ETF insight

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Examining floating rate investments

Investors looking for low volatility, income-producing investments

Investors are yield hungry and that desire is not likely to diminish anytime soon. According to Canaccord Genuity analysts the number of baby boomers in the Canadian population is expected to increase almost two-fold, reaching 39% over the next 15 years. Not surprisingly, they want low volatility, income-producing investments.

Particular focus has been on fixed income. With the likelihood of increased rates in the not-too-distant future, investors are seeking products that can provide protection while still generating a reliable yield. Some have looked to mutual funds and exchange-traded funds (ETFs) focused on floating rate loans. These products have drawn considerable interest in recent years, but are often misunderstood.

As their name denotes, these funds invest in floating rate loans. They are debt instruments whose coupon rates vary based on a predetermined spread above a benchmark rate that is regularly reset. The most commonly used benchmark is the London Interbank Offered Rate (LIBOR), which is essentially the average rate that the most creditworthy international banks will lend to each other.

The current attraction to floating rate funds, and their major advantage, is their low sensitivity to interest rate changes. Since the loans have a floating rate they are not subject to the same kind of pricing risk as a bond in a rising rate environment. However, neither will they gain much when rates decline.

There is some rationale that floating rate funds may perform well over the near term. According to BlackRock, bank loans have tended to do much better than higher-quality fixed income over the last three Fed tightening cycles. Floating rate funds also offer attractive relative yields and, currently, many have yields comparable to high yield bonds.

Floating rate funds are not without risk. Like bonds, they are subject to credit risk although their claim on the company's capital structure ranks higher, so recovery on default tends to be better. BlackRock estimates the default rate for loans over the next two to three years to be roughly half the 4% average recorded over the last 20 years. They also point to a Moody's study, which found that recoveries in the same period averaged approximately 80% and did not deviate appreciably in the past three market downturns.

Floating rate funds are not meant to be a core holding but rather can play a complementary role in portfolio diversification. They have historically experienced low correlation with stocks and investment grade bonds, which helps lower the risk profile of a fixed income portfolio, an important aspect to consider when guarding against rising rates.

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In their quest for yield investors need to be mindful that these products are complicated and due diligence is essential. They should look for answers to important questions such as a fund's compatibility with their risk tolerance; fund liquidity and the ability to exit in a timely fashion; the investment grade of the loans; the fund manager's experience in this asset class; and the fees, which are diverse.

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