities are sold at face value in increments of \$1,000 through brokers such as Charles Schwab and Merrill Lynch. Issuance of retail floating-rate notes has picked up, says Patrick Kelly, managing director of **LaSalle Broker Dealer Services**, which sells them to brokers. Retail notes are less actively traded than regular bonds, so they are most appropriate for buy-and-hold investors.