Floating Rate Loans as a Hedge Against Rising Rates

The last three months of 2016 was a tough period for the bond market as the 10-Year Treasury Yield jumped from 1.6% to 2.45% and the benchmark Bloomberg Barclays Aggregate Bond Index lost about 3%, marking the worst quarter in 35 years for the index. The jump in yields in the fourth quarter could be attributed to some of President Trump's agenda to increase fiscal spending, decrease taxes and relax regulations. These policies are all pro-growth policies which could spur inflation.

As 2017 progresses, there are signs that interest rates may further rise. For example, the U.S. consumer price index (CPI) in January rose to 2.5% on a year-over-year (YoY) basis. This was the largest yearly increase in five years. This could impact interest rates because the U.S. Federal Reserve has a dual mandate to promote maximum sustainable employment and price stability. The second mandate of price stability can be interpreted as low and stable inflation. Although the Fed may prefer a broader measure of inflation called PCE, or personal consumption expenditures, that measure is also on the rise, which some are predicting may hit the Fed's target of 2% in the coming months. The unemployment rate is already currently in the Fed's target range, which is under 5%. In December, the Fed signaled that it would raise rates three times or 0.75% in 2017. Traders seem to doubt this, as the fed funds futures markets are only pricing in two rate hikes. Should the Fed raise rates at the pace it said it would, this could surprise the market.

Consumer Price Index

Date	*YoY Change*
1/31/2008	4.28%
1/31/2009	0.03%
1/31/2010	2.63%
1/31/2011	1.63%
1/31/2012	2.93%
1/31/2013	1.59%
1/31/2014	1.58%
1/31/2015	-0.09%
1/31/2016	1.37%
1/31/2017	2.50%

Source: U.S. Bureau of Labor Statistics

With the possibility that rates could move even higher this year, many investors are searching for income solutions that are less interest rate sensitive or, in other words, possess less duration. One option investors have been gravitating toward is bank loans. Also known as floating rate notes, these securities have a very low duration and a relatively high yield. These are notes that have interest rates pegged to a reference index, such as LIBOR. When LIBOR rates increase, the yield on these notes also increases. However, the opposite is true when rates fall. This is unlike traditional bonds which have a constant yield and the price of the bond then adjusts for the rise or fall in interest rates. When interest rates rise, bond prices fall and vice versa. However, before investing in bank loans, investors should to be aware of some risks and intricacies regarding the investment.

One of the major risks to bank loans is credit risk. These notes are typically senior secured debt meaning in a default scenario, holders of the notes are paid back before bond holders and, of course, equity holders who are last in line to get paid back. However, bank loans still tend to be

© Tower Square Investment Management LLC

below investment grade, so if rates rise and companies do not have strong balance sheets, the increased interest expense may cause corporations financial distress and they may default on these loans. In a weaker market environment, as seen in 2008, bank loan indices saw losses around 30%. Though they did rebound nearly 50% in 2009, credit risk is something to consider.

Another thing to be aware of is that bank loans can be more sensitive to supply and demand shocks than other asset classes. If bank loans experience negative returns, investors selling out of the asset class could further exacerbate price declines. In addition, this asset class is less liquid. Selling the securities in a weak market could force the underlying portfolio managers to liquidate at poor prices.

While interest rates may continue to rise as inflation ticks up, company balance sheets are fairly strong and companies are not taking on a lot of leverage, as seen in the latter half of past credit cycles. Investors and CEOs alike still have the memories of 2008 fresh in their minds and are not taking the same risks. Defaults are expected to remain low even though rates are expected to increase. This could bode well for the bank loan market.

This report is created by Tower Square Investment Management LLC

© Tower Square Investment Management LLC

About Tower Square Investment Management®

Tower Square Investment Management LLC is an SEC registered investment adviser owned by Cetera Financial Group®. It provides investment research, portfolio and model management, and investment advice to its affiliated broker-dealers, dually registered broker-dealers and registered investment advisers.

About Cetera Financial Group®
Cetera Financial Group (Cetera) is a leading network of independent retail broker-dealers empowering the delivery of objective financial advice to individuals, families and company retirement plans across the country through trusted financial advisors and financial institutions. Cetera is the second-largest independent financial advisor network in the nation by number of advisors, as well as a leading provider of retail services to the investment programs of banks and credit unions.

Through its multiple distinct firms, Cetera offers independent and institutions-based advisors the benefits of a large, established broker-dealer and registered investment adviser, while serving advisors and institutions in a way that is customized to their needs and aspirations. Advisor support resources offered through Cetera include award-winning wealth management and advisory platforms, comprehensive broker-dealer and registered investment adviser services, practice management support and innovative technology. For more information, visit ceterafinancialgroup.com.

"Cetera" refers to the network of retail independent broker-dealers encompassing Cetera Advisors, Cetera Advisor Networks, Cetera Investment Services, marketed as Cetera Financial Institutions, Cetera Financial Specialists, First Allied Securities, Girard Securities, and Summit Brokerage Services.

Disclosures
The material contained in this document was authored by and is the property of Tower Square Investment Management LLC. Tower Square Investment Management provides investment management and advisory services to a number of programs sponsored by affiliated and non-affiliated registered investment advisers. Your registered representative or investment adviser representative is not registered with Tower Square Investment Management and did not take part in the creation of this material. He or she may not be able to offer Tower Square Investment Management portfolio management services.

Nothing in this presentation should be construed as offering or disseminating specific investment, tax, or legal advice to any individual without the benefit of direct and specific consultation with an investment adviser representative authorized to offer Tower Square Investment Management services. Information contained herein shall not constitute an offer or a solicitation of any services. Past performance is not a guarantee of future results.

For more information about Tower Square Investment Management strategies and available advisory programs, please reference the Tower Square Investment Management LLC Form ADV disclosure brochure and the disclosure brochure for the registered investment adviser your adviser is registered with. Please consult with your adviser for his or her specific firm registrations and programs available.

No independent analysis has been performed and the material should not be construed as investment advice. Investment decisions should not be based on this material since the information contained here is a singular update, and prudent investment decisions require the analysis of a much broader collection of facts and context. All information is believed to be from reliable sources; however, we make no representation as to its completeness or accuracy. The

© Tower Square Investment Management LLC

opinions expressed are as of the date published and may change without notice. Any forward-looking statements are based on assumptions, may not materialize, and are subject to revision.

All economic and performance information is historical and not indicative of future results. The market indices discussed are unmanaged. Investors cannot directly invest in unmanaged indices. Please consult your financial advisor for more information.

Additional risks are associated with international investing, such as currency fluctuations, political and economic instability, and differences in accounting standards.

While diversification may help reduce volatility and risk, it does not guarantee future performance.

The ***Bloomberg Barclays Capital U.S. Aggregate Bond Index****, which was originally called the Lehman Aggregate Bond Index, is a broad based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government–related and corporate debt securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS (agency and non-agency) debt securities that are rated at least Baa3 by Moody's and BBB- by S&P. Taxable municipals, including Build America bonds and a small amount of foreign bonds traded in U.S. markets are also included. Eligible bonds must have at least one year until final maturity, but in practice the index holdings has a fluctuating average life of around 8.25 years. This total return index, created in 1986 with history backfilled to January 1, 1976, is unhedged and rebalances monthly.*

© Tower Square Investment Management LLC