Caselet #21 – Sparky Learns about Floater Spread Duration

Learning Outcome Statement

After completing this caselet, students and trainees should be able to explain the difference between interest rate duration and spread duration for floating rate notes.

Caselet #21

Renowned Darla Moore School of Business graduate and bond analyst, Ms. Jane Gotzrox, is once again ready to extend her intern’s fixed income analytical ability.

“Sparky,” she says, “today I want you to learn an important distinction about floating rate notes. Some unsophisticated investors think that because the coupon rate changes with short-term rates, they have no price risk.’ It’s hard to be more wrong, eh, Sparky?”

“To see the error of their ways, I want you to find a 10-year corporate floater. Be sure that it is non-callable. You remember how, yeah?”

“Open Excel with Yield Book Add-in. Begin a Security Search, use Security Type CFLOAT for corporate floater. Use 10 years from this year for Maturity in your search. Choose one of the bonds that comes up, copy its CUSIP and paste it in your spreadsheet. Then, use the Indicative Data function to look at its CallFlag. You want it to be N, yeah?”

“Once you have the issue identified, I want you to find its Effective Duration for a par price. Use the Price/Yield function builder. Why should you expect a number less than 1 for this bond with 10 years to maturity, Sparky? Oh, yes, and while you’re at it, get the bond’s OAS, too.”

“Next, I want you to show what happens to its price if its OAS blows out. Increase it by 100bp. Sparky, can you guess what name we give the percentage change in price for a one percent change in pricing spread? Yeah? Good.”

“When you’re done, be sure to keep your work for your interview notebook. Include some brief notes on what you found and what it means. Your predecessors have found that taking three or four of the caselets that they liked best, understood best and could explain most clearly really helped their chances in the job market.”