Loomis on Loans

A quarterly look at data and topics in the syndicated loan market

GOOD DECISIONS, MARKETS, AND DEFAULTS

We say we are in the good decisions business because decisions are all we can control. In a global pandemic, it is challenging to make decisions based on facts and analysis rather than emotions. Whether it is stopping the pain of declining prices or resisting the urge to think markets are efficient, as investors we must overcome our emotions.

Through decades of observing market downturns, we have learned a few important things.

1. We have recovered from each downturn.
2. Prices seen in a downturn do not always reflect value due to technical pressure (see "What Makes a Loan Price Tumble?" on page 2).
3. We have to focus on what we believe to be true.

Here is what we believe. We believe the U.S. will recover from this virus. We believe we will emerge from our sheltering homes and consume again. We believe we will generally resume the patterns of life that existed before COVID-19, with varying lags.

In the bank loan market, we believe this crisis will trigger some bankruptcies, and thus, defaults. However, we believe that bank loans currently appear attractive despite potential default losses. Let's walk through technicals in weak markets, the arithmetic behind default recovery, and how defaults could affect portfolio return potential.

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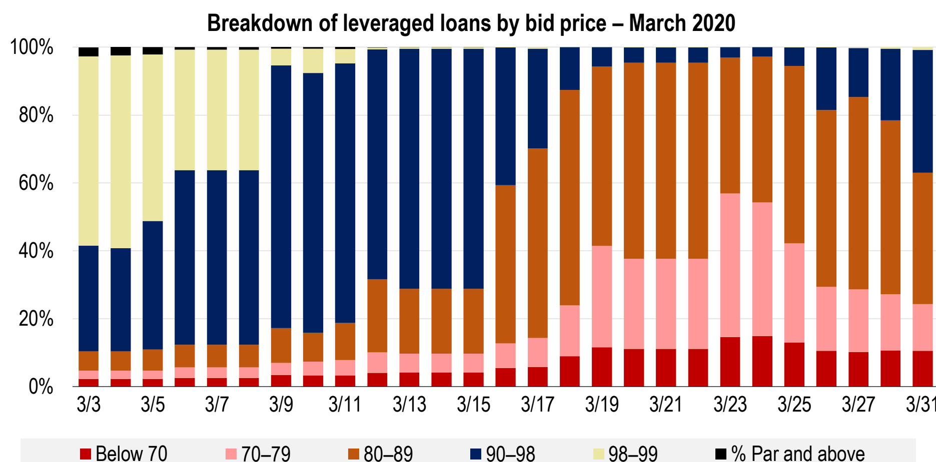
S&P/LSTA Index	1Q 2020 Return	Price	Change since 12/31/2019	Spread
"All" Leveraged Loan Index	-13.05%	83.43	-14.1%	L+345
BB Index	-10.88%	88.59	-11.1%	L+254
B Index	-13.72%	82.94	-15.1%	L+372

Source: S&P Capital IQ, as of 3/31/2020



Source: LCD, an offering of S&P Global Market Intelligence; S&P/LSTA Leveraged Loan Index

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

Past market experience is no guarantee of future results.

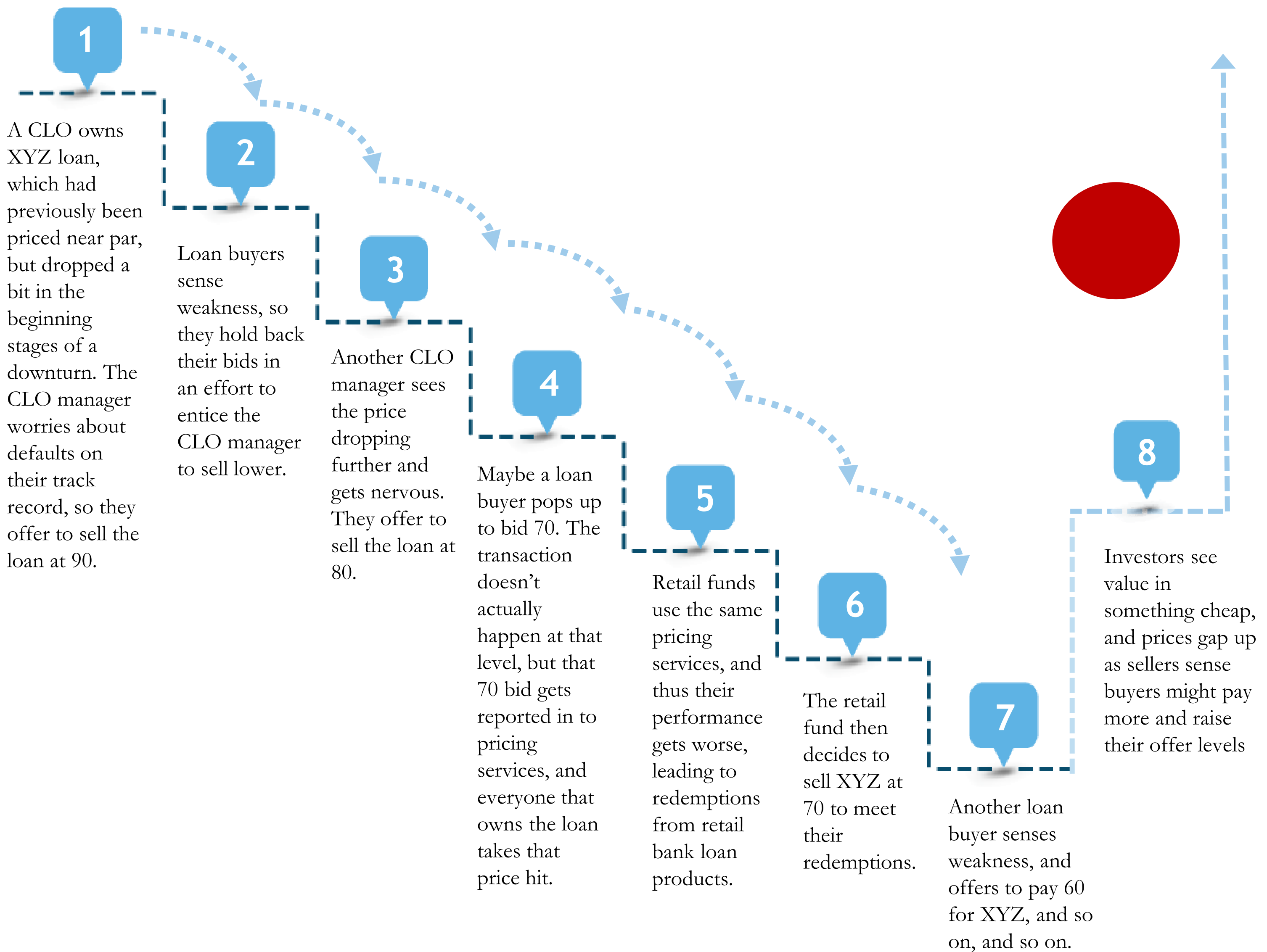
LOAN MARKET QUICK TAKE

March 2020 brought unprecedented volatility to the loan market, with the worst monthly return since October 2008. The accompanying chart shows the shift in prices of the S&P/LSTA Leveraged Loan index during the month, which began with the majority of loans priced above 98. No sector was left unharmed, but oil and gas, representing 3.6% of the index, was the lowest performer. The biggest segments of the index, technology and healthcare, fared relatively better, though cable TV is the least affected. CLO issuance paused during the latter portion of the month, with $17.4 billion issued in 2020. Retail flows turned mildly positive in January, then reversed and accelerated in mid-March, with outflows totaling approximately $16.5 billion. Despite this activity, the index grew to almost match its record height at $1.2 trillion.

WHAT CAN MAKE A LOAN PRICE TUMBLE?

In a downturn, we have found that many managers sell loans because they have to, think they need to, or cannot take the pain ("the pain trade"), rather than because of a clear loss of fundamental value. These motivations can lead to a series of events that cause prices to drop lower and lower despite limited change to corporate fundamentals. As Collateralized Loan Obligations (CLOs) together with retail funds represent typical behavior of the bank loan ownership base, let's take a look at an example of what might transpire in a downturn.

EXAMPLE OF EVENTS



These market technicals could cause portfolio managers to feel pain and undercut the idea of market efficiency. At some point, most loan investors will realize the value there, and prices can quickly gap up again. Our intense focus on what a company is worth guides us as to when to sell, hold, or to try to buy more of a loan. Relying on our team of analysts and decades of loan market experience to help determine the real value of each company helps us to make good decisions in the face of these disorienting technicals.

The information above is for illustrative purposes only as an example of what might transpire in a downturn. These steps may not all be fully followed during the investment process. This information is not intended to represent any investment transaction.

Investing involves risk including possible loss of principal.

Please see Key Risks on the last page.

Loans can offer attractive return potential even with the chance for higher default rates

HYPOTHETICAL SINGLE-LOAN DEFAULT ARITHMETIC

Company XYZ was valued at $1 billion in 2019. It has $400 million of bank loans in its capital structure. Because a crisis hit and the market is worried that a lack of liquidity will cause the company to default, Company XYZ is now seen as being worth $500 million, half of its value in 2019. What does this perceived valuation change mean for the bank loan? At a high level, if the company defaults, its $500 million value covers the value of the $400 million loan.

What could this company be worth to an investor who believes the markets will recover? Let's assume this investor buys Company XYZ's outstanding loans at 60. The buyer of this loan is a buying senior secured claim on Company XYZ for 24% of what the company was worth just a year ago. ($400 million loan at 60% of par value = $240 million or 24% of $1 billion 2019 valuation). Because the loan is senior and secured, the buyer of these loans only needs Company XYZ to be worth approximately $400 million to recover the complete investment at par. And if the loan is worth par, that's a 66.7% return on price appreciation alone (price movement from 60 to 100).

So what should an investor without cash pressures do with this loan if they own it already? If they think that company is worth a lot more than where the loan is currently trading, they should keep the loan even if XYZ will default.

HYPOTHETICAL PORTFOLIO DEFAULT LOSS ARITHMETIC

Assume a portfolio of hundreds of loans with an average price of 85 today. Assume this portfolio has an all-in coupon of 4% and that the average price will increase 10 points to 95 in 12 months. Without considering defaults or transaction costs, the one-year return of this portfolio should be 16.47% (11.67% price appreciation + 4% coupon on 85 average price).

But defaults may tick up in this cycle, so it's important to account for the impact of default losses on the return we calculated above. We consider a default rate of 10% and a recovery value of 60 cents on the dollar representative of a bad recession. If we assume that 10% of the portfolio defaults, forgoes income, and recovers 60% of its par value, this portfolio should take a 3.41% hit on the return we calculated above (10% of price loss from 85 to 60 + forgone 4% coupon on 85 price), leaving a gross return of 13.06%. That's a fairly attractive 12-month return, historically, for a portfolio of senior, secured loans.

Even in the scenario outlined above, there is potential for greater returns. More loans could see price appreciation closer to par. Fiscal and monetary stimulus could lead fewer loans to default, and those that do could recover more. In addition, interest rates will likely rise at some point in the future, increasing demand for the asset class.

CONCLUSION

This is a bleak period. People are worried about getting sick and the economy not rebounding, personally, locally, or nationally. It is natural to want to stop the pain, build cash, shelter in place, and wait for the storm to pass. This kind of market cannot be efficient because humans tend to make bad decisions under emotional pressure. But we are sitting at our desks every day trying to focus on what we believe: America will recover, consumers will consume, companies will be worth a lot more than they are now at some point, and loans are senior and secured, at the top of the value chain. In that context, market pain, market technicals, and defaults are all distractions from the good decisions to be made.

Hypothetical scenario analysis is shown for illustrative purposes only. The use of hypothetical scenario analysis has inherent limitations and should not be viewed as predictions of future events or as a forecast for any Loomis Sayles product or strategy. The Analysis relies on opinions, assumptions and mathematical models which can turn out to be incomplete or inaccurate. Data and analysis does not represent an actual investment product. Actual results will be different. Views and opinions are subject to change at any time without notice.

Investing involves risk including possible loss of principal.

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Past market experience is no guarantee of future results.

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DISCLOSURE

KEY RISKS

Credit Risk, Issuer Risk, Interest Rate Risk, Liquidity Risk, Derivatives Risk, Leverage Risk, Counterparty Risk, Non- US Securities Risk, Prepayment Risk, Extension Risk and Management Risk.

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All indices are unmanaged and do not incur fees. You cannot invest directly in an index.

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