



## High-yield bank loan mutual funds may offer hidden risk

*By Don Martin*

Bank loan mutual funds buy a participation in a commercial business bank loan (not a mortgage loan). They are sometimes called prime funds because they earn a yield roughly the same as the prime rate - and the yield can change monthly along with changes in the prime rate.

Using investment-screening software, the asset classes with the best Sharpe ratios are bank loan funds, followed by foreign stocks. A Sharpe ratio is a measure of risk to reward. Bank loan funds appear to have less risk than a stock because they are a loan that must be paid back before the stockholders get paid, and they are ahead of bondholders in the event of a default.

Because the prime rate is 8.25 percent and the S&P annual return has been 2.5 percent since June 2001, the higher return in bank loan funds seems attractive. However, there is hidden risk in bank loan funds. The loans could be paid back at less than face value in the event of a default. The loans are usually "B" paper (meaning junk-bond grade). Because junk bonds have had low rates of default in recent years, it creates the appearance of low risk. However, when the next recession occurs, there will be many defaults, and bank loan fund assets may get paid back at a deep discount.

The best quality "A" paper commercial business loans are hard to find, because those companies do not need to borrow. With today's private equity leveraged buyout craze, too many "B" paper loans have been made and sold to bank loan funds.

During the previous recession, there were not as many private equity leveraged buyouts that were financed indirectly by bank loan funds, thus seeing how such funds did in the previous crash would not show how bad the damage could be during the next crash.

The key idea is to see such loan funds as simply another type of junk bond - one that carries a risk of a 30 percent decline in value during a crash. These could be worse than junk bonds because some bank loan funds use leverage. If a crash comes, you could lose even more principal because of the leverage. Better to wait and buy it after a crash at a 30 percent discount. Let someone else make 8.25 percent while you hold your funds in the safety of a six-month Treasury bill at 5.1 percent, then buy after a crash.

Many funds are paying investors only 6 percent because the bank that originated the loan keeps part of the interest payment as a servicing fee and the mutual fund management company keeps 1 percent for management fees. Thus, a fund that holds 8.25 percent prime-rate notes may get paid 7.25 percent by the bank, and the fund subsequently charges its shareholders 1 percent a year. If a fund is paying investors 8 percent, the fund is using leverage.

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