Floating rate relief from rising interest rates

Pioneer Investments head of UK institutional business Jonathan May believes that floating rate securities could be a useful portfolio diversification tool in a rising rate environment

The Federal Reserve raised US interest rates at its December meeting and it is Pioneer Investments' view that the pace of further tightening could be faster than currently envisaged. With this in mind, how should institutional investors position themselves for a rising interest rates environment?

We believe diversification is key. Seeking out investments strategies that are lowly correlated to core asset classes can help shield portfolios from volatility during periods of market transition.

Floating rate securities can be an attractive hedge to interest rate risk while also providing an attractive yield profile.

What are floating rate securities?

Floating rates securities are debt instruments, typically bank loans, with coupon payments that fluctuate, or 'float', based on short-term reference rates, such as 90-day US LIBOR. These bank loans are arranged by commercial or investment banks on behalf of corporate borrowers and then distributed to investors such as mutual funds and pension funds.

The companies that issue bank loans are typically rated below investment grade. In terms of credit rating, they are similar to high yield bonds. However, a key difference is that bank loans are typically senior to high-yield bonds in an issuer's capital structure and are secured by specific company assets which can result in lower credit risk. As a result, their senior and secured capital structure position has historically allowed bank loans to have lower default rates and higher recovery values than high-yield bonds.

Why invest in a floating rate securities?

A primary reason to consider floating rate securities is their risk and return profile characteristics. Because bank loans are issued by below investment-grade rated companies, they typically offer a higher yield than investment grade rated bonds. However, because of their senior secured capital structure position loans tend to have less credit risk than high-yield bonds.

Another important reason for investing in bank loans is their floating rate coupon. This presents a unique opportunity to invest in an income generating investment with low price volatility. The coupon of a floating rate loan typically adjusts on a quarterly basis to a predetermined spread over LIBOR (usually 90-day LIBOR). This short reset feature allows the bank loan coupon to quickly adjust in line with any interest rate movements. This quick reset feature also means that bank loans are a very short duration instrument, which can allow them to help diversify a core fixed income portfolio. Additionally, it is always helpful to bear in mind that the income generated by bank loans will increase if short-term interest rates rise and vice-versa.

These unique characteristics of floating rate funds have allowed them to have relatively low correlation to other assets classes. This leads to increased portfolio diversification.

Consider diversified and higher quality approach

At Pioneer Investments, we believe a more conservative approach to the asset class is the most efficient way to benefit from the diversification benefits bank loans offer. Our approach focuses on the higher credit quality and more liquid segment of the bank loan market and aims to produce attractive risk-adjusted total returns over the long term. We utilise a highly diversified, value-oriented approach driven by rigorous fundamental credit research.

Access through multi-asset credit

Floating rate securities can be accessed through a multi-asset credit strategy where the portfolio's exposures are actively monitored and can be quickly adjusted in response to a changing investment case. Moreover, floating rate securities are just one of a wide range of attractive opportunities available within the multi-asset credit universe and it is our view that maintaining a well-diversified portfolio can help to protect assets during periods of market volatility.

Pioneer Investments' credit opportunities and dynamic credit strategies are actively managed and the flexible, multi-asset credit approach is designed with the aim to transform market challenges into investment

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