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INSIGHTS WEBINAR SUMMARY

The Durability of the Bank Loan Market Makes the Case for a Tactical and Strategic Allocation

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Andy McCormick, head of Fixed Income and CIO, and Paul Massaro, head of Global High Yield, recently discussed recent market activity and the resulting potential investment opportunities for institutional investors.

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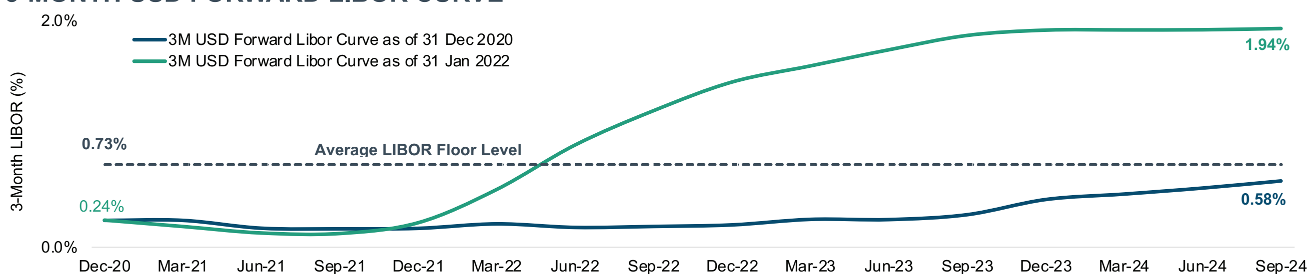
Bank Loans – a valuable asset across Fixed Income

- Bank Loans continue to have a unique combination of competitive yields, alongside a very low duration profile. Looking at the historical pattern of loan performance, in periods of rising policy rates and rising Treasury yields, it is particularly compelling versus other fixed income alternatives.
- In terms of being constructive on a risk asset, investors should pay attention to the market technicals. As the forward curve has shifted, we briefly saw a meaningful percentage of the market trade north of par in January. However, inflation concerns as well as recent geopolitical tensions has "kept a lid" on dollar prices and has allowed us to enter a lot of these loans at prices below par, while maintaining very attractive income.

3-MONTH USD FORWARD LIBOR CURVE



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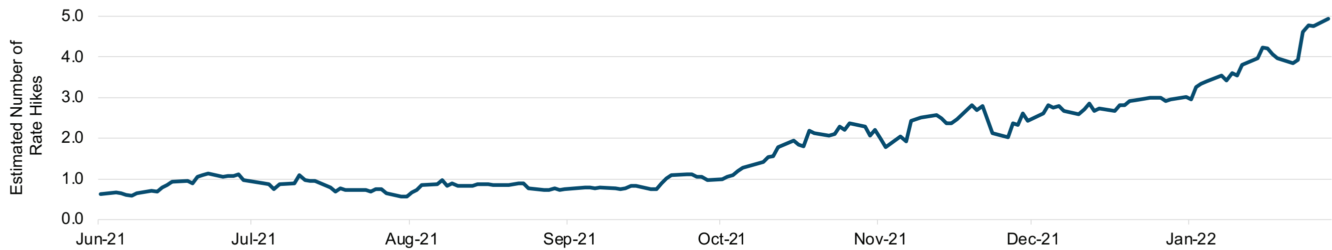
- People seem confident that the Fed can stay the course, but next year becomes a tougher call.
- Economies in Europe are more exposed to energy from Russia, resulting in an interesting rate environment with expected ongoing volatility. Given that expectation for continued rate volatility, the Fed's path of anticipated rate increases, and the ability to still buy relatively high-quality paper at a discounted price, we view the asset class as a "safe haven," where you would think of it as more of an income generator as policy rates rise throughout 2022 and beyond. This additional income impact can be powerful.

NUMBER OF RATE MOVES PRICED IN FOR DECEMBER 2022



Source: Bloomberg Finance, LP. Please see the Additional Disclosures page for information about this Bloomberg information.

Dates represent points along the forward curve for 3-month LIBOR. For dates that have already been observed as of the date of the forward curve, observed LIBOR rates are used.

Potential Upside:

- The loan market has a structural composition around technology, services, and healthcare—the asset class' three largest industries. There is much less exposure to heavy cyclical industries such as energy and other commodity-based sectors compared to the high yield market.
- Given the durability of returns (24 out of 25 calendar years of positive returns), this asset class can work as a strategic allocation over time.
- That return profile, combined with an extremely low duration profile contributes to the lower volatility of the asset class over time, resulting in higher Sharpe Ratios.
- Generally, negatively correlated with other fixed income sectors, particularly Treasuries.

Bank Loans – a consistent performance vehicle over time

- Long-term performance numbers of the asset class validate the case for a strategic allocation in fixed income portfolios. Displayed in the chart below, in 24 out of the last 25 years, the asset class has generated positive returns. During different economic cycles, interest rates cycles, and credit spread movement in those 25 years, there has only been one time where we've seen meaningful negative return scenario and that was in 2008 during the GFC.

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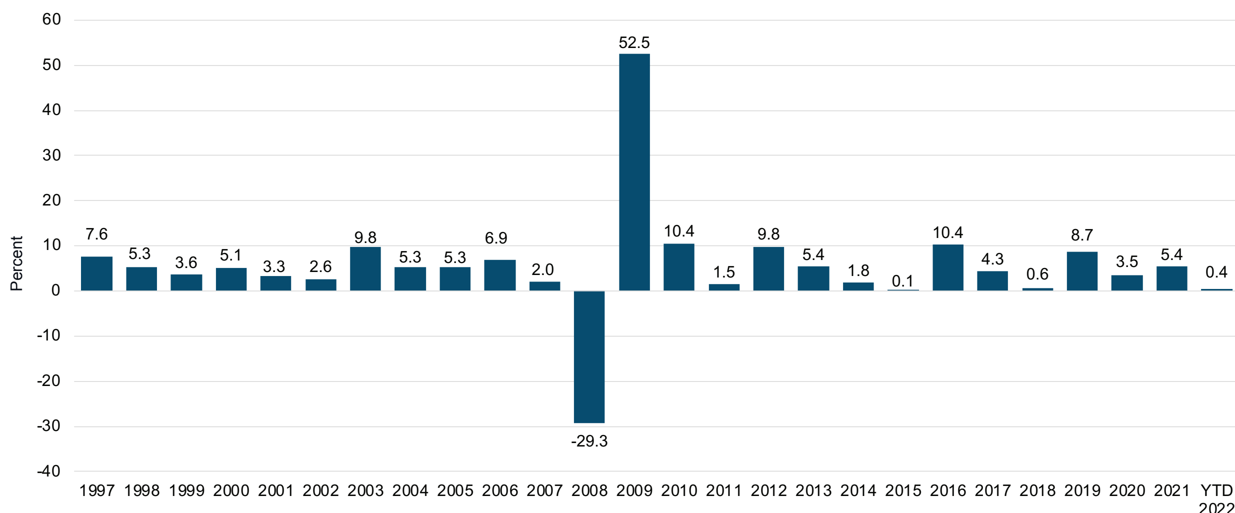


Past performance is not a reliable indicator of future performance.

Source for annual returns: S&P Global Market Intelligence.

Please see the Additional Disclosures page for information about this S&P information.

Tremendous growth in the loan market: Is this sustainable?

- The short answer is yes.

  Key reasons include:

  – Over the last few years, there has been a clear shift in the below investment grade market from high yield to loans as issuers, and particularly PE sponsors, have demonstrated a preference for the loan market. The largest increase we've seen in the high yield market has mostly been through the fallen angel impact from the coronavirus pandemic.

  – Over the next two years, the loan market could surpass high yield in terms of total size. The loan market has matured significantly over the past 5-10 years and there is a robust secondary market for loans that simply did not exist 10-15 years ago.

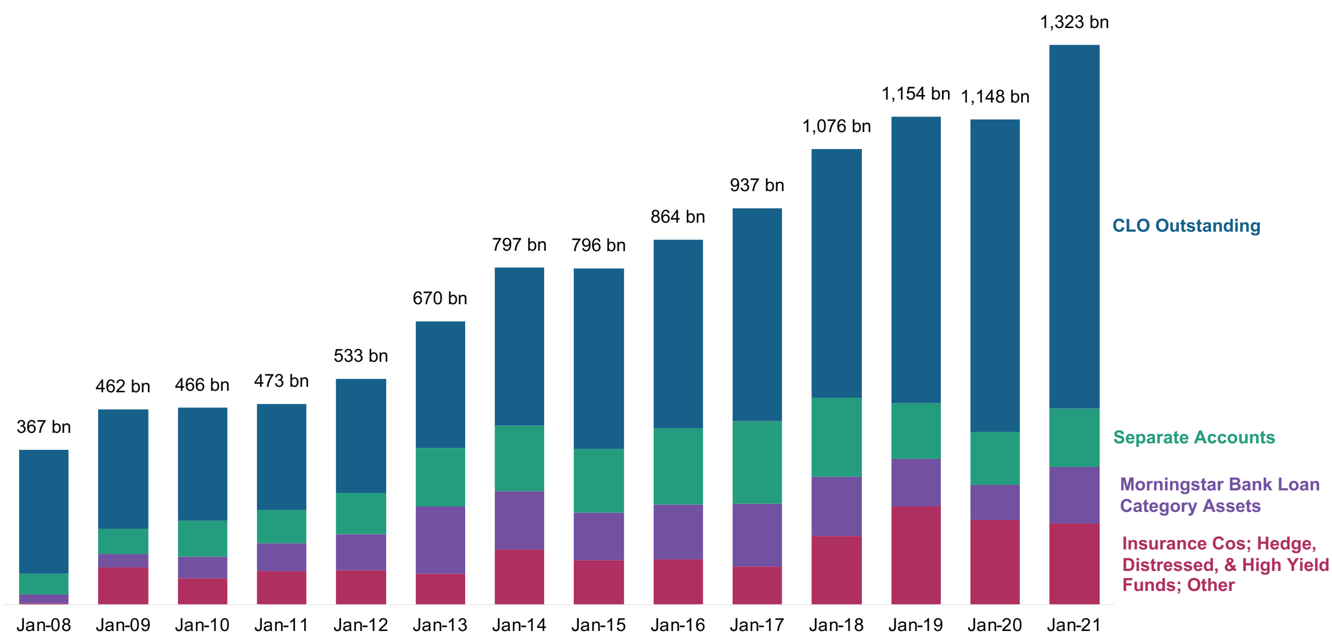
  – There are a lot of great features in loans: secured by companies' assets and sit at the top of the capital structure, low historic volatility, floating rate income, and downside risk mitigation relative to other risk asset classes.

  – There has been a broader acceptance of collateralized loan obligations (CLO) in the market, from new players, insurance companies, and anyone attracted to the steady historic returns and high ratings.

> "For all those reasons, it seems to be a very established market at this point, very sizable and scaled."
>
> **— Paul Massaro, CFA,**
> *Head of Global High Yield*

Areas of opportunities within the market

- **High Yield:** particularly in the BB and the first lien senior secured portion of the high yield market, prices have started to come down below par and this gives investors additional convexity we just haven't seen in a long time in the high yield market.
- **Loan market:** loans with a zero Libor floor that have been trading at a discounted price, investors should be able to capture all the rate movement right up front as well as that pull-to-par over time.
- **Sector specific:** Positions in the veterinary hospitals space are becoming interesting, especially on the loan side. Coming out of the pandemic, if people have bought or adopted a pet, veterinary businesses should have structurally higher earnings potential over the next 3-5 years.



Sources: S&P LCD, Morningstar, eVestment Alliance, LLC, and BofA Global Research

Loan market key trends and innovations – subordinated deals

- Within private credit, there is a lot you can do here, given how large that market has become. For example, we have seen interesting deals within the subordinated space are attractive. Five or six years ago, there could only be a limited amount done within that space while today, you can see up to $900 mm for a particular private or club deal in a subordinated piece of paper.
- There has been a new focus on developing private equity-sponsored relationships. Our recent to partnership with Oak Hill Advisors (OHA) has opened new possibilities in that area.

Capital markets activity

- Deal flows will continue to rise as many more companies are coming to market and taking advantage of the execution available. We feel deal flow will continue to be robust in 2022.
- Diligence is needed with covenants and structures, which is why we rely heavily on our research staff for interpretation and understanding as 'covenant lite' deals have become more prevalent in the markets recently.

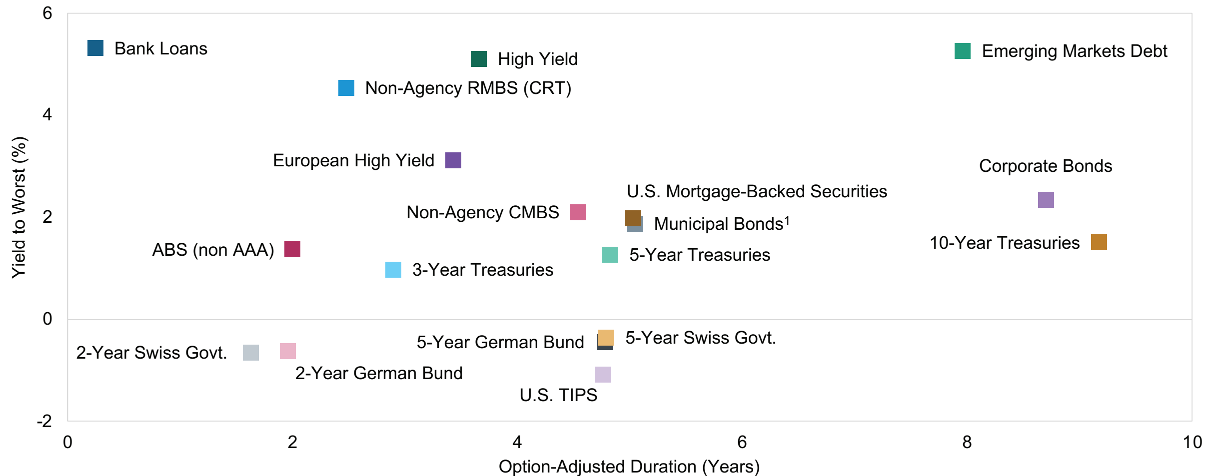
Overall Fixed Income markets relative value

What are we keeping an eye on?

- As the chart below shows, loans offer compelling yield with a uniquely low duration profile
- There is still a large volume of negative-yielding debt
- Scarcity of value in income overall, globally
- Focusing on credit risk in the short end of the curve

> "Private credit is an asset class is as popular as a standalone application, but it's also finding its way into commingled vehicles and broad mandates across the platform."
>
> — **Andy McCormick,** *Head of Global Fixed Income and CIO*

10 Years Ended 31 December 2021
Figures are calculated in US Dollars



Past performance is not a reliable indicator of future performance.
Sources: J.P. Morgan Chase & Co., Bloomberg Index Services Ltd., Bloomberg Finance, L.P., and ICE BofA.
[1] Taxable-equivalent yield assuming a 40.8% tax rate.
Bloomberg Indices: Corporate Bonds: U.S. Corporate Investment Grade Index; Municipal Bonds: Municipal Bond Index; U.S. Mortgage-Backed Securities: MBS Index; U.S. TIPS: U.S. Treasury: U.S. TIPS; 2 Year Swiss Govt.: Swiss Aggregate: Treasury 1 - 3 Years; 5 Year Swiss Govt.: Swiss Aggregate: Treasury 3 - 7 Years.
J.P. Morgan Chase & Co. Indices: High Yield: Global High Yield Index; Bank Loans: Leveraged Loan Index; Emerging Markets Debt: EMBI Global Diversified Index; 2 Year German Bund: 2 Year German Bund benchmark; 5 Year German Bund: 5 Year German Bund benchmark.
From Bloomberg Finance, L.P.: 3-Year Treasuries represented by the U.S. 3-Year Treasury Note in the U.S. Treasury Actives Curve; 5-Year Treasuries represented by the U.S. 5-Year Treasury Note in the U.S. Treasury Actives Curve; 10-Year Treasuries represented by the U.S. 10-Year Treasury Bond in the U.S. Treasury Actives Curve.
European High Yield represented by the ICE BofA European Currency High Yield Constrained Excluding Subordinated Financials Index Hedged to USD.
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Source for ICE index data: ICE BofA. Please see the Additional Disclosures page for information about these sources.

Final Remarks

- Bank loans paired with long-term Treasuries could be a good position, obviously, in a flattening yield curve, given the negative correlation between the two asset classes, and the same is true for CLOs being paired with long-term Treasuries.
- When research work is done around what the market looks like over time, we have found that the vast majority of loans are refinanced before two years to maturity. This is because issuers don't like to take the market risk of potentially not being able to access capital in a downturn. This provides us with a better working understanding around when we can expect loans to be refinanced.
- CLO markets are a growing share of the loan market which we think reflects that the world is waking up to this asset class. There is meaningful institutional demand for this asset class.
  - Investors can attract AA or AAA rated CLOs, which we believe is a viable place for portfolio managers to place cash given it's a highly liquid market.
- Cash distribution and liquidity rules:
  - All loans are typically reset on rates on a rolling quarterly basis and that exact timing all depends on when the loan is issued and funded.
  - In the end, you can own a laddered portfolio due to the interest rates changing throughout the calendar year.
- Generally, investors should think about everything as a portfolio of loans, much like High Yield, where there is diversified set of names underneath, and we are trading those every day in the market.

> "Over the last few years, you have folks feeling forced into lower credit quality investments, but now given the move in rates we have seen there are actually some yields out there in higher quality assets, such as the secured portion of the high yield market."
>
> **— Paul Massaro, CFA**
> *Head of Global High Yield*

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