The Resiliency of Leveraged Loans

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Rising interest rates have meant increased demand for assets that can help mitigate interest rate risk and potentially add value as rates rise. Leveraged loans are floating rate bank loans that can offer these attributes. They also may provide an opportunity to smooth overall volatility and further diversify investment portfolios.

We take a closer look at the argument for maintaining a consistent allocation to leveraged loans in an investment portfolio and discover some interesting comparisons to core bonds and the U.S. equity market along the way.

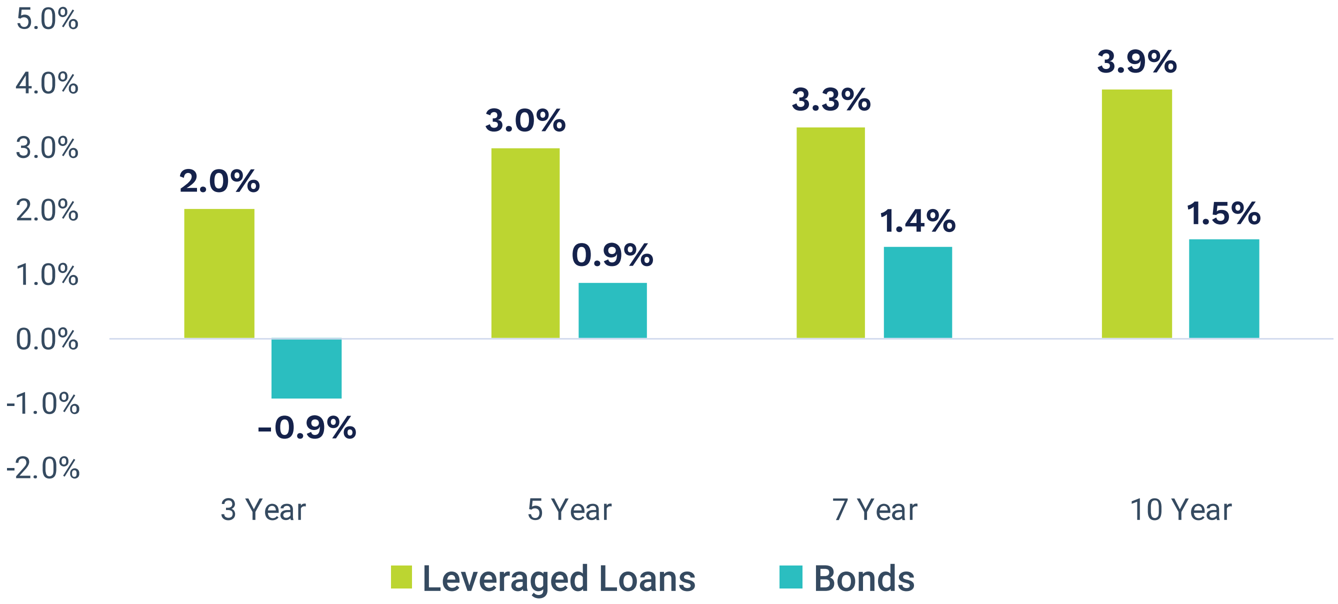
LEVERAGED LOANS COMPARED TO BONDS – IT'S NOT JUST ABOUT THE FLOATING RATE

The last year has been unusual for the markets; the historical negative correlation between bonds and equities (when equities rise, bonds fall and vice versa) seems to be a thing of the past. The Federal Reserve has been aggressively raising interest rates and is messaging its resolve in fighting record inflation. As investors move to position portfolios for an ongoing rising rate environment, demand for floating rate assets has increased.

Investors seeking income look to leveraged loans for the greater yield, and may view them as a tactical call on rising interest rates. However, maintaining a consistent exposure to leveraged loans throughout rate cycles and opportunistically allocating exposure when warranted may be a more modern approach to the credit allocation of a portfolio.

To make the argument of including leveraged loans along with traditional credit assets in a credit asset allocation, let's compare the performance of a benchmark for leveraged loans to a benchmark for the broad bond market. Over the long-term, loans can offer a compelling complement.

Leveraged Loans Have Outperformed Bonds



Annualized returns. Leveraged loans are represented by the Credit Suisse Leveraged Loan Index; Bonds are represented by the Bloomberg U.S. Aggregate Bond Index. It is not possible to invest directly in an index.
Past performance is not indicative of future results. As of June 30, 2022.

Leveraged loans are collateralized, senior secured debt, at the top of a company's corporate capital structure. While leveraged loans are below investment grade and may carry higher levels of risk than investment grade bonds, the historical average recovery rate for these types of securities is 76%, and the median is 96%, higher than many other types of higher-yielding debt.[1]

Finally, because leveraged loans are negatively correlated to bonds, adding leveraged loans to a core bond portfolio can provide portfolio diversification.

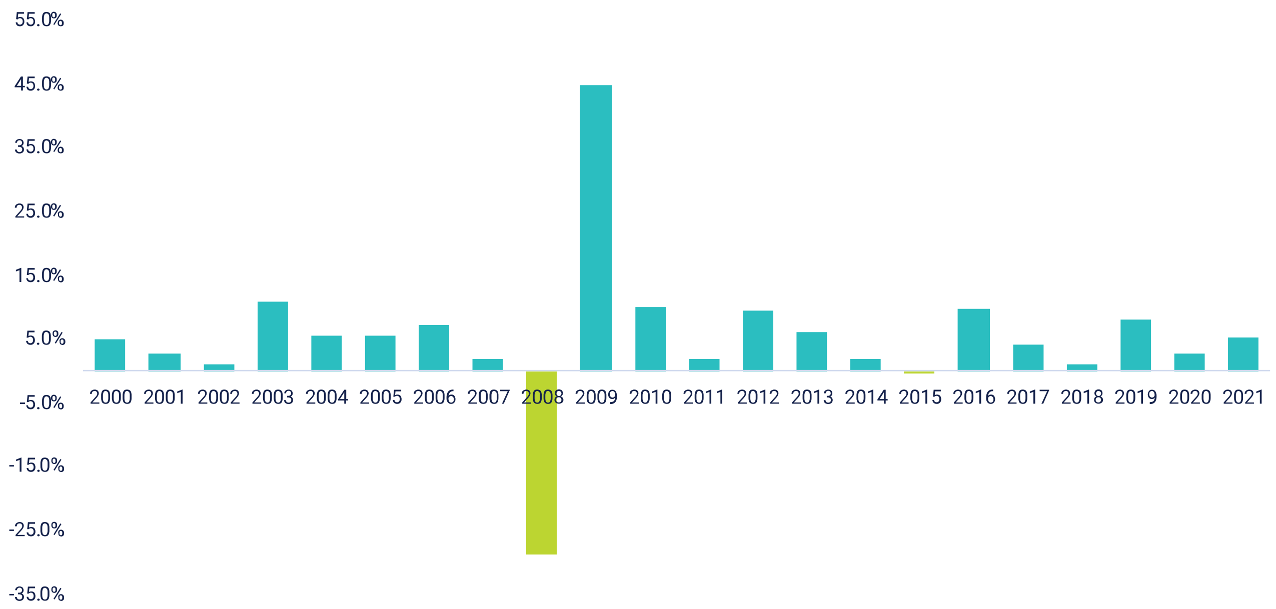
SO, HOW DO LEVERAGED LOANS COMPARE TO EQUITIES?

The analysis versus equities is even more cogent. The recent tendency for bond and equity markets to move in tandem means investors may have lost a source of diversification. Leveraged loans may be able to fill that gap. Looking at the S&P 500 as a proxy for the equity markets, from January 31, 2000, to December 31, 2021, the S&P 500 had 92 down months.

In 85 of these months, bank loans turned in better performance than equities. Translated to a percentage, 92% of the time, leveraged loans outperformed when equities (as represented by the S&P 500) had a downturn.

Over the same period, loans have had only two down years, in 2008 and then a very slight negative performance in 2015. This long-term history of positive annual performance speaks to the resiliency of loans across market downturns.

Leveraged Loans Exhibit Resiliency Across Market Cycles



Source: Bloomberg. Data monthly from January 31, 2000 to December 31, 2021. Loans represented by the Credit Suisse Leveraged Loan Index (All loans). Past performance is not indicative of future results.

DOES A RISING RATE ENVIRONMENT RAISE THE RISK OF DEFAULT?

Floating rates can be attractive due to the potential for the coupon payments on the loans to increase as rates go up. But this also means that the companies are paying higher debt service costs. This is an important consideration in the credit selection process.

Quality	Liquidity
Selecting higher-quality loans can help mitigate the risk of default.	Larger-sized loan tranches are typically more liquid as they are more appealing to large institutional investors.

The leveraged loan default rate, as measured by the S&P/LSTA Leveraged Loan Index, hit a record low in April 2022. While the rate is rising, the long-term average default rate of the index is 2.77%.

Historical Loan Default Rates

Source: S&P Global. As of July 2022.

THE REWARD FOR CONSISTENT INVESTING

Leveraged loans can offer investors a source of increased yield and interest rate risk mitigation.

However, regarding them as only a tactical investment in a rising rate environment misses some significant portfolio benefits. Beyond the yield premium, these assets offer risk-adjusted returns that can beat the broad bond market, the portfolio diversification benefits of an uncorrelated asset class, and a consistency that can help smooth returns across market cycles.

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Footnote

1. Fitch Ratings, 2002-2021.