Floating-Rate Loans | Leveraged Credit

The "anti-bond" rides again — Loans excel as diversifiers in volatile 1Q21

By: Andrew N. Sveen, CFA | & Christopher Remington | April 12, 2021

Boston - A number of years ago, we first described floating-rate loans as the "anti-bond" for their potential to provide valuable diversification when traditional bonds sell off. Loans lived up to that name in dramatic fashion during the first quarter — the most volatile period since the onset of the pandemic a year ago, as investors grappled with the prospects of stronger growth and higher inflation.

Also, quite dramatically, duration was transformed from textbook fixed-income jargon to a real-life factor with bite. For a large part of four decades, bond investors have had no better friend than duration, which specifies the sensitivity of a bond's price to interest-rate moves (up or down).

Investors got a reminder last quarter that it cuts both ways —when rates rise, long-duration bonds lose value. The yield on the 10-year U.S Treasury almost doubled to 1.74%, as of March 31, and when the dust settled, most major fixed-income sectors were deep in the red for the quarter.

Except for floating-rate loans, and to a smaller extent, high-yield bonds.

Because the yield on loans can adjust with short-term rates, their duration is near zero. Last quarter proved that thanks to zero duration, loans can offer unique diversification in a portfolio even before short-term rates advance. For example, as the table below shows, the 1.8% return on loans was 500 basis points greater than the 3.4% loss on the Bloomberg Barclays U.S. Aggregate Index.

Loans rose to the top as other bond sectors sold off in 1Q21

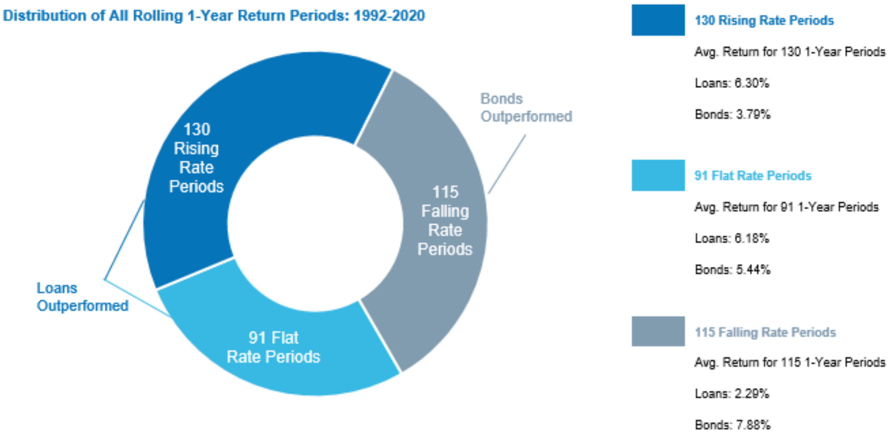
	1Q21 Total Return	Duration (years)	Yield on 3/31/2021
Floating-Rate Loans	1.80%	0	4.4%
High-Yield Bonds	0.90%	4	4.3%
Municipal Bonds	-0.35%	5.3	1.2%
Mortgage-Backed Securities	-1.10%	4.1	1.8%
Bloomberg/Barclays U.S. Agg	-3.37%	6.4	1.6%
U.S. Treasury	-4.25%	6.8	1.0%
Emerging Markets Debt (hard currency)	-4.54%	7.9	5.3%
US. Corp. Investment Grade	-4.65%	8.5	2.3%

Sources: Eaton Vance, S&P/LSTA, Bloomberg, as of 3/31/21. Data provided is for informational use only. Past performance is no guarantee of future results. It is not possible to invest directly in an Index. Loans are represented by the S&P/LSTA Leveraged Loan Index, an unmanaged index of the institutional leveraged loan market. High-yield bonds are represented by the ICE BofA U.S. High Yield Index, an unmanaged index of below-investment-grade U.S. corporate bonds. Municipal bonds are represented by the Bloomberg Barclays Municipal Bond Index, an unmanaged index of municipal bonds traded in the U.S. Mortgage-backed securities are represented by the Bloomberg Barclays U.S. Mortgage Backed Securities (MBS) Index, which measures agency mortgage-backed pass-through securities issued by GNMA, FNMA and FHLMC. The Bloomberg Barclays U.S. Aggregate Index is included as a broad measure of U.S. investment-grade bonds, and an unmanaged index comprising domestic investment-grade bonds, including corporate, government and mortgage-backed securities. U.S. Treasury is represented by the Bloomberg Barclays U.S. Treasury Index, which measures public debt instruments issued by the U.S. Treasury. Emerging markets debt is represented by the J.P. Morgan Emerging Markets Bond Index (EMBI) Global Diversified, an unmanaged index of USD-denominated bonds with maturities of more than one year issued by emerging markets governments. U.S. corporate investment-grade is represented by the Bloomberg Barclays U.S. Corporate Investment Grade Index, an unmanaged index that measures the performance of investment-grade corporate securities within the Bloomberg Barclays U.S. Aggregate Index.

One important takeaway from the results in the table is that even bonds of high credit quality are vulnerable to rising rates — and the longer the duration, the more vulnerable they are. Consider two investment-grade categories with comparable yields: mortgage-backed securities (MBS) and investment-grade corporate debt. With a duration of 4.1 years, MBS lost 1.1% last quarter while corporate debt, with a duration of 8.5 years, lost 4.7%. With just one exception in the table, the longer the duration, the worse the performance.

The track record shows that the first quarter was no fluke. In 336 rolling one-year periods since 1992, loans have outperformed bonds, on average, during 130 rising rate periods. (See chart below.) Of course, there are no assurances that rates will keep rising, so it is equally impressive to note that loans outperformed bonds during the 91 periods in which rates were flat.

1Q21 was no fluke: Since 1992, loans have outperformed bonds when rates rise



Sources: Eaton Vance, Credit Suisse, Bloomberg, U.S. Federal Reserve as of 12/31/2020. Data provided is for informational use only. Past performance is no guarantee of future results. It is not possible to invest directly in an index. Loans are represented by Credit Suisse Institutional Leveraged Loan Index and bonds are represented by the Bloomberg Barclays U.S. Aggregate Index. Analysis includes all rolling one-year periods since inception of Credit Suisse Institutional Leveraged Loan Index in February 1992.

As of March 31, 2021, the 4.40% yield on the S&P/LSTA Leveraged Loan Index was the highest available on domestic fixed-income sectors. To us, this could represent a "win-win" position — the inflationary/rising rate scenario doesn't have to materialize for investors to benefit.

Bottom line: The 1Q21 bond market sell-off underscores how valuable "anti-bond" loans can be in portfolio diversification — potentially even more so if short rates start to rise. Loans may offer an excellent tool for investors to prepare for the changing risk profile of today's bond market.

Loans are traded in a private, unregulated interdealer or interbank resale market and are generally subject to contractual restrictions that must be satisfied before a loan can be bought or sold. These restrictions may impede the strategy's ability to buy or sell loans (thus affecting their liquidity) and may negatively impact the transaction price. It may take longer than seven days for transactions in loans to settle. Due to the possibility of an extended loan settlement process, the strategy may hold cash, sell investments or temporarily borrow from banks or other lenders to meet short- term liquidity needs. Loans may be structured such that they are not securities under securities law, and in the event of fraud or misrepresentation by a borrower, lenders may not have the protection of the anti-fraud provisions of the federal securities laws. Loans are also subject to risks associated with other types of income like high-yield bonds described above. Investments in foreign instruments or currencies can involve greater risk and volatility than U.S. investments because of adverse market, economic, political, regulatory, geopolitical, currency exchange rates or other conditions. Changes in the value of investments entered for hedging purposes may not match those of the position being hedged.

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