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Credit Market
Why Bank-Loan Funds Shine --- Higher Yields Lure Flock of Investors; Returns Near 7%

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Late in economic cycles, investors often try to lock in long-term yields before slowing growth and falling demand for credit pull rates downward.

But this cycle hasn't been usual. Yields remain low, and there is uncertainty about where they are headed. That is stoking demand for mutual funds that buy floating-rate corporate loans made by banks.

Such funds pay nearly 7%, well above the 4.64% benchmark 10-year Treasury yield. Their yields are higher because the borrowers have sub-investment-grade credit ratings.

Such loans offer more protection than similarly rated bonds. Loans rank above bonds in the corporate-finance hierarchy, so loanholders get repaid ahead of bondholders in debt restructurings.

But unlike the coupons of fixed-rate bonds, loan coupons can drop. They are pegged to a short-term floating benchmark such as the London interbank offered rate, or Libor. That would seem to make loans and loan funds less attractive when rates might be headed lower.

Still, loan funds merit a permanent home in portfolios, some argue. They reason that at current, relatively low levels, fixed-coupon bond yields -- which move inversely to their prices -- have little room to drop, barring a much worse-than-expected U.S. downturn.

That means fixed-coupon bonds don't have potential for much price appreciation. "There's a low probability that bonds, or bond funds, are going to deliver returns in excess of their coupons," says Scott Page, who co-manages the Eaton Vance Floating-Rate Fund.

Floating-rate securities also could be a better bet if rates rise. Fixed-coupon issues would lose value, at least on paper. But while coupons of floating-rate securities would increase, their prices would remain steady.

Investors have flocked to loan funds. In the first four months of this year, their assets grew 14% to more than $25 billion, according to AMG Data Services, Arcata, Calif.

Early last year, the RiverSource Investments unit of Ameriprise Financial Inc., Minneapolis, launched a floating-rate fund. Since then, more than $600 million has flooded in, even though the firm more actively marketed another fund, says Colin Lundgren, a senior fixed-income manager.

The two-year-old, $4-billion Hartford Floating Rate Fund has seen similarly strong growth. Investors not only like its 6.56% yield, says co-manager Michael Bacevich, but they also "take comfort in the fact that [net asset value] has been virtually steady since inception." The fund is part of the Hartford Financial Services Group Inc. in Connecticut.

Mr. Bacevich and others caution that investors need to be careful when deciding whether to buy a bank loan fund. As elsewhere in the financial world, strong demand for yield has helped erode credit standards in the loan market.

Bank loans are made with restrictions, or covenants, that are intended to prevent borrowers from taking actions that might hurt their credit standing. But restrictions have grown looser in recent years, loan specialists say.

Investors shouldn't opt for the fund with the highest yield, they add. A lower yield may mean a fund is making more prudent investment decisions.

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At Eaton Vance, Mr. Page and co-manager Payson Swaffield are selective about the types of loans they buy and also limit the size of positions in each. "We don't see any reason to take a big bet on a company or an industry, because we don't get paid to take those bets," says Mr. Page.

Alcoa-Alcan Tie-Up

Risks Junk Rating

Credit-rating firms Standard & Poor's and Moody's Investors Service warned that should Alcoa Inc. acquire competitor Alcan Inc. for $27 billion, the combined entity could fall below investment-grade and face much higher financing costs.

Standard & Poor's, which rates both companies three notches above speculative grade, or junk, at BBB-plus, placed the ratings on CreditWatch with negative implications.

"Without a meaningful equity offering or asset-divestiture program that reduces debt on the balance sheet, it is highly unlikely the combined corporate credit rating will retain an investment-grade rating, which would represent at least a three-notch downgrade for Alcoa's and Alcan's existing corporate ratings," Standard & Poor's said.

It expressed concerns over the potential combined entity's "very aggressive debt levels and the ability to reduce debt to more appropriate levels within a reasonable time."

Moody's placed Alcoa's A2 senior unsecured rating -- which is two notches above S&P's rating of Alcoa -- and Alcan's Baa1, equivalent to S&P's BBB-plus, under review for a possible downgrade. It also warned about the possibility of a junk-rated combined entity.

Regulatory hurdles are expected, according to S&P, given Alcoa and Alcan's combined market position in the aluminum sector. "It is quite possible other suitors could enter the mix, resulting in more aggressive competing bids," it added.

Alcoa's 5.55% bonds due 2017 were 0.23 percentage point wider at 1.12 percentage point, according to MarketAxess, an electronic-trading platform for corporate bonds. The cost of protecting $10 million of Alcoa bonds was around $45,000 a year for a five-year period, up from $22,500 on Friday, according to Scott MacDonald of Aladdin Capital Holdings.

-- Marine Cole

Short-Maturities Lower

Shorter-dated U.S. Treasury bond prices ended lower in a quiet session, as investors prepared for tomorrow's Federal Open Market Committee meeting.

The two-year note, the most sensitive to official rate changes, was down 1/32 point, or $0.3125 per $1,000 face value, at 99 21/32 to yield 4.679%, up from 4.670%, as yields move inversely to prices. The benchmark 10-year note was up 1/32 at 99 29/32 to yield 4.636%.

Yesterday's main-market event came with the auction of three-year notes, which the Treasury will stop issuing. The sale saw weak demand particularly from large domestic and foreign investors, which took 18.9% of the offering, compared with the 25.5% average of the past five auctions.

The auction's largely lackluster performance suggests that "investors are patiently awaiting the Fed meeting before allocating to the front-end," said George Goncalves, chief Treasury, TIPS and agency strategist at Morgan Stanley in New York.

Later this week, the government will also sell 10- and 30-year bonds, and investors are also waiting to see how strong demand is in these auctions.

AUCTION RESULTS

Here are the results of yesterday's Treasury auctions. All bids are awarded at a single price at the market-clearing yield. Rates are determined by the difference between that price and the face value.

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13-WEEK AND 26-WEEK BILLS

	13-Week	26-Week
Applications	$37,840,544,000	$36,885,485,000
Accepted bids	$13,000,024,000	$12,000,137,000
Accepted noncomp	$1,948,645,000	$1,771,082,000
Accepted frgn non	$355,000,000	$225,000,000
Auction price (Rate)	98.796778(4.760%)	97.565750(4.815%)
Coupon equivalent	4.898%	5.017%
Bids at market yield	1.41%	75.48%
Cusip number	912795ZU8	912795A92

Both issues are dated May 10, 2007. The 13-week bills mature Aug. 9, 2007, and the 26-week bills mature Nov. 8, 2007.

THREE-YEAR NOTES

Applications	$33,490,091,000
Accepted bids	$14,000,011,000
Bids at market-clearing yield accepted	90.24%
Accepted noncompetitively	$391,341,000
" foreign noncompetitively	$50,000,000
Auction price (Rate)	99.794740(4.574%)
Interest rate	4.5%
CUSIP Number	912828GR5

The notes are dated May 15, 2007, and mature May 15, 2010.

-- Deborah Lynn Blumberg

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