This undiscovered asset class could be the contrarian play you're looking for.

Bobbing Along

By Bruce W. Fraser

IF YOU HAVEN'T SHIFTED A PORTION OF YOUR CLIENTS' FIXED-income assets from longer-term vehicles to shorter-term instruments, shame on you. But it's not too late to consider a shorter-term strategy to take advantage of today's unusual interest rate climate. After all, financial advisers customarily recommend that all clients, including high-net-worth individuals, hold bonds or bond funds in a diversified portfolio.

But bond strategies sometimes get lost in the shuffle because the sizzle is in equities. Holders of bonds and bond mutual funds are typically counseled to think of them as long-term investments, made once and then left to professionals to manage. But with barely enough heat in either equities or bonds these days, it may be time to look at floating rate funds.

The market has slogged along for the better part of the last few years. Some advisers who don't pay much attention to bonds—or are used to thinking of bonds as stodgy or boring—may not have realized it, but your clients can get almost as good a return on the fixed income side by investing in shorter term vehicles. What's more, there's less risk and no need to tie up your clients' money for a long duration.

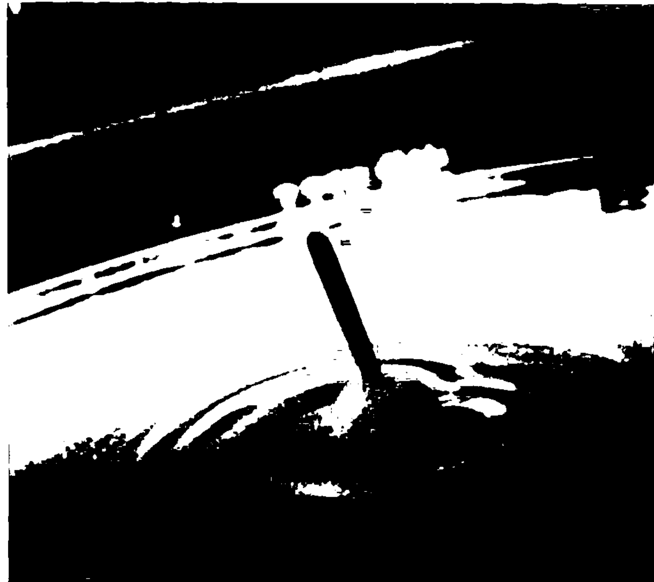
What's occurred over the past few months is an unexpected "flattening" of the yield curve between two-year and 10-year Treasuries. Indeed, the gap had shrunk to less than 10 basis points between these two instruments as of the end of November 2005—the shortest gap in five years.

And going farther out, the gap separating two-year and 30-year Treasuries was only 30 basis points. The upshot is that investors haven't been getting enough compensation on the long end of the yield curve, analysts say, for exposure to inflation and other risks that come with holding Treasuries and municipal debt with longer maturity.

"It's not a bet I would want to take," says Don Cassidy, senior research analyst at Denver, Col.-based Lipper Inc. "I think (investors) have been moderately fortunate. Send the thank-you notes to China and our trade deficit. Have they been adequately rewarded? Probably not. Historically, you'd get more of a spread than you did. So far, you've been lucky for not accepting a small premium. You're lucky (rates) haven't gone up more than they have at the long end."

For fixed-income investors, the idyll came to an end in June 2004 when the Federal Reserve began pushing up short-term yields in a series of 13 back-to-back rate hikes. Longer-term yields have been checked by stronger demand for U.S. debt, inflation, and anticipation that higher rates will take hold, slowing the economy. Fed chairman Alan Greenspan framed it in testimony to Congress recently as "a conundrum" in the yield curve.

From roughly 1966 onward, in periods of prior interest- rate increases, the prices of intermediate- and long-term bonds have periodically been observed to decline in the face of rising interest rates, according to data from Ibbotson Associates compiled by Kevin Gahagan. But in the current rate environment, there's been no ripple on the yield curve, explains Gahagan, a principal at Mosaic Financial Partners, a wealth management firm in San Francisco. Long-term bond prices have performed better than expected given past history.



"It's somewhat surprising, as I would have expected to see long-term and intermediate bond prices decline," he says. "Bond investors want safety and yet high yield, but the two don't necessarily go together. They may be mutually exclusive."

To be sure, you can get a return these days north of 4 percent in a plain old vanilla money market fund or short-term CD. But you might also consider putting some of your clients' fixed-income money in a relatively overlooked sector—so-called "floating rate funds" or "loan participation funds," aka "bank loan funds" and "leveraged loan obligation funds."

These funds have a short history. Most bank loan funds are offered in a closed-end format and currently trade at significant discounts to net asset value, which juices their yields.

Among the oldest surviving closed-end loan participation funds are the ING Prime Rate Trust Fund (originally the Pilgrim Prime

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Rate Fund), incepted in May 1988 and the Van Kampen Senior Loan IB Fund, the Merrill Lynch Floating Rate Fund and the Morgan Stanley Income Trust Fund, all launched in 1989. Most of the remaining bank loan funds have been created within the last five years or so.

Over the past three years, the closed-end versions have posted a total return of 9.49 percent annualized, and their open-ended counterparts 4.91 percent, according to Lipper. "The closed-end side got helped because many of those funds use leverage," explains Cassidy. There are a total of 41 funds in Lipper's open- and closed-end loan participation fund universes, and counting share classes, 94 loan participation funds in all with assets totaling approximately $24 billion.

THERE WAS A TIME A COUPLE OF YEARS AGO WHEN YOU COULD PICK UP THESE INSTRUMENTS, AND YOU WERE MAKING MUCH MORE YIELD THAN IN A MONEY MARKET FUND.

Floating rate funds are not to be confused with ultra- or short-term bond funds. Ultra bond funds invest in bonds with maturities of 30 days to one year, according to Lipper. Short-term bond funds invest in bonds of usually higher quality debt, with a maturity of two- to two-and-a-half years. Floating rate funds invest in bank loans with short duration interest rate reset.

Their reset periods typically range from 30 to 60 days. The valuation change on the underlying assets is primarily credit related rather than interest-rate related. The assets are commonly senior in the capital structure of the borrower and typically secured by the assets of the borrower, ordinarily a non-investment grade company. Non-investment grade senior and secured floating rate loans typically have much higher recovery rates in the event of a default than high-yield bonds.

The appeal of these funds, of course, is that in a rising rate environment they experience less principal erosion than would occur in a typical fixed-income fund. Their rates adjust consistent with the rise in rates and therefore insulate investors from interest-rate risk. Given the recent history of the yield curve, these have been good instruments to hold, as opposed to instruments with longer-term maturities. In third quarter 2005, for example, long-term government bond funds were down 1.06 percent; intermediates fell 0.59 percent, whereas the Lipper leveraged-loan category ended the same period up 1.5 percent.

Lately, these portfolios have generated lots of interest among advisers, fund portfolio managers and other financial cognoscenti in the fixed-income community. Michael W. Roberg, executive vice president and chief income officer of MFS Investment Management in Boston, regards floating rate funds as the best place to be now in fixed income.

"The credit fundamentals support this category, and they are a great diversifier on the fixed income side," Roberg told a press briefing in New York recently. MFS's open-end bank loan fund, launched early in 2005, was up 4.75 percent through the end of last November. Howard Tiffen, lead portfolio manager of the Van Kampen Senior Income Trust Fund, a closed-end offering, says, "Loans are looked upon by many investors as a perfect product for a rising-rate environment, so they do work well today. But more importantly, this is an asset class that for the last 16 years has never produced a negative return." The NAV of his fund rose 5.19 percent last year through Nov. 30.

The dilemma for investors is that ultimately bank loans and borrowers can—and do—default on occasion, a danger especially when the economy weakens. For example, in 2001, at the height of the bear market, Morgan Stanley's closed-end bank loan fund lost nearly 6 percent, and in 2002, 0.78 percent because of loan problems in the fund's portfolio. So while investors are insulated to some degree from interest-rate risk, they do assume credit risk—the risk that borrowers will default on their loans.

John Coumarianos, a mutual fund analyst at Morningstar in Chicago, is somewhat cautious on the category, believing that investors take on too much credit risk. "There was a time a couple of years ago when you could pick up these instruments, and you were making much more yield than in a money market fund," he says, "whereas now you're still making it, but it may not be commensurate with the credit risk you're taking on."

Adviser Bob Wander of Wander Financial Services in New York has selectively invested clients in these funds over the past five years. He cautions against using bank rate funds that are overweighted in any one industry in order to avoid a repeat of the 2000 meltdown when some of these funds were hurt. As an ex-banker, he is particularly sensitized to the credit risks, which he feels are insufficiently emphasized. "The underlying loans are extended to companies that generally have a poor credit rating although they are typically collateralized," Wander says.

There's another downside. Unlike bond funds, which invest in readily marketable securities, bank loan funds are investing in less liquid loans, which impacts the liquidity of the fund for investors. Investors are essentially locked into the funds for a full quarter or more since there are no daily redemptions.

"It's difficult to assess the true value of loans in these funds at any point in time because there's no daily market valuation for bank loans," says Mosaic's Gahagan, who so far hasn't committed any clients' money to bank loan funds. "We haven't pulled the trigger on them," he says. "I'm not opposed, but basically not convinced." For now, Gahagan is fulfilling that need with short-term and ultra-short bond funds, where he feels investors get equivalent returns with less credit risk exposure.

Still, there are different ways to play this game. You could paint bank loan funds with a contrarian flair to them. Wealth manager

WHY NOW?

LATELY, FLOATING RATE FUNDS HAVE BEEN SHOWING UP ON more financial advisers' radar screens. Credit the flattening of the yield curve and the current interest rate climate for their growing popularity. Michael W. Roberg, executive vice president and chief income officer of MFS Investment Management in Boston, cites four reasons why he believes the category is currently the best place to be in fixed income:

- In an environment of tighter monetary policy, rates on these funds are reset to the LIBOR rate and so are not hurt by rising interest rates the way other fixed-income products are.
- Because of their seniority in the capital structure and their collateral protection, bank loans typically have strong recovery rates, which is why they have strong Sharpe ratios.
- The sources of risk for this market are benign—credit fundamentals are good and default risk is low.
- Bank loans have low correlation to other asset classes and therefore are a great diversifier for a portfolio.

Roberg is cautious on the high-grade market, not because of default risk, but because he feels spreads are very tight. There is also "event risk"— that is, companies with good credit ratings take on significant debt to buy back stock, which can boost the equity but tends to hurt the bonds. With merger and acquisition activity picking up, this has become an increasing risk of late, he says. — BWF

other bond instruments, and especially to equities. Kinder is putting nearly all of his 115 clients into these funds. They typically represent about 5 percent of his clients' fixed-income portfolios, he says.

Kinder especially likes the Highland Floating Rate Fund, which last year returned nearly 6 percent through November. "They've had the best performance over the past five years of all the floating rate funds, and the default rate was just over 1 percent in 2004," notes Kinder. "Their default rate has been lower than their competitors, so we think the managers have a good understanding of this market. Plus, their expense ratio is under 90 basis points, which is very competitive."

Historically, bank rate funds have maintained a relatively stable share price as advertised. Is that because there are no daily redemptions, or because most of the funds re-adjust every 30 to 60 days with interest rates? "It's probably a combination of the two," says Lipper's Cassidy. "The investors are more relaxed in a loan participation fund when rates rise. They don't have to worry about redeeming."

So what do you look for in a bank loan fund? Seek out a fund company with a good history of managing bond funds, and especially high-yield bond funds, and funds with low expenses, advises Morningstar's Coumarianos, who recommends Fidelity Floating Rate High Income, an open-end bank loan fund that allows daily redemptions—the exception to the rule—and Eaton Vance Floating Rate Fund, a closed-end version. He points out that some offerings, like ING's bank loan fund, have relatively high expense ratios, which eat into returns.

Van Kampen's Tiffen says different investors will be attracted

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Keith Newcomb of Full Life Financial LLC in Nashville, Tenn., is counseling clients who might think of turning tail and running from fixed income altogether to view floating rate funds as a smart way to maintain fixed income exposure while reducing credit rate risk. Newcomb is placing clients, including the more conservative ones, in these vehicles.

"They're a component in almost all my discretionary portfolios," he says. "They're really underutilized. The stable value funds have all closed their doors. Floating rate funds are almost the next best thing. Make no mistake—the risk is very real, but in the quest for competitive yield, the tradeoff for reducing interest-rate risk makes an appealing alternative. They offer competitive values."

Kirt Kinder, an adviser in Palm Harbor, Fla., agrees that there is a contrarian side. "We're in a period of rising rates, so basically, the longer term maturities might not perform that much better than shorter term maturities over the next few years," he says. But he also likes the funds as well for their diversification value relative to

to different kinds of bank loan vehicles. Those with a medium or higher capacity to accept risk would probably find the closed-end variety the more sensible option, he says. The discounts they trade at can push yields up as high as 9 percent, and they are less volatile than a closed-end bond fund. On the other hand, for investors with a medium-term outlook, but a lower capacity to accept risk, the open-end versions would probably be more suitable, he says.

Right now, the fundamentals are pretty good. With interest rates ascending, it's generally a good situation for these funds as yields go up in tandem with rates. But the experts caution against going overboard: If there is a prolonged economic downturn, such as the one that began in 2000, these funds could decline in value.

"Except in a recession, and even six to 12 months after," says Cassidy, "it's a good asset class for investors who understand it."

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