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Don't Bank On It

Leveraged loans and managed futures offer opportunities, but beware risks

Alternative Investing | By GREGORY ZUCKERMAN

Q: How can one invest in bank loans ? Are there mutual funds or ETFs that invest in the area?

A: As the economy improves, investors have shifted to riskier investments, such as stocks and junk bonds. Lately, more have taken an interest in so-called leveraged loans, or those made by banks to companies with lower credit ratings. These loans can have sizable yields, a nice feature in a world where Treasurys and investment-grade bonds offer skimpy interest rates. Lately, more of these loans have been placed in vehicles called collateralized loan obligations.

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Investors are flocking to leveraged loans partly because of a view that corporate defaults will stay low. These loans also kept their value better than some other investments during the financial crisis.

One newer exchange-traded fund that buys bank loans and is recommended by some advisers: The PowerShares Senior Loan Portfolio . This fund aims to track a leading index of leveraged loans, or those made to non-investment-grade companies. It has a yield of about 4.7% and as of late April owns loans including to Tribune Co. and Clear Channel Communications, two media companies.

Floating-rate mutual funds, such as the T. Rowe Price Floating Rate Fund and Eaton Vance Floating Rate Fund, also buy bank loans, as well as other debt securities. They have yields of 2.6% to 4%.

Scott Miller Jr., a managing partner of Blue Bell Private Wealth Management LLC in Blue Bell, Pa., recommends that investors use closed-end mutual funds to invest in senior loans. Closed-end funds buy a group of loans, giving an investor diversification. And because a portfolio manager buys and sells the loans, there's a level of due diligence that's necessary because some of these loans can be risky.

"Even though these loans are secured by cash, assets or other property, a seasoned manager with a dependable track record is essential to avoid" losses caused by defaults and other issues, he says.

As with any closed-end fund, those that trade at a premium to their net asset value are least attractive, advisers say. Buying a bank-loan closed-end fund at a discount to its NAV provides a better chance for safety and higher return than buying a fund at a premium or a new issue.

Investments in bank loans could do better than bonds if inflation flares up and interest rates climb. That's because many of these loans are short term and their rates float. So if inflation rises and rates jump, the loans will be replaced by new, higher-yielding loans, helping an investor, advisers say.

But returns are not likely to match those of stocks or junk bonds if the economy continues to improve. And if the economy slips, loan defaults could rise, hurting these investments.

Mr. Miller notes that these loans are usually illiquid, or can be hard to sell at short notice without moving prices. And prices can tumble if a loan payment is missed. That's why most of the mutual funds focused on this investment can only be redeemed quarterly, reducing their attractiveness, some advisers say.

Q: Are managed-futures mutual funds good investments in this rocky market?

A: Managed-futures traders use futures contracts to bet on commodities, currencies and other investments. Returns from managed-futures investing often are not correlated to stock and bond markets, which is one reason this area has attracted a surge of money in recent years. Some managed-futures investors bucked the market in 2008. Mutual funds have been rolled out that allow individuals to make these kinds of investments.

"Unlike most traditional investments, the performance of managed-futures funds is based on factors such as trend following, price movement and volatility rather than economic fundamentals," says Robert Benson, chief investment officer at Laird Norton Tyee, a wealth-management firm in Seattle.

But there are real dangers. For one thing, Bradley Alford, chief investment officer of Alpha Capital Management, in Atlanta, warns there often are hefty fees that investors may not be aware of. "I don't like these products, the fees are high and it can be hard to figure out all the underlying fees," Mr. Alford says.

Indeed, managed-futures funds aren't required to spell out all their fees. Terry Tian, an analyst at Morningstar, says some larger funds have annual expense ratios of as much as 5%, even though their websites list fees of only about 2%. "It's very hard for investors to know" what they're paying, he says.

Many also don't fully divulge details of their investments. Funds often do much or all of their investing through offshore subsidiaries, giving them favorable tax treatment for investment gains, Mr. Tian says. But some of those subsidiaries also pay fees to investment advisers. Some say these performance-based fees can act as an incentive for an investment manager to take bigger risks in search of bigger payoffs. Investors usually aren't told how much the managers are paid.

An alternative for investors who qualify is to invest directly in a managed-futures trading firm.

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