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How floating rate notes offer benefits across market cycles

Floating rate notes can offer investors a way to stay ahead of interest rate swings – offering capital stability and attractive income opportunities when markets shift. Paired with other fixed income assets, they can help build resilient portfolios that balance yield, diversification and long-term performance.

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Most bonds are sensitive to changes in interest rates. If an investor buys a conventional bond and interest rates go up, the price of the bond will decline. Floating rate notes, which automatically adjust their coupon when the prevailing rate changes, are an exception. They are frequently used by investors who want to protect the value of their fixed income investments in the face of uncertain interest rates.

Combined with other fixed income instruments, including fixed-rate bonds, corporate credit and others, we think floating rate notes offer a compelling mix of yield and capital protection, which can apply across a range of market environments.

Key takeaways

- Floating rate notes adjust their coupon in response to changes in a reference rate, protecting the value of the bond from price volatility.
- Floating rate corporate bonds offer potential for active investors to generate additional return versus cash alternatives.
- Combining floating rate notes with other fixed income assets including fixed-rate bonds can contribute to resilient portfolio positioning.

How floating rate notes work

To understand why floating rate notes were created, consider a common pitfall for bond investors – rising interest rates.

Imagine a company issues a five-year fixed-rate bond with a 4% coupon, matching prevailing interest rates at the time – a seemingly attractive investment. Now suppose the central bank raises rates to 5%. Suddenly, that fixed 4% coupon looks less appealing, as the bond pays below the new market rate.

The coupon can't change. What can change is the bond's price, which falls. Assuming an initial bond price of EUR 100, it will decline to approximately EUR 95 (assuming an interest rate duration of five years, all other things being equal). At that price, the bond's fixed-rate coupon will generate a yield equivalent to an identically priced bond that pays 5%.

The fall in price – equivalent to 5% of the bond's value – indicates the significant impact that rising interest rates can have on bond portfolios.

Floating rate notes are different. Because the coupon of a floating rate note is linked to a reference rate, it automatically adjusts when that rate changes. In the example above, there would be no fall in price – the floating rate note would simply reset its coupon to 5%, matching the prevailing interest rate.

What about when rates fall?

The ability to protect the value of capital in a rising interest rate environment makes floating rate notes popular with a variety of investors, either as a standalone investment or as part of a diversified fixed income portfolio.

In fact, the ability to protect against rising rates is so well-established that investors sometimes assume that in the opposite environment, when rates are falling, floating rate notes are the wrong investments to hold. But this is not necessarily true.

Returning to the example, let's imagine that interest rates did not rise. Instead, they fell to 3%. This is good news for the holder of the fixed-rate bond, which will rise in price in proportion to the fall in rates.

For the floating rate note, the coupon will adjust to the new rate. As in the previous case, its price will stay the same. There is no loss of capital. The tendency of a floating rate to protect value holds true in a falling as well as rising interest rate environment.

Outperformance potential versus cash alternatives

In a rate-cutting environment, the income from floating rate notes will inevitably decline as coupons reset lower in line with the reference rate. However, deposit rates will also fall under these conditions, reducing yields on money market funds and short-term bonds as well.

Corporate floating rate notes generally trade at a yield spread above cash, offering investors an additional income cushion. Moreover, credit spread curves tend to be steep, meaning investors are typically rewarded for extending maturities by one, two, or even three years with higher compensation.

Active investors can aim to generate additional return versus cash alternatives in a number of ways:

- They can buy longer-dated corporate floating rate notes – beyond the short maturities common in money market funds – to take advantage of steep credit spread curves. This approach allows them to earn additional income and benefit from "rolling down" the curve as the bonds shorten in maturity.
- Actively selecting issuers that are fundamentally attractively valued and dynamically allocating across global markets can further enhance the risk-adjusted return potential.
- Finally, strategies with the flexibility to adjust the mix between fixed rate and floating rate instruments can help preserve income when entering a monetary easing environment.

Floating rate notes tend to demonstrate a low correlation with other fixed income assets, which makes sense given their unusual lack of sensitivity to changes in interest rates.

This property of being relatively uncorrelated with other fixed income instruments can make them a useful diversifier, providing price stability in the face of interest rate volatility. We therefore believe that combining floating rate notes with other fixed income instruments offers an attractive opportunity for consistently good risk-adjusted returns.

Outlook for fixed income

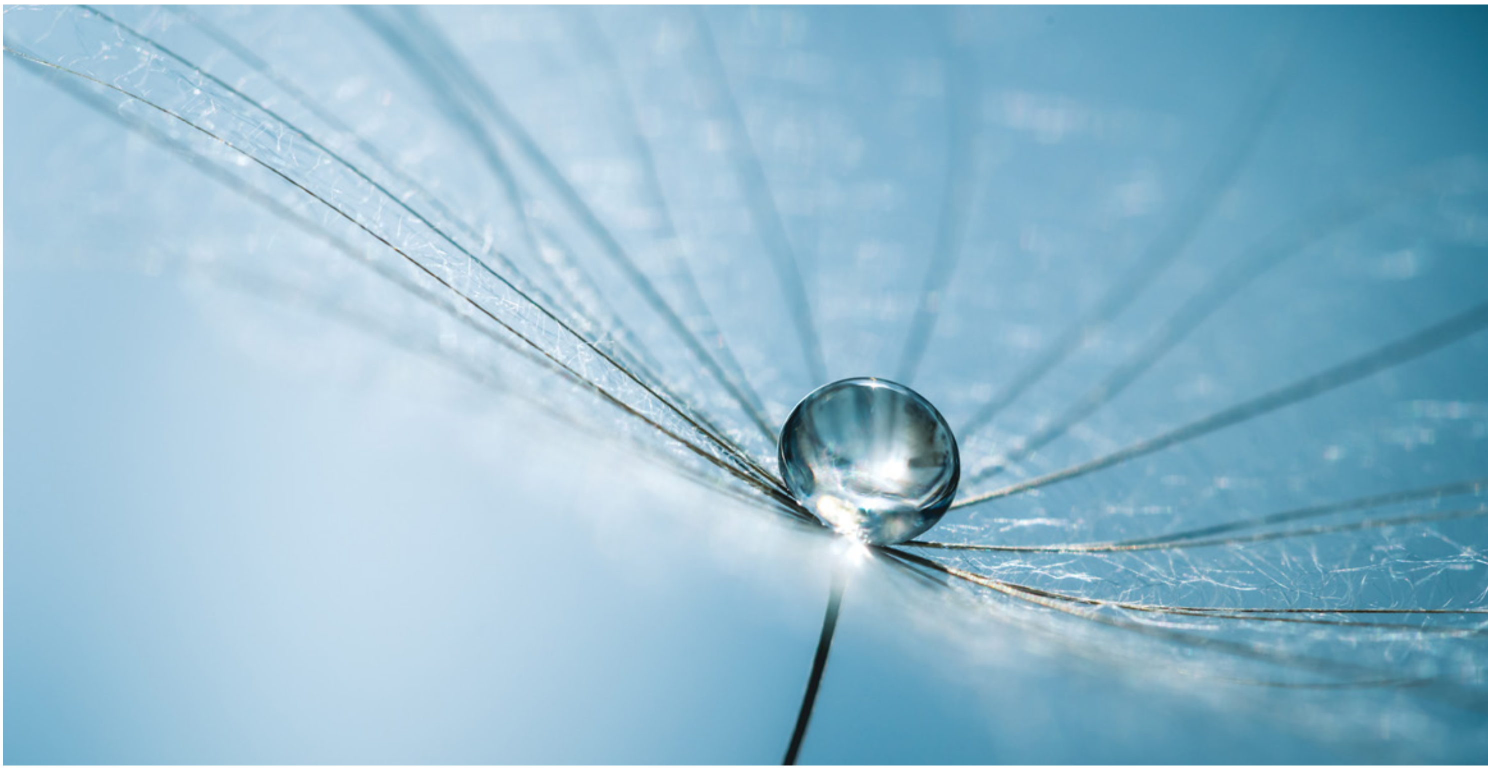
What is the macroeconomic outlook for 2026 and how does this impact fixed income assets? We expect global growth to remain resilient, supported by the largely pro-growth policy agendas of the major economies. In developed markets, central banks are likely to normalise policy rates towards neutral levels following the aggressive tightening of recent years. Fiscal policy should remain supportive, with governments prioritising infrastructure and strategic investment to offset lingering trade and geopolitical uncertainties. Inflation expectations continue to diverge – prices are likely to rise in the US, remain moderate in the euro area, and stay subdued in Asia and major emerging markets.

In our opinion, this combination of steady growth and contained inflation creates a broadly supportive backdrop for fixed income. While accommodative monetary policy points to lower income from floating rate instruments, it also provides a strong stimulus for economies and corporates. This outlook supports our favourable view of high-quality corporate bonds, where demand remains robust. Although valuations in some areas appear quite rich, we hold high conviction in key sectors such as financial services and favour a diversified approach – combining floating rate notes with fixed-rate securities from high-quality issuers.

We believe the most effective way to execute this kind of strategy is by following three key principles:

1. Selecting from a very broad range of fixed income assets across different geographies.
2. Conducting our own in-house research rather than relying on third parties.
3. Employing a flexible approach that allows us to adjust the portfolio's balance between fixed and floating rate bonds in response to market conditions.

Guided by these principles, investors can use floating rate notes to stay ahead of interest rate swings when markets shift.



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