

On The Cover/Top Stories

## Take a Risk

Bernard Condon 03.10.08, 12:00 AM ET

**Michael Lewitt**


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**Contrarians buy debt when the headlines rail about a debt crisis. Like right now.**

From his glass-walled office Michael Lewitt could see the trading floor was getting panicky: One trader fidgeted in his chair, another stared blankly at a stock ticker on the TV overhead, a third clutched his head. By the time the Dow Jones industrial average had fallen 300 points, the veteran fund manager had had enough.

He grabbed a pair of dice from his desk, walked onto the floor and jokingly began rolling them. "Google (nasdaq: [GOOG](#) - news - people )," yelled Lewitt, 50. "Citigroup (nyse: [C](#) - news - people ). Apple (nasdaq: [AAPL](#) - news - people )."

"You're making me anxious," a 23-year-old analyst burst out, not getting the point that he should calm down.

The market's gyrations can drive even the most dispassionate investors to distraction. So Lewitt has been busy lately reminding his traders to keep their cool--and to buy into downturns. The cofounder of \$1 billion Hegemony Capital of Boca Raton, Fla., once a big short-seller of corporate debt, is turning bullish.

His favorite target is in a once obscure corner of the securities market: floating-rate bank loans (also known as leveraged loans) to outfits also burdened with junk bond debt. Buyout funds used these loans to complete their deals. Leveraged loans are risky, yes, but well worth it, he thinks, with senior secured loans yielding a floating-rate 5.5% of par value and trading at 86 cents to the dollar, down from 101 cents only nine months ago. "I've never seen loans priced this cheaply--ever," says Lewitt, who has been trafficking in dodgy debt since 1987, when he was an investment banker at the junk shrine of that age, Drexel Burnham Lambert.

Lewitt was once an aspiring scholar doing graduate work at Yale under the curmudgeonly Harold Bloom, whose celebrated book, *The Western Canon*, slammed faddish literary criticism. Lewitt, who left academia in 1982, writes an investment newsletter sprinkled with references to

Ralph Waldo Emerson and Henry David Thoreau, and filled with contempt for investment fads.

The happy result of the credit crisis is that leveraged loans are getting interesting. Which ones? Broad swaths of the American economy not exposed to shaky consumers will do just fine in a recession, he says. So loans to big industrial companies with lots of exports, for instance, will come through the turmoil intact.

All leveraged loans have been trading down because of recession fears. Another factor is technical: selling by investors hit with subprime mortgage losses who need to raise cash fast. The loans are oversold, says Lewitt. He expects defaults on junk bank loans will peak at an annualized 3% rate near the end of the year, up from around 1% today. That's bad, but not bad enough to explain paper selling at a 14% discount to par. These loans, which are senior to bonds and secured by assets, are at the top of the totem pole in a Chapter 11 filing. Investors in such loans typically recover 70% of principal in a bankruptcy, versus 20% for junk bonds.

Individual investors can't buy into the multimillion-dollar bank loans, but they can get exposure through mutual funds (see table). The 103 bank loan funds followed by mutual funds rater Morningstar are down in total return (price and interest) 7% this year through mid-February but rose 4% annually over the past five years.

### Close to the Flame

These brave funds own bank loans to the highly leveraged or plain old junk bonds. If you think we're bottoming, buy them.

FUND   INVESTMENT	TOTAL RETURN		ANNUAL EXPENSES PER \$100	COMMENT
	YEAR TO DATE	3-YEAR ANNUALIZED		
<b>BRUCE FUND</b>   stocks and bonds	-3.8%	5.2%	\$0.78	Lots of convertibles in drugmakers.
<b>EATON VANCE FLOATING RATE-A</b>   junk loans	-3.1	2.9	1.05	Owens slug of solid BB-rated issues.
<b>FIDELITY FLOATING RATE HIGH INCOME</b>   junk loans	-3.1	3.2	0.72	Buying loans to big firms.
<b>PIMCO HIGH YIELD-D</b>   junk bonds	-0.1	5.4	0.90	Ditched risky retail sector bonds.
<b>T ROWE PRICE HIGH YIELD</b>   junk bonds	-2.5	4.6	0.77	Shunning CCC issues, buying loans.

Performance through Jan. 31. Sources: Morningstar, Lipper.

Not all these funds are wonderful. Beware of hot hands. Some outperformed by buying the very dickest loans, like second liens (stuff that has made Lewitt bearish until recently). Or by using too much leverage. Example: Van Kampen Senior Loan.

Among the wisest of these players is Fidelity Floating Rate High Income, run by a junk bond analyst turned junk loan trader with a conservative bent. That has held back her performance in the past. But last year when prices began to fall, manager Christine McConnell returned 2.7% versus the industry's 1.1%, according to Morningstar. She began losing money this year. Recent yield: 6.9%. McConnell focuses on loans to big companies like **Charter Communications** (nasdaq: [CHTR](#) - news - people ) and Georgia-Pacific sporting tight covenants (restrictions on things like debt-equity ratios). Another prudent fund: **Eaton Vance** (nyse: [EV](#) - news - people ) Floating Rate, run by an 18-year loan-trading veteran, Scott Page. The fund has lost 3.1% this year but has averaged a 2.9% annual return over the last three years.