Bank Loans – More than a Rate Hedge

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Some retail investors may have conditioned themselves to manage their bank loan exposure relative to their interest rate view, rather than incorporating other major protections such as security and seniority into their decision-making, especially at a time of increasing credit or late-cycle scrutiny. In the aggregate, the differentiating features of bank loans have produced attractive risk-adjusted returns relative to other income alternatives over multiple credit cycles and interest rate regimes, specifically through income. *To be clear, the bank loan market is an income asset class, not solely an interest rate hedging tool.* Further, the loan market is attractive relative to other credit spread income-producing asset classes, namely, the high yield market, even during the current low rate environment.

Let's consider the global landscape and the scarcity of yield. Global central banks have continued, and in some cases have accelerated, accommodative policy measures. The U.S. Federal Reserve (Fed) has also pivoted to a more dovish stance with two interest rate cuts thus far in 2019. Global negative-yielding debt currently stands at US$14T and the entire Swiss and German yield curves are negative. Given the aging of populations and the ballast that bonds provide to an overall investment portfolio, investors are finding it increasingly difficult to generate adequate risk-adjusted income.

Retail investors, as suggested above, have had a difficult time looking past the "interest rate hedge" tool. The data bear this out. As the 10-year U.S. Treasury rate increased entering 2017 and the first nine months of 2018, the loan market experienced positive retail flows. With the start of the dislocation in 4Q18 and the Fed's dovish pivot, the subsequent decline in rates has resulted in 41 consecutive weeks and $36.4B in retail outflows (as of 8/31/19). While the high yield market witnessed redemptions during the rising rate period, investors subsequently returned to that market as interest rate (duration) risk became less of a concern.

The shift from loans into high yield has resulted in loans currently providing more yield-to-maturity than high yield as the demand for high yield has significantly tightened spreads. As such, there is an income advantage in loans relative to high yield, but retail investor flows are not reflecting it.

In sum, the loan market should be viewed more broadly as a *senior, secured* floating rate income product. Today, despite the prospect of additional rate cuts, investors benefit from a higher yield while maintaining a senior position in the issuer's capital structure and a secured interest in all asset of the issuer, which is important as the credit cycle matures. Over time, the loan market has provided attractive, long-term, income-focused outcomes for investors relative to high yield, U.S. Treasuries, and even equities. Even with the current interest rate environment, loans should continue to part of investors' fixed income allocation as they search for yield in a thoughtful, prudent manner.

Photo: Getty Images

For more detail, see www.newfleet.com/articles/more-than-a-rate-hedge-the-overlooked-return-potential-of-bank-loans-in-a-yield-starved-environment ■

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