Leveraged Credit Opportunities Beyond High Yield Bonds

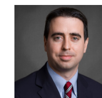
Bank loans can enhance the opportunity set and return potential.

May 2023

KEY INSIGHTS

- Pairing bank loans with high yield bonds can expand a leveraged credit portfolio's opportunity set while adding diversification benefits.
- Bank loans provide less risky access to sub-investment-grade credit than bonds due to the loan asset class's structurally defensive nature.
- Diversification between loans—largely issued by private companies—and bonds can help manage risk and unlock relative value as market conditions change.

Rodney Rayburn, CFA
Portfolio Manager, Credit Opportunities Strategy



Jason Bauer, CFA
Associate Portfolio Manager, Credit Opportunities Strategy

Following the global financial crisis, banks were forced to move loans made to sub-investment-grade companies off their balance sheets. This allowed credit investors greater access to these securities and led to the expansion of the bank loan market, also known as the leveraged loan market, which has grown nearly threefold since 2006. Today the scale of the leveraged loan market is on par with that of high yield bonds. Despite the comparable size of the markets, only about 35% of sub-investment-grade companies issue both high yield bonds and bank loans. Therefore, to access the complete leveraged credit opportunity set, it is imperative that investors consider both high yield bonds and bank loans.

The issuer composition of the two markets also varies. While the risk characteristics and considerations of below investment-grade bond and bank loan issuers are similar, large publicly traded companies tend to dominate the high yield bond market. Approximately 70% of the high yield bond market is public companies, while the loan market is roughly 70% private firms. A portfolio's exposure to private companies can add diversification benefits.

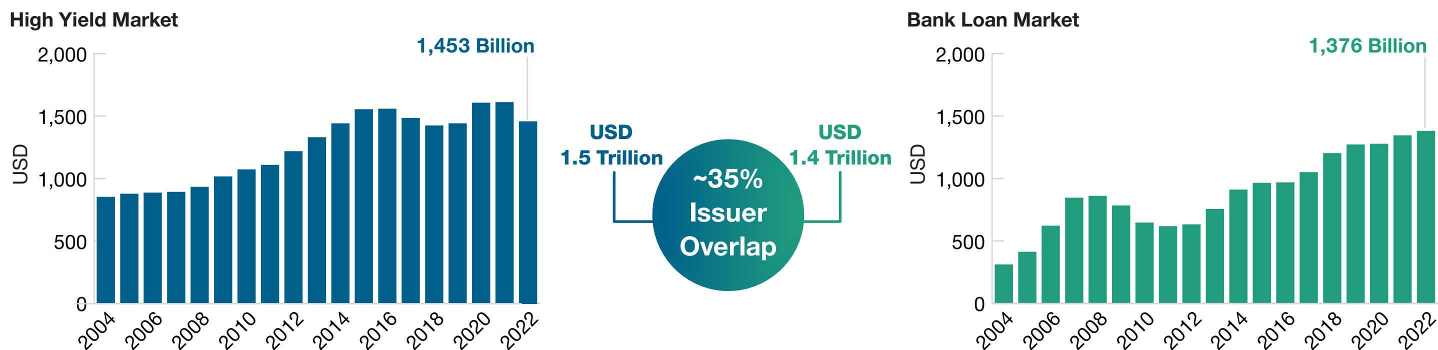
Relatively Less Risky Access to Sub-Investment-Grade Credit

Bank loans generally have sub-investment-grade credit ratings, but they provide lower-risk access to the high yield market relative to bonds. The loan asset class has a higher repayment priority than high yield bonds if an issuer defaults, which historically has resulted in higher recovery rates in default situations. At the end of 2022, for example, the long-term recovery rate for U.S. high yield bonds was around 40%, compared with roughly 64% for U.S. loans. In addition, the long-term loan default rate (2.9%) is lower than for high yield bonds (3.0%).[1]

[1] Source: J.P. Morgan. The default rates are for the 25 years (loans) and 25 years (high yield bonds) ended December 31, 2022.

Comparable Scale of U.S. High Yield and Bank Loan Markets

(Fig. 1) Size and overlap of high yield bond and bank loan markets

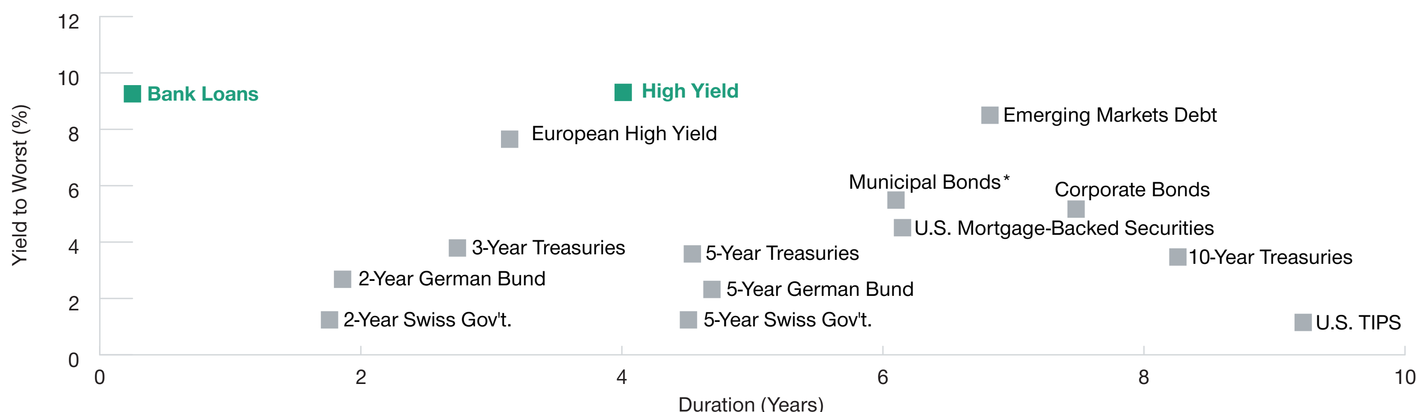


As of March 31, 2023.
Sources: Credit Suisse and J.P. Morgan. See Additional Disclosures.

Like high yield bonds, which pay a fixed interest rate, bank loans are a high-income asset class. The average coupon of the bank loan market is currently 8.7%,[2] which can help buffer returns during periods with price volatility. Furthermore, the floating rate feature of loans—coupons adjust quarterly based on a short-term benchmark rate—gives them a very low duration[3] profile, meaning they should perform well relative to other fixed income asset classes as rates increase. In 2022, for example, leveraged loans

Compelling Yield/Duration Profile

(Fig. 2) Duration and yield across asset classes



As of March 31, 2023.

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 BofAML (See Additional Disclosures).
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 Gov't.: Swiss Aggregate: Treasury 1-3 Years; 5-Year Swiss Gov't.: 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.
*Taxable-equivalent yield assuming a 40.8% tax rate.

[2] Based on the J.P. Morgan Leveraged Loan Index as of March 31, 2023.
[3] Duration measures a fixed income security's sensitivity to changes in interest rates.

ended the year nearly unchanged while most other traditional fixed income asset classes experienced losses in excess of 10%.

Given their shorter-duration profile and seniority in the capital structure, we believe the loan asset class offers investors a more defensive way to add exposure to the below investment-grade market while also providing attractive income. Still, bank loans are subject to credit risk, and selecting winners while avoiding troubled credits through active management is critical.

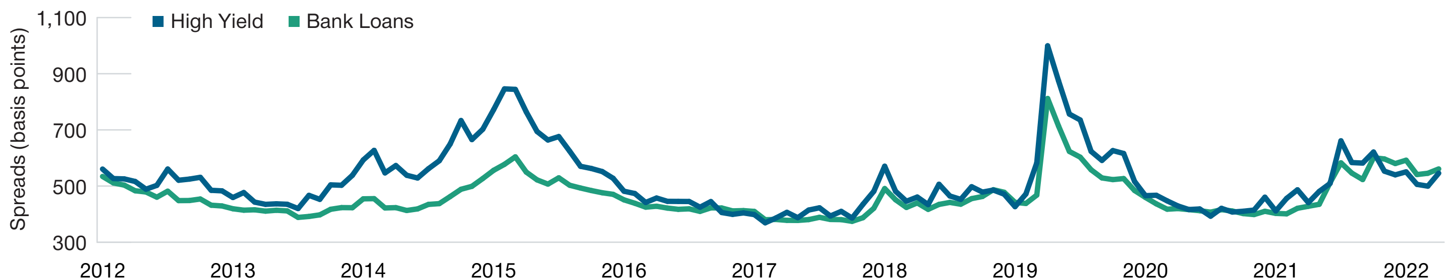
Flexibility Is Key to Unlocking Relative Value

While adding bank loans to a portfolio can have benefits, market conditions will generally dictate the relative value between bonds and loans. Therefore, we believe a portfolio can add significant value by opportunistically shifting between the two asset classes. For instance, it can be beneficial to tilt the portfolio more toward loans during periods of rising interest rates, as the floating rate feature of bank loans provides a low duration profile.

Alternatively, when high yield bond credit spreads[4] look wide compared with bank loan spreads—as they did during

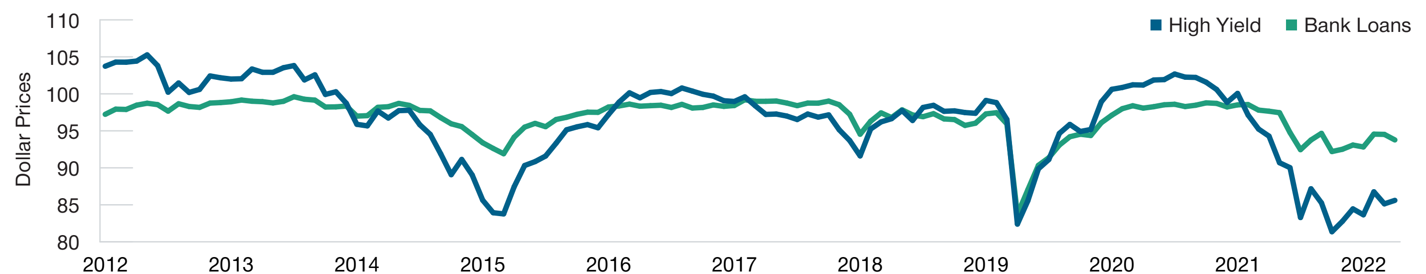
Relative Value Between Bonds and Loans

(Fig. 3) High yield bond and bank loan spreads



High Yield Market represented by the JP Morgan Global High Yield Index. Bank Loan market represented by the JP Morgan Leveraged Loan Index. Spread used for high yield is spread to worst. Spread used for bank loans is spread forward to maturity.
Past performance is not a reliable indicator of future performance.

(Fig. 4) High yield bond and bank loan dollar prices



High Yield Market represented by the JP Morgan Global High Yield Index. Bank Loan Market represented by the JP Morgan Leveraged Loan Index. As of March 31, 2023.
Past performance is not a reliable indicator of future performance.
Source: J.P. Morgan. See Additional Disclosures.

[4] Credit spreads measure the additional yield that investors demand for holding a bond with credit risk compared with a high-quality government security having a comparable maturity.

the 2015–2016 energy sell-off and in March 2020, for example—adding the potential to benefit more from narrowing spreads through a greater allocation to high yield bonds could enhance returns. High yield bonds and bank loans can react differently to changes in the macro environment due to their differing coupons and the distinct call[5] protection features of the asset classes. This underscores the value of a credit team that evaluates companies' entire capital structures to identify which issues are likely best positioned to benefit from evolving macro conditions.

More Attractive Absolute Return

A flexible allocation between high yield bonds and bank loans can result in better outcomes. Figure 5 shows that a static 20% allocation to loans or a 50/50 allocation between bonds and loans could have resulted in cumulative returns of 25.4% and 24.2%, respectively, from July 2015 through March 2023. However, a flexible allocation to loans and bonds, such as the one employed by our below investment-grade team with its deep expertise and understanding of both markets, returned 35.8% during the same period.[6]

Enhanced Risk-Adjusted Performance

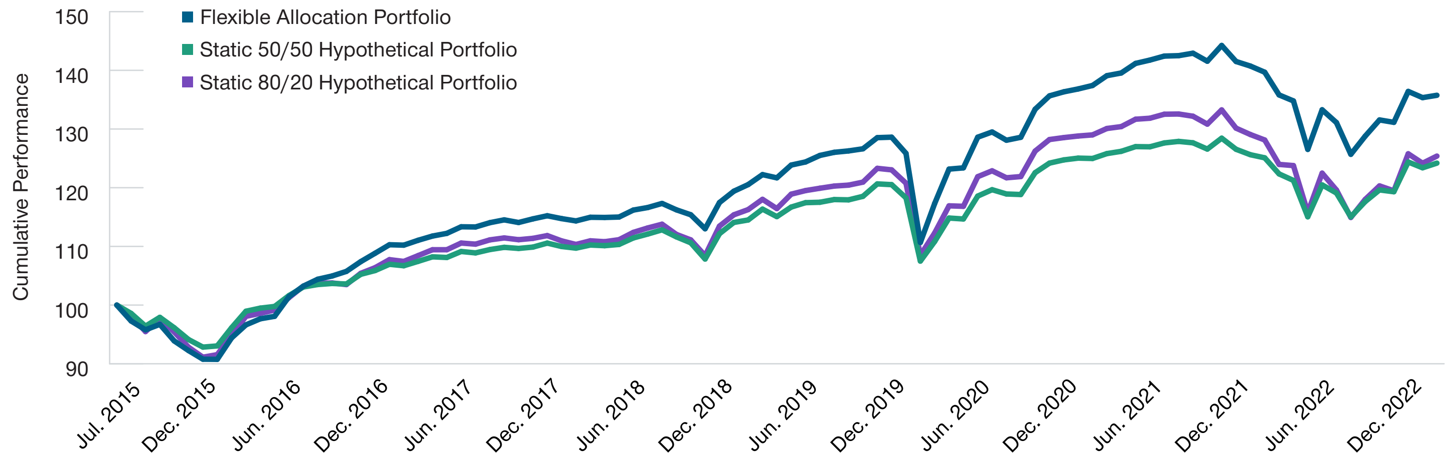
Flexible allocations to both bank loans and high yield bonds can also yield better risk-adjusted returns. For example, the portfolio with a flexible allocation to loans had a higher Sharpe ratio[7] than both the static 80/20 and 50/50 high yield bond/loan hypothetical portfolios. Notably, even the static portfolios provided better risk-adjusted returns than the standalone high yield bond portfolio, which demonstrates that the addition of structurally defensive loans can benefit a leveraged credit portfolio.[8]

Adding bank loans to an actively managed high yield bond portfolio could reduce interest rate risk, add diversification through exposure to private credits, and potentially enhance risk-adjusted returns. We believe the long-term historical performance of the loan asset class in a range of rate environments speaks to its durable nature and value as a strategic allocation.

[5] A call provision gives an issuer the right to redeem a fixed income security prior to its maturity by paying back the principal amount.
[6] As of March 31, 2023. Returns are those of the T.Rowe Price Credit Opportunities Fund. **Past performance is not a reliable indicator of future performance.**
[7] Calculated as an asset's return above the risk-free rate, divided by the standard deviation of the asset's excess return. A higher Sharpe ratio indicates a higher return per unit of risk.
[8] For the period from August 1, 2015, through March 31, 2023.

Flexible Allocation Can Add Value

(Fig. 5) Portfolio cumulative performance chart



As of March 31, 2023.

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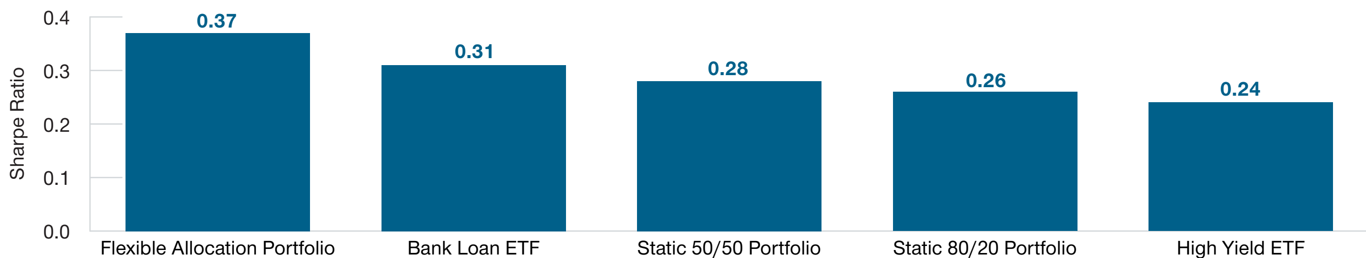
The static portfolios are hypothetical and do not represent actual portfolios. The underlying allocations are based on actual ETF returns. See additional important details on this performance below.

Source: Created with Zephyr StyleADVISOR. ETF returns are at NAV.

Flexible Allocation Can Yield Better Risk-Adjusted Returns

(Fig. 6) Sharpe ratio



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The static portfolios are hypothetical and do not represent actual portfolios. The underlying allocations are based on actual ETF returns. See additional important details on this performance below.

Source: Created with Zephyr StyleADVISOR. ETF returns are at NAV.

The information presented herein for the static portfolios is hypothetical in nature and is shown for illustrative, informational purposes only. Data does not reflect the actual returns of any portfolio/strategy but rather the results of a theoretical blend of the indicated ETFs. The assumption of constant benchmark weights has been made for research purposes and is unlikely to be realized. The hypothetical portfolios do not reflect actual trading or the impact that material economic, market, or other factors may have on weighting decisions. Actual results experienced by clients may vary significantly from the hypothetical illustrations shown.

Invesco Senior Loan ETF is the largest passively managed bank loan exchange-traded fund (ETF) as determined by assets under management as of March 31, 2023. iShares iBoxx High Yield Corporate Bond ETF is the largest passively managed high yield bond ETF as determined by assets under management as of March 31, 2023. **Flexible Allocation Portfolio represented by the T. Rowe Price Credit Opportunities Fund, Static 50/50 Portfolio represented by 50% iShares iBoxx $ High Yield Corp Bd ETF and 50% Invesco Senior Loan ETF rebalanced monthly, Static 80/20 Portfolio represented by 80% iShares iBoxx $ High Yield Corp Bd ETF and 20% Invesco Senior Loan ETF rebalanced monthly. See below for standardized performance and Appendix for additional important information.**

Performance Details

Standard performance periods

Total Return (%) as of March 31, 2023	1 Year	Annualized 3 Years	5 Years	10 Years
iShares iBoxx $ High Yield Corp Bd ETF (NAV Return)	-3.93	4.12	2.41	3.00
iShares iBoxx $ High Yield Corp Bd ETF (Market Price Return)	-3.09	4.22	2.48	3.03
Markit iBoxx USD Liquid High Yield Index	-3.25	4.76	2.91	3.49
Invesco Senior Loan ETF (NAV Return)	1.54	4.85	2.33	2.38
Invesco Senior Loan ETF (Market Price Return)	1.36	4.77	2.26	2.34
Morningstar LSTA Leveraged Loan 100 Index	2.42	6.50	3.37	3.31

Market returns are based on the midpoint of the bid/ask spread at 4 p.m. ET and do not represent the returns an investor would receive if shares were traded at other times. Performance data quoted represents past performance and is not a reliable indicator of future performance. Investment return and principal value will fluctuate so that an investor's shares, when sold, may be worth more or less than their original cost. Current performance may be lower or higher than the performance data quoted. To obtain the most recent month-end performance, visit the ETF companies' websites. Fund performance reflects applicable fee waivers, without which performance data quoted would have been lower.

Source for Invesco returns and iShares returns: Morningstar (see Additional Disclosures).

Returns include reinvestments of dividends and capital gains. Returns greater than one year are annualized.

There are difference between open-ended mutual funds that are actively managed and exchange-traded funds that are passively managed that impact performance. These differences include, but are not limited to, investment objectives, trading, pricing, investment strategy, tax implications, fees, expenses and trading costs, and transparency. These differences should be carefully considered when making investment decisions.

All investments involve risk, including possible loss of principal. When valuations fall and market and economic conditions change, it is possible for both actively and passively managed investments to lose value.

Fixed income securities are subject to credit risk, inflation risk, liquidity risk, call risk, and interest rate risk. As interest rates rise, bond prices generally fall.

Although actively managed mutual funds have the potential to outperform an index, this is not guaranteed, and they may trail the index.

Index performance does not reflect the expenses of managing a portfolio as an index is unmanaged and not available for direct investment.

For more information about the ETFs, visit the fund companies' websites.

Credit Opportunities Fund Performance Detail

Total return (%) as of March 31, 2023. Figures are calculated in U.S. dollars.

			Annualized			
	Three Months	1 Year	3 Years	5 Years	Since Manager Inception*	Since Inception†
Credit Opportunities Fund (Net of Fees)	3.51%	-2.82%	7.04%	3.49%	4.06%	2.82%
Bloomberg U.S. High-Yield 2% Issuer Capped Bond Index	3.57	-3.35	5.88	3.19	4.19	3.69

Performance data quoted represents past performance and is not a reliable indicator of future performance. Investment return and principal value will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance data quoted. To obtain the most recent month-end performance, visit troweprice.com.

The fund's gross expense ratio as reported in the most recent prospectus was 1.10%. For information about the expenses and waivers, see the prospectus for details. Yield and share price will vary with interest rate changes. Investors should note that if interest rates rise significantly from current levels, bond fund total returns will decline and may even turn negative in the short term. The loans and debt securities held by the fund are usually considered speculative and involve a great risk of default and price decline than higher-rated bonds. The fund may have other share classes available that offer different investment minimums and fees. See the prospectus for details. The fund's total return figures reflect the reinvestment of dividends and capital gains, if any.

*Rodney Rayburn assumed portfolio manager responsibility on July 9, 2015. July 31, 2015, represents the first full month after inception.

Source for Bloomberg index returns: Morningstar (see Additional Disclosures).

† August 29, 2014.

Appendix

Fund Description and Investment Objective

(Fig. A1) Portfolio characteristics as of March 31, 2023

Fund Name	Type	Inception	AUM (USD)	Gross Expense Ratio (%)	Investment Objective
T. Rowe Price Credit Opportunities Fund (PRCPX)	Mutual Fund	4/29/2014	109 Million	1.10	The investment seeks a combination of long-term capital appreciation and high income
iShares iBoxx $ High Yield Corp Bd ETF (HYG)	ETF	1/12/2023	12.5 billion	0.48	The investment seeks to track the investment results of the Markit iBoxx USD Liquid High Yield Index
Invesco Senior Loan ETF (BKLN)	ETF	3/3/2011	3.8 billion	0.66	The investment seeks to track the investment results (before fees and expenses) of the Morningstar LSTA U.S. Leveraged Loan 100 Index

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All investments involve risk, including possible loss of principal. When valuations fall and market and economic conditions change, it is possible for both actively and passively managed investments to lose value.
Fixed income securities are subject to credit risk, inflation risk, liquidity risk, call risk, and interest rate risk. As interest rates rise, bond prices generally fall. Investments in high-yield bonds involve greater risk of price volatility, illiquidity, and default than higher-rated debt securities.
Investments in bank loans may at times become difficult to value and highly illiquid; they are subject to credit risk such as nonpayment of principal or interest, and risks of bankruptcy and insolvency.
Although actively managed mutual funds have the potential to outperform an index, this is not guaranteed, and they may trail the index.
Index performance does not reflect the expenses of managing a portfolio as an index is unmanaged and not available for direct investment.
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