Seeking to Optimize Cash Allocations With Low Duration Bonds

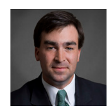
Flexible strategies can invest across low duration universe.

August 2023

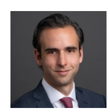
KEY INSIGHTS

- Many investors overlook the importance of cash in the asset allocation decision.
- Investors without immediate liquidity needs can potentially earn incremental yield over government money market funds in a low duration bond fund.
- Low duration bond funds are not bound by money market fund regulations, so they can invest out to three years to potentially lock in yield for longer periods.

Cheryl Mickel, CFA®
Head of Low Duration Team and Co-portfolio Manager, Short Duration Income Fund



Alex Obaza, CFA®
Portfolio Manager, Ultra Short-Term Bond Fund



Thomas Heidenberger, CFA®
Portfolio Specialist

Low duration[1] bond funds, such as the T. Rowe Price Ultra Short-Term Bond Fund, have provided a sustained yield advantage over time compared with a traditional money market fund. These low duration strategies can take on marginally more credit and interest rate exposure and risk, which creates the potential for compelling returns versus traditional cash management vehicles. This naturally leaves investors asking themselves about the opportunity cost[2] of their cash holdings.

In order to capitalize on higher potential returns, an investor can consider a strategic or long-term approach to cash investing. This requires an investor to separate immediate liquidity needs from cash that is not needed for at least three to six months. Investors can consider an investment product for the latter portion, such as the T. Rowe Price Ultra Short-Term Bond Fund, where they can potentially benefit from higher yield and total return compared with traditional cash alternatives.

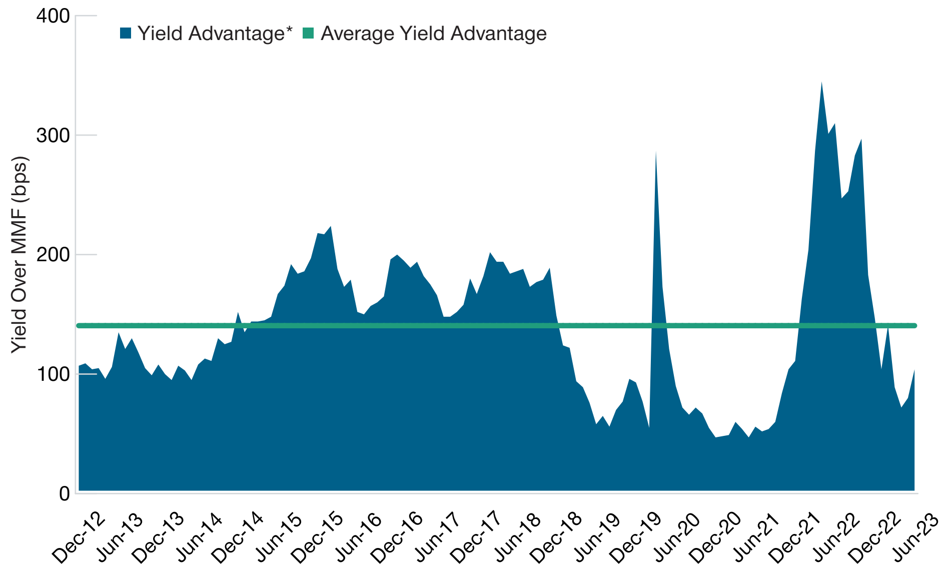
Strong Flows Into Retail Money Market Funds

While bank accounts are insured (up to USD 250,000) by the Federal Deposit Insurance Corporation (FDIC) against the risk of bank failure, and their principal values do not fluctuate as interest rates rise or fall, the advantage of higher yields on money market funds has driven many bank customers to move their assets from deposit accounts to money market funds, contributing to the recent stress on regional banks. Retail money market funds have been a destination for assets from bank deposits due to money market funds' increased use

[1] Duration measures a bond's sensitivity to changes in interest rates.
[2] The loss of potential gain from other alternatives when one option is chosen.

Historical Yield Advantage

(Fig. 1) Yield premium of short-term bonds over money market fund (MMF) median



As of June 30, 2023.

Sources: Bloomberg Index Services Limited, Lipper. Yield measure is yield to maturity.

Past performance is not a reliable indicator of future performance.

*Bloomberg US Corporate 1-3 Year Index yield minus Lipper U.S. Government Money Market Funds median yield. A basis point is 0.01 percentage point.

of the Federal Reserve's reverse repo program,[3] which provides a significant yield advantage over bank deposit rates because of the program's close tie to the federal funds rate.

The Investment Company Institute (ICI) reported that money market fund assets increased to over USD 5 trillion as of May 2023. Nearly 40% of that total was in retail funds across government, prime,[4] and tax-exempt strategies.

Money Market Regulations Limit Maturities and Yield...

However, recent money market reform regulations (SEC rule 2a-7) limit retail money market funds to a 60-day weighted average maturity (WAM) to ensure the highest level of liquidity consistent with a lower risk profile for investors. As we near the peak of the current U.S. interest rate cycle, many of these money market funds will lengthen WAMs to hold higher yields for as long as possible—but regulatory requirements still cap their WAMs and yields. While money market mutual funds do not guarantee an investor's deposit like an FDIC-insured bank account, U.S. Treasury and government money market mutual funds are required to invest at least 99.5% of their assets in fixed income securities backed by the full faith and credit of the U.S. government. Retail prime money market mutual funds can invest in a broader range of short-term instruments, including commercial paper issued by corporations.

...But Low Duration Bond Funds Provide Multiple Ways to Source Yield

Compared with a traditional money market fund, the Ultra Short-Term Bond

[3] The reverse repo program involves the Fed selling a security overnight to a counterparty, such as a money market fund, while simultaneously agreeing to buy it back at a slightly higher price. The difference in price represents interest paid to the counterparty.

[4] Prime money market funds can invest in corporate obligations.

Fund can cast a wider net across the universe of low duration investments, and it has the flexibility to invest in instruments that mature in as long as three years. This provides the fund with more ways to potentially source more yield from multi-sector credit allocation, duration, or a combination of both while taking on additional risk.[5]

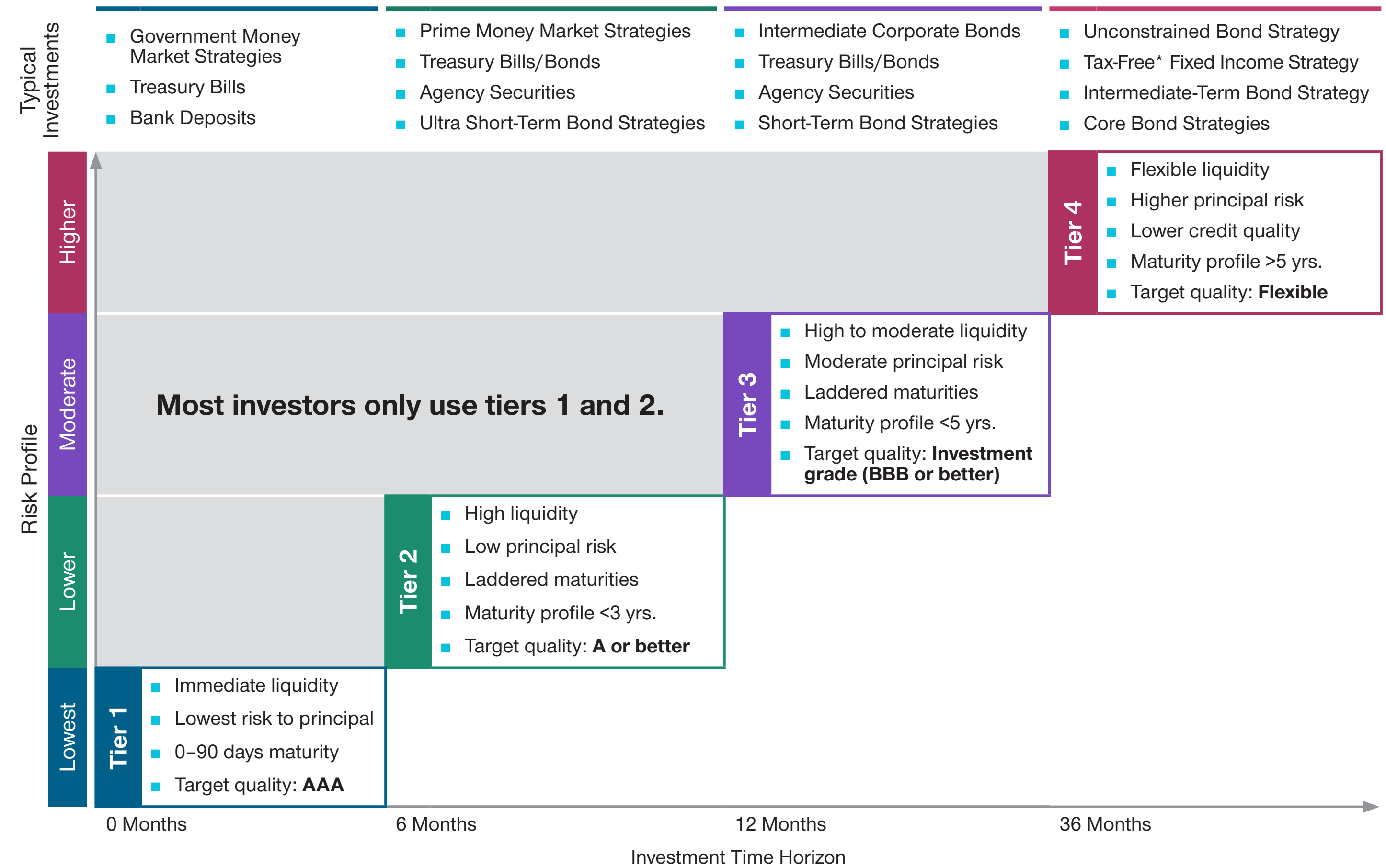
This should help keep its yield competitive with money market fund yields even as we enter an expected higher-for-longer interest rate environment.

A More Strategic Approach to Cash Investing

The fund seeks to deliver an incremental return over government money market funds for investors who want a cash alternative allocation but do not have immediate liquidity needs. However, many investors simply lump their cash

Cash Investment Opportunity Set

(Fig. 2) Many investors ignore tiers 3 and 4 opportunities.

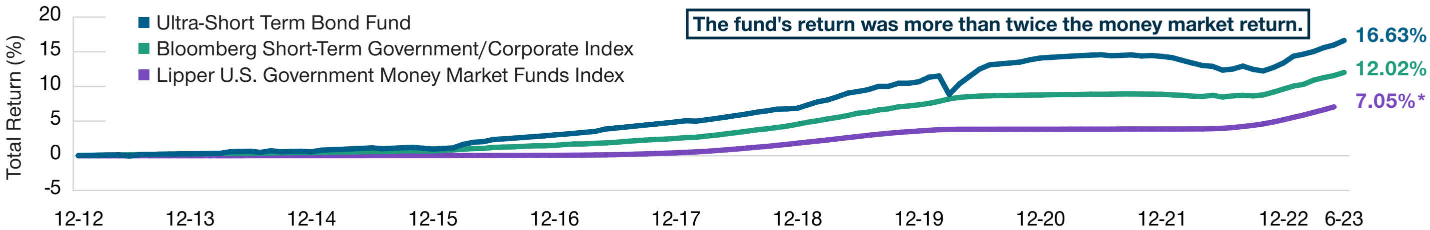


Source: T. Rowe Price.
For illustration purposes only. This is not intended to be investment advice or a recommendation to take any particular investment action. Characteristics of specific investments may vary.
Target quality refers to credit quality of the underlying bonds that the strategies typically seek to invest in. The credit ratings are based on S&P and Moody's ratings. A rating of "AAA" represents the highest-rated investment-grade rating, and a rating of "A" represents the second-lowest investment-grade rating. A rating of "BBB" represents the lowest investment-grade rating.
* State and local taxes may apply, and/or alternative minimum tax.
Investment Products are not FDIC-insured. Treasury bills and bonds are backed by the full faith and credit of the U.S. Government. Tier 4 investments are subject to the highest level of relative risk and include increased interest rate risk and credit risk. They may be subject to other types of risks such as international investing and derivatives risk. See additional risks in the Additional Disclosures section.

[5] Due to the nature of the fund's investment universe, the fund will take on incrementally more credit and interest rate risk than a money market fund. Investors should also be prepared to take on fluctuations in principal value.

Fund Cumulative Return Outpaced Money Market Funds

(Fig. 3) Cumulative total return vs. benchmark, money markets



As of June 30, 2023 (May 31, 2023 for Lipper data).

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.

Index data is for illustrative purposes only and is not indicative of any specific investment. Investors cannot invest directly in an index. Lipper U.S. Government Money Market Index is not a benchmark for the fund and is included for illustrative purposes only.

Sources: T. Rowe Price, Bloomberg Index Services Limited, Lipper. Please see additional disclosures.

* Through May 31, 2023.

Ultra Short-Term Bond Fund

Average Annual Total Returns as of June 30, 2023

1 year	5 year	10 year
3.81%	1.97%	1.56%

Gross expense ratio: 0.31%. Returns are for Investor Class.

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allocations into money market funds, overlooking the potential for higher yields and returns that may be available from low duration bond funds.

Across fixed income, particularly in low duration bonds, yield plays a greater role than price appreciation in generating excess returns.[6] As corporate bonds and securitized issues typically have higher yields than Treasuries, we tend to overweight these sectors in the portfolio to achieve a yield advantage. By employing sector rotation and rigorous credit selection using our extensive research capabilities, we seek to identify the appropriate sectors and most favorable bonds for investment while appropriately monitoring and managing risk.

WHAT WE'RE WATCHING NEXT

We rely heavily on our global team of credit analysts when investing in fixed income sectors with credit risk. Strong fundamental credit analysis is even more essential with the potential for the U.S. economy to tip into recession, which could increase default rates.

[6] Excess return is the difference between an investment's return and that of its benchmark.

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While **U.S. government-backed securities** generally are considered to be among the highest credit quality, they are subject to market risk. The primary source of risk is the possibility of rising interest rates, which generally cause bond prices, and a bond fund's share price, to fall.

Ultra short-term bond funds and short-term bond funds are subject to credit risk, liquidity risk, call risk, and interest rate risk. Yield and share price will vary with interest rate changes. The funds involve more risk than a money market mutual fund and are not subject to the same diversification and maturity standards. The net asset value will fluctuate, and investing in these products could result in the loss of principal.

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