Floating rate funds:

More to know than floating rates

Patrick Riordan, CFA • Mutual fund research analyst

What you need to know

» Floating rate funds are mutual funds that own adjustable-rate loans, primarily from below-investment-grade companies.

» Floating rate funds have grown more popular with investors in recent years, but these funds have some distinct drawbacks, including poor credit quality, liquidity risks and limited price appreciation.

» We do not believe floating rate funds are necessary to include in a well-diversified portfolio. It's important to work with your Edward Jones advisor to decide whether they're appropriate for you at all.

» While floating rate funds can help protect investors from rising short-term interest rates, they're not without risks. Because of their high risk, we believe floating rate funds are appropriate only if you're seeking aggressive income.

What are bank loan funds?

If you haven't heard the term "floating rate fund," you may recognize one of its aliases: senior loan funds, bank loan funds or leveraged loan funds. The names used for these investments may vary, but the definition is the same. Floating rate funds are mutual funds that own adjustable-rate loans, primarily from below-investment-grade companies. Having credit quality that's below investment grade means there's greater risk that the company could default and not be able to fully repay the loan.

What makes bank loan funds different from bond funds:

- The funds primarily own bank loans that pay a floating interest rate, which means the interest rate can vary over the life of the loan.
- The credit quality of these loans is generally poor and would be considered below investment grade.
- Given the higher credit risk, bank loans tend to yield more than investment-grade bonds but also have a higher rate of default.
- Bank loans are contracts and are less liquid than bonds because they do not trade like registered bonds.
- Bank loans are a higher priority and are often backed by specific collateral, which can result in higher recovery rates than bonds in the event of a default.

Our recommendation

We consider floating rate funds to be aggressive-income investments with a risk level similar to high-yield bond funds and should not be viewed as an alternative to investment-grade bonds.

We do not believe floating rate funds are necessary to include in a well-diversified portfolio. If you want to invest in bank loans, we recommend high-yield funds and other taxable bond funds that can invest in bank loans when the portfolio managers view the loans as attractive. Investors who own other bond funds may already have some exposure to bank loans. Remember, it's important to work with your Edward Jones advisor to decide whether they're appropriate for you at all.

Potential benefits:

Many investors are concerned about the potential for rising interest rates – because when interest rates go up, bond values go down. So they may be looking for investments that can benefit as rates increase. While there are no "magic bullet" investments in a rising-rate environment, floating rate funds can appear attractive. Make sure you understand a few of the potential benefits:

Variable interest rate

Bank loans in the fund pay a variable interest rate that resets every 30 to 90 days. If short-term interest rates rise, the loans held by the fund may pay higher interest rates, resulting in more income paid from the mutual fund to its investors. This may help offset the negative impact that rising interest rates would have on the value of fixed-income investments. But because the variable interest rates are based on short-term rates, not every rising rate environment will be beneficial for bank loan funds. There may be times when long-term interest rates rise and short-term interest rates remain low, resulting in no change to the loans' interest rate.

Diversification

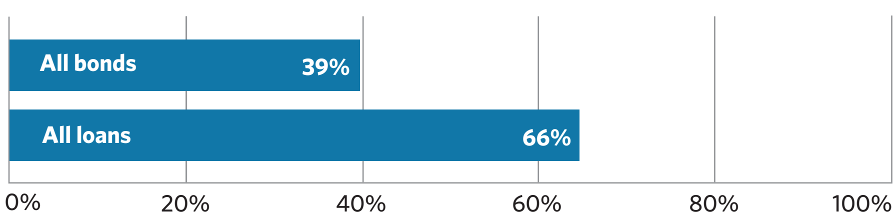
Due to the variable interest rate, bank loan funds may provide a diversification benefit to a fixed-income portfolio. Historically, bank loans have had a low correlation to investment-grade bonds and U.S. Treasuries, which normally see their values decline when interest rates rise. However, due to the poor credit quality of the loans, bank loans' performance tends to be correlated with below investment-grade bonds – values typically decline in the same periods where high-yield bonds decline. Floating rate funds and high-yield bond funds provide fewer diversification benefits to stock portfolios than most other fixed-income investments.

Higher priority and secured

Bank loans owned by the fund are usually a higher priority compared to bonds and common stockholders. That means in the event of default, bank loans would be repaid first with any remaining assets. In addition, bank loans are often backed by specific collateral. The combination of these two characteristics has traditionally resulted in higher recovery rates for loans compared to those of bonds. While bank loans do have higher priority, they are typically issued by lower-quality companies that may have limited options and should not be used as a substitute for investment-grade bonds. Generally, following a default, the interest payments will be suspended while the company is restructured or liquidated, and the eventual recovery may still be lower than the price paid for the bank loan. Despite the higher recovery rates compared to high-yield bonds, there are other drawbacks of bank loans, as discussed in the following section.

Average discounted recovery rates for loans and bonds

(1990-2020)



Source: JP Morgan. These are past recovery rates and are not a guarantee of future recovery rates.

Security priority for repayment from highest to lowest

- Bank loans
- Senior bonds
- Subordinated bonds
- Preferred stock
- Common stock

Potential drawbacks:

Floating rate funds have grown more popular with investors in recent years, but these funds have some distinct drawbacks:

Poor credit quality

Floating rate funds typically own bank loans from companies with limited financing options. These companies may not be able to issue stocks or bonds – perhaps, for example, because they are smaller or riskier. Bank loans may be the only financing available to them. Many times these companies are highly leveraged – meaning the company has a lot of debt relative to its size – which increases the risk. Most would consider these non-investment-grade loans.* It's important to note the benefits of variable interest rates could diminish if the rising-interest-rate environment isn't accompanied by a strong economy. That's because each company would have higher interest costs, which could put pressure on their already leveraged financial position. However, the increased demand and profits of a strong economy could offset this pressure.

Liquidity risks

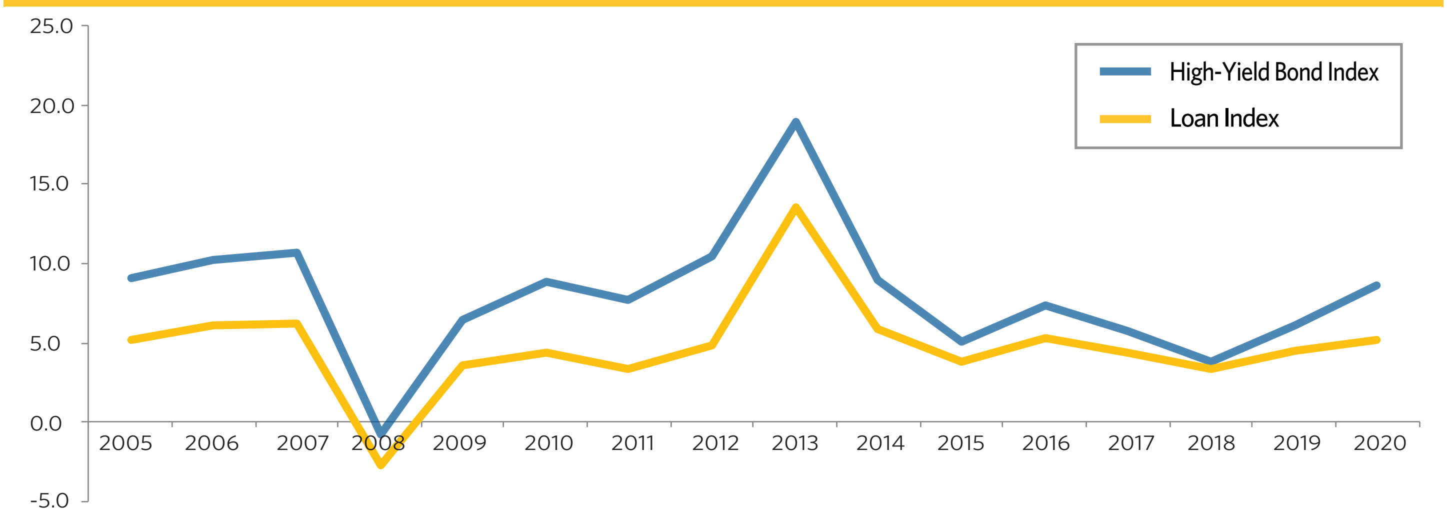
Liquidity refers to how easily a security can be converted into cash. While the size of the bank loan market has grown significantly in recent years, it's still relatively small compared to the investment-grade or high-yield bond market. In addition, bank loans are not registered securities and are more difficult and time-consuming when completing trades than bonds. When bank loans experience selling pressure, a smaller market and less demand could lead to lower loan prices, which could negatively impact the value of bank loan funds. Given the increased time required to complete trades of loans, floating rate funds are required to hold cash and other highly liquid assets to manage investor redemptions, resulting in a lower overall portfolio return.

Limited price appreciation

Unlike banks, companies borrowing with bank loans are often able to refinance their loans at any time by repaying them at the face amount (or par value). During improving credit environments when high-yield bonds are appreciating, the price of bank loans will generally increase to a lesser amount because they can be refinanced at will and replaced with a lower-interest-rate loan. This refinancing can limit the upside price appreciation for investors and lead to floating rate funds underperforming high-yield bonds.

We consider bank loans as aggressive income, and recommend you focus on high-yield funds if you are seeking exposure to aggressive-income investments. Additionally, many high-yield managers have the flexibility to allocate a portion of the fund to bank loans during periods they believe bank loans can add value. The chart below details the rolling five-year performance of the bank loan index relative to the high-yield index, demonstrating constant outperformance of high yield over the period, despite the similar level of risk.

Rolling Five-Year Performance (%)



Source: Morningstar. Past performance is not a guarantee of future performance. High-Yield Index represented by the Bloomberg Barclay U.S. HY 2% Issuer Cap Index, Bank Loan Index represented by the Credit Suisse Leveraged Loan Index. An index is not managed and is unavailable for direct investment.

What should investors do?

While floating rate funds can help protect investors from rising short-term interest rates, they're not without risks. Because of their high risk, we believe floating funds are appropriate only if you're seeking aggressive income, particularly given the poor credit quality and liquidity risks they face.

We recommend adding aggressive-income investments to your portfolio only if you already own income investments. Due to their higher risk and smaller recommended allocation, we believe the best way to invest in aggressive-income investments is through broadly diversified funds. Keep in mind that you may be getting some aggressive-income exposure through an investment-grade bond fund, so a dedicated high-yield fund may not be necessary. If you and your Edward Jones advisor decide that a high-yield fund is right for you, we recommend a relatively small allocation, generally no more than 20% of your portfolio's fixed-income allocation invested in aggressive income, depending on your circumstances.

Prepare for a possible increase in interest rates

Talk with your Edward Jones advisor about rebalancing your portfolio, if needed, to ensure you have an appropriate mix of stocks and bonds. Also, check that the fixed-income portion of your portfolio has no more than 25% in long-term bonds. We don't believe floating rate funds are necessary to include in a well-diversified portfolio, but it's important to understand the potential benefits and drawbacks if you do.

*Debt securities are rated by an independent rating agency such as Standard & Poor's (S&P), Moody's, and/or Fitch. S&P rates borrowers on a scale from AAA to D. AAA through BBB represent investment grade, while BB through D represent non-investment grade. Moody's rates borrowers on a scale from Aaa through C. Aaa through Baa3 represent investment grade, while Ba1 through C represent non-investment grade. Fitch rates borrowers on a scale from AAA through D. AAA through BBB represent investment grade, while BB through D represent non-investment grade.

Mutual fund investing involves risk. Your principal and investment return in a mutual fund will fluctuate in value. Your investment, when redeemed, may be worth more or less than the original cost.

The prospectus contains more complete information, including the fund's investment objectives, risks, and charges and expenses as well as other important information that should be considered. Your financial advisor can provide a prospectus, which should be read carefully before investing.

