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Opportunity Knocking in Loan Land

By: Andrew N. Sveen, CFA | & Christopher Remington | November 3, 2022

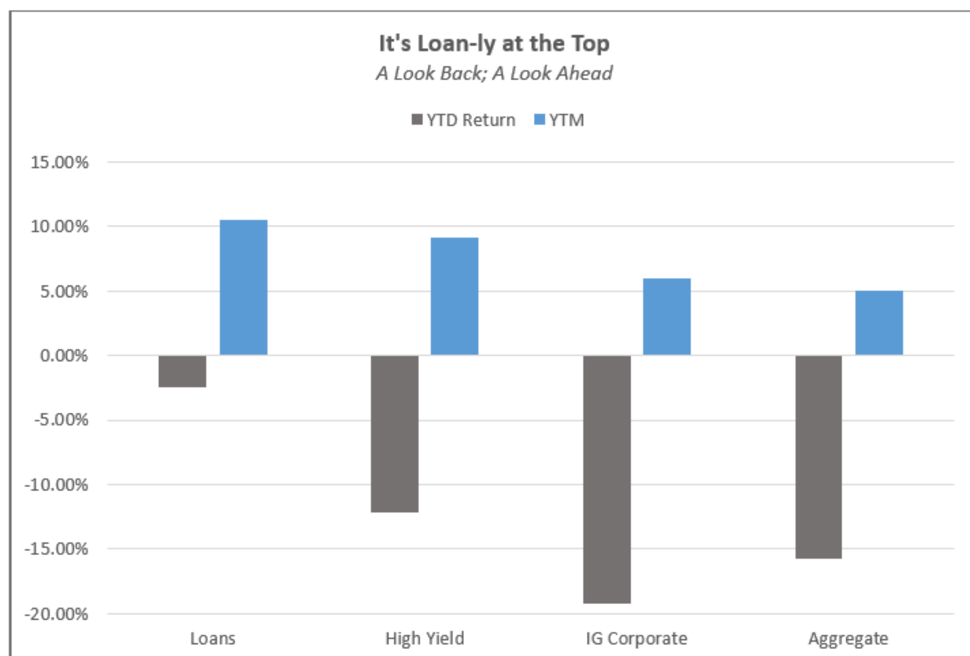
Boston - In this remarkable year for fixed income investing, we recap for investors what we are seeing, what we are doing and what we are thinking. Spoiler alert: We see loans as a spotlight opportunity in fixed income.

What we are seeing

It's been a year of bifurcations and paradoxes in loan land. Capital markets are sharply lower on both sides of the 60/40 divide, weighed upon by the impact of rising discount rates and input costs as well as the uncertainties of potential recessionary risks ahead. By contrast, our senior secured corporate loan asset class stands tall in the year-to-date performance tables, outperforming equity and bond markets alike, and by a remarkably cavernous margin. It's *loan-ly* at the top.

The drivers of loan outperformance have been the asset class' familiar and longstanding calling cards: the absence of bond duration that's roiled fixed-rate markets and a preferred credit profile that tends to draw consistent institutional buyers. It has also helped that loan coupons have adjusted higher and higher with each hike in short-term policy rates. Taken together, the "price" component of total return has benefited from semi built-in "stabilizers," while the "income" element has been contributing more and more.

The paradox? Intermediary clients were allocating to the asset class with resolve earlier this year, ahead of recent Fed hikes (and presumably for the benefit of them) at a time when loans were trading in the $98 to $98.5 price context and a yield-to-maturity of 4% to 4.5%. Meanwhile, loan fund payouts have nearly doubled from their start-of-year levels, yet there are now only muted flows into loan products despite trading around $92 to $92.5 and a yield-to-maturity over 10%. The takeaway: Loans are cheap in both absolute and relative terms. Opportunity knocks.



Source: Credit Suisse Leveraged Loan Index, ICE BofA US High Yield Index, ICE BofA US Corporate Index and Bloomberg US Aggregate Bond Index as of October 31, 2022.

What we are doing

To be sure, there are real risks unfolding, pun intended. Markets have moved on from the duration sell-off (following which many bond

market watchers say the "pain is now in") to today, more pressingly, the earnings picture, credit risk and the potential for defaults ahead. Like stocks, high yield bonds and other corporate asset classes, the loan market is indeed cyclical in its fundamental ups and downs.

Given the collective weight of factors like higher input and debt service costs, declining business and consumer confidence, major declines in equities and so on, it would be natural to expect a pick up in the number of trouble spots, and indeed we do.

We believe the key is to be as shored up as possible and that's precisely how we're spending our days. Our investment team is 40 strong and we've been hard at work re-underwriting and reaffirming portfolio credits, resizing or in some cases exiting positions where appropriate. We do this in the normal course, but at times like these the mission takes on even more importance.

To share an example, we've recently dissected our holdings for names with fixed charge coverage beneath 1.2 times, a liquidity level generally held to be sort of a minimum stall speed. We conducted the same analysis early this year, before the large spike in inflation and short-term rates, and the percentage of portfolios that fall into this camp has risen only five percentage points since then. We find most of these credits indeed have redeeming qualities — for example, low loan-to-value loans or still-improving COVID names. Our "watch list" of credits that we are truly concerned with in the near term is limited.

What we are thinking

There remains a chorus of media pundits and market strategists delivering clients an oversimplified view of our asset class: "Defaults will rise, so avoid." This misses the forest between the trees, however, for what matters isn't an absolute level or up/down direction but rather "what's priced in" versus the actual losses given the rate of default that unfolds. We think this more nuanced analysis leads to bullish resolve, while the shorter-shrift approach leads to fear and missed opportunity.

In the headlines, much has been made about the larger single-B belly of our asset class, but consider that more than 90% of B-rated loans are sponsor-backed deals in which shrewd private equity firms are keen to keep their shirts. By looking after their own equity interests, they in turn help "shore up" the senior debt that sits above.

Elsewhere much ink has been spilled on how higher interest costs will squeeze issuers. Few seem to talk about or frankly know that many issuers have indeed hedged their loan coupons. Estimates are that some 50% to 75% of loans outstanding have their floating coupons swapped to fixed rates for the next couple of years. So rising payouts to investors do not equal 1:1 higher debt service for issuers. Not to mention that issuers collectively entered this period on historically strong credit footing.

In the final analysis, we most often find ourselves "doing the math" for clients, and we'll do it here. Take the eight-point price discount (the flip side of today's $92 price) and extrapolate an implied forward default rate based on expected recoveries. If a conservative 70% recovery level is used — for historical context, the S&P Global Loss Database shows a multi-decade average of 75% — today's market price pre-bakes a 27% forward default experience ahead.

For context, that's about double the experience of the global financial crisis and more than five times the deep but short COVID recession. By contrast, the current default rate is below 1%, and our expectations are for per annum levels to rise while remaining in the lower single digits. Much more draconian levels are already "priced in." So even if fundamentals get worse, we think returns can get better.

It isn't a non sequitur to have a bullish-sounding tone at a time of heightened credit stresses. To be sure, some of best-ever returns for this asset class overlapped directly with sharply rising defaults — 2009 and May to December 2020 are the best examples. That's because the market became deeply oversold ahead of these periods, just like now, leaving prices to rebound markedly as fundamentals and technicals *eventually* returned to equilibrium.

The key word above is *eventually*, as we're not calling for a beeline back to par. Calling the bottom in any asset class is a fool's errand. Prices in the near term are by definition unpredictable. Lengthening the time horizon a bit, historical experience suggests that allocations made at these levels have been some of the most rewarding.

Bottom line: Here are a few ways to think about the loan allocation for investor portfolios right now:

Loans can be a powerful income generator, and yields could continue to track higher with the Fed. If investors need income, we believe this market is an answer.

Loans are a bond diversifier, consider 2022 as Exhibit A. Duration may indeed make sense following the bond market sell-off, but loans are a hedge.[1]

Finally, many investors are maxed out on private market holdings, given the denominator effect of falling markets elsewhere and investment policy statements that limit private holdings. We think loans can complement private credit with comparable if not higher prospective returns, along with greater liquidity and a larger cap profile to boot.

Wherever you may place them, we see loans as an opportunistic multivitamin for portfolios today.

[1] Diversification does not eliminate the risk of loss.

The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.**

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