Fixed Income

ULTRA SHORT-TERM BOND: A FLEXIBLE ALTERNATIVE FOR SHORT-DATED INVESTMENTS

KEY POINTS

■ The T. Rowe Price Ultra Short-Term Bond Fund was created five years ago to address investor demand for high-quality, short-dated investment alternatives that sought to provide flexibility and stability while generating income.

■ Our approach takes advantage of T. Rowe Price’s robust credit research capabilities to utilize our more flexible opportunity set in an effort to increase income.

■ Managing risk remains an important goal for investors seeking yield in a rising rate environment.

What need was addressed through the creation of the Ultra Short-Term Bond Fund five years ago?

Looking back to the fund’s 2012 inception, there were a few catalysts for launching the Ultra Short-Term Bond Fund. Among them was the need to provide investors a better return in the low interest rate environment, which we expected to continue for quite some time. We believed that investing in higher-yielding investment-grade securities that are longer in maturity (up to three years) than money market funds are restricted to could provide better outcomes. Money market funds are restricted to maturities that cannot exceed 60 days and are largely limited to the two highest credit rating tiers. The T. Rowe Price Ultra Short-Term Bond Fund can invest in the entire investment-grade universe with maturities of up to three years, including short-term investment-grade and government securities, asset-backed securities, and bank obligations.

Another catalyst for the creation of the fund was that anticipated money market reform would curtail investment opportunities available to money fund investors. Institutional investors would be forced into prime money funds with floating net asset value (NAV) money market fund investments that could also impose restrictions on their most liquid investment or government money funds with very low returns. Institutional investors largely chose to move their assets from prime money funds into government money market funds. Retail investors would have a similar choice: a government money fund offering very low returns but a stable $1.00 NAV, or a prime money fund that might impose fees or restrictions on withdrawals.

Last, over the long term, we believed that an ultra short-term bond fund would provide traditional money market investors with another investment option for those investors willing to accept additional risk in return for the potential of increased yield. That brings us to today’s climate.

What specific features or strategies did you highlight as objectives for the Ultra Short-Term Bond Fund?

We designed the Ultra Short-Term Bond Fund as an investment option that would provide investors with a flexible alternative to traditional money market funds, allowing them to potentially increase their returns while maintaining stability and income-generation potential. The fund’s approach is supported by our robust credit research capabilities, enabling us to take advantage of more flexible opportunity sets to increase income. Managing risk remains an important goal for investors seeking yield in a rising rate environment, and we continue to address the evolving needs of our clients with innovative investment strategies.
alternative for money market investors; however, the Ultra Short-Term Bond Fund is not a money market fund—it’s a bond fund that prioritizes liquidity and price stability, while maintaining a low duration profile.

**Liquidity.** In the past, money market investors had the ability to make withdrawals without restrictions. This feature has been limited somewhat following money fund reforms. Because this was an important feature to investors, the Ultra Short-Term Bond Fund maintains a large buffer of liquid assets to accommodate redemptions in an effort to provide similar access to unrestricted withdrawals.

**Principal Stability.** Money fund investors are also accustomed to a stable $1.00 share NAV. This changed with money market reform, reducing options that could guarantee a stable $1 per share NAV. We felt investors would seek alternatives that focused on minimizing price fluctuations. While the NAV for Ultra Short-Term Bond Fund is not fixed, historically, it has been relatively stable (Figure 1).

**Low Duration.** The Ultra Short-Term Bond Fund also features a low duration profile, and thereby has reduced sensitivity to interest rate changes. We wanted to take our experience in money market fund investing and apply it to ultra short-term bond, by extending maturities to one- to three- years in an effort to provide an incremental yield advantage.

**Describe your investment strategy. What are you doing to enhance principal stability?**

The Ultra Short-Term Bond Fund was designed to provide unrestricted redemptions, increased income, and reduce price fluctuations. Achieving all three of these features creates an attractive product for low-duration investors.

To achieve ample liquidity, we routinely maintain a position in U.S. Treasury bills, strictly to meet redemptions. This comes out of the lessons learned in 2008. If liquidity evaporates in the market and demand goes away, you don’t want to be a forced seller at distressed prices simply to fund redemptions. A liquidity position in Treasuries becomes invaluable in that environment.

To enhance income, we can buy securities that have slightly longer maturities that come with additional spread. We can increase yields in sync with the three-month Libor rate, but because we may own securities that have a three-year final maturity, we get the incremental spread associated with a three-year bond.

By building a portfolio of bonds maturing at different dates, we seek to increase liquidity, reduce interest rate risk, and diversify credit risk. Our securitized positions pay down principal and interest each month, providing a source of cash flows as they mature that allow us to either increase our liquidity buffer or reinvest back into the market at higher rates.
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What aspects of your strategy do you feel contributed to the early success of the Ultra Short-Term Bond Fund?

The benefit of an ultra short-term bond fund is that it can provide incrementally better return than money funds by taking on short-dated credit risk. While money funds are constrained to a very short maturity horizon, typically one month to three months, the Ultra Short-Term Bond Fund typically invests in securities that mature in one year to three years and occasionally even out to five years. It can also include floating rate debt. Similarly, the fund can invest in the full investment-grade spectrum. While money funds are constrained to the two highest ratings categories, the Ultra Short-Term Bond Fund can invest in securities rated BBB or higher.

Another advantage of the Ultra Short-Term Bond Fund is that the fund can invest in a more diverse set of security types. Not only are we investing in corporate bonds and government bonds, but we have fairly robust positions in securitized products, including asset-backed securities, mortgage-backed securities, and commercial mortgage-backed securities.

How have you used the Ultra Short-Term Bond Fund’s more flexible opportunity set?

Our extensive use of floating rate securities as we transitioned to a rising rate environment benefitted performance. We incepted the fund in the midst of Federal Reserve quantitative easing, which lasted for the first two to three years of the fund’s existence. At that time, the strategy invested in longer-dated credit to provide yield pickup and some principal returns as all rates were continuing to fall and spreads narrowed. That situation changed by about the third quarter of 2016 with the prospect that the Fed would begin to unwind its balance sheet, which it has since begun to do.

The shift to floating rate securities is all about what I see as a repricing of interest rates following the financial crisis and the last 10 years of central bank-induced rate suppression. I believe we are at the cusp of a period of time where we will see rates move back to more normal levels, where short-term rates in the 3% to 4% range are not unusual at all.

I don’t think investors have fully grasped the implications, especially in fixed income portfolios, of a very slow and steady progression of rate increases by the Federal Reserve through 2018 and 2019. That’s going to move base rates, such as the Libor rate and the overnight federal funds rate, to the 3% range for very short-dated investments.

In this rising rate environment, where do you feel the Ultra Short-Term Bond Fund fits into a portfolio for retail investors and/or an advisor?

More importantly, in the current environment, as interest rates move higher—and I believe they will—we are in the final stages of a bond bull market or the early stages of a bond bear market. As a result, with its really low duration profile, the Ultra Short-Term Bond Fund provides the balanced attributes that fixed income investors may be looking for in this environment.

Is the move to ultra short-term bond funds a temporary shift specific to this rising rate environment?

No, I see an ultra short-term bond fund as a core part of an investor’s

**TABLE 2: T. Rowe Price Ultra Short-Term Bond Fund Lipper and Morningstar Category Percentiles**

<table>
<thead>
<tr>
<th></th>
<th>Average Annual Total Returns</th>
<th>Cumulative Total Returns</th>
<th>Lipper Ultra-Short Obligations Funds</th>
<th>Morningstar Ultrashort Bond Average</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1 Year</td>
<td>3 Years</td>
<td>5 Years</td>
<td>Since Inception</td>
</tr>
<tr>
<td><strong>Ultra Short-Term Bond Fund</strong></td>
<td>1.75</td>
<td>1.52</td>
<td>1.15</td>
<td>1.02</td>
</tr>
<tr>
<td>Lipper Ranking</td>
<td>23 out of 137</td>
<td>17 out of 106</td>
<td>19 out of 87</td>
<td>—</td>
</tr>
<tr>
<td>Lipper Percentile</td>
<td>17</td>
<td>16</td>
<td>22</td>
<td>—</td>
</tr>
<tr>
<td>Morningstar Ranking</td>
<td>39 out of 179</td>
<td>34 out of 139</td>
<td>30 out of 109</td>
<td>—</td>
</tr>
<tr>
<td>Morningstar Percentile</td>
<td>22</td>
<td>24</td>
<td>28</td>
<td>—</td>
</tr>
</tbody>
</table>

Sources: Lipper and Morningstar. Rankings are based on total return within respective peer group.

Performance data quoted represents past performance and does not guarantee future results. Investment return and principal value will fluctuate so that an investor’s shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance data quoted. To obtain the most recent month-end performance, visit troweprice.com. Total return figures include changes in principal value, reinvested dividends, and capital gain distributions.

The fund’s gross and net expense ratios as reported in the most recent prospectus were 0.44% and 0.35%, respectively. The fund operates under a contractual expense limitation that expires on September 30, 2019.
portfolio. With a focus on trying to maintain price stability and investments in liquid assets, such as U.S. Treasury bills, an ultra short-term bond fund can complement many other investments.

Q As the Fed continues to raise rates and other central banks look to do the same, do you see continued flows into the space?

Definitely. It’s my view that the Fed is going to raise rates at least three times throughout 2018 and probably at least another three times in 2019. That brings the overnight rate to somewhere in the range of 3%, which would affect interest rates at all maturities.

As a result of rising rates and perhaps a slightly risk-off sentiment that is beginning to creep into the equity as well as fixed income markets, we are seeing very good and continued flows into the product.
T. Rowe Price focuses on delivering investment management excellence that investors can rely on—now and over the long term.

To learn more, please visit troweprice.com.