LOAN-PARTICIPATION FUNDS: BROADENING YOUR BOND PORTFOLIO

By Albert J. Fredman

These closed-end funds package participations in senior, secured floating-rate bank loans, and as ultra-short-term bond portfolios, they have virtually no interest-rate risk because the loans' yields float up as rates rise, helping to keep prices steady.

Including bonds in an asset-class mix—while definitely prudent—has a potential drawback: Both bonds and stocks lose value as interest rates rise.

Bear markets in bonds can be painful, as many individuals who held them in 1994 know. Interest-rate risk has the greatest impact on long-duration bonds, although intermediate-term and even short-term issues are impacted. Money market funds sidestep interest-rate risk, but their returns often are paper-thin after accounting for taxes and inflation. Thus, they generally are unattractive as a major proportion of an individual's long-term asset-class mix.

For those willing to venture off the beaten path and assume some risk, loan-participation funds (aka floating-rate loan funds) provide excellent diversification when mixed with stock and bond portfolios. These closed-end funds package participations in senior, secured floating-rate bank loans. Loan-participation funds are the fastest-growing category within the quirky world of closed-end funds. Such funds now have more assets than either domestic equity or world equity closed-end funds, according to Lipper Inc. As ultra-short-term bond portfolios, they have virtually no interest-rate risk because the loans' yields float up as rates rise, helping to keep prices steady.

Yields range from one to three percentage points above the one-year CD rate—depending on the riskiness of the portfolio. Rather than buying the banks' CDs, sophisticated investors are turning to the higher-yielding loan funds. Because a senior loan investment has virtually no correlation with price movements in conventional bonds and equities, it can reduce the volatility of a bond and stock portfolio while promising higher returns than a money market fund.

SENIOR LOANS

Senior loans are syndicated commercial loans made to corporations, partnerships, and other entities—including firms that issue below-investment-grade debt or junk bonds. Such loans may finance leveraged buyouts and merger and acquisition activity. This is a $508 billion market representing 5.7% of the roughly $9 trillion U.S. debt market. The senior secured loan market is nearly as large as the high-yield bond market. As will be explained, high-yield bonds are significantly riskier than senior loans. Banks syndicate loans among institutional investors, including loan-participation funds, for a fee. Other lenders are playing a bigger role, as bankers try to scale back the amount of capital they must hold against their loans. A specific lender owns only a fraction of each loan. Senior loans typically change hands in $5 million to $10 million blocks. Prospective investors must keep the following characteristics in mind:

- *Interest rates float:* Rates on senior loans periodically are reset to float at a fixed spread of two or three percentage points above the three-month

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London Interbank Offered Rate (or LIBOR). LIBOR is the rate that the largest international banks charge each other for loans. The reset period normally is 30, 60, or 90 days. Because their rates rise when interest rates increase, these loans have virtually no interest-rate risk. The funds pay monthly income, which increases as rates ratchet upward. Conversely, payments decline when rates fall. Loan-participation funds normally have relatively stable net asset values.

- *Loans are below-investment grade*: Less creditworthy companies borrow in this sub-sector of the high-yield debt market. Most loans are unrated or rated below investment grade by major rating agencies. Borrowers also may be issuers of junk bonds, typically with double-B or single-B ratings. Default rates on senior loans are low in a strong economy but can escalate during tumultuous conditions. In addition, highly leveraged borrowers may experience difficulty in meeting larger interest payments when rates rise sharply.
- *Lenders have a senior claim on assets*: Lenders face less risk than a company's unsecured debt holders and preferred and common shareholders. Junk bond holders hardly ever have senior standing.
- *Most loans are collateralized:* Assets pledged by the borrower typically back senior loans. Collateral may include a company's accounts receivable, inventory, patents, trademarks, plant and equipment, and stock in operating subsidiaries. Conversely, pledged assets rarely back junk bonds. Of course, a borrower's collateral may lose value.
- *Prepayments are common:* Most loans have three- to 10-year maturities although the majority are prepaid within two or three years. Senior loans are prepayable at par without penalty. Prepayments account for most of a loan fund's portfolio turnover. In addition, loans normally are amortizing—that is, principal is repaid gradually over a loan's life.
- *An illiquid but rapidly growing secondary market:* Although trading volume and liquidity still are low, progress is evident. The growing volume of loan trading among institutional participants during the 1990s is adding liquidity. Trading volume of senior secured loans was $67.3 billion in 1998, up from $62 billion in 1997. Unscheduled loan prepayments add an important dimension of liquidity for loan funds.
- *Relatively high research costs:* To guard against being saddled with problem loans, borrowers must be carefully analyzed. Special expertise is required because many of these firms are not publicly traded and therefore not followed by Wall Street. Analyzing loans is labor-intensive, requiring a team of credit analysts. Higher costs result in significantly higher expense ratios than those typical of bond funds.

LOAN FUNDS

Investors in loan-participation funds benefit from the manager's expertise and the fund's extensive diversification. Bigger funds generally function better because their managers can have more clout with bankers and can spread their assets over more than 100 loans in a wide variety of sectors. While the default rate has ranged up to 6% of the value of the senior loan market, it has averaged about 2% annually since 1989. Research indicates that the recovery rate on defaulted loans is between 80% and 85%, more than twice the 35% rate realized be subordinated debt holders. As a group, loan funds have less credit risk than high-yield bond funds. In addition, because of its short duration of about two months, a senior loan fund is unaffected by interest-rate risk.

Open-end funds cannot invest in senior loans because they must be able to handle daily redemptions. Legally, an open-end fund is required to invest at least 85% of its assets in liquid securities. For that reason, loan-participation funds use one of two closed-end structures:

- *Traditional exchange-traded*: These funds can be bought and sold daily, as any stock. In the customary closed-end format, exchange-traded funds have both a market price at which shares are bought and sold, and a net asset value that reflects the per share value of the underlying assets in the fund. Typically, the market price fluctuates more than the net asset value, introducing an additional dimension of risk and return.
- *Continuously offered funds with periodic tenders*: Funds using this format are priced at net asset value and have quarterly tender windows in which shares can be redeemed, although a few funds also offer redemptions monthly. Shares can be purchased at any time through the company or a financial advisor. While investors can cash out at net asset value (less any back-end load), they must wait for a redemption window. Each quarterly window lasts several weeks and redemptions normally are limited to 25% of a portfolio's shares outstanding. Continuously offered funds are closed-end even though they don't trade on an exchange because investors cannot redeem their shares daily, as with open-end funds.

Table 1 lists funds in both the exchange-traded and continuously offered groups. All those in the first category trade on the New York Stock Exchange.

The loan fund universe experienced substantial recent growth and more than half of the funds listed in Table 1 began in 1998 or 1999. As a group, loan funds recently had $28 billion in total net assets. These funds now account for about 17% of overall closed-end assets versus 3% about five years ago, according to Lipper Inc. With about $8 billion in assets, Van Kampen Prime Rate is the largest in the group. It holds about 300 loans with none representing more than 3% of its assets.

Loan funds appear under the subheading "loan-participation funds" in the weekly closed-end funds table in Barron's and The Wall Street Journal (on Mondays).

CONTINUOUS OFFERED FUNDS

While there is no charge to invest in a continuously offered fund, those choosing to redeem are subject to a back-end load or contingent deferred sales charge. Such charges commonly begin at 3% and step down yearly until phased out after several years. Some funds charge a 1% exit fee in the first year only.

In April 1998, Boston-based CypressTree Investment Management introduced the first no-load loan-participation fund. A specialist in senior secured loans, CypressTree manages more than $2 billion for institutions. Its senior loan fund allows monthly redemptions. SteinRoe also offers no-load loan funds.

EXCHANGE-TRADED FUNDS

Investors in exchange-traded funds pay usual brokerage commissions to buy and sell shares. Three of the four exchange-traded loan funds went public in 1998, so their track records are short. However, Eaton Vance and Van Kampen both manage continuously offered loan funds that began in 1989. Although Pilgrim Prime Rate Trust began in May 1988 as a continuously offered fund, it has been exchange-traded since May 1992. It converted to the latter format to offer holders daily liquidity through an NYSE listing. As interest rates fell during the early 1990s, these funds experienced massive redemptions.

On June 24, 1998, the $1.8 billion Van Kampen American Capital Senior Income Trust offering was the largest closed-end IPO in a decade and the second largest ever. The fund employs 23 credit analysts in addition to a manager. Eaton Vance Senior Income can invest up to 10% of its assets in junk bonds, giving it a duration of about 230 days versus an average of about 50 days for the others. That gives the fund a higher yield and a less stable net asset value.

The exchange-traded funds generally have yields that are roughly 150 basis points higher than their continuously offered counterparts because they can be more fully invested. The latter must maintain an extra buffer of cash to accommodate periodic redemptions. In addition, the exchange-traded funds leverage about 30% of their assets to enhance returns. As interest rates rise, the increased borrowing costs are matched by a corresponding increase in yield on the loan portfolio. Leverage could adversely affect performance if loan defaults rise substantially when economic conditions sour. The fully invested position and leverage of the exchange-traded

TABLE 1. LOAN-PARTICIPATION FUNDS

*Exchange traded:***	Date of Inception	Total Net Assets ($ mil.)*	Expense Ratio (%)	Telephone
Eaton Vance Senior Income	10/27/98	359.7	1.25	800-225-6265
Pilgrim Prime Rate Trust	5/12/88	1,194.8	1.05	800-992-0180
Travelers Corporate Loan	11/14/98	148.8	1.05	212-816-8297
Van Kampen Senior Income	6/24/98	1,816.3	1.05	800-341-2929
Continuously offered:				
AIM Floating Rate	5/01/97	354.4	1.50	800-347-1919
CypressTree Senior Floating Rate Fund	4/01/98	33.4	1.25	800-876-5957
Eaton Vance Advisers Senior Floating-Rate	4/01/98	130.6	1.20	800-225-6265
Eaton Vance Classic Senior Floating-Rate Fund	2/24/95	4,160.3	1.45	800-225-6265
Eaton Vance Prime Rate Reserves	8/04/89	3,390.9	1.30	800-225-6265
Franklin Floating Rate	10/10/97	867.4	1.40	800-342-5236
Kemper Floating Rate	5/25/99	42.0	1.47	800-621-1048
Merrill Senior Floating Rate II	4/05/99	177.5	1.67	609-282-2800
Merrill Senior Floating Rate	10/24/89	3,284.0	1.33	609-282-2800
MSDW Prime Income Trust	11/30/89	2,420.2	1.40	800-869-3863
North American Senior Floating Rate; B	8/31/98	21.6	1.40	800-872-8037
North American Senior Floating Rate; C	8/31/98	83.3	1.40	800-872-8037
Stein Roe Floating Rate Inc	12/18/98	0.9	1.30	800-338-2550
Stein Roe Institutional Floating Rate***	12/18/98	119.1	0.90	800-338-2550
Van Kampen Prime Rate	10/04/89	8,304.5	1.36	800-421-5666
Van Kampen Senior Floating Rate	3/27/98	1,349.6	1.63	800-421-5666

**As of June 30, 1999, or nearest available date.*
***Expense ratios of exchange-traded funds exclude interest charges associated with the use of leverage.*
****$250,000 minimum investment*
Source: Lipper Inc. and individual funds

TABLE 2. EXCHANGE-TRADED LOAN-PARTICIPATION FUNDS*

Fund (NYSE Symbol)	Avg. Daily Volume (Shares)	Avg. Disc. (-)/ Prem. (+) (%)	Recent Disc. (-)/ Prem. (+) Range (%)
Eaton Vance Senior Income Trust (EVF)	140,340	–3.90	–8.07 to +0.20
Pilgrim Prime Rate Trust (PPR)	342,480	+3.88	–2.6 to +8.75
Travelers Corporate Loan Fund (TLI)	24,996	–5.55	–9.48 to +0.49
Van Kampen Senior Income Trust (VVR)	401,630	–5.77	–11.25 to +4.17

**Data cover past 52 weeks or life of fund (if shorter); all periods end 7/2/99.*
Source: Wiesenberger, a Thompson Financial Company

funds causes net asset values to fluctuate more than those of the continuously offered portfolios.

In addition, the exchange-traded funds have market prices that fluctuate more than their net asset values. These funds may offer an opportunity to buy at a discount to net asset value, as evident from their discount/premium fluctuations in Table 3. The three exchange-traded funds that went public in 1998 offer limited discount/premium history. The oldest loan fund, Pilgrim Prime Rate traded at discounts from 1992 through 1995. In 1996, it averaged a slight premium and has sold at larger premiums since then. Year-by-year information on Pilgrim Prime Rate can be found on Morningstar's Web site (www.morningstar.com) or in Morningstar Mutual Funds.

Discounts and premiums are influenced by a variety of factors including investor sentiment, fund performance, the interest rate outlook, and sporadic buying and selling by large investors. If rates are expected to rise, you may see discounts narrowing or turning to premiums and existing premiums expanding. The opposite may occur if rates are likely to fall. Investors in closed-end equity funds often see much deeper discounts than those on loan funds. Because they are more conservative income-oriented vehicles, closed-end bond funds typically trade at smaller discounts than do the equity funds. You may be doing well to find a good loan fund at a 5% or 6% discount. It's also more common to see bond funds at premiums.

Table 2 indicates that most loan funds trade in fairly high volumes, so they offer ample liquidity for large investors.

EVALUATING PERFORMANCE

Table 3 provides the yearly net asset value total returns of five loan participation funds that began in the late 1980s. For comparison purposes, a composite yearly return also is provided for money market funds. Large differences between loan fund and money fund returns are evident. In 1994, when the Federal Reserve raised interest rates six times, loan funds stood out with their 6.91% return. Conversely, major bond indexes generated negative total returns. But the loan funds missed out with their 8.25% return in 1995 when interest rates fell and bond returns near 20% were common. Falling interest rates raise bond prices, but loan prices, hold steady.

Unlike bonds and stocks, a loan portfolio rarely produces capital gains—it is an income vehicle. However, loan defaults will cause modest erosion in the net asset value and total return of a fund over the years because offsetting capital gains normally are not generated. Consequently, a loan fund's yield typically overstates the true return. Morgan Stanley Dean Witter estimates that the impact of default losses reduces a fund's total return by about 5%. Thus, a fund with an 8.4% yield might experience a 0.4% loss due to defaults, resulting in an 8% total return. The impact of defaults varies with factors such as the economic climate, the riskiness of the portfolio, and the fund's age.

Finally, fluctuating discounts and premiums on the exchange-traded funds can lead to capital gains or losses for investors. For instance, your return is enhanced if you buy at a discount and sell at a narrower markdown or a premium.

ANALYZING A LOAN FUND

If you are interested in investing in loan participation funds, make sure you consider the following factors:

- *Yield*: Compare a fund's yield with that of its peers. It's also informative to compare a yield with the three-month LIBOR rate and the rate on one-year CDs. A fund could be expected to yield between 1.5 and 3.75 percentage points above LIBOR. A fund's expense ratio, the riskiness of its loans, and whether or not it is exchange traded are primary determinants of its yield. You should know why a fund's yield is higher or lower than yields of its competitors.
- *Expenses*: Compare a fund's expense ratio with those of its peers. Newer funds may have capped expenses, so even though costs appear low now they could rise in the future. Keep in mind that expense ratios between 1.2% and 1.6% are typical for the group. The expense ratios of exchange-traded loan funds often are reported with the interest cost of leverage included. Comparing them with the expense ratios of the unleveraged continuously offered funds is misleading. Table 1 reports expense ratios without interest. Differences can be substantial. For example, Pilgrim

TABLE 3. YEARLY NET ASSET VALUE TOTAL RETURNS OF OLDER LOAN-PARTICIPATION FUNDS

	Total Returns (%)					
	1994	1995	1996	1997	1998	5-Yr Avg.
Eaton Vance Prime Rate Reserves	6.07	7.94	6.84	6.98	6.90	6.94
Merrill Senior Floating Rate	6.23	7.79	6.18	7.40	5.46	6.61
MSDW Prime Income Trust	7.56	8.39	7.27	7.91	6.65	7.55
Pilgrim Prime Rate Trust	8.20	9.20	8.29	8.70	8.26	8.53
Van Kampen Prime Rate Income	6.51	7.93	6.82	6.92	6.62	6.96
Average of loan funds	**6.91**	**8.25**	**7.08**	**7.58**	**6.78**	**7.32**
Money fund composite	**3.66**	**5.36**	**4.88**	**4.90**	**4.86**	**4.73**

Source: Lipper Inc.

Prime Rate has a 2.86% expense ratio with interest versus 1.05% without.

- *Past performance*: Even though the histories of newer funds are short, you can examine how other funds have done in the same family or what the manager's track record was at another firm.
- *Stability of net asset value:* Examine the stability of a fund's quarterly net asset value. The net asset value is affected by changes in the real or perceived credit quality of the loan portfolio. The most stable funds have net asset values that vary by only a few pennies over the years.
- *Portfolio diversification:* Be aware of the number of companies and sectors represented in a fund. Funds that have placed big bets on just a few companies and sectors are riskier.
- *Premium/discount:* If you select an exchange-traded fund, consider its discount/premium history and that of its peers in making your decision. Try to buy at a deeper-than-average discount. The Closed-End Fund Association's Web site (www.cefa.com) provides the most recently available discounts and premiums. You also can call the funds directly for this information.
- *Liquidity and trading considerations:* Other things equal, favor exchange-traded funds that have high average daily volume. To reduce transaction costs, place a limit order to try to buy at or slightly below the bid. Using an on-line broker can minimize commissions.
- *Redemption fees*: On continuously offered funds, these fees are a negative because you cannot be certain you will hold a fund long enough for the fees to disappear.
- *For literature and other information:* Contact the funds. Everen Securities, Gruntel & Co., Morgan Stanley Dean Witter, and Prudential Securities are among the firms with closed-end analysts tracking floating-rate loan funds. Morningstar Mutual Funds profiles a few of the older loan funds in their "ultra-short bond" category.

CONCLUDING COMMENTS

Mixing dissimilar asset classes is the cornerstone of good asset allocation. With stock prices at lofty levels, those who are overweighted in equities may be considering rebalancing their assets. Because their returns are independent of those on the stock and bond components of a portfolio, loan-participation funds deserve consideration. Although they are a fixed-income asset, they are less subject to the interest-rate risk that can affect intermediate and longer-term bonds.

And in spite of their hefty expense ratios, loan funds have delivered returns that compare favorably with those on certificates of deposit and money market funds. The older ones have consistently produced favorable returns in the 1990s with no major problems. However, they are not a money fund alternative because they do have credit risk and although their net asset value is highly stable, it is not pegged to a fixed level, as it is with a money fund.

Loan funds are particularly attractive when the Fed has a bias toward credit tightening and interest rates are likely to trend upward. Such funds will produce higher monthly payments as interest rates rise and bonds lose value in a booming economy. Conversely, when the economy slips into a recession and interest rates fall, a loan fund's income is reduced, but bond prices rise. Further, loan funds face a growing proportion of defaults during recessions.

Both the exchange-traded and continuously offered structures have their advantages and disadvantages. The continuously offered funds allow you to buy and sell at net asset value. You may face a back-end load, but it could be avoided with a no-load fund or minimized with a low-load portfolio. The exchange-traded funds offer higher yields and sometimes can be purchased at discounts. In addition, you don't have to wait for a tender window to sell shares. However, if you buy at a premium it may deflate or drop to a discount—particularly in a recession. Finally, the leverage characteristic of exchange-traded funds—while it boosts return—adds risk during difficult times. ◆