TREASURY FLOATING RATE NOTES: DON'T OVERTAX YOURSELF

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The fixed income landscape continues to wrestle with the potential for more interest rate risk. A debate has begun to emerge around the fate of the U.S. Treasury (UST) 10-Year yield. Indeed, some market participants continue to expect another round to the upside, while a separate camp feels the worst could be over. I'm not going down either road in this blog post. Rather, I'd like to settle on the rate risk aspect that does not seem to be up for much debate: the Federal Reserve (Fed) will likely continue on its gradual hiking path.

Against this backdrop, investors may wish to continue considering Treasury floating rate notes (FRNs). Because these securities are referenced to the Treasury's weekly three-month t-bill auction, they offer investors a means to insulate their portfolios from potential Fed rate hikes. Given the Fed's guidance and market outlook for additional increases in the Federal Funds Rate in 2018 and 2019, some "Fed protection" seems warranted.

We have previously highlighted the benefits of Treasury FRNs in various blog posts from a rate perspective, but are there other benefits worth noting? One aspect to Treasuries that tends to get overlooked is that interest income is exempt from state and local taxes. This exemption also applies to FRNs.

Typically, investors do take tax considerations into their investment process. The recent Tax Cuts and Jobs Act of 2017 may heighten this awareness because the changes included in this legislation will be brought to the fore for the upcoming 2018 tax season. Specifically, the caps on deductions for state and local income taxes, as well as mortgage interest, may create a different environment than investors previously had been used to. As a result, investments with a tax advantage may be an important part of future portfolio construction.

Conclusion

How can Treasury FRNs help a fixed income portfolio for this potentially changing investment landscape? As the Fed raises rates, the rate hike is reflected in the weekly three-month t-bill auction, and by extension the UST FRN. This not only offers investors a rate hedge for their portfolios but also provides the opportunity for higher-yield enhancement as a result of the Fed's tightening moves, with essentially no duration risk. By utilizing the Treasury FRN space, investors have the potential to not only employ "Fed protection" but also potentially add a "tax-advantaged" element to it. The WisdomTree Floating Rate Treasury Fund (USFR), is a solution that seeks to track UST FRNs, with the character of the aforementioned tax exemption getting passed through to shareholders.

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DEFINITIONS

Interest rate risk : The risk that an investment's value will decline due to an increase in interest rates.

10- Year Treasury : a debt obligation of the U.S. government with an original maturity of ten years.

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Rate Hike : refers to an increase in the policy rate set by a central bank. In the U.S., this generally refers to the Federal Funds Target Rate.

Floating Rate Treasury Note : a debt instrument issued by the U.S. government whose coupon payments are linked to the 13-week Treasury bill auction rate.

Treasury : Debt obligation issued by the U.S. government with payments of principal and interest backed by the full faith and credit of the U.S. government.

Treasury Bill : A treasury bill (T-Bill) is a short-term debt obligation backed by the U.S. government with a maturity of one month (four weeks), three months (13 weeks) or six months (26 weeks).

Federal Funds Rate : The rate that banks that are members of the Federal Reserve system charge on overnight loans to one another. The Federal Open Market Committee sets this rate. Also referred to as the "policy rate" of the U.S. Federal Reserve.

Duration : A measure of a bond's sensitivity to changes in interest rates. The weighted average accounts for the various durations of the bonds purchased as well as the proportion of the total government bond portfolio that they make up.