Bank Loans Can Play Both Offense and Defense in an Uncertain Environment

With the US shift toward tighter monetary policy, investors are increasingly turning to fixed income strategies that may help them navigate rising interest rates. We believe floating-rate bank loan strategies currently offer attractive yield potential and interest rate risk protection, as well as defensive attributes should credit markets weaken.

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The US Federal Reserve re-embarked on unwinding its zero interest rate policy at the end of 2016, with additional rate increases expected for 2017 given steadily stronger key US economic indicators.

The US recovery, however, remains largely uneven, while markets such as Europe and China face mounting challenges. As such, we anticipate that rate changes will continue to be gradual with smaller, uneven increases over multiple years — unlike the rate hike cycle that started in 2004, when rates went up 425 basis points in just two years.[1]

Bank loans may offer a compelling solution for investors concerned about rising interest rates. These variable-rate loans issued for companies rated below investment grade tend to offer higher coupons than investment grade credits do, typically adjusting at 90-day intervals – almost eliminating duration risk. Current spreads compared with those of most other debt assets remain attractive, offering a relative income advantage to investors starved for yield.

Bank Loans Offer Several Attractive Features

Profile and Comparison to High Yield and Investment Grade Bonds

	Bank Loans	High Yield Bonds	Investment Grade Bonds
Security	Yes — 1st ranking	Some	Mostly unsecured
Ranking	Senior	Structurally subordinated	Senior
Covenants	Generally comprehensive	Mostly incurrence	Unrestrictive to partial
Term	5–9 years	7–10 years	30 years; perpetual
Income	Cash pay — floating	Cash pay — fixed	Cash pay
Spread/OAS	LIBOR + 442 bps†	Treasury + 409 bps‡	Treasury + 123 bps‡
Credit Rating	BB–CCC	BB–CCC	AAA–BBB
Bankruptcy Treatment	May continue to pay interest	No interest	No interest

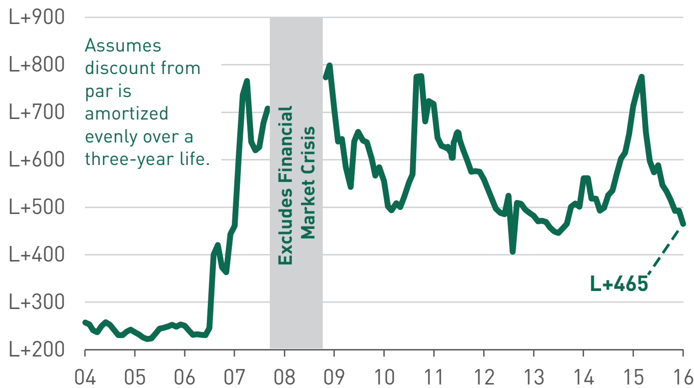
Source: Credit Suisse. A Case for Leveraged Loans — Global Leveraged Finance Research; Exhibit 1 December 2009. † S&P/LSTA. Discounted spread to maturity, as of 31 December 2016. ‡ Barclays Capital, as of 31 December 2016. Any views represent the opinion of the manager and are subject to change.

Now that most of these securities have moved above their LIBOR floors – the minimum base rate component of their coupons, which have been, on average, set around 1% – any new rate increases should directly correspond to higher yields for investors. Plus, bank loans may protect against two big tail risks we see today:

- **Rising rates in a strengthening economy.** Bank loans' yield-reset feature may hedge against rising interest rates if the Fed decides to act on a strengthening economy and rising inflation. Traditional fixed-rate bonds, meanwhile, may be even more vulnerable to rising rates than they have been in the past based on the scant cushion their low yields offer to absorb losses.
- **Rising defaults in a weakening economy.** If the economy decelerates and defaults rise, bank loans' more senior capital structure position, generally secured by most of the company's assets, may ensure stronger recovery rates than those of other higher-yielding bonds.[2]

Of course, it's important to remember that investing in non-investment-grade bank loans involves a degree of caution, and investors should carefully consider the type of strategy best suited for their needs.

Yields for Bank Loans Remain Attractive
Spreads Over LIBOR



Source: S&P/LSTA. Data as of 31 December 2016. Past performance is not indicative of future results. Any views are the opinion of the investment team and subject to change.

A growing market expands the opportunity

The bank loan segment, as measured by the S&P/LSTA Leveraged Loan Index, has grown nearly 50% during the past decade into a $880 billion market. A number of factors contributed to this growth, including issuer interest and investor demand.

The expansion of the loan market universe has broadened the opportunity set for investors. "Covenant-lite" loans now represent a significant share of the overall market and have attracted a number of high-quality issuers that otherwise would have raised capital through high yield bonds.

While some investors may still be averse to bank loans based on poor performance during the financial crisis, in hindsight, that period appears to be more of a perfect storm for these securities, which were largely pressured by technical factors rather than fundamentals. Highly leveraged investors were forced to sell at starkly depressed prices, pushing valuations even lower. While defaults rose in 2009 to 9.6%, somewhat higher than in past recessions, they tumbled sharply again in 2010.[3]

Overall, the loan market has grown over the past several years, which gives us a larger universe of loans, a wider array of investors, and improving transparency. As of 31 December 2016, there were more than 1,000 loan issuers to choose from, providing sufficient breadth to construct well-diversified portfolios. Investors can tailor portfolios to avoid or emphasize certain industries, or to focus on optimal risk/return metrics.

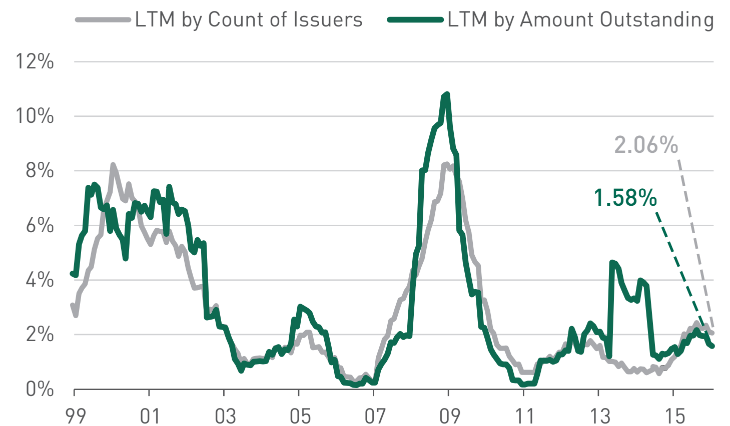
While most loan issues have multiple market makers, liquidity has compressed somewhat as a result of the restrictions put in place by the Dodd-Frank Act. In our view, this compression places a mildly greater premium on credit selection and surveillance, so as to minimize the situations in which a large number of institutions are trying to exit a given loan issue at the same time.

Defaults continue to be relatively low and loan coupons compare favorably with high-yield payouts but with notably less risk should defaults rise.[4] At current valuations, investors appear fairly compensated for what we continue to view as only modest default risk outside the commodity sectors. We believe the attractive income streams and the seniority and security of bank loans should result in a fairly resilient outcome in a credit market downturn, while outperforming through rising interest rates.

Finally, credit fundamentals have weakened somewhat, with earnings growth slowing over the past two to three quarters. Beyond the clearly stressed energy and commodity markets, which represent less than 6% of the S&P/LSTA Leveraged Loan Index and have been improving, certain sectors are showing strain, particularly retail. Potential changes in health care, tax reform, and trade regulation under the new US presidential administration also warrant close monitoring. That said, corporate liquidity remains generally good, and the US economy appears likely to maintain a 2%-3% growth rate.

Given where spreads are, we believe bank loans remain a good value proposition relative to other fixed income asset classes. And while risks are elevated versus last year, a disciplined credit research process can help deliver a successful outcome for portfolios.

Defaults Remain Low With a Favorable Outlook
Annual Loan Default Rates



Source: S&P/LSTA. Data as of 31 December 2016. Past performance is not indicative of future results. Any views are the opinion of the investment team and subject to change.

Investing in bank loans

Greater investor interest along with the wider choice in individual securities has resulted in many more investment managers offering bank loan strategies. However, the dispersion of manager returns in the segment can be considerable. For example, the top 5th percentile of strategies delivered 5.40% in total return for the past three years while the bottom 95th percentile returned only 1.72%.[5]

We believe that, to deliver stable alpha and limit default loss, investment managers should have:

- **Strong credit research capabilities.** Each issuer comes with distinct credit and potential return considerations. The ability to analyze risk and potential downside exposure of individual securities, industries, and the overall segment is critical.
- **The ability to be nimble.** Managers with a large amount of assets under management may have difficulty effectively maneuvering during changing markets and/or opportunistically taking advantage of short-term individual credit pricing dislocations in a meaningful way, given that the impact on the overall portfolio is simply too small.
- **Experience across full credit cycles.** Over 60% of the bank loan strategies have track records of less than 10 years.[5] Experienced teams can navigate varying markets.

Investors may use loans as a component of their high yield allocation or as a strategic investment, allocating exclusively to loans within their high yield allocation. Generally, the larger the position, the more effectively the allocation can serve as a hedge against interest rate risk, with some investors establishing separately managed accounts that enable them to tailor the investment guidelines to their risk tolerance and specific investment objectives.

Overall, we believe bank loans may be well suited to help investors successfully adapt to the new rising rate cycle while securing an attractive income stream. Bank loan spread yields more than compensate for default risk, in our view, and these loans can provide a hedge against inflation and an unexpected spike in defaults. Finally, in the event higher-yielding credit markets weaken, bank loans can play a defensive role in an investor's portfolio.

1 Source: Federal Reserve http://www.federalreserve.gov/releases/h15/data.htm.
2 Source: Credit Suisse. A Case for Leveraged Loans — Global Leveraged Finance Research; Exhibit 1 December 2009.
3 Source: Credit Suisse Leveraged Finance Default Review, 12 January 2015, Exhibit 65.
4 Source: Standard & Poor's LCD and S&P/LSTA, as of 31 December 2016.
5 Source: eVestment Alliance (eASE Analytics), as of 31 December 2016, based on the eA US Floating-Rate Bank Loan Fixed Income peer group. Track record measured as of 30January 2017.

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