Bank Loans: Looking Beyond Interest Rate Expectations

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KEY TAKEAWAYS

- Bank loans are designed to be somewhat resistant to both principal risk (because of collateral) and interest rate risk (because of floating coupons).
- An allocation to bank loans can be a strong addition to a fixed income portfolio for both the short-term and long-term investor.

Fixed income investors may be stymied by the current mix of interest rate projections and global macroeconomic news. Interest rates remain near historical lows, and investors continue to move between risky assets and relative safe havens like Treasurys based on the latest market headlines. We believe that bank loans can be a compelling addition to fixed income portfolios in this environment and, more importantly, over the long term.

Bank loans have floating-rate coupons, a senior, secured position in the capital structure and an active secondary market—all characteristics that make them compelling investments, in our view. However, bank loans are often perceived as a one-way bet on increasing interest rates or only appropriate as a tactical allocation. In reality, the bank loan asset class can serve a variety of short-term and long-term portfolio functions and deserves deeper exploration.

What are Bank Loans?

When a company seeks capital to invest in its business or to simply finance its ongoing operations, the company may borrow money, raise funds by issuing bonds or stock, or pursue all of these avenues. In fact, many companies that borrow funds through the bank loan market also issue public debt. These are not small companies. Most syndicated bank loans in the US market have principal amounts outstanding between $100 million and $5 billion.

COMPARISON OF FIXED INCOME ASSET CLASSES

	BofA MERRILL LYNCH US CORPORATE INDEX	S&P/LSTA LEVERAGED LOAN INDEX	BofA MERRILL LYNCH US HIGH YIELD INDEX
CURRENT YIELDS	3.35%	4.65%	5.90%
YIELD-TO-WORST[1]/ 36-MONTH YIELD	3.35%	4.42%	5.88%
AVERAGE PRICE (USD)	104.22	98.22	100.82
COLLATERAL	No	Yes	Rarely
SENIORITY	Sometimes	Yes	Sometimes
EFFECTIVE DURATION (YEARS)	7.06	0.10	4.21

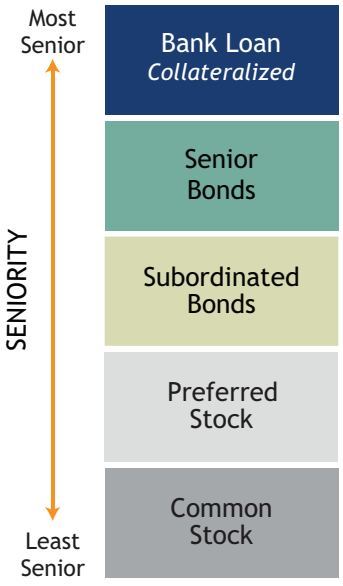
Source: Standard & Poor's Leveraged Commentary and Data and BofA Merrill Lynch. Data as of 3/31/2017. Please note that the BofA Merrill Lynch US Corporate Index reflects the performance and characteristics of the investment grade corporate credit asset class. See page 7 for Index Definitions & Disclosures.

Past performance is no guarantee of future results.

Bank loan-issuing companies usually have below investment grade (i.e., high yield) credit ratings, and bank loans tend to offer coupon income greater than investment grade bonds but lower than high yield bonds. The greater yield versus investment grade reflects greater perceived credit risk of bank loans, while the slightly lower yield relative to high yield is the result of bank loans' higher position in the capital structure. For investment grade investors seeking more yield, bank loans provide an intermediate step up in credit risk. The table above compares these asset classes.

CORPORATE CAPITAL STRUCTURE

Source: *Loomis Sayles.*



As an investment option, bank loans have several key features that can benefit investors, including seniority, security and a floating rate of interest.

- **Seniority:** Bank loans, also known as senior loans, are the senior, secured debt at the top of a company's capital structure; the chart at left illustrates this. Importantly, the holders of a company's bank loan have a priority claim over the company's assets in the event of default.
- **Security:** Bank loans are collateralized, meaning the assets of the borrower secure the loan. Bank loans usually have more covenants in their credit agreement (the equivalent of a bond indenture) than do high yield bonds. Even so-called "covenant-lite" bank loans are typically only missing one or two financial covenants, such as an interest coverage test.[2] Bank loans tend to be issued with seven- to eight-year maturities but are often prepaid early, usually in about three years, in part because these covenants are a burden to borrowers.
- **Floating Rate of Interest:** Bank loans are also issued with a floating rate of interest, which protects bank loan prices from declining when rates are rising, a marked difference from typical fixed income bonds. Specifically, interest payments on loans are set at a base rate, usually the 3-month London Interbank Offered Rate (LIBOR), plus a spread to reflect credit quality. LIBOR+2.5-3.5% has been a common historical average interest rate range.

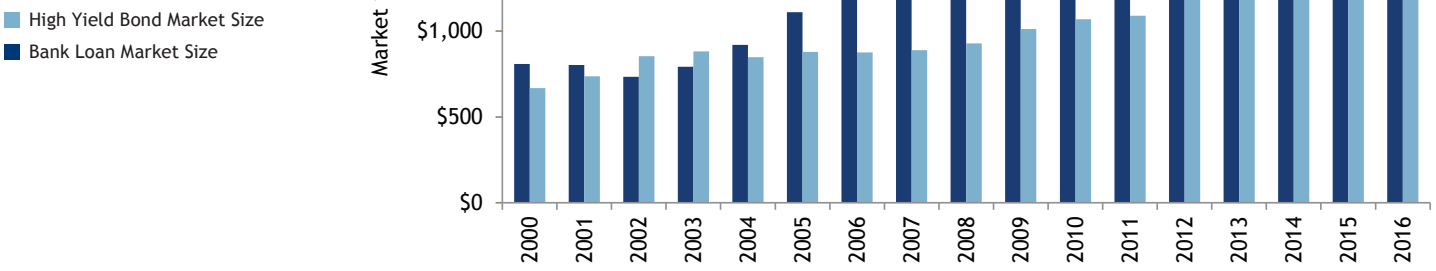
[1]*Yield-to-worst is the lowest potential yield for a callable bond.*
[2]*Interest coverage test requires that a borrower maintain a certain ratio of earnings to interest payments.*

The bank loan market is broadly syndicated and consists of loans made by major commercial and investment banks. Bank loans are actively traded in the secondary market like high yield and investment grade bonds, and most major financial firms trade bank loans. As shown in the chart below, the bank loan market is larger than the high yield market in the US, though some portion of the loans are held by banks and not actively traded. Bank loans are also generally rated by Moody's and/or Standard & Poor's.

BANK LOAN & HIGH YIELD MARKET SIZE

Source: *Credit Suisse and Loan Pricing Corporation.*

Data as of 12/31/2016.



Risks and Other Considerations

Despite their attractive features, bank loans, of course, are not without risks. The principal risks associated with bank loans are credit quality, market liquidity, default risk and price volatility. While bank loans are secured by collateral and considered senior in the capital structure, the issuing companies are often rated below investment grade and may carry higher risk of default.

In addition, the secondary bank loan market, at times of technical pressure, may experience reduced liquidity that may, in turn, adversely affect the prices of these loans. An example of extreme technical pressure was the 2008 global financial crisis, when forced selling to panicked buyers resulted in steep price declines; a brief history is provided on the next page. Inefficiencies in pricing and liquidity vary over time in size and frequency but are constants in the market due to investors' tendency to overreact to corporate events, swings in the supply and demand of government and corporate credit, and perceptions of macroeconomic risk. Furthermore, bank loans, like most high yield bonds, do not trade on an exchange but over-the-counter. However, unlike high yield bonds, settling over-the-counter bank loan trades is a fairly manual process that can take longer than trades settled through clearing houses. Bid/ask spreads may also be slightly wider on average for bank loans than for high yield bonds, which can result in greater price volatility. However, many bank loans are more liquid than many bonds.

HISTORY OF BANK LOANS
1980s & 1990s
• Banks reduced their exposure to bank loans by offering their bank loans to non-bank institutions. Mutual funds and insurance companies were early buyers.
• In the 1990s, more loan funds were started, and pension managers and structured vehicle investors became attracted to the asset class.
2000s
• Collateralized loan obligations (CLOs) became major buyers of loans. CLO structures were highly leveraged, but buyers were assured by a history of consistent positive annual returns.
• Hedge funds also were major buyers of loans; they were attracted by loans' LIBOR-based coupon versus hedge funds' LIBOR-based funding, and often leveraged their borrowing to help boost prospective returns.
GLOBAL FINANCIAL CRISIS: 2007-2009 AND BEYOND
• Structured mortgage products saw their funding costs spike in 2007, which caused contagion in CLOs. Suddenly, billions of loans could not be converted into structured products because funding costs were too high. Those loans had to be sold in the open market to panicked buyers, resulting in deep discounts.
• In 2008, despite relatively solid performance by the borrowers backing the bank loans, the category's prices declined on forced selling and deleveraging. This created pricing at a level that assumed 100% default rates. 2008 became the first year when bank loan returns were negative since the index's inception in 1992.
• Late in 2008 and early in 2009, the selling pressure eased. Investors raised new money to buy what they perceived as vastly undervalued credits. Loan prices began a typically rising trend back toward par, generally maintaining that value until mid-2015.
• In late 2015, energy concerns combined with regulatory fears to create technical pressure in the market, causing the second negative year in bank loan history. However, the underlying fundamentals drove a market rebound in 2016 to make the aggregate return of the two years strongly positive.

CORRELATIONS OF THE CREDIT SUISSE LEVERAGED LOAN INDEX TO VARIOUS ASSET CLASSES

JANUARY 1992 – MARCH 2017

BLOOMBERG BARCLAYS US GOVERNMENT INTERMEDIATE INDEX	-0.29
BLOOMBERG BARCLAYS US GOVERNMENT LONG INDEX	-0.26
BofA MERRILL LYNCH US MORTGAGE BACKED SECURITIES INDEX	-0.02
CITIGROUP 1-MONTH TREASURY BILL INDEX	0.00
GOLD SPOT COMMODITY INDEX	0.02
BLOOMBERG BARCLAYS GLOBAL AGGREGATE BOND INDEX	0.04
BofA MERRILL LYNCH US CORPORATE BOND INDEX	0.31
BofA MERRILL LYNCH US FIXED RATE ASSET BACKED SECURITIES INDEX	0.36
S&P 500® INDEX	0.42
DOW JONES US TOTAL STOCK MARKET INDEX	0.44
MSCI WORLD INDEX	0.46
CREDIT SUISSE HIGH YIELD INDEX	0.76

Sources: Credit Suisse, Bloomberg Inc. and Ibbotson Associates.
Data as of 3/31/2017. See page 7 for Index Definitions & Disclosures.

Why Invest in Bank Loans?

Understanding the features and risks of bank loans is key to understanding the tactical (short-term) and strategic (long-term) role of bank loans in a fixed income portfolio. In our opinion, the case for bank loans is strong.

In an environment of global economic uncertainty and persistently low interest rates, bank loans' dual protection of principal and interest may be uniquely suited to the prevailing market conditions. Bank loans are designed to be somewhat resistant to both principal risk (because of collateral) and interest rate risk (because of floating coupons). Since bank loans are senior and secured, they are more protected from a decline in enterprise value of the borrowing company, unlike bonds that are lower in the capital structure. Since bond prices often fall when interest rates rise, this could have significant implications for more traditional bond portfolios as rates normalize. Floating-rate coupons allow bank loan prices to remain fairly steady during periods of rising rates/falling prices. Also, when bank loans offer current yields close to other near-rated bonds, this up-rate optionality is, by implication, cheap.

The long-term strategic case for bank loans is driven by the asset class's behavior over a full credit cycle and its historically low correlation to other asset classes. First, the credit cycle is characterized by market conditions of rising rates or declining corporate credit conditions. Rates tend to rise in an improving economy; corporate credit conditions tend to decline in a deteriorating economy. Because economies tend to rise or fall more than they stay the same, one of the two tactical drivers for bank loans is often in effect. Most other asset categories generally are hurt by rising rates, declining corporate credit, or both. Bank loans directly benefit from rising rates and are somewhat insulated from declining credit by their senior, secured position in the capital structure.

Second, the relatively low correlation of bank loans to other asset classes could provide diversification to fixed income portfolios. The Credit Suisse Leveraged Loan Index has generally posted positive annual returns and has low correlation to fixed income and equity assets. Since its 1992 inception, the index had 23 positive annual return periods and 2 negative annual return periods, compared with 4 negative annual periods for the Credit Suisse High Yield Index and 5 negative annual return periods for the BofA Merrill Lynch US Corporate Bond Index.

Additionally, low volatility from both interest rate changes and credit pressures suggests that bank loans should have low correlation with other investment categories over long periods. The table on the previous page shows that only high yield has exhibited a strong correlation to bank loan returns, a phenomenon significantly increased by the global financial crisis. In summary, the strategic case for holding a long-term bank loan allocation is supported by the asset class's unique characteristics that adjacent sectors, such as high yield bonds or investment grade corporates, generally lack.

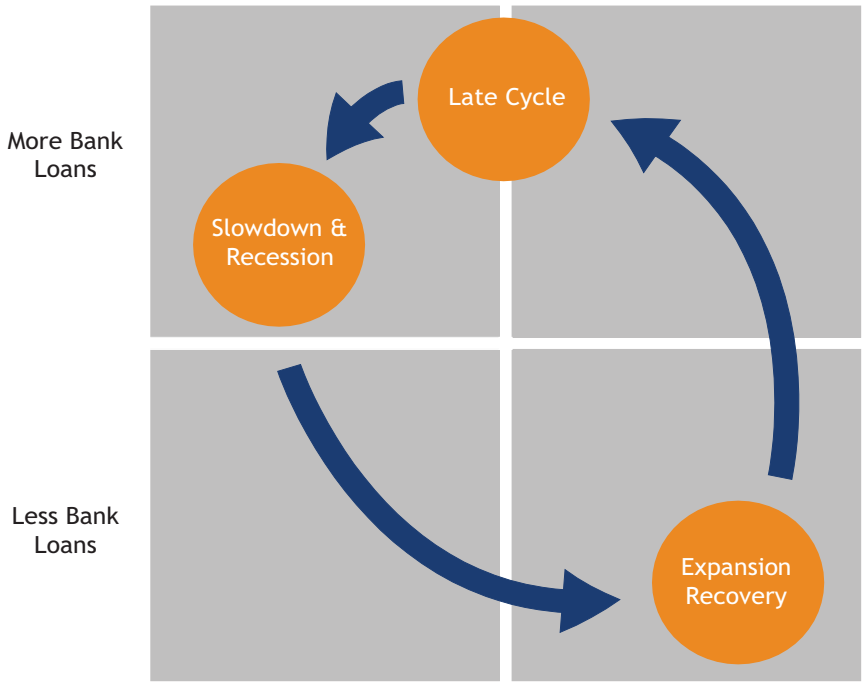
The Role of Bank Loans in a Fixed Income Portfolio

As noted previously, bank loans' investment profile generally places the asset class between high yield bonds and investment grade bonds, including Treasurys. When investor risk appetite is strong, higher-risk assets (such as high yield bonds) may outperform bank loans. When investors become risk averse, higher-quality assets (such as investment grade bonds and mortgages) may outperform bank loans. Recognizing the relative swings in markets, a flexible approach to building a bank loan portfolio can be advantageous. The ability to add risk through high yield or reduce risk via Treasurys, for example, can help a bank loan portfolio manager benefit from different parts of the business cycle as well as technical pressures. Examples of how portfolio allocations might shift during a typical business cycle are shown in the chart below.

POTENTIAL ALLOCATIONS THROUGH THE BUSINESS CYCLE

Source: *Loomis Sayles.*

The graphic reflects the opinions and assumptions of the authors only and does not necessarily reflect the views of Loomis, Sayles & Company, L.P. Others may have different views. These views apply under normal market conditions and are subject to change at any time without notice.



While flexibility to adjust allocations at the margin can be important to overall portfolio construction, bank loans are inherently credit assets. Therefore, security-specific fundamental credit research is critical to the investment process and portfolio construction. Successful bank loan investing is mostly about winning by not losing. Bank loan issues should be selected for investment largely based on their creditworthiness, structure and price. The following factors are examples of key credit considerations:

- Cash flow projections
- Capital structure
- Underlying asset values and collateral
- Market position
- Management strength
- Industry developments
- Political climate
- Economic forecasts

Given that most bank loans typically trade near par, except in a recession or credit crisis, good performance from consistently strong "loan picking" is unlikely. Occasionally, a loan will get cheap on price, but more typically, a loan perceived as "cheap" will merely carry a higher yield that is related to its credit risk. A bank loan portfolio manager creates a portfolio from hundreds of issues, so broad and deep research support is key to an effective investment process, in our view.

Bank Loans are Additive to Fixed Income Portfolios

The position of bank loans in the menu of fixed income investment choices is unique; bank loans typically offer a higher yield relative to investment grade bonds and generally a higher capital structure position relative to high yield bonds. Bank loans can be additive to a fixed income portfolio by providing some protection from rising interest rates because of their floating-rate coupon and from credit deterioration because of their senior, secured position in the corporate capital structure. Bank loans may also provide diversification benefits from their low correlation to other assets. While bank loan markets can be subject to technical pressures, they are established and broad. An allocation to bank loans can be a strong addition to a fixed income portfolio for both the short-term and long-term investor.

A version of this report was originally published in September 2012. We have updated the data and content as necessary and otherwise believe the information is current and relevant.

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Index Definitions & Disclosures

Bloomberg Barclays Global Aggregate Bond Index *covers the most liquid portion of the global investment grade fixed-rate bond market, including government, credit and collateralized securities. The liquidity constraint for all securities in the index is $300 million.*

Bloomberg Barclays US Government Intermediate Index *is a total return index. Using the coupon accrual method total returns are calculated as the change in the flat or "and-interest" price. The flat price is the average of the bid and ask prices plus accrued coupon. A one-bond portfolio is constructed containing the shortest noncallable bond with a maturity of not less than five years, and is "held" for the calendar year. Monthly returns are computed.*

Bloomberg Barclays US Government Long Index *is a total return index. To the greatest extent possible, a one-bond portfolio with a term of approximately 20 years and a reasonably current coupon was used each year. The bond was "held" for the calendar year and monthly returns were computed. Total returns were calculated using the coupon accrual method and are calculated as the change in the flat or "and-interest" price. The flat price is the average of the bid and ask prices plus accrued coupon.*

Bank of America Merrill Lynch US Corporate Index *is a Merrill Lynch generated total return index that includes investment grade corporate bonds with ratings of BBB-/Baa3 and above. This index includes fixed rate coupon bearing instruments but excludes floating rate debt, equipment trust certificates and Title II securities.*

Bank of America Merrill Lynch US High Yield Index *tracks the performance of US-dollar-denominated below investment grade corporate debt publicly issued in the US domestic market. Qualifying securities must have a below investment grade rating (based on an average of Moody's, S&P and Fitch) and an investment grade rated country of risk (based on an average of Moody's, S&P and Fitch foreign currency long term sovereign debt ratings). In addition, qualifying securities must have at least one year remaining term to final maturity, a fixed coupon schedule and a minimum amount outstanding of $100 million.*

Bank of America Merrill Lynch US Fixed Rate Asset Backed Securities Index *is a total return index tracking the overall performance of US fixed-rate asset-backed securities (ABS) and includes US-dollar-denominated ABS having a fixed coupon, a minimum amount outstanding of $25 million and an investment grade credit rating of BBB or higher.*

Bank of America Merrill Lynch US Mortgage Backed Securities Index *is a Merrill Lynch generated total return index that includes the GNMA, FNMA and FHLMC sectors. This index includes fixed rate, coupon bearing instruments and the amount outstanding in each agency/type/coupon subdivision of the mortgage market must be no less than $200 million at the start and at the close of the performance measurement periods. It excludes FHA project notes, CMOs, ¼ coupon pass-throughs, GNMA IIs, GPMs, Mobile Homes, and IOs and POs.*

Citigroup 1-Month Treasury Bill Index is a total return index*. Each month a one-bill portfolio containing the shortest-term bill having not less than one month to maturity is constructed. To measure the holding period returns for the one-bill portfolio, the bill is priced as of the last reading day of the previous month-end and as of the last trading day of the current month.*

Credit Suisse High Yield Index *is designed to mirror the investable universe of the US-dollar-denominated high yield debt market (rated 5Bs or lower; minimum $75 million outstanding; publicly registered or 144-A; no floating rate or convertible debt). If an issuer has more than two issues outstanding, only the two most liquid are included in the index. Issuers within one year of maturity are removed from the index. Fallen angels must "season" for three months before inclusion. Energy High Yield Bonds, Defensive High Yield Bonds, Cyclical High Yield Bonds, BB-rated Bonds, B-rated Bonds and CCC-rated bonds are sub-sectors of the Credit Suisse High Yield Index. Construction rules for these sub-sectors mirror those of the Credit Suisse High Yield Index.*

Credit Suisse Leveraged Loan Index *is designed to mirror the investable universe of US-dollar-denominated leveraged loans (rated 5Bs or lower or carrying spreads of LIBOR + 125 bps or higher). Tenor must be one year or longer; only funded term loans are included, and loans are removed at upgrade to investment grade, maturity, refinancing or workout.*

Dow Jones US Total Stock Market Index *measures all US equity securities that have readily available prices.*

Gold Spot Commodity Index *returns are calculated from month-end closing prices, expressed in US dollars per troy ounce. Total returns are equal to the change in price from month-end to month-end.*

MSCI World Index *is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets.*

S&P 500 Index *includes 500 leading companies in leading industries of the US economy, capturing 75% coverage of US equities. S&P 500® is a registered service mark of McGraw-Hill Companies, Inc.*

S&P/LSTA Leveraged Loan Index *is an unmanaged index of the institutional leveraged loan market.*

Indexes are unmanaged and do not incur fees. It is not possible to invest directly in an index.

Additional Disclosures

Diversification does not ensure a profit or guarantee against a loss.

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