Why Floating Rate Loans Can Actually Help Manage Risk

Newfleet ASSET MANAGEMENT
A Virtus Investment Partner

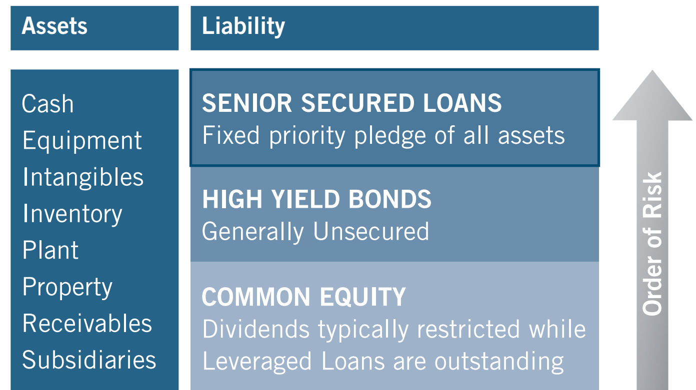
The major protections in floating rate loans—limited duration risk, seniority, and collateral—result in a long-term smoothing of volatility. In the context of risk assets, floating rate loans (also known as leveraged loans) may help mitigate current market risks without sacrificing the potential for strong yield.

Floating rate loans are usually thought of as a way to add risk to portfolios – a move that may seem unappealing at first glance as risk assets took a beating in 2022.

However, many investors may not realize that floating rate loans can help moderate this volatility: along with an attractive risk premium, its protective characteristics may lessen rate risk and overall volatility compared with equities.

Floating rate loans have two features that may help reduce risk in the current environment. First, their floating coupon relies on a short-term rate that quickly resets every one to three months—a helpful feature in a rapidly rising rate environment that typically hurts fixed-rate bond performance.

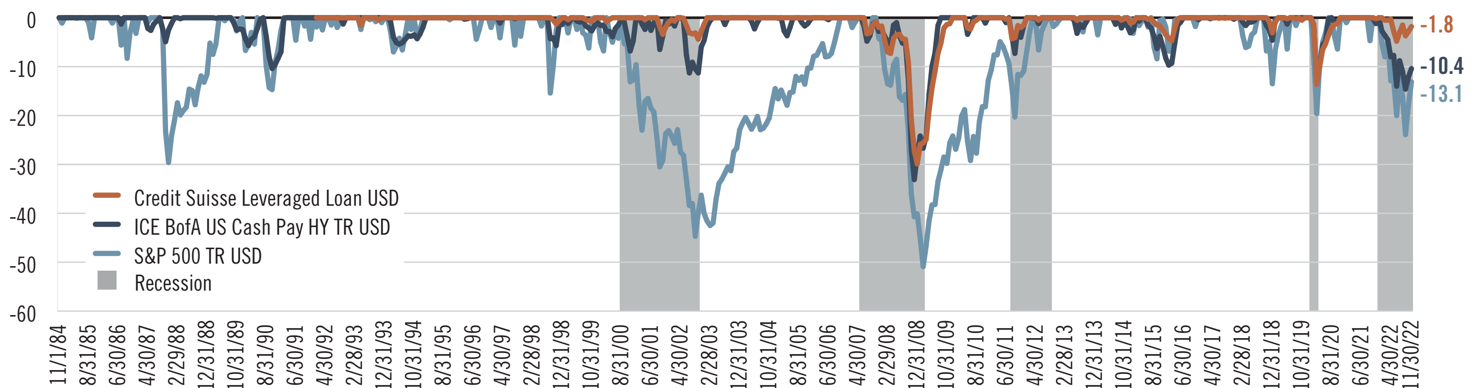
Second, floating rate loans have seniority in the capital structure—meaning they have the highest priority on the borrower's pledged collateral over the claims of unsecured debt as well as preferred and common stocks. This seniority has historically contributed to higher recoveries for investors. Since 2001, the average recovery rate for loans in default has averaged roughly 64% compared with 41% for high yield bonds, according to J.P Morgan.



The floating rate loan market has protective features that result in less long-term volatility. This includes limited duration risk, seniority, and collateral. During periods of financial stress (see below), loans have experienced less significant drawdowns compared with asset classes such as high yield and equities.

Through end of November 2022, the drawdown for floating rate loans has stayed in the low single digits, while comparable asset classes have experienced declines in the double-digit range.

FIVE LARGEST DRAWDOWNS: LOANS AND HIGH YIELD VS. EQUITIES



Index	Dot-Com Drawdown 8/31/00-10/31/02	Great Financial Crisis 5/31/07-2/28/09	U.S. Debt Downgrade/ Eurozone Crisis 8/31/11-9/6/12	Covid-19 Drawdown 1/31/20-4/30/20	Current Drawdown 12/31/21-11/30/22
CS Leveraged Loan	-4.4	-29.9	-4.3	-13.6	-4.8
ICE BofA US Cash Pay HY	-11.3	-33.1	-7.3	-13.1	-14.6
S&P 500® Index	-44.7	-50.9	-20.3	-19.6	-23.9

Source: Bloomberg LP, Credit Suisse Leveraged Loan Index, ICE BofA U.S. Cash Pay High Yield Index, S&P 500® Index. As of November 30, 2022.

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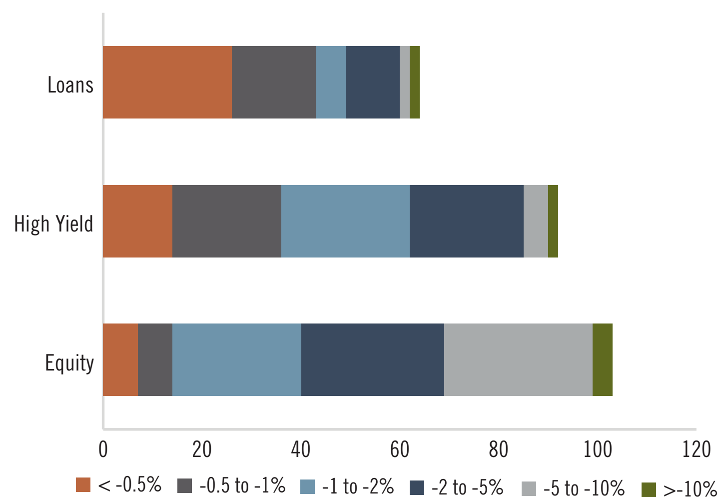
Loans also offer smoother performance month-to-month—an attractive feature for investors that seek to prioritize short-term liquidity without sacrificing yield. A breakdown of monthly returns from January 1999-November 2022 shows that loans experienced fewer negative months, and, within that, fewer heavy losses, compared with high yield and equities.

Within equities, 86% of its negative months suffered losses between 1% to 10%. Within high yield, over half of its negative months lost between 0.5% to 5%. By contrast, 41% of loan's negative months lost less than 0.5%.

In fact, of all loan losses by month, nearly 70% lost only 1% or under.

Though the current environment presents a challenge for investors, it has also created an attractive entry point for investors looking to add loans. Current coupon and prices for loans imply a total return opportunity that approaches long-term equity performance. Its attractive risk premium, low duration, and potential downside protections compared to equities make it an attractive addition to investors' portfolios.

MONTHLY LOSSES BY ASSET CLASS – JAN. 1999-NOV. 2022



Source: LCD, Morningstar, Morningstar LSTA U.S. Leveraged Loan Index, ICE BofA U.S. Cash Pay High Yield Index, S&P 500® Index. As of November 30, 2022.

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IMPORTANT RISK CONSIDERATIONS: Credit & Interest: Debt instruments are subject to various risks, including credit and interest rate risk. The issuer of a debt security may fail to make interest and/or principal payments. Values of debt instruments may rise or fall in response to changes in interest rates, and this risk may be enhanced with longer-term maturities. **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 are subject to credit and call risk, may be difficult to value, and have longer settlement times than other investments, which can make loans relatively illiquid at times. **High Yield Fixed Income Securities:** There is a greater risk of issuer default, less liquidity, and increased price volatility related to high yield securities than investment grade securities. **Leverage:** When a fund leverages its portfolio, the fund may be less liquid, may liquidate positions at an unfavorable time, and the volatility of the fund's value may increase. **Liquidity:** Certain securities may be difficult to sell at a time and price beneficial to the fund.

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 **ICE BofA US Cash Pay High Yield Index** tracks the performance of U.S. dollar denominated below investment grade corporate debt, currently in a coupon paying period, that is publicly issued in the U.S. domestic market. **LIBOR:** London Interbank Offered Rate. The **Morningstar LSTA U.S. 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 **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. **SOFR:** The Secured Overnight Financing Rate. 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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