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Fundamentals

Floating Rate Funds

Fundamentals **is a series of white papers addressing a range of topics related to constructing and implementing an investment portfolio. This educational series has been created to help Financial Advisors and their clients discuss relevant investment strategies and vehicles. To learn more about how floating rate funds can help you pursue your investment goals, please contact your Financial Advisor.**

The prospect of an upward trend in interest rates has many investors wondering what to do with their fixed income investments. If and when interest rates rise, principal invested in fixed income products tends to decline in value. Furthermore, new investments in fixed income products may mean forgoing further opportunities to obtain higher bond yields if interest rates continue to rise in the future.

Alternatively, investors who wait to invest in the bond market may forgo higher income than can be earned with money market rates. Investors must therefore consider the likelihood that future rates will increase enough to offset any income lost by delaying an investment in bonds.

For certain investors who want current exposure to the bond market and a chance to participate in a rising interest rate environment, *floating rate funds* may offer one solution to this timing dilemma.

Floating Rate Funds

Floating rate funds are open-end mutual funds, closed-end mutual funds, or exchange-traded funds that invest in bank loans with variable rates. Typically, such loans are senior secured loans made to corporations by banks. A loan is *senior* when it has the highest priority in the borrowing corporation's capital structure; the borrower must satisfy interest and principal payments owed on the loan to the lending bank before it satisfies its obligations to its other lenders. A loan is *secured* when the borrower designates a portion of its assets as collateral. The lending bank has the right to seize this collateral if the borrower defaults on the loan.

In exchange for the loan provided by the bank, the borrowing corporation agrees to pay a variable interest rate that is based on a floating rate index, such as the London Interbank Offered Rate (LIBOR)[1], plus a premium that depends on the borrower's credit rating. The loan rate is reset to reflect changes in the floating rate index, typically every 30 to 90 days. This floating rate mechanism differentiates bank loans from traditional bond investments.

[1] LIBOR is the interest rate the world's most credit-worthy banks charge one another for large loans and is used as a base interest rate for loans made to major corporations.

UBS

The Bank Loan Market

In recent years, the primary and secondary markets for bank loans have become larger and more complex. Banks have increasingly acted as distributors of loans to third parties rather than as lenders. This is a marked shift from a decade ago, when a borrowing corporation typically expected the bank that had originated a loan to hold the loan in its portfolio until the corporation retired it. Borrowing corporations regarded a bank's willingness to hold the loan as a sign of the bank's commitment.[2]

However, several changes in the banking industry have forced corporations to become more comfortable with the reassignment of their loans to third parties. The most important of these has been banks' need to reduce concentration within their loan portfolios. This need was highlighted by an increase in loan defaults during the mid-1990s and later by an increase in bank mergers—which created further loan portfolio concentration—following the overhaul of the Glass-Steagall Act in 1999. The increase in defaults and the subsequent decrease in loan originations drove yields to levels that were attractive to third party investors, while the banks' diversification efforts provided these investors with increasing opportunity to purchase bank loans.[3]

These factors have led to an extensive change in the number and activity level of the different participants within the bank loan market. Whereas 10 years ago, banks represented about 70% of the primary loan market, in 2003 they represented only 25%.[4] The same is true of the secondary market, where institutional investors, including insurance companies, mutual funds, hedge funds, and issuers of collateralized loan obligations, have become much larger holders of bank loans and important drivers of the growth in the trading volume of bank loans.

[2] "Secondary Market Gains Status," by Richard H. Gamble. BusinessFinanceMag.com
[3] "The Evolution of the Corporate Loan Asset Class," by Allison Taylor and Ruth Yang. *Loan Syndications and Trading Association,* 2004.
[4] Ibid.

Floating Rate Versus Fixed Income Investments

The floating rate feature of bank loans differentiates them from traditional fixed income investments. The prices of traditional fixed income investments move inversely with changes in market yields, making such investments highly sensitive to changes in interest rates. As rates increase, for example, the value of principal invested in a fixed income bond decreases because the bond's coupon becomes relatively less desirable in the new, higher-rate environment.

But principal invested in floating rate instruments, such as bank loans, has far less sensitivity to interest rate changes, since the coupons on bank loans are periodically reset to prevailing market rates. The floating rate mechanism of bank loans reduces the interest rate sensitivity, and thus the principal volatility, of a floating rate fund. This reduced principal volatility is the primary reason net asset values (NAVs) for floating rate funds usually trade in a tight range around par value.

However, the floating rate feature also has its disadvantages. If rates fall, principal invested in bank loans will fail to appreciate meaningfully, and the interest rates for a floating rate fund's underlying loans will be adjusted to the new lower market rates.

Who Should Consider Floating Rate Funds?

Although floating rate funds are not suitable for all investors, those comfortable with the associated risks may want to consider an investment in a floating rate fund. In a rising interest rate environment, such funds may provide advantages over fixed income investments of similar quality; namely, the potential for reduced fluctuation of principal and the ability to earn higher income if interest rates rise. Floating rate funds may be appropriate for investors seeking to:

- Generate a stream of current income
- Decrease the volatility of principal in their fixed income allocation
- Hedge against rising interest rates

The Role of Floating Rate Funds in an Investment Portfolio

Floating rate funds can play several different roles in an investment portfolio—from hedging against interest rate risk in a rising rate environment to adding diversification and risk-adjusted return potential to a portfolio.

Hedging Against Rising Interest Rates

The performance of floating rate funds is less sensitive to interest rate movements than the performance of fixed rate bonds. When interest rates rise and bond prices fall, floating rate fund prices tend to be relatively less volatile. For investors, this can be a valuable hedge against interest rate risk in a rising interest rate environment. Of course, there are other influences, such as default, that can affect the floating rate fund prices. The risks associated with floating rate funds are discussed further under *Floating Rate Fund Considerations*.

Enhancing Risk-Adjusted Return Potential

Floating rate funds can help curb volatility in an investment portfolio, while offering competitive current income potential. We have established that a traditional bond comes under pricing pressure as interest rates rise. The yield on a floating rate instrument, on the other hand, is benchmarked to an index, such as LIBOR. As the benchmark index fluctuates (in response to interest rates), the floating rate instrument periodically adjusts—or floats—to keep in step with the benchmark. In a rising rate environment, the coupons on floating rate bonds will also rise as the coupon is adjusted. Since floating rate funds are less sensitive to interest rate movements, the share prices of these funds are, in turn, less sensitive to interest rate movements, which can result in a lower level of volatility in the investment portfolio.

Further Diversifying an Investment Portfolio

Floating rate loans are loosely correlated to fixed income and equity investments. *Correlation* is a measure of the degree to which two securities move in similar patterns. Diversifying a portfolio with loosely or negatively correlated securities can reduce overall portfolio volatility, as the independent price movements of the different securities offset each other. Combining floating rate funds with other investments with lower or negative correlations can complement a diversified investment portfolio.

Floating Rate Fund Considerations

Floating rate funds can provide investors with an opportunity to participate in the bond market in a rising interest rate environment. However, investors should be aware of the following risks associated with bank loans and floating rate funds.

Credit Risk

With the exception of U.S. Treasury obligations, all fixed income instruments are subject to varying degrees of credit risk. Bank loans, in particular, are often made to the same corporations that issue high yield bonds. Such corporations often have credit ratings that are below investment grade, thereby making credit risk an especially important consideration for bank loan investors.

Credit risk, sometimes called *default risk,* is risk associated with an adverse credit event. The most clear-cut adverse credit event occurs when an issuer defaults on an interest or principal payment. Another example is a downgrade of the issuer's credit rating by a major rating agency. Adverse credit events can have a material effect on the secondary market value of principal invested in a bond, regardless of whether the bond has a fixed or floating rate.

Nevertheless, there are important differences in the credit exposure of a bank loan relative to that of a high yield bond. The senior status of bank loans specifies that the bank receives first priority in receiving interest and principal payments and has first claim on the corporation's assets in the event of default. Additionally, unlike high yield bonds, which are often unsecured, bank loans provide an extra measure of safety insofar as the collateral agreements stipulate that specific assets be pledged to secure the loan. In cases of default, recovery rates[5] for bank loans have averaged significantly higher than recovery rates for high yield bonds.

[5] "Recovery rate" is the percentage of each dollar of invested principal that is recaptured through bankruptcy proceedings.

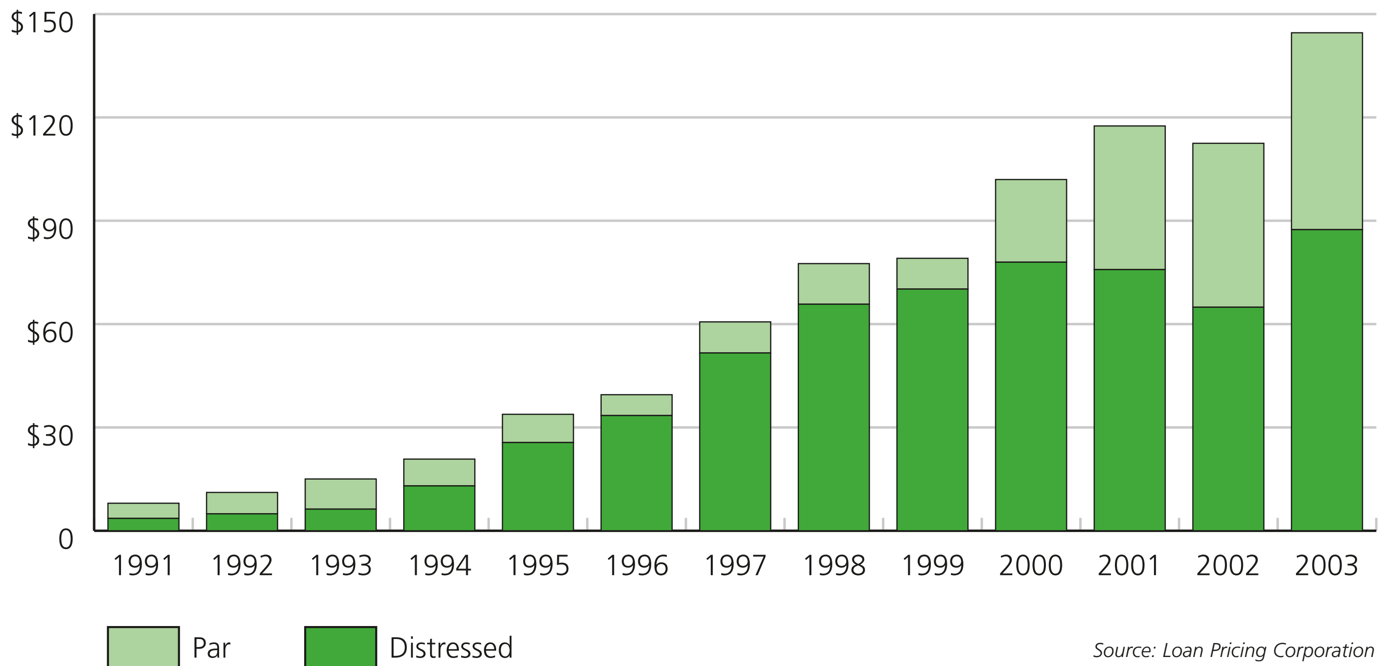
Call Risk

Bank loans are issued at par and can be called by the borrowing corporation at any time, limiting the premium at which a loan will sell even when the issuer's credit condition significantly improves. This arrangement indicates that bank loans have little price appreciation potential but—should an adverse credit event occur—significant price depreciation potential. Many floating rate funds diversify their portfolios across loans made to several different issuers in order to manage the asymmetric price potential introduced through call risk.

Liquidity Risk

Liquidity risk is another concern for bank loan investors. Closely associated with default risk, *liquidity risk* is risk that an investment cannot be bought or sold quickly enough to prevent or minimize a loss. Although liquidity risk can be present in even the largest and most active markets, it is generally of greater concern in smaller, less active markets. According to the Loan Pricing Corporation, *annual* trading in the secondary market for bank loans has grown from $11 billion in 1992 to $112 billion in 2002. Although this represents rapid growth, compared with the Federal Agency Securities market, which has an average *daily* trading volume of $87 billion, the market for bank loans is still relatively small. In the event of a market-wide flight-to-quality, the smaller and less credit-worthy bank loan market is likely to experience decreased liquidity and an overall drop in value, which could cause floating rate funds' NAVs to fall.

Growth of Bank Loan Secondary Market



Source: Loan Pricing Corporation

Interest Rate Risk

Since bank loans are indexed to a floating rate, they are less sensitive to changes in interest rates. However, because floating rates on senior loans are reset to prevailing rates only periodically, changes in interest rates can be expected to cause some fluctuation in a floating rate fund's net asset value. Similarly, reset rates vary among loans, and funds invested in a higher proportion of loans that reset less frequently are likely to have more fluctuation in their net asset values.

Assessing Floating Rate Mutual Funds

For investors seeking to take advantage of the floating rate mechanism, floating rate funds can offer investors an efficient and affordable way to participate in the market. Investors should also consider the following when assessing floating rate funds.

Diversification

Diversification is one of the main benefits of investing in mutual funds, and, given the risks associated with investing in floating rate funds, diversification within a floating rate fund can be especially beneficial. Diversification is an important way for floating rate fund managers to manage credit, call and liquidity risks. Many floating rate funds diversify their portfolios across loans made to several different issuers and industries. Investors and their Financial Advisors should review the fund's largest portfolio holdings to determine whether the fund is too concentrated in any one corporation or industry.

Quality

Fund managers and analysts concentrate on credit research, attempting to balance the average credit rating of the portfolio with opportunities to pick up additional yield. Investors should be comfortable with the average credit quality of the fund and with the degree to which the team emphasizes credit research. Diversification and careful credit research help to reduce some portfolio risk associated with individual loan defaults. Investors and their Financial Advisors should review the credit quality distribution of the loans in a floating rate fund to make sure they understand the amount of credit risk in the portfolio. When evaluating floating rate funds, they should also determine the percentage of a fund's loans that are marked to market prices regularly, if not daily, to ensure that the NAV accurately reflects the value of the fund's assets.

Leverage

Some funds permit their portfolio managers to borrow against fund assets to purchase additional floating bank loan securities in an attempt to enhance yield. The fund prospectus states whether or not the managers employ this strategy, as it is a requirement to disclose this. Because the introduction of leverage in the investment process can increase the volatility of the fund's returns, investors need to be aware of this added risk and make sure they are comfortable with the approach.

Redemption Policies and Fees

Other unique considerations for floating rate funds include redemptions and fees. First, investors should be aware of any restrictions on redemptions. Although several floating rate funds now allow daily redemptions, a number of funds allow redemptions only once a quarter or less. Second, expense ratios for floating rate funds tend to be higher than those of the average bond fund. This is due to credit research, a time consuming and costly endeavor, which is essential to managing a portfolio of bank loans. Although investors should choose a bank loan fund backed by a strong research effort, identifying a floating rate fund with a lower expense ratio can help improve investment results, all else being equal.

Summary

- Floating rate funds are mutual funds that invest in bank loans with variable rates.

- Variable rate, senior secured loans are loans made to corporations by banks. A loan is *senior* when it has the highest priority in the borrower corporation's capital structure. A loan is *secured* when the borrower posts a portion of its assets as collateral. The lending bank has the right to seize this collateral if the borrower defaults on the loan.

- The floating rate feature of bank loans differentiates them from traditional fixed income investments.

- Principal invested in floating rate instruments, such as bank loans, has far less sensitivity to interest rate changes, since the coupons on bank loans are periodically reset to prevailing market rates. The floating rate mechanism of bank loans reduces the interest rate sensitivity, and thus the principal volatility, of a floating rate fund.

- If interest rates fall, principal invested in bank loans will fail to appreciate meaningfully, and the interest rates for the underlying fund loans will be adjusted to the new lower market rates.

- Floating rate funds may be appropriate for investors who wish to:
  - Generate a stream of current income
  - Preserve capital
  - Hedge against rising interest rates

- Floating rate funds can play several different roles in an investment portfolio—from hedging against interest rate risk in a rising rate environment to adding diversification and risk-adjusted return potential to a portfolio.

- Floating rate funds can provide investors with an opportunity to participate in the bond market in a rising interest rate environment. However, investors should be aware of the risks associated with bank loans and floating rate funds, including:
  - Credit risk
  - Call risk
  - Liquidity risk
  - Interest rate risk

- For investors seeking to take advantage of the floating rate mechanism, floating rate funds can offer investors an easy and affordable way to participate in the market. Investors should consider the following when assessing floating rate funds:
  - Diversification
  - Quality
  - Leverage
  - Redemption policies and fees

Important Information to Consider when Investing in Mutual Funds

Mutual funds involve investment risk, including the possible loss of principal. Unlike bank deposits, mutual funds are not insured or guaranteed by the FDIC or any other government agency.

Each mutual fund's prospectus includes information about the investment objectives, risks, charges and expenses associated with the fund. You should obtain a prospectus from your Financial Advisor and read and consider this information carefully before investing.

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