LORD ABBETT

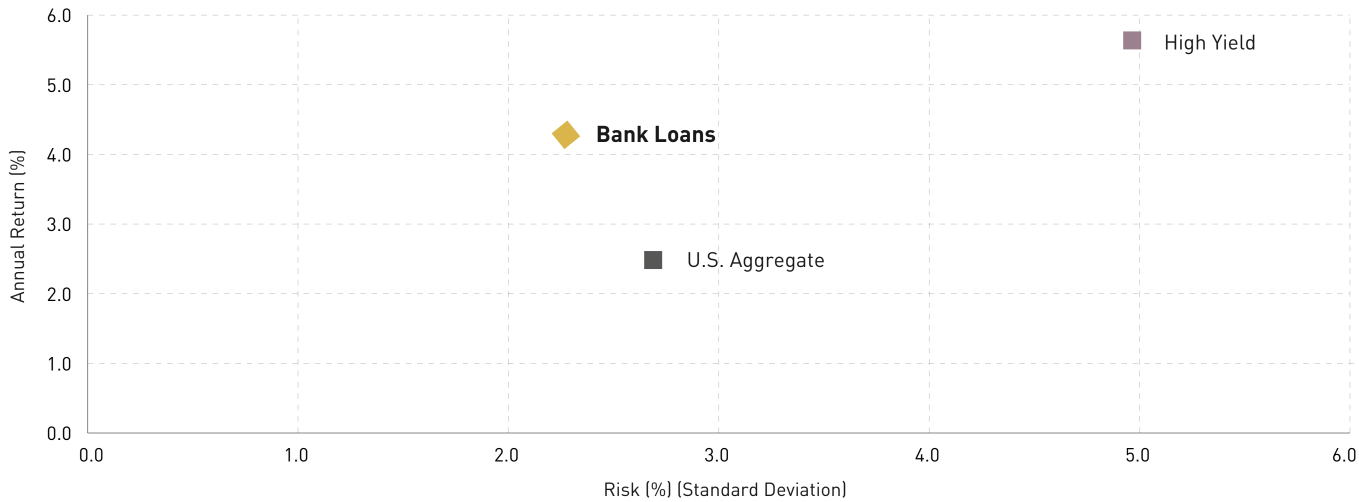
MARKET VIEW

BANK LOANS: GETTING A FIX ON FLOATING RATE

Investors may have questions about the asset class amid concerns about changing credit conditions. Here, we provide some helpful context.

CHART 1. BANK LOANS HAVE PROVIDED ATTRACTIVE RISK-ADJUSTED RETURNS IN RECENT YEARS

TRAILING FIVE-YEAR ANNUAL RETURN AND VOLATILITY (STANDARD DEVIATION), AS OF AUGUST 31, 2018



	RETURN (%)				SHARPE RATIO	
As of 08/31/2018	YTD	1 Year	3 Year	5 Year	3 Year	5 Year
Bank Loans	**3.65**	**5.29**	**4.96**	**4.27**	**1.59**	**1.63**
U.S. Aggregate	-0.96	-1.05	1.76	2.49	0.35	0.72
High Yield	1.93	3.27	7.06	5.64	1.15	1.02

Source: Morningstar. Bank Loans=Credit Suisse Leveraged Loan Index. U.S. Aggregate=Bloomberg Barclays U.S. Aggregate Bond Index. High Yield=ICE BofAML U.S. High Yield Index.

Performance quoted above is historical. Past performance is not a reliable indicator or guarantee of future results. The historical data are for illustrative purposes only, do not represent the performance of any specific portfolio managed by Lord Abbett or any particular investment, and are not intended to predict or depict future results. Investors may experience different results. Bank loans are often less liquid than other types of debt instruments. Due to market volatility, the market may not perform in a similar manner in the future. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.

IN BRIEF

- While bank loans have delivered higher risk-adjusted returns than other major fixed-income segments in recent years, investors may have concerns, based on media accounts, of weakening credit conditions.
- To be sure, certain recent developments, including a decrease in the level of covenant protection, may increase the potential for lower recoveries on loans in the next default cycle.
- But the key, of course, is when the credit cycle will turn. With the U.S. economy appearing to be on sound footing, we believe the environment for bank loans should remain favorable.

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Floating-rate bank loans had another positive month of returns in August 2018, with the representative Credit Suisse Leveraged Loan Index (the Loan Index) up 3.65% year to date through August 31. By comparison, the broad investment-grade benchmark, the Bloomberg Barclays U.S. Aggregate Bond Index (Aggregate Index), posted a negative return of 0.96% for the same period.

In fact, loans have outperformed the Aggregate Index over the trailing one-, three-, and five-year periods, and, given their lower volatility when compared to high-yield bonds, have generated higher risk-adjusted returns than both investment-grade and high-yield bonds over the past five years. (See Chart 1.)

Throughout this period of strong performance, there have been a number of articles in the financial press highlighting the potential risk in the asset class, especially given the prevalence of "covenant-lite" loans (see box, "Covenant-Lite Loans: A Closer Look"). A recent *Wall Street Journal* article cited a Moody's report that lowered the credit rating agency's expectations for recoveries on bank loans in the case of default in the next credit downturn to 61%, versus the long-term average recovery rate of 77%.[1]

Should investors in floating-rate bank loans be concerned? While we get many questions from investors when such stories appear, these developments are not new news to experienced investors in the loan market.

Certainly, some aspects of the loan market have changed over time. Not only has there been a reduction in the amount of covenant protection in a typical loan deal but also there has been an increase in the number of companies opting to borrow in the loan market over the high-yield bond market. As leveraged loans have taken share from high-yield bonds, the size of the loan market has grown to more than $1 trillion (based on the market value of the Loan Index, as of August 31, 2018), rivaling the size of the U.S. high-yield market (as represented by the Bloomberg Barclays U.S. High Yield Index). This also has led to an increasing proportion of "loan-only" borrowers in the Loan Index. While loans maintain the senior position in a company's capital structure, the increase in loan-only capital structures means there is less subordinated debt as a cushion below the senior position.

Given some of these trends—an increase in loan-only borrowers, a decrease in the level of covenant protection, and a change in the ratings mix for the loan index—we would agree that there is the potential for lower recoveries on loans in the next default cycle.

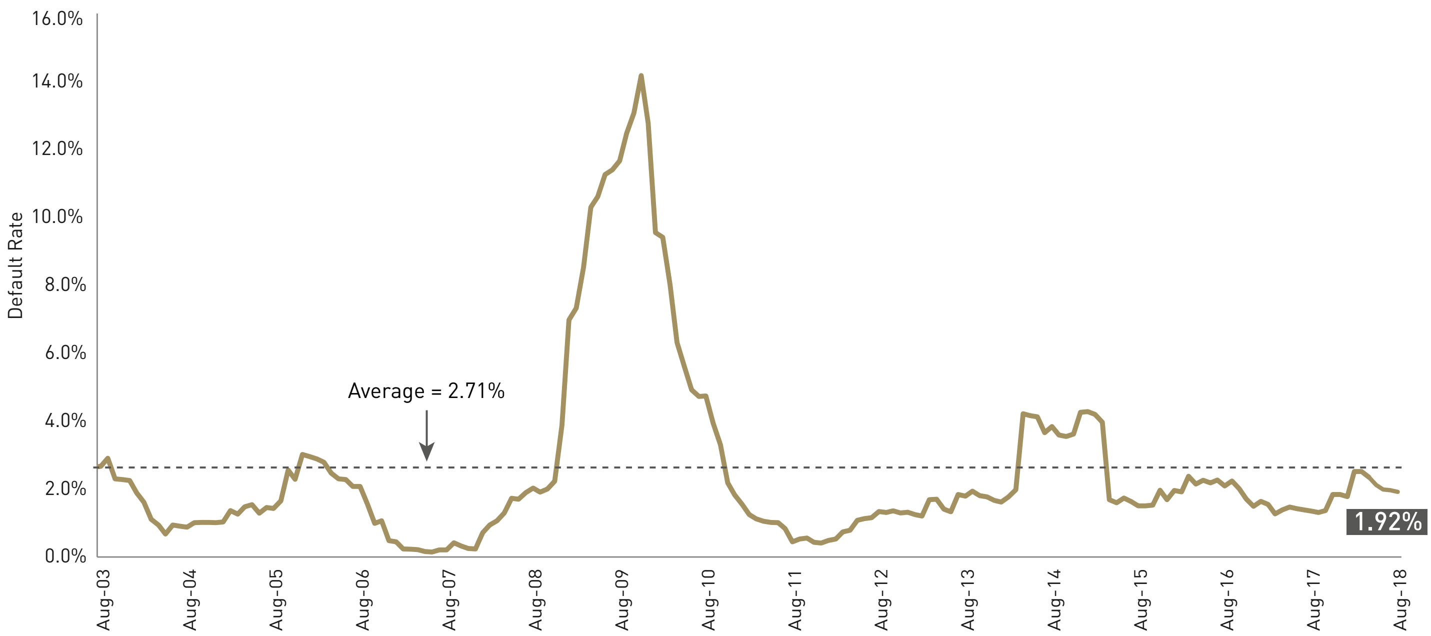
The question, however, is in the timing of that next cycle. We surely don't know exactly when it will occur, but there are a few things to consider.

The current U.S. credit environment is quite benign. According to J.P. Morgan research, there were no defaults in the month of August for either high-yield bonds or bank loans. In fact, over the trailing four months, there have been only two companies that have defaulted, affecting a total of $1 billion in bonds and loans—the lightest volume over a four-month stretch in more than a decade. Over the trailing 12 months, the default rate for loans has been running below 2.0%, based on data from J.P. Morgan. (See Chart 2.)

Further, based on research from both J.P. Morgan and Credit Suisse, defaults are expected to remain quite low over the next year.

CHART 2. BANK-LOAN DEFAULTS HAVE REMAINED LOW

U.S. LEVERAGED LOAN-DEFAULT RATE (PAR WEIGHTED BY VOLUME), AS OF AUGUST 31, 2018



Source: J.P. Morgan.

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Even Moody's, in its report highlighting structural risks to the loan market, reiterated its expectations that the default rate should remain low, and may actually decline over the next 12 months.

Expected economic growth is another important input in assessing the health of a credit cycle. In that regard, the current U.S. economic backdrop remains solid:

- *GDP growth*—The U.S. Bureau of Economic Analysis recently raised its estimate for second-quarter gross domestic product (GDP), to 4.2%, the highest level in four years.
- *Employment*—The August jobs report from the U.S. Bureau of Labor Statistics showed the U.S. economy added 201,000 jobs for the month, ahead of estimates, with the unemployment rate holding steady, at 3.9%.
- *Corporate profits*—The U.S. Commerce Department recently reported 16.1% year-over-year growth in corporate profits in the second quarter of 2018, the fastest growth rate in six years.
- *Manufacturing*—The August manufacturing index from the Institute for Supply Management rose to the highest level in 14 years, indicating continued strength in the factory sector.

At some point, though, there will be a period of economic weakness, which will lead to increased credit difficulties among highly leveraged borrowers. In that case, there likely will be an increase in defaults, with lower recoveries on bank loans relative to previous cycles. (Even if loan recoveries drop to 61%, that would still compare favorably to the recovery rates of 30–40% typical of unsecured bonds.) But for now, it appears that it may be some time before that occurs.

In the meantime, loans continue to offer a source of high current income, without the duration exposure of traditional fixed-rate bonds. As illustrated in Chart 3, the average coupon in the Loan Index has adjusted higher (to 5.80%, as of September 6) along the rise in short-term rates. Market consensus suggests another two rate hikes by the U.S. Federal Reserve in 2018, which should translate to higher coupons for floating-rate loans.

So, how should one approach the loan market? While many tend to focus on the direction of interest rates with floating-rate loans, the key to this asset class is credit. Given the potential for credit issues lurking in the future, we would emphasize that bank loans are not an asset class where a passive approach would be prudent. Successful investment in bank loans requires in-depth credit research by experienced analysts with a deep understanding of the issuers and industries in which they compete. In addition, thorough covenant analysis, collateral analysis, and a strong grasp of the nuances of deal structures are vital to understanding your protection as a lender. At Lord Abbett, we believe an active approach can allow our investment team to adjust the portfolio for the market environment, moving across the credit-quality spectrum, identifying those industries and individual issuers that present the best risk/reward opportunities, while avoiding those issuers and deal structures that pose risks to lenders.

But what if the U.S. economy were to suffer a downturn? Of course, that likely would not be a good environment for bank loans (nor for other risk asset classes such as high-yield bonds and equities). Typically, long-duration, government-related securities would fare well in such a scenario. In today's environment, however, such securities come with significant duration risk, and would

CHART 3. BANK-LOAN COUPONS HAVE FLOATED HIGHER

AVERAGE COUPON RATE IN THE CREDIT SUISSE LEVERAGED LOAN INDEX, SEPTEMBER 6, 2013–SEPTEMBER 6, 2018

Source: Credit Suisse. For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment.

suffer in a period of rising rates. With the economy appearing to be on sound footing, the environment for bank loans should remain favorable. [*Bank loans, of course, are not without risks. The principal risks associated with bank loans are credit quality, market liquidity, default risk and price volatility.*]

Summing Up

The varying market and economic environments of the past decade underscore the importance of strategic diversification within fixed-income portfolios. We believe one sensible approach would be to include allocations to bank loans (which tend to fare well in a stable to improving economy) and high-quality core bonds (which typically do well in a slowing economy or periods of increased volatility), along with short-duration credit and high-yield bonds (which would provide additional sources of high income with limited interest-rate sensitivity). ■

[1]Matt Wirz, "Leveraged Loans Not as Safe as They Once Were," The Wall Street Journal, August 18, 2018.

COVENANT-LITE LOANS: A CLOSER LOOK

Covenants are part of the credit agreement between borrowers and lenders that spell out the terms of the loan and the obligation of the borrower, thus providing protection to the lender. Over time, so-called "covenant-lite" loans, which typically have fewer restrictions than conventional loans, have become a larger part of the market, and now account for more than 75% of the benchmark Credit Suisse Leveraged Loan Index.

While investors would always prefer more lender protection, two points should be kept in mind:

1. "Covenant lite" does not mean "no covenants" at all. Covenants come in many forms, including affirmative, which spells out what the borrower must do; negative, which limits the company's ability to take certain actions that could be credit negative; and financial, which enforces minimum levels of financial performance the company must maintain. While covenant-lite loans may have fewer covenants, their credit agreements still contain many stringent requirements regarding the borrower's financial condition and ability to meet principal and interest payments.
2. Covenants alone, however, imply very little about the overall credit risk of a loan. Other financial measures, such as leverage, interest coverage, collateral valuation, credit rating, use of proceeds, and, from a broader perspective, industry dynamics and the competitive position of a company, provide greater insight to the credit risk of a deal.

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IMPORTANT INFORMATION

A Note about Risk: The value of an investment in fixed-income securities will change as interest rates fluctuate and in response to market movements. As interest rates fall, the prices of debt securities tend to rise. As interest rates rise, the prices of debt securities tend to fall. High-yield securities, sometimes called junk bonds, carry increased risks of price volatility, illiquidity, and the possibility of default in the timely payment of interest and principal. Bonds may also be subject to other types of risk, such as call, credit, liquidity, interest-rate, and general market risks. Lower-rated bonds carry greater risks than higher-rated bonds. The principal risks associated with bank loans are credit quality, market liquidity, default risk and price volatility. While bank loans are secured by collateral and considered senior in the capital structure, the issuing companies are often rated below investment grade and may carry higher risk of default.

Moreover, the specific collateral used to secure a loan may decline in value or become illiquid, which would adversely affect the loan's value. Longer-term debt securities are usually more sensitive to interest-rate changes; the longer maturity of a security, the greater the effect a change in interest rates is likely to have on its price. No investing strategy can overcome all market volatility or guarantee future results.

Neither diversification nor asset allocation can guarantee a profit or protect against loss in declining markets.

There is no guarantee that the floating-rate loan market will perform in a similar manner under similar conditions in the future.

Forecasts and projections are based on current market conditions and are subject to change without notice. Projections should not be considered a guarantee.

Any examples provided are for informational purposes only and are not intended to be reflective of actual results.

Glossary

A **coupon** is the annual interest rate paid on a bond, expressed as a percentage of the face value.

Duration is the change in the value of a fixed-income security that will result from a 1% change in market interest rates. Generally, the larger a portfolio's duration, the greater the interest-rate risk or reward for underlying bond prices.

Sharpe ratio is a way to examine the performance of an investment by adjusting for its risk. It is the average return earned in excess of the risk-free rate per unit of volatility or total risk.

Standard deviation is a measure of the dispersion of a set of data from its mean.

Treasuries are debt securities issued by the U.S. government and are secured by its full faith and credit. Income from Treasury securities is exempt from state and local taxes.

The **ICE BofA Merrill Lynch U.S. High Yield Index** tracks the performance of U.S.-dollar denominated below investment grade corporate debt publicly issued in the U.S. domestic market.

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The **Credit Suisse Leveraged Loan Index** is designed to mirror the investable universe of the U.S. dollar-denominated leveraged loan market.

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