Newfleet
ASSET MANAGEMENT
A Virtus Investment Partner

High Yield Bonds and Bank Loans

MARKET CONVERGENCE AND THE CASE FOR A FLEXIBLE APPROACH TO LEVERAGED FINANCE

The convergence of high yield bonds and bank loans into a single leveraged finance asset class provides the opportunity for a single investment manager with expertise and resources in both high yield and bank loans to effectively manage a flexible strategy that tactically rotates between the two sectors. Benefiting from access to a broader opportunity set, the result is a more diversified portfolio that has the potential to perform well in various investment environments and provide attractive income and competitive risk-adjusted returns.

INTRODUCTION

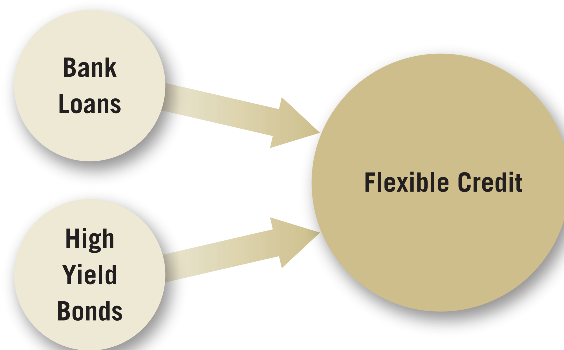
High yield bonds and bank loans, collectively known as leveraged finance, are two sectors of the fixed income market that are converging as a single non investment grade asset class. Traditionally, investors have implemented their high yield and bank loan allocations through separate, dedicated mandates, adjusting their exposures to each asset class (or sector) based on a view of the credit or interest rate environment. The distinction between high yield and bank loans has blurred over the past 20 years or so, which we believe argues for a more efficient investment approach to leveraged finance through an actively managed, flexible strategy that tactically rotates across and within each asset class. This approach enables a single investment manager with purview over a larger opportunity set to capitalize on technical dislocations and differential relative value opportunities within industries, credit quality tiers, and across the capital structure. Effective implementation of such an approach requires an investment manager with not only expertise in each asset class, but an integrated, adaptive research capability consistent with evolving market dynamics.

The paper begins with a brief historical perspective on the convergence of high yield bonds and bank loans into a single leveraged finance asset class. We then discuss advantages of combining high yield and loans into a single investment approach in terms of expanded investment opportunity set, issuer overlap, and structural differences between the two markets. The paper then turns to the risk and return benefits that a flexible high yield/bank loan strategy has the potential to provide.

EXHIBIT 1: A FLEXIBLE APPROACH TO A LEVERAGED FINANCE STRATEGY

Objective: Produce Attractive Income and Total Return

- Bank loans provide a natural hedge against rising rates
- Senior secured status provides credit protection
- Historically low correlation with rates
- Equity-like total return opportunities



- Consistent with the convergence of leveraged finance markets
- Low correlation to other interest rate sensitive asset classes
- Attractive income and total return potential

DRIVERS OF CONVERGENCE

The convergence of bank loans and high yield bonds is a result of both asset classes developing characteristics of the other. Exhibit 2 highlights the changes in the U.S. bank loan and high yield markets over the past decade. Emblematic of the convergence trend is the substantial increase in "covenant lite" shares for bank loans, together with the meaningful increase in secured shares for the high yield market. The latter trend in particular has continued into 2019 with $12.4 billion in new secured notes by high yield issuers through the end of February. In terms of credit quality, the bank loan market has migrated heavily to B-rated issues while the high yield market has experienced an upward shift in credit quality, as evidenced by the increase in BB-rated debt and subsequent decrease in single B and CCC/CC-rated exposure. The shifts in credit quality and structural changes could result in more similarity in recovery rates for high yield bonds and loans in the next cycle.

For some historical perspective, bank loans have evolved from their role of private bank funding of M&A and leveraged buyouts in the 1980s to a common form of corporate financing today. Over time, as corporate borrowers integrated bank loans and high yield bonds into their capital structures, the distinctions between the two debt instruments faded, prompting underwriting desks and other parties to consolidate their analysts and traders into single teams to cover both loans and high yield. The Financial Crisis accelerated the convergence as bank loans became more widely accepted as a non investment grade instrument, and as the search for yield in the low interest rate environment increased demand for more credit sensitive assets. In 2018, heightened demand for loans was met by a loosening of restrictions and more "covenant lite" features that resemble the less restrictive structure of high yield bond offerings, making the two instruments even less distinguishable. With the expectations of rising rates in 2018, issuers preferred to finance through the loan market, where demand for loans resulted in "bond like" financing, but still with the prepayability of loans. To start 2019, however, the supply/demand dynamics has reversed as a more dovish Federal Reserve has dampened the demand for loans and contributed to the shift in issuance from loans to high yield, exemplified by the increase in secured note offerings as discussed above. TransDigm's $3.8 billion offering, the largest secured note issuance ever, was issued instead of a loan to finance recent M&A.

FEATURES/ADVANTAGES OF COMBINING HIGH YIELD AND BANK LOANS

Expanded Opportunity Set

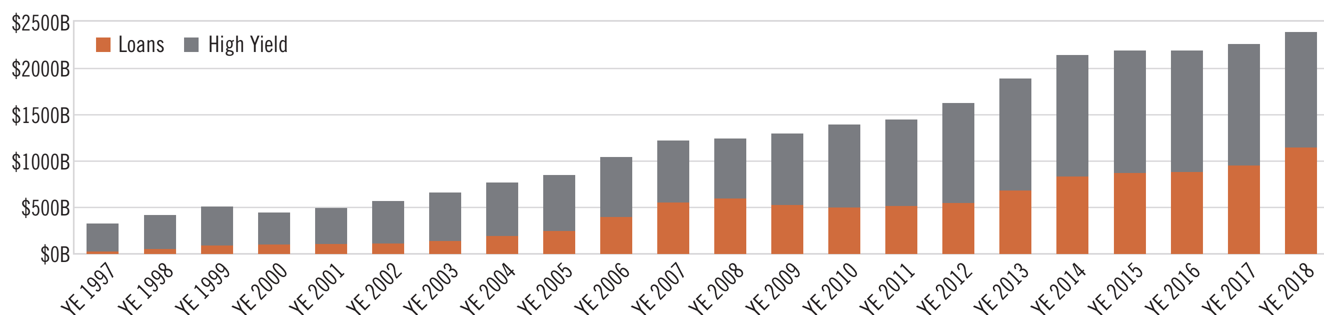
Combining bank loans and high yield bonds in a single strategy roughly doubles the size of the opportunity set from that of each asset class separately (Exhibit 3), providing the potential for a more diversified source of returns.

EXHIBIT 2: THE EVOLUTION OF THE U.S. LEVERAGED FINANCE MARKET

U.S. INSTITUTIONAL LOAN MARKET*			U.S. HIGH YIELD MARKET**		
	2018	2007		2018	2007
Total Par Outstanding	$1.08 trillion	$554 billion	**Total Par Outstanding**	$1.17 trillion	$629 billion
Issuer Count	1,113	851	**Issuer Count**	911	894
U.S. Domiciled Borrowers' Share	85%	94%	**U.S. Domiciled Borrowers' Share**	86%	90%
Top 3 Sectors	Technology, Services, Healthcare (33% combined)	Healthcare, Utilities, Auto (23% combined)	**Top 3 Sectors**	Communications, Consumer Cyclical, Energy (49% combined)	Consumer Cyclical, Communications, Consumer Non-Cyclical (50% combined)
BB Rated Share	27%	51%	**BB Rated Share**	46%	36%
B Rated Share	54%	30%	**B Rated Share**	40%	43%
CCC/CC Rated Share	6%	2%	**CCC/CC Rated Share**	14%	20%
Covenant-lite Share	80%	17%	**Secured Share**	18%	10%

*Source: LCD, an offering of S&P Global Market Intelligence. **Source: Bloomberg Barclays.
Based on S&P/LSTA Leveraged Loan Index and Bloomberg Barclays U.S. High-Yield 2% Issuer Capped Index.

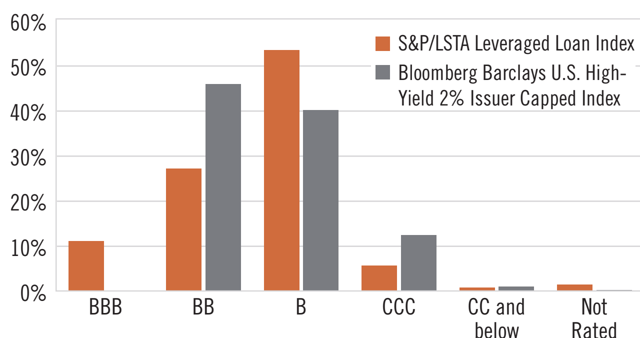
EXHIBIT 3: EXPANDED OPPORTUNITY SET – HISTORICAL MARKET SIZE (PAR OUTSTANDING)



Source: LCD, an offering of S&P Global Market Intelligence; Bloomberg Barclays; as of 12/31/18.
Includes all loans including those not in the LSTA/LPC mark-to-market service. Vast majority are institutional tranches.

The expanded opportunity set extends to both industry and credit quality breakdowns. The proportional representation across industries of the bank loan and high yield markets is quite different. Energy, for example, represents 14.2% of the high yield market but only 2.9% of the loan market (data as of 12/31/18). Conversely, technology has a higher weighting in loans (13.8%) than in high yield (7.1%). A portfolio manager's favorable view on the energy sector would thus be more difficult to implement in a dedicated bank loan portfolio than in a combined bank loan/high yield approach. Correspondingly, as Exhibit 4 shows, there is a difference in the distribution by credit quality tier of the two asset classes. Finally, Exhibit 5 compares the performance differential among credit quality tiers for the two, demonstrating that the ability to rotate across and within bank loans and high yield can add value. The expanded opportunity set opens up a wide array of investable options for an investment manager to source and implement ideas, again, providing the potential for a more diversified stream of returns and an improved risk management profile than available from investing in either asset class separately.

EXHIBIT 4: CREDIT QUALITY DISTRIBUTION – LOANS VERSUS HIGH YIELD



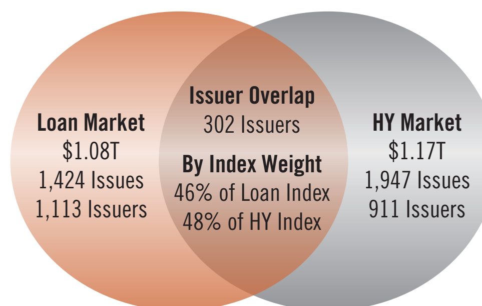
Source: LCD, an offering of S&P Global Market Intelligence; Bloomberg Barclays; as of 12/31/18.

As one last but critical advantage of combining bank loans and high yield, the expanded opportunity set offers an additional layer of liquidity management. This is especially relevant when considering the liquidity challenges of loan-only portfolios, at least in terms of settlement times.

Issuer Overlap

Issuers utilize both the bank loan and high yield markets as funding conditions fluctuate and as considerations of their capital structure dictate. As Exhibit 6 indicates, a meaningful overlap exists in the high yield and bank loan markets based on both numbers of issuers and par value.

EXHIBIT 6: ISSUER OVERLAP



Source: FactSet. S&P/LSTA Leveraged Loan Index and Bloomberg Barclays U.S. High-Yield 2% Issuer Capped Index. As of 12/31/2018.

Investment managers with a dedicated bank loan or high yield mandate are limited in how they choose to invest in a company, lacking the opportunity to substitute one debt instrument for the other on the basis of relative value or as macroeconomic or other conditions might warrant. An issuer's loan and high yield bond might trade similarly, for example, but holding the loan can offer protection in a rising rate environment or holding the high yield bond might provide an equity-like total return opportunity, independent of credit considerations and all else being equal.

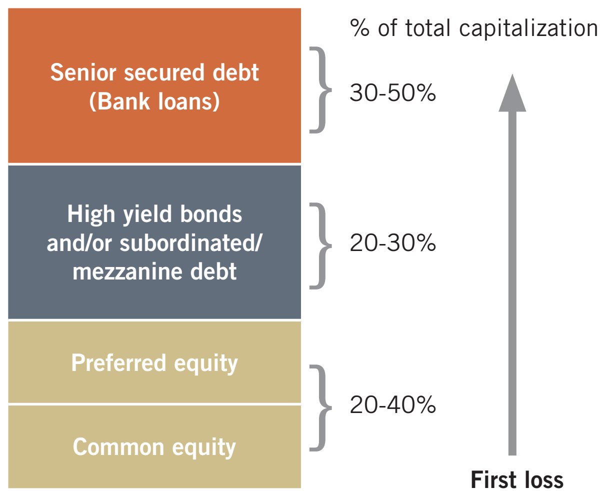
EXHIBIT 5: RETURNS BY CREDIT QUALITY

2014	2015	2016	2017	2018
CCC Loans 6.09%	BBB Loans 3.25%	CCC High Yield 31.46%	CCC Loans 10.73%	CCC Loans 2.35%
BB High Yield 5.37%	BB Loans 2.23%	CCC Loans 29.05%	CCC High Yield 10.38%	B Loans 0.86%
BB Loans 1.52%	B Loans -0.82%	B High Yield 15.80%	BB High Yield 7.32%	BBB Loans 0.20%
B High Yield 1.48%	BB High Yield -1.00%	BB High Yield 12.78%	B High Yield 6.48%	BB Loans -0.42%
B Loans 1.43%	B High Yield -4.63%	B Loans 10.80%	B Loans 4.55%	B High Yield -1.31%
BBB Loans 1.16%	CCC Loans -8.43%	BB Loans 7.33%	BB Loans 3.44%	BB High Yield -2.42%
CCC High Yield -1.11%	CCC High Yield -12.11%	BBB Loans 5.87%	BBB Loans 2.53%	CCC High Yield -3.84%

Source: LCD, an offering of S&P Global Market Intelligence; Bloomberg Barclays; as of 12/31/18.

Managers with a flexible mandate can also exploit dislocations and identify relative value opportunities across the capital structure. Exhibit 7 shows the range of securities that a manager can evaluate to invest in any given issuer.

EXHIBIT 7: ILLUSTRATIVE CAPITAL STRUCTURE



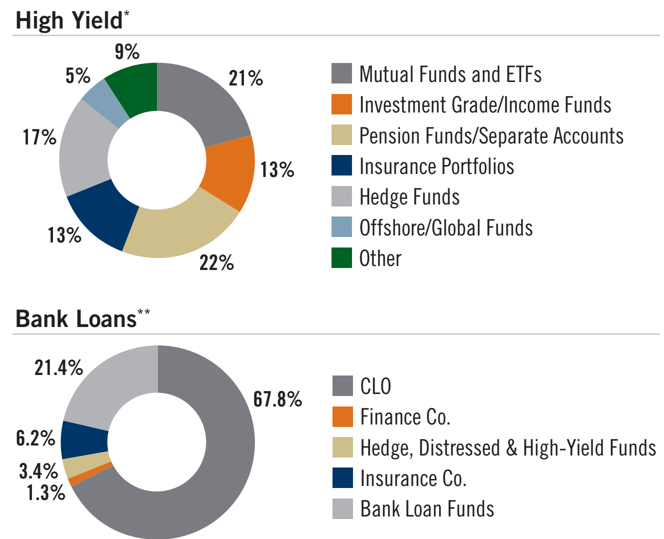
A flexible mandate also offers a degree of protection against idiosyncratic risk and correlation creep. Given the number of issuers that have a significant presence in both the loan and high yield markets, a plan sponsor or other investor with dedicated strategies may have exposure to an issuer through both its loan and high yield portfolios. In contrast, a manager with a flexible mandate has broader oversight and control over aggregate exposures. Similarly, the use of dedicated strategies may lead to unintentional industry concentration risk or manager style risk that a single-manager, flexible mandate can avoid.

While a manager of a single-asset-class strategy may have some latitude to cross over to other asset classes, the flexibility is often limited by mandate. A well-resourced manager with a constant pulse on the bank loan and high yield markets is better positioned to make the most effective assessments of relative value and risk.

Structural Differences in the High Yield and Bank Loan Markets

The underlying investor base is very different between the high yield and bank loan markets. Institutional investors/ collateralized loan obligations (CLOs) make up the majority of the loan market whereas retail investors represent a greater portion of the high yield market (Exhibit 8).

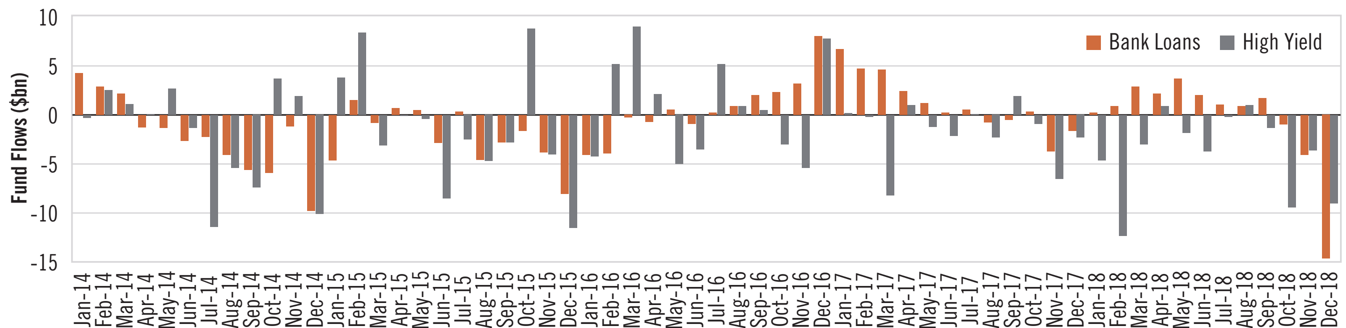
EXHIBIT 8: INVESTOR BREAKDOWN



*Source: Bloomberg Barclays. As of 12/31/18.
**Source: LCD, an offering of S&P Global Market Intelligence. As of 12/31/18.

The differences in investor base can drive technical dislocations that managers with a flexible strategy can consider in their high yield/bank loan allocations. Exhibit 9 shows the variability in mutual fund flows between the two asset classes over the past five years. In February of 2018, for example, high yield bond funds had $10.4 billion of outflows while loan funds saw $970 million of inflows. Loan flows typically follow a trend based on interest rates. As rates continued to rise in 2018, loan funds had positive flows through September. A meaningful dislocation of risk assets in the fourth quarter of 2018 resulted in massive outflows for both high yield and loan funds. Entering 2019, the Fed's more dovish posture continued to drive negative flows for bank loans while high yield flows have turned positive.

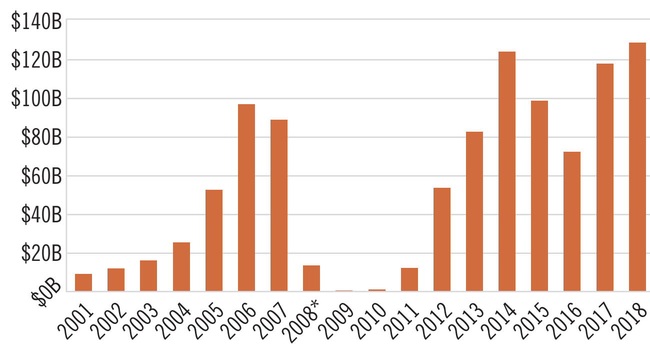
EXHIBIT 9: MUTUAL FUND FLOWS



Source: Lipper FMI.

Mutual fund flows do not capture all of the possible sources of technical dislocation in the market. A change in demand for CLOs, which are a large component of the loan market, could disrupt the supply/demand dynamic. Particularly robust over the past number of years, CLOs have had some weaker periods historically (Exhibit 10) and are off to a slow start in 2019.

EXHIBIT 10: CLO ISSUANCE



*2008 excludes 3 market value vehicle rollovers.
Source: LCD, an offering of S&P Global Market Intelligence.

Relative Value Analysis

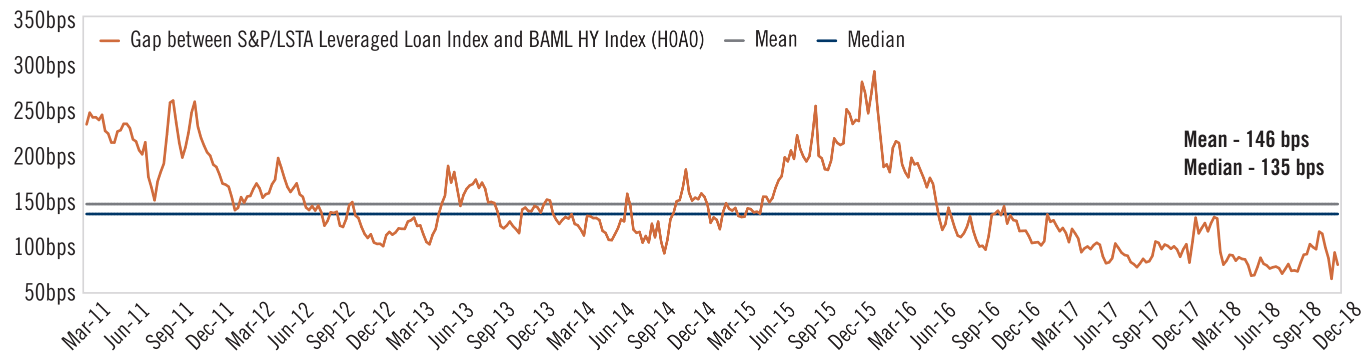
Despite the commonality of credit quality of the underlying issuer, the differences between bank loans and high yield bonds discussed above (e.g., investor base and fund flows) can translate to different return profiles and thus differences in relative value.

Exhibit 11 shows the yield differential between high yield bonds and bank loans, which can be used as a signal for adjusting the allocation between the two asset classes. In the 2015-2016 timeframe, the gap between bank loans and high yield was well above the median level, suggesting that high yield was the more attractive investment. In 2017 and 2018, the yield advantage of high yield over loans contracted considerably, indicating the increasing attractiveness of loans as interest rates rose. Given the recent change in sentiment by the Fed and the prospect of a range-bound environment, a more balanced allocation to high yield and bank loans may be warranted. A manager with a flexible mandate can fine-tune such adjustments agilely.

PERFORMANCE AND RISK

Combining high yield bonds and bank loans in an actively managed, flexible strategy takes advantage of the two asset classes' common and complementary attributes, enhancing diversification and providing the potential for attractive risk-adjusted returns. Exhibit 12 shows the risk-adjusted returns over a 20-year period for the S&P/LSTA bank loan and Merrill Lynch high yield indices, and their credit quality subsets, compared to the risk-adjusted returns of the 10-year U.S. Treasury and the S&P 500. In nearly all instances, the returns per unit of risk of the bank loan and high yield indices exceeded those of the Treasury and equity market.

EXHIBIT 11: YIELD GAP BETWEEN BANK LOANS AND HIGH YIELD



Past performance is not indicative of future results.
As of 12/31/18. Source: LCD, an offering of S&P Global Market Intelligence (S&P/LSTA Leveraged Loan Index); Bloomberg L.P. (BAML HY Index).

EXHIBIT 12: RISK-ADJUSTED RETURNS

	S&P/ LSTA LL Index	BB Loans Index	B Loans Index	ML US HY Index	ML US BB HY Index	ML US B HY Index	ML 10+Yr US Treasury	S&P 500® Index
Annualized Return	4.95%	4.38%	4.79%	6.99%	7.22%	6.47%	5.11%	8.93%
Standard Deviation	5.70%	4.94%	6.90%	8.72%	7.07%	8.61%	7.12%	14.98%
Return Per Unit of Risk	0.87	0.89	0.69	0.80	1.02	0.75	0.72	0.60

February 1997 – December 2018. Source: LCD, an offering of S&P Global Market Intelligence.

Correlation

Bank loans pay a floating rate that typically resets every 90 days to the 3-month LIBOR rate, thus accounting for their low correlation to interest rates relative to traditional fixed-rate debt. High yield historically also has had a lower correlation with interest rates as the higher coupon helps offset the price decline caused by rising rates. Exhibit 13 shows the lower correlation of a Leveraged Finance Proxy (50/50 S&P/LSTA Leveraged Loan Index and Bloomberg Barclays U.S. High-Yield 2% Issuer Capped Index) to other asset classes including U.S. Treasuries and U.S. investment grade corporates.

The stability of cash flows provided by leveraged finance can provide investors with a less correlated return stream and help mitigate equity risk while providing a competitive total return. High yield is often characterized as a hybrid asset class, as securities derive equity-like returns from both income and price appreciation. Returns on high yield bonds tend to experience lower volatility than equities as equity returns are predominantly driven by capital appreciation. Because bank loans are traditionally a par asset class, they tend to experience even less sensitivity to equity risk as returns are predominantly driven by coupon. Given their positioning in the capital structure, loans, and then bonds, would experience higher recovery rates than equity holders.

Rising Rate Environment

High yield and loans historically have proven to provide a valuable hedge against rising interest rates. Exhibit 14 shows the performance of the two sectors during rising rate environments with a comparison to investment grade bonds.

CONCLUSION

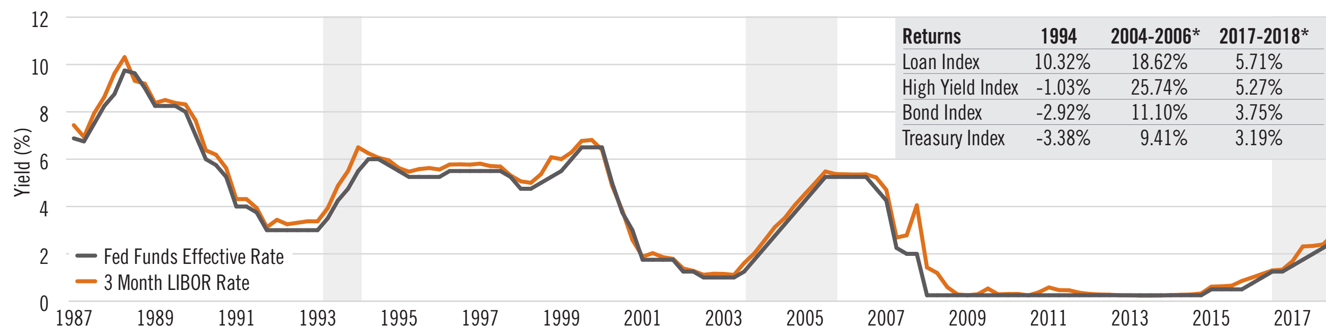
The convergence of high yield bonds and bank loans into a single leveraged finance asset class enables a skilled investment manager to look holistically across an expanded opportunity set to identify relative value opportunities from the perspective of both credit and capital structure analysis. The potential benefits to the client include a more diversified portfolio with competitive risk-adjusted returns and attractive income. Effective implementation of such an approach requires the portfolio managers and investment team to have experience and expertise in both bank loans and high yield and the research infrastructure and perspective to evaluate and compare each sector in depth and in relation to each other.

EXHIBIT 13: CORRELATION MATRIX

Index	Proxy (50/50)*	Leveraged Loans	High Yield Bonds	U.S. Treasury	Inv. Grade Corporate Bonds	U.S. Equities
Leveraged Finance Proxy (50/50)*	1.00					
S&P/LSTA Leveraged Loan Index	0.91	1.00				
Bloomberg Barclays U.S. Corporate High Yield	0.96	0.77	1.00			
Bloomberg Barclays U.S. Treasury	-0.30	-0.35	-0.24	1.00		
Bloomberg Barclays U.S. Corporate Investment Grade	0.47	0.31	0.53	0.38	1.00	
S&P 500® Index	0.58	0.44	0.62	-0.28	0.21	1.00

Past performance is not indicative of future results. Source: Zephyr, for period 1/1/97-12/31/18. *Leveraged Finance Proxy represents 50% S&P/LSTA Leveraged Loan Index and 50% Bloomberg Barclays U.S. High-Yield 2% Issuer Capped Index. Indices used: Bloomberg Barclays U.S. High-Yield 2% Issuer Capped Index, S&P/LSTA Leveraged Loan Index, Bloomberg Barclays US Corporate Index, Bloomberg Barclays US Treasury 7-10 Year Index, S&P 500 Index.

EXHIBIT 14: FED FUNDS EFFECTIVE RATE, 3 MONTH LIBOR AND SELECT FIXED INCOME PERFORMANCE



*Arithmetic cumulative returns from 2004–2006 and 2017–2018.

Past performance is not indicative of future results. As of 12/31/2018. Source: Credit Suisse, Bloomberg Barclays. Loan Index is the Credit Suisse Leveraged Loan Index. Bond Index is the Bloomberg Barclays U.S. Aggregate Bond Index. Treasury Index is the Bloomberg Barclays U.S. Treasury Index. High Yield Index is the Bloomberg Barclays U.S. High-Yield 2% Issuer Capped Index.

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Past performance is not indicative of future results.

IMPORTANT RISK CONSIDERATIONS: Credit & Interest: Debt securities are subject to various risks, the most prominent of which are credit and interest rate risk. The issuer of a debt security may fail to make interest and/or principal payments. Values of debt securities may rise or fall in response to changes in interest rates, and this risk may be enhanced with longer-term maturities. **High Yield-High Risk Fixed Income Securities:** There is a greater level of credit risk and price volatility involved with high yield securities than investment grade securities. **Foreign Investing:** Investing internationally involves additional risks such as currency, political, accounting, economic, and market risk. **Industry/Sector Concentration:** A fund that focuses its investments in a particular industry or sector will be more sensitive to conditions that affect that industry or sector than a non-concentrated fund. **Bank Loans:** Loans may be unsecured or not fully collateralized, may be subject to restrictions on resale and/or trade infrequently on the secondary market. Loans can carry significant credit and call risk, can be difficult to value and have longer settlement times than other investments, which can make loans relatively illiquid at times. **Leverage:** When a fund leverages its portfolio, the value of its shares may be more volatile and all other risks may be compounded. **Liquidity:** Certain securities may be difficult to sell at a time and price beneficial to the fund.

The **S&P/LSTA Leveraged Loan Index** is a daily total return index that uses LSTA/LPC Mark-to-Market Pricing to calculate market value change. On a real-time basis, the index tracks the current outstanding balance and spread over LIBOR for fully funded term loans. The facilities included in the Index represent a broad cross section of leveraged loans syndicated in the United States, including dollar-denominated loans to overseas issuers. The **Bloomberg Barclays U.S. High-Yield 2% Issuer Capped Bond Index** is a market capitalization-weighted index that measures fixed rate non-investment grade debt securities of U.S. and non-U.S. corporations. No single issuer accounts for more than 2% of market cap. The index is calculated on a total return basis. The **ICE BofAML US High Yield Index (HOAO)** tracks the performance of U.S. dollar-denominated below investment grade corporate debt publicly issued in the U.S. domestic market. Qualifying securities must have a below investment grade rating. Original issue zero coupon bonds, 144a securities, both with and without registration rights, and pay-in-kind securities, including toggle notes, qualify for inclusion. Eurodollar bonds, taxable and tax-exempt U.S. municipal, warrant-bearing, DRD-eligible and defaulted securities are excluded from the Index. The **BofA Merrill Lynch 10+ Year U.S. Treasury Index** is a subset of the BofA Merrill Lynch U.S. Treasury Index, including all securities with a remaining term to final maturity greater than or equal to 10 years. The **S&P 500® Index** is a free-float market capitalization-weighted index of 500 of the largest U.S. companies. The index is calculated on a total return basis with dividends reinvested. The **Bloomberg Barclays U.S. Corporate High Yield Bond Index** measures fixed rate non-investment grade debt securities of U.S. corporations, calculated on a total return basis. The **Bloomberg Barclays 7-10 Year US Treasury Bond** measures the performance of US Treasury securities that have a remaining maturity of at least seven years and less than ten years. The **Bloomberg Barclays U.S. Corporate Investment Grade Bond Index** measures performance of investment grade corporate bond funds. The index is calculated on a total return basis. The **Credit Suisse Leveraged Loan Index** is a market-weighted index that tracks the investable universe of the U.S. dollar denominated leveraged loans. The index is calculated on a total return basis, is unmanaged and not available for direct investment. The unmanaged index returns do not reflect any fees, expenses, or sales charges. The **Bloomberg Barclays U.S. Aggregate Bond Index** measures the U.S. investment grade fixed rate bond market. The index is calculated on a total return basis. The **Bloomberg Barclays U.S. Treasury Index** measures U.S. dollar-denominated, fixed-rate, nominal debt issued by the U.S. Treasury. Treasury bills are excluded by the maturity constraint, but are part of a separate Short Treasury Index. STRIPS are excluded from the index because their inclusion would result in double-counting. The indexes are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and they are not available for direct investment.

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