Loomis on Loans

Back to the Future: Rate Volatility is a Game Changer

We believe bankers have structured leveraged loans as a category to reduce the effect of volatility related to changes in interest rates and firm valuations – typically major causes of volatility in most other asset classes. We believe loans have the potential to exploit these benefits given their floating rate nature, seniority in a company's debt profile, and by being secured by the company's assets. History shows the structure has worked: most loans generally trade near par, most of the time, regardless of interest rates or generic sentiment swings. During times when loan prices have traded down on market technicals, such as in the Global Financial Crisis (GFC) or the pandemic of 2020, prices have generally rebounded quickly on the strength of corporate fundamentals.

Many parties stand to benefit from the correct structuring of loans. As senior secured instruments, loans need to be paid back before unsecured debt, preferred stock, and common equity investors can earn their rates of return. The reputations of private equity sponsors and management teams could suffer if loans default and subsequently have poor recoveries. Fee revenue of underwriting banks can be negatively affected if syndicated deals are structured poorly, while from the manager standpoint, Collateralized Loan Obligations (CLOs), retail, and institutional loan managers pour hundreds of millions of research dollars into analyzing loan capital structures in order to avoid defaults. With all these parties interested in a successful outcome, it may not be surprising that the majority of loans issued have been fully repaid and often trade at par.

CORRELATION WITH THE MORNINGSTAR LSTA US LEVERAGED LOAN TR USD INDEX, PRE PANDEMIC

	ICE BofA US Corporate Index	ICE BofA US High Yield Index	S&P 500 Index
1997 - 2019	0.33	0.77	0.44
Pre-GFC	0.01	0.58	0.23
Post-GFC	0.32	0.83	0.61

Pre-GFC: 1/31/97 – 12/31/07 | Post-GFC: 7/31/09 – 12/31/19
Source: ICE BofA, Morningstar LSTA, The information presented above is shown for illustrative purposes only. ***Past market experience is no guarantee of future results.***

Why then, despite a steady record of low defaults, have there been a variety of negative theories about loans for the last 15 years? We believe the negative perception is largely due to the way the mortgage-backed security debacle of the GFC has left investors cautious towards asset classes that may be less familiar. Collateralized Loan Obligations (CLOs) were conflated with Collateralized Bond Obligations (CBOs) and Collateralized Mortgage Obligations (CMOs), but each have a different underlying asset (loans vs. bonds vs. mortgages) and fundamentals which affect overall performance. At Loomis, we pride ourselves on our bottom-up, loan-by-loan research process and portfolio construction approach, but we do admit that most of the loans we chose not to invest in, also did not default.

We like to say it is better to invest on probabilities than what we can imagine. Historically, the loan market has usually rewarded that approach.

LOAN MARKET QUICK TAKE as of September 30, 2022

Morningstar LSTA Index	3Q 2022 Return	Price	YTD Price Change	Nominal Spread
"All" Leveraged Loan Index	+1.37%	$91.92	-$6.72	354
BB Index	+2.45%	$95.66	-$3.59	276
B Index	+1.18%	$91.63	-$7.45	380

Source : Morningstar LSTA Leveraged Loan Index, as of 9/30/22
The information presented above is shown for illustrative purposes only. Some or all of the information on this table may be dated, and, therefore, should not be the basis to purchase or sell any securities. The information is not intended to represent any actual portfolio. Indices are unmanaged and do not incur fees. It is not possible to invest directly in an index.
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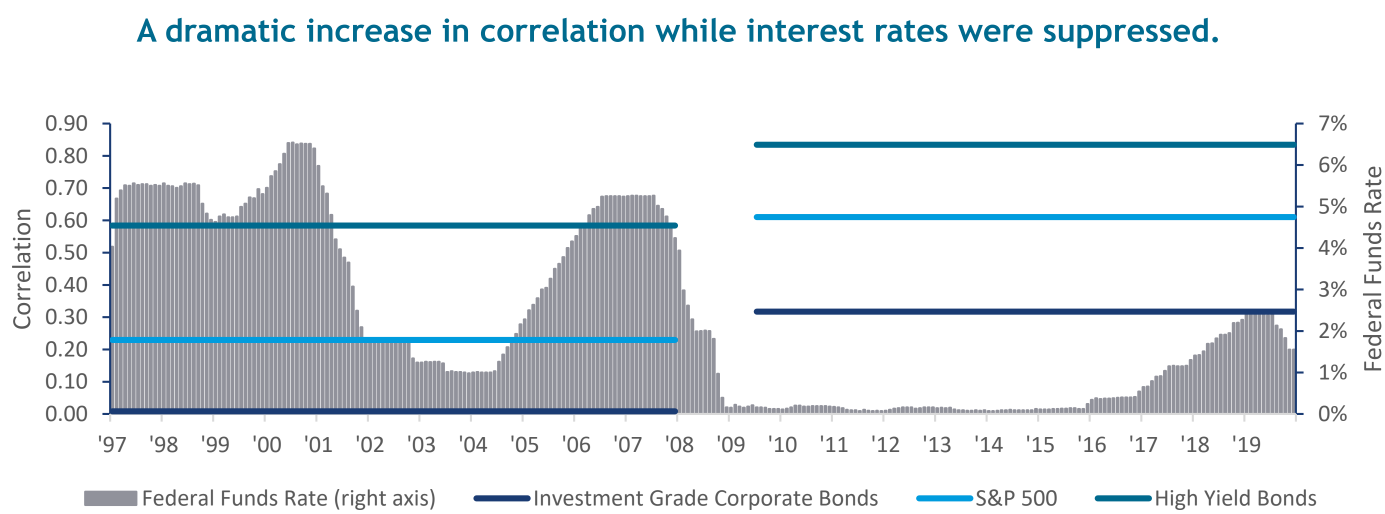
The changing interest rate environment of 2022 has inspired us to take a look back at the way loans have historically behaved versus other asset classes prior to 2007. The GFC triggered a decade of interest rate suppression (the Federal Funds rate from the end of the GFC in July 2009 through the end of 2019 averaged just 0.59%) which amplified the returns of rate-sensitive securities, and led asset classes to become more correlated. From the inception of the Morningstar LSTA Leveraged Loan Index in 1997 through the start of the GFC in 2008, the Federal Funds rate ranged from 1% to 6.5%. During that same period, bank loans displayed low correlation to investment grade corporate bonds and only slightly higher correlation with the S&P 500. Even correlation with the high yield bond market, with which the loan market overlaps on an issuer basis, was significantly lower than it has been since the GFC.

AVERAGE MONTHLY CORRELATION OF VARIOUS ASSET CLASSES WITH THE MORNINGSTAR LSTA LEVERAGED LOAN INDEX, PRE- AND POST-GFC



Source : Loomis Sayles, Bloomberg, ICE BofA, Morningstar LSTA

The chart presented above is shown for illustrative purposes only. **Past market experience is no guarantee of future results.**

While we acknowledge rates are not the only thing to consider when investing in the loan market, we believe loans can add value in asset allocation via their yield and effect on volatility, especially when rates rise. 2022's outperformance of loans versus high yield, investment grade bonds and the S&P 500 may be a preview of their value in a world with more volatile rates.

RETURNS BY ASSET CLASS as of September 30, 2022

	Year-to-Date	Last Twelve Months
Morningstar LSTA Leveraged Loan Index	-3.25%	-2.53%
ICE BofA US High Yield Index	-14.62%	-14.06%
ICE BofA Current 10-Year Treasury Index	-16.83%	-16.20%
ICE BofA US Corporate Index	-18.33%	-18.19%
S&P 500 Total Return Index	-23.87%	-15.50%

The chart presented above is shown for illustrative purposes only. ***Past market experience is no guarantee of future results.***

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LET'S CHAT

Questions or concerns about the bank loan market?

Email Cheryl Stober to learn more.
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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.

Any investment that has the possibility for profits also has the possibility of losses, including the loss of principal .Diversification does not ensure a profit or guarantee against a loss.

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