Perpetual knowledge bank series: Fixed versus Floating Interest Rates

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15 April 2021

Fixed income securities are originated in the primary market, from where they are sold from arranging intermediaries to investors. Although some investors buy and hold fixed income securities from issue to maturity, they are commonly traded in the secondary market. However, factors such as central bank policy, interest rate movements and the economic environment can impact a security's face value and yield once trading in the secondary market.

It is therefore important to understand that corporate bonds can be fixed interest or floating rate investments. This means that the interest rate on the money lent by the investor is either set in advance or linked to a variable interest rate.

Definitions

Fixed rate means the interest rate of the asset is set and the dollar value of the interest payment will be the same every period. The interest rate stays the same for the life of each bond. For example, a $100 bond with an 6% fixed interest rate will pay investors $6 a year in six-monthly or quarterly instalments called coupon payments.

Floating rate assets have a variable interest rate. This means the interest rate may change, usually in line with an official interest rate such as the 90-day Bank Bill Swap Rate (BBSW). The coupon will be determined by the reference rate (which moves) plus a fixed margin. The interest payment on a floating rate asset will typically move up or down as interest rates move up or down. The prospectus will tell investors exactly how and when the floating rate will be calculated for coupon payments, but they are usually quarterly payments.

Investors may choose to invest in fixed or floating bonds to better meet cash flow requirements or because of a better perceived return on one bond over another.

Inflation and risk

Fixed securities prices are directly exposed to underlying rate movements, in a way that floating rate note securities are not. If the underlying interest rates, mostly set up and influenced by central bank policies, increase or decrease, it affects the value or price of a fixed bond. If interest rate rises, the fixed coupon on the bond does not, so the price of the bond goes down. And vice versa. Interest rate movements, however, do not have much impact on the price of a floating rate bond because these follow the movements of the underlying interest rate. The interest rate movement is reflected in the coupon paid to the investor: interest rate falls, coupon of a floating rate bond goes down; interest rate rises, coupon goes up.

Floating rate assets tend to be more capital stable and favoured by institutional investors who do not want to take on interest rate risk. These products take marginal interest rate risk as interest is adjusted quarterly and tied to a benchmark – in Australia the 90-day BBSW currently. Floating rate investments also suit investors expecting a rising interest rate environment.