Investment Insights
February 2022

SIERRA MUTUAL FUNDS | OCEAN PARK ASSET MANAGEMENT

Floating Rate Notes: A Diversifier for Rising Rates

Introduction

Floating Rate Notes, which are also commonly called Floating Rate Loans, can serve as a good diversifier within fixed income portfolios, but they are a category that is overlooked by many fixed income investors. Floating Rate Notes characteristics -- low duration and interest payments tied to short-term rates -- can be beneficial in a market where the Fed has announced it will soon be raising short-term rates and where long-term rates have moved up.

Floating Rate Notes Have a Unique Structure

The structure of floating rate notes is very different from almost all other fixed income instruments. They are not bonds, but instead are loans or notes. In many cases they are issued as part of a leveraged buy-out ("LBO") and they are typically below investment grade. The fact that they are loans means that they can be customized to fit each individual LBO. But since the loans aren't standardized, floating rate notes have longer settlement periods than bonds. Floating Rate Notes are typically the most senior debt that companies offer. This gives them priority in case of defaults, with the result that their losses, in case of bankruptcy, are typically lower than high yield corporate bonds.

Floating Rate Notes' Characteristics Are Designed for Periods of Rising Short-Term Rates

Markets today are difficult for fixed income investors since long-term interest rates are much lower than the current level of inflation. The U.S. Federal Reserve (the "Fed") has announced it will start pulling back the support it has given markets through ultra-low short-term rates and monthly purchases of Treasuries and mortgages. In our opinion markets expect the Fed to stop its purchases of Treasury bonds and mortgages in the first quarter and to increase the Federal Funds rate from the current level of close to zero to about 1% by year-end. Some firms, such as Goldman Sachs, recently increased their expectation of Fed Funds rate hikes to five this year. We believe this would result in a year-end Fed Funds rate above 1.25%.

Floating Rate Notes are well-designed for periods of rising short-term rates since they typically re-set the interest rate they pay each quarter. Unlike a 10-year Treasury bond, which pays out the same coupon through maturity, owners of Floating Rate Notes will see rising interest payments when short-term U.S. rates rise.

This characteristic is different from most fixed income categories and can make Floating Rate Notes a potentially effective diversifier within a fixed income portfolio. Floating Rate Notes typically have low correlation of returns with the Bloomberg Barclays U.S. Aggregate Bond Index (the "Agg"), a commonly used benchmark for investment grade fixed income. Floating Rate Notes are negatively correlated to two of the three Agg components: Treasuries and Mortgages.

Floating Rate Notes' Returns Have Historically Been Positively Correlated With Inflation

Floating Rate Notes can be a good alternative investment in periods of inflation since this asset class' returns are typically correlated with inflation. This correlation may be due to rising inflation leading to rising short-term rates, which can increase payouts from Floating Rate Notes. Indices like the Agg and most traditional bond categories have a negative correlation to inflation. This is true both for the 12-month change in Consumer Price Inflation and the next five year inflation levels implied by Treasury Inflation Protected bonds. Financial markets' focus on high current inflation and the Fed's policy change towards rising short-term rates has benefited Floating Rate Notes so far this year, as it is one of the few fixed income categories with positive returns in January 2022. We have added to this category in our mutual funds and models this year. It's a category we will continue to keep an eye on as we move forward in 2022.

Doug Loeffler, CFA, CAIA
Executive Vice President of Investment Management

Doug Loeffler is Executive Vice President of Investment Management at Sierra Mutual Funds & Ocean Park Asset Management. He provides research, analysis, and support for the investment activities of the organization and appears on behalf of the firm in the financial press.

Investments in Mutual Funds involve risk including the possible loss of principal. There is no assurance that the Fund's will achieve their investment objectives. Mutual fund investing involves risk, including the loss of principal and there can be no guarantee the strategies and processes discussed will be successful.

Investors should carefully consider the investment objectives, risks, charges, and expenses of the Sierra Mutual Funds. This and other important information about the Sierra Mutual Funds can be obtained in the prospectus, which can be obtained on our website www.sierramutualfunds.com or by calling 1-866-738-4363. The prospectus should be read carefully before investing. The Sierra Mutual Funds are distributed by Northern Lights Distributors, LLC, member FINRA/SIPC.

DISCLOSURES:

This material is not intended to be a recommendation or investment advice, does not constitute a solicitation to buy or sell securities, and is not provided in a fiduciary capacity. The information provided does not take into account the specific objectives or circumstances of any particular investor, or suggest any specific course of action. Investment decisions should be made based on an investor's objectives and circumstances and in consultation with his or her advisors. Economic conditions remain highly uncertain and there is no guarantee that the information presented in this commentary will come to fruition. Neither Ocean Park Asset Management, Inc., nor Wright Fund Management, LLC are affiliated with Northern Lights Distributors LLC.

If you do not wish to receive communication via email reply back to this email with "Unsubscribe" as the subject line.

DEFINITIONS:

A floating-rate note (FRN) is a debt instrument with a variable interest rate. The interest rate for an FRN is tied to a benchmark rate. Benchmarks include the U.S. Treasury note rate, the Federal Reserve funds rate—known as the Fed funds rate—the London Interbank Offered Rate (LIBOR), or the Prime Rate. Even though FRN's are correlated with rising inflation, there is no guarantee that the FRN's rate will rise as fast as interest rates in a rising-rate environment. FRNs may be issued with or without a callable option, which means the issuer has the right to return the investor's principal amount and stop making interest payments. The callable feature is known upfront and allows the issuer to pay off the bond before maturity.

Sierra Mutual Funds & Ocean Park Asset Management, Inc.
3420 Ocean Park Boulevard, Suite 3060 | Santa Monica, CA 90405 | Sales: 844.727.1813

SIERRA MUTUAL FUNDS | OCEAN PARK ASSET MANAGEMENT

Entire publication ©2021 Sierra Mutual Funds & Ocean Park Asset Management.
All rights reserved.

1200-NLD-02102022
0497-OP00XCOM 02092022