

From: Mercado, Darla (NBCUniversal)
To: Paul Winter
Subject: Thanks again!
Date: Tuesday, June 27, 2023 12:44:09 PM
Attachments: image001.png
image005.png

Hi, Paul:

I enjoyed our chats last week! My story ran yesterday, and I thought I'd share it with you. Thank you for your insight:
<https://www.cnbc.com/2023/06/26/this-little-known-income-play-offers-portfolios-price-stability-and-yield.html>

Let's continue to stay in touch!
Darla Mercado

This little-known income play offers portfolios price stability and yield

PUBLISHED MON, JUN 26 2023 1:35 PM EDT UPDATED MON, JUN 26 2023 3:33 PM EDT

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As investors seek yield in short-term certificates of deposit and Treasury bills, they should be aware of another fixed income play that takes advantage of today's higher interest rates.

Enter the humble floating rate note. These instruments are fixed-income securities that pay a coupon based on a reference rate that resets periodically. These can be issued by financial institutions, corporations and the federal government, typically coming in at 2- to 5-year maturities.

"Floating rate notes can be used to lower the overall duration of an investor's fixed income portfolio," said Allison Bonds, head of private wealth management and independent wealth management at State Street's U.S. SPDR ETF business.

Duration, which is measured in years, is the gauge of a bond's price sensitivity to interest rate changes. Bond prices move opposite their yields, and issues with longer duration are more likely to see price swings as rates

change. For floating rate notes, the duration is close to zero, while the fixed-rate corporate bond market has a duration of 7 1/2 years, Bonds said.

Floating rate notes' short duration gives them a measure of relative price stability, while offering investors' portfolios some support through variable income. Still, the market is a small one compared with better-known fixed income plays amid rapidly rising rates. The [iShares Floating Rate Bond ETF \(FLOT\)](#) has about \$7 billion in assets, while the [iShares 1-3 Year Treasury Bond ETF \(SHY\)](#) has \$27 billion in assets, according to FactSet.

FLOATING RATE NOTE ETFS

TICKER	NAME	TOTAL RETURN YTD	30-DAY SEC YIELD	EXPENSE RATIO
FLOT	iShares Floating Rate Bond ETF	3.06%	5.81%	0.15%
FLRN	SPDR Bloomberg Investment Grade Floating Rate ETF	3.12%	5.74%	0.15%
VRIG	Invesco Variable Rate Investment Grade ETF	3.48%	5.97%	0.30%
USFR	WisdomTree Floating Rate Treasury Fund	2.46%	5.24%	0.15%
TFLO	iShares Treasury Floating Rate Bond ETF	2.31%	5.25%	0.15%

Source: FactSet, fund websites

"Flows have been more muted in 2022 and 2023, likely due to the speed of the current hiking cycle, which has been the fastest in decades, making cash itself a more attractive opportunity to earn income," Bonds said.

A bet on higher rates

The Federal Reserve foresees two more rate hikes this year, according to its [latest dot plot](#). That's on top of the 10 rate increases it has put in place since March 2022.

Federal Reserve Chair Jerome Powell [recently indicated](#) that he sees more hikes coming, saying, "Inflation pressures continue to run high, and the process of getting inflation back down to 2% has a long way to go."

It's the prospect of higher rates for longer, along with the inverted yield curve, that make floating rate notes an attractive play for some.

"This is my personal view, but I don't see rate cuts," said Paul Winter, certified financial planner and president of Five Seasons Financial Planning. "If we do get them, I don't see us going back to zero on the federal funds rate."

For his clients, Winter has committed between a quarter and a third of investors' fixed income allocation to floating rate notes. He prefers using exchange-traded funds to get the exposure, citing more liquidity compared with buying individual issues.

Where you keep these notes also matters. The interest they generate is taxed as ordinary income, which has a top marginal rate of 37%. These investments are better contenders for tax-deferred accounts such as your individual retirement account, rather than your taxable account.

Income, price stability, tame returns

In a falling rate environment, floating rate notes may generate lower coupon payments, and total returns may be less than anticipated if future interest rate expectations aren't met, Bonds said.

There is also some concern around reinvestment risk. Once the Fed begins cutting rates, could investors be left without a source of attractive yield if they haven't locked into a longer-term fixed income asset?

"It's lower coupon rates versus the opportunity to lock in high fixed rates now if you consider the environment," said

Collin Martin, fixed income strategist at Charles Schwab. "Based on updated projections that the Fed is close to the end of the rate hiking cycle, there isn't much room for the coupons to rise."

Finally, opportunities for price appreciation are also limited, which is another factor for investors to weigh.

"If you remember Covid and the great recession of 2008, high-quality bonds experienced price appreciation," said Winter. "There was a flight to quality and people fled to Treasuries." That means in a recession, you may not get an increase in floating rate note prices to offset a decline in equities, he said.

From: Paul Winter <pwinter@fiveseasonsfp.com>
Sent: Thursday, June 22, 2023 3:34 PM
To: Mercado, Darla (NBCUniversal) <darla.mercado@nbcuni.com>
Subject: [EXTERNAL] RE: Thank you for your help!

Thanks, Darla.

'til tomorrow,

PW

Paul Winter

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From: Mercado, Darla (NBCUniversal) <darla.mercado@nbcuni.com>
Sent: Thursday, June 22, 2023 11:14 AM
To: Paul Winter <pwinter@fiveseasonsfp.com>
Subject: Thank you for your help!

Hi, Paul:

It was great speaking with you earlier this week. My story posted yesterday on CNBC Pro, our premium site. The link is here: <https://www.cnbc.com/2023/06/21/muni-bonds-can-offer-portfolios-tax-free-income-as-recession-looms.html>, but I've attached the text below in case you don't have an account. I'm looking forward to chatting about floating rate note ETFs tomorrow!

Darla Mercado

Municipal bonds can offer your portfolio tax-free income and stability as recession fears loom

PUBLISHED WED, JUN 21 2023 12:46 PM EDT UPDATED WED, JUN 21 2023 3:16 PM EDT

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Senior woman working at home using lap top
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Look no further than your home state if you're seeking some recession protection and tax-free income for your portfolio.

"People see [municipal bonds] as a defensive position for two reasons," said Shannon Saccocia, chief investment officer at NB Private Wealth.

"One, they're fixed income and they're intended to insulate [portfolios] from economic slowdowns and the impact on equities," she said. "Two, they have an extra layer of defensive protection and are used by retail investors who assign a premium to the tax efficiency of those bonds."

Recession fears linger as Federal Reserve Chair Jerome Powell has said the central bank isn't done hiking, but state and local governments' "rainy day" funds are at record highs of \$120 billion, according to Bank of America.

"Historically, municipal bonds have had low default rates," wrote Jared Woodard, investment and exchange-traded fund strategist at Bank of America, in a June 12 report. "Today, low expected defaults are reinforced by the quality of state and local balance sheets."

Investors are also hopping into munis. The [Vanguard Tax-Exempt Bond ETF \(VTEB\)](#) has seen \$2.7 billion in flows in 2023, according to FactSet. Meanwhile, the [iShares National Muni Bond ETF \(MUB\)](#) has picked up \$171 million in flows this year.

IN SEARCH OF TAX-FREE YIELD

TICKER	NAME	30-DAY SEC YIELD	EXPENSE RATIO
MUB	iShares National Muni Bond ETF	3.36%	0.07%
VTEB	Vanguard Tax-Exempt Bond ETF	3.48%	0.05%
FMHI	First Trust Municipal High Income ETF	4.00%	0.70%
JMST	JPMorgan Ultra-Short Municipal Income ETF	3.19%	0.18%
MUNI	Pimco Intermediate Municipal Bond Active ETF	3.13%	0.35%

Source: Fund websites

Choosing the right play

High-income investors — particularly those in the 32% marginal federal income tax bracket — appreciate that muni bonds generate tax-free income on a federal basis. That income may also be exempt from state taxes if you reside in the same locale as the issuer.

As a result, it makes most sense to keep these bonds in a taxable account.

For investors who live in high tax states, fund families offer ETFs and mutual funds that are particular to those locations. For instance, there's the [Vanguard California Intermediate-Term Tax-Exempt Fund Investor Shares \(VCAIX\)](#) and the [Nuveen New York Quality Municipal Income Fund \(NAN\)](#).



Quality matters in this space, particularly as large cities grapple with office vacancies. “In general, we are much more favoring higher quality types of bonds,” Nisha Patel, managing director and portfolio manager at Parametric, said Tuesday on “The Exchange.”

“Even if you stick to high quality bonds, the great ones, the local school districts, the essential water sewer systems, we’re seeing an opportunity to lock in ... over 3% tax-free yields, which on a taxable equivalent basis is 5.5% to 6%,” she said.

Patel also recommended going for longer-term issues to “lock in those yields” and avoid reinvestment risk. “We like adding duration in today’s portfolio,” she said. Bond duration measures the sensitivity of an issue’s price in response to a change in interest rates, and bonds with greater duration are more sensitive to changes in rates.

An array of choices

Mutual funds and ETFs are a way to get exposure, but investors should be fee-conscious. They should also be aware of the quality of the underlying holdings and potential default risk from municipalities with uncertain finances.

“Not every town, not every state is created the same,” said Saccocia. “The muni market is so bifurcated and so disparate that you can add value through issuer selection.”

In select situations, some advisors are recommending closed-end municipal bond funds. These offerings issue a set number of shares and can trade at a premium or discount to their net asset value. The catch is that these funds may also use leverage, which can magnify gains or losses.

“That discount to NAV will translate to higher yield and a lower price,” said Paul Winter, a certified financial planner

and portfolio manager at Five Seasons Financial Planning. He noted he tends to use funds that have little to no leverage.

Closed-end muni bond funds trading at a deep discount include the [BNY Mellon Municipal Income \(DME\)](#) and the [MFS High Income Municipal \(CXE\)](#). Both are trading at a nearly 16% discount to NAV, according to data from Nuveen's CEF Connect.

"Like any other bond exposure, there's almost always a trade-off between yield and risk," said Winter. "The muni bond space is no exception to that."



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