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INVESTING

Floating-Rate Funds Offer Solid Yields

When interest rates eventually rise, the value of bonds will fall. Seeking protection from that potential loss, investors have flocked to floating-rate bank-loan bond funds, many of which are paying a decent yield of 3% or more.

Over the 12 months that ended November 30, investors plowed a net $59.7 billion into floating-rate funds, also known as bank-loan funds. "There's just a ton of interest in the floating-bank-loan category," says Sarah Bush, a senior mutual fund analyst at Morningstar, which compiled the fund-flow data.

Floating-rate bond funds invest in loans that banks make to small and midsize companies. The rates of these bank loans are tied to a short-term benchmark, and thus are reset—or "float"—periodically when rates move. When rates rise, investors can get a quick boost in yield. The prices of these funds are less sensitive to big interest-rate swings than bond funds with fixed rates.

But these funds do have risks. You're often "swapping your interest-rate risk for credit risk," says Donald Bennyhoff, a senior investment analyst at Vanguard. The bank loans tend to be made to companies with below-investment-grade credit ratings, so the risk of default is comparable to that found in high-yield (junk) bond funds. But Bennyhoff says that most defaulted bank loans eventually are repaid because of the way the debt is structured. "You've got very high seniority in the pecking order," he says.

Even so, in a credit crisis, people tend to dump floating-rate funds. "This is the type of category where you really could see significant losses," Bush says. She notes that in 2008, the average bank-loan fund tracked by Morningstar lost 30%. Together, junk-bond funds and floating-rate bond funds should be no more than 5% of your total portfolio.

Solid Choices in Floating-Rate Funds

If you want to add a bank-loan fund to your holdings, **Eaton Vance Floating Rate** (symbol EVBLX, 4.4% one-year total return through January 8) works hard to keep risk under control. It is a conservatively managed $14.2 billion portfolio with loan holdings that are spread over more than 500 debt issuers. Although the fund charges a 2.25% front-end load, if you work with a financial adviser you may be able to invest without that fee. The fund yields 3.4% and has an expense ratio of 1.02%.

Fidelity Floating Rate High Income (FFRHX, 3.8%) takes a cautious approach, too. The $8.9 billion portfolio has more than 500 holdings. Although the fund is sold without a front-end load, there is a 1% redemption fee for shares held for fewer than 60 days. Fund manager Eric Mollenhauer started in the job only last April, but Morningstar's Bush says he is "backed by a very strong research staff." Both Fidelity and Eaton Vance are known for their credit research, an important consideration when picking a floating-rate bond fund. The Fidelity fund yields 2.6% and has an expense ratio of 0.71%.

There are floating-rate products with lower credit risk, but at the cost of lower returns. At the end of January, the U.S. Treasury was set to begin selling two-year floating-rate notes that will fluctuate with the yield of the three-month T-bill, recently at 0.04%. Another example is **iShares Floating Rate Bond ETF** (FLOT, recent price $51), which buys investment-grade securities. The $3.7 billion fund yields 0.32%. As an exchange-traded fund, it has a super-low expense ratio of 0.20%. The iShares ETF carries an Af rating (the "f" suffix indicates a bond fund) from Standard & Poor's. "I am comfortable with the credit risk," says financial planner Kevin Brosious, of Wealth Management Inc., in Allentown, Pa., who has clients in the fund.

Because iShares Floating Rate's yield is greater than money funds, some people might be tempted to use the ETF to hold short-term cash for a rainy-day reserve. Jeremy Paul, managing partner at RPL Wealth Advisors, in New York City, says that's not wise. "Cash is cash, and anything other than cash doesn't behave the same way," Paul says. **K** —JOSEPH LISANTI