What Investors May Be Missing on Floating Rate Loans

Those focused on short-term movements in interest rates may not realize floating rate bank loans' historical track record of providing attractive income and effective portfolio diversification.

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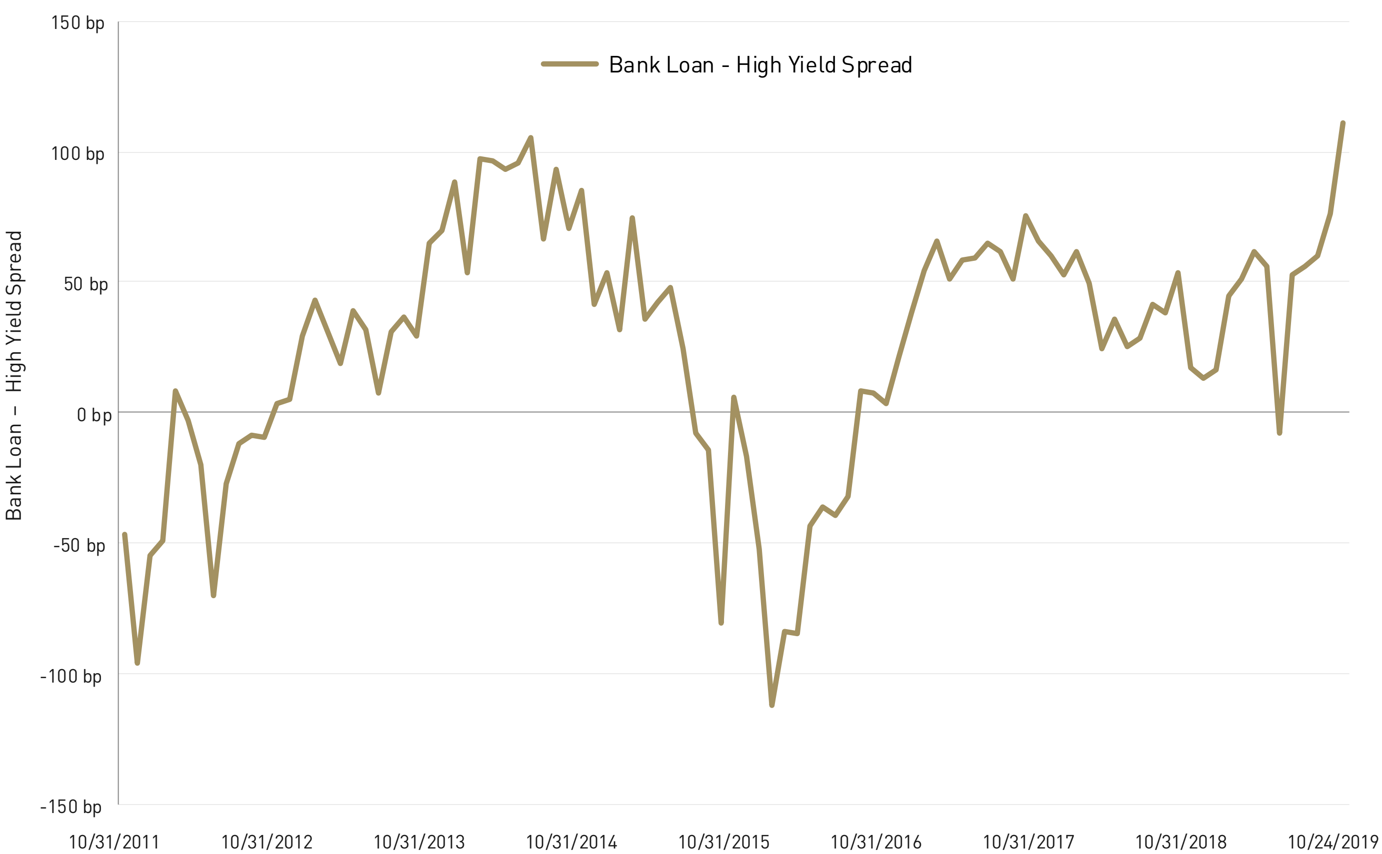
Chart 1. Spread Differential: Bank Loans Versus High Yield
As of October 24, 2019



Sources: CS Leveraged Loan Index (spreads indicated by 3-year Discount Margin [DM], BAML U.S. High Yield Index (option-adjusted spreads). The information shown is for illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment. Indexes are unmanaged and are not available for direct investment. **Past performance is not a reliable indicator or a guarantee of future results**.

In Brief

- It is clear that retail investors have tactically allocated in and out of bank loans in the past, with the primary driver of flows being predictions of interest rate moves.
- Despite the concerns about the asset class indicated by flow data, we believe bank loans have delivered an attractive return profile for investors over the years.
- Heightened concerns over liquidity risk and credit risk have led to a large divergence in returns within both the high yield and bank loan markets, creating potentially interesting opportunities for active managers.

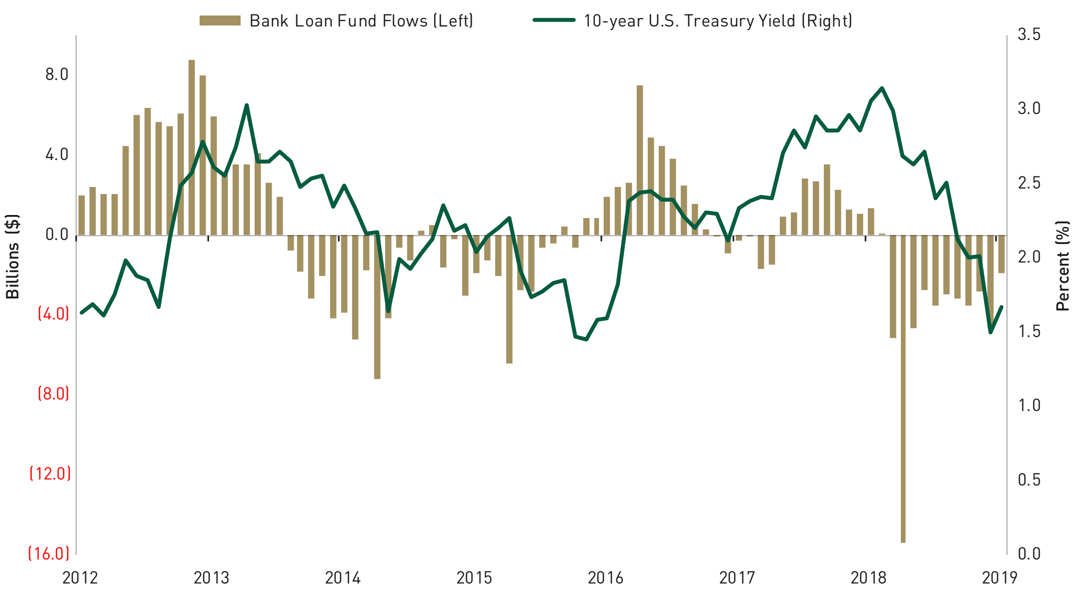
It has often been said that investors would be well-served to stick to long-term asset allocation plans, and limit their tactical movements based on emotions or predictions of short-term market moves. Another common refrain is that correctly predicting the direction of interest rates has historically been very difficult to get right with any consistency, even by professional forecasters.

With that as a backdrop, we thought it would be interesting to review retail mutual fund flows in the floating rate loan market.

Chart 2 details the monthly flows in and out of the Morningstar Bank Loan mutual fund category, compared to the yield in the 10-year U.S. Treasury bond. It is clear that retail investors have tactically allocated in and out of the asset class, with, we believe, the primary driver of flows being predictions of interest rate moves.

Chart 2. Bank Loan Fund Flows Have Been Driven by Rate Expectations

Bank loan fund flows versus U.S. Treasury Yields (as of September 30, 2019)



Sources: Strategic Insight (Morningstar Category Fund Flows), Bloomberg (Treasury Yield).

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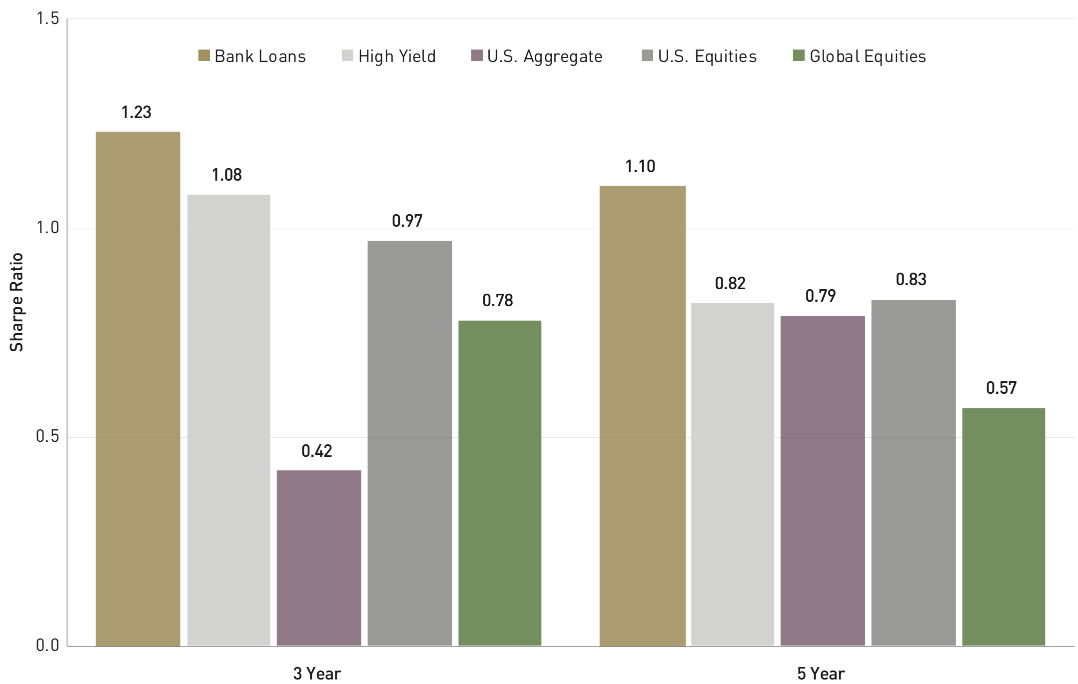
There are a few distinct periods illustrated here:

- **March 2012-March 2014:** The category received cumulative inflows of approximately $88 billion, with assets peaking at $155 billion. During this period, the yield on the 10-year Treasury rose by over 150 basis points (bps), peaking at over 3.0%.
- **April 2014-April 2016**: As the 10-year bond yield retraced back to below 1.50%, $58 billion exited the category and assets in the category declined to below $100 billion.
- **June 2016-October 2018**: 10-year bond yields rose to approach 3.25%, $46 billion flowed back into the category, bringing assets back up to the previous peak of $155 billion.
- **November 2018–September 30, 2019:** Over $50 billion has left the asset class as rates have declined. With the yield on the 10-year bond revisiting the low in yields seen in mid-2016, category assets have returned to the lows seen at that time.

What if investors had maintained their allocation to bank loans? Chart 3 summarizes risk-adjusted returns of major asset classes over the trailing three and five years ended September 30, 2019. While longer duration core bonds, represented by the Bloomberg Barclays U.S. Aggregate Bond Index (U.S. Aggregate), have had a strong rally over the past year amid the sharp drop in U.S. Treasury yields, over the past three and five years, bank loans (as measured by the Credit Suisse Leveraged Loan Index) have outperformed the U.S. Aggregate, and have done so with lower volatility. And given their lower volatility, bank loans have also provided higher risk-adjusted returns (as measured by the Sharpe ratio) than high yield bonds and equities. In short, despite the aversion to the asset class indicated by flow data, bank loans historically have delivered an attractive return profile for investors.

Chart 3. In Our Opinion, Loans Have Delivered Attractive Risk-Adjusted Returns

As of September 30, 2019



Source: Bank Loans=CS Leverage Loan Index, High Yield=ICE BAML U.S. High Yield Constrained Index, U.S. Equities=S&P 500® Index, Global Equities=MSCI ACWI Index, U.S. Aggregate=Bloomberg Barclays U.S. Aggregate.

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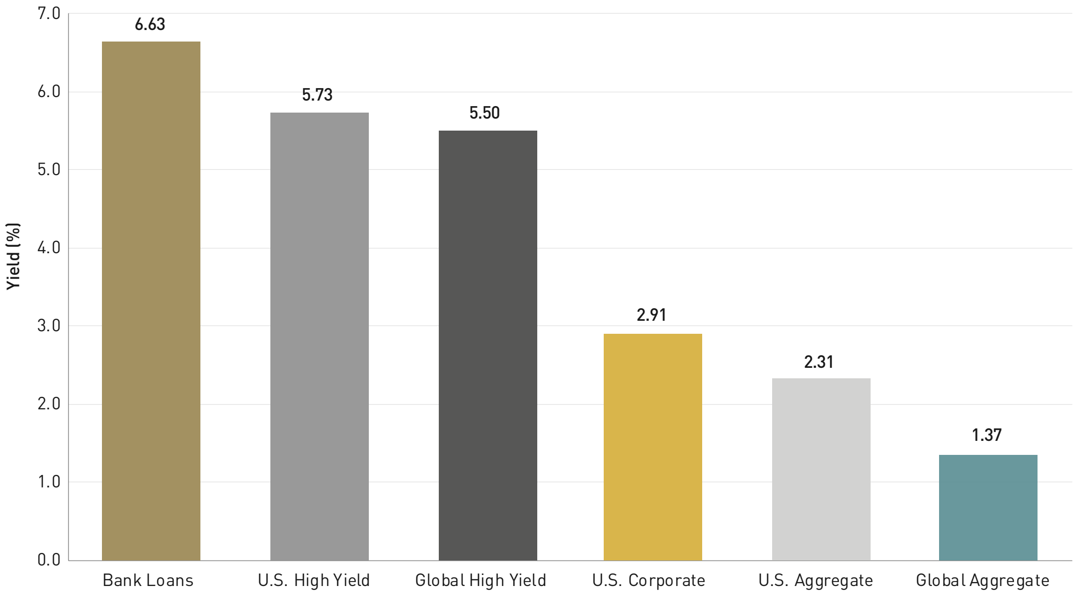
Chart 4. Loans Have Offered High Yield Relative to Other Fixed-Income Sectors

As of September 30, 2019



Source: Bank Loans=CS Leverage Loan Index, U.S. High Yield=BAML U.S. High Yield Loan Index, Global High Yield= BAML Global High Yield Index, U.S. Corporate=Bloomberg Barclays Corporate Index, U.S. Aggregate=Bloomberg Barclays U.S. Aggregate, Global Aggregate=Bloomberg Barclays Global Aggregate.

Note: yield indicated for bank loans is yield to 3-year average life; all others are yield to worst. The information shown is for illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment. Indexes are unmanaged and are not available for direct investment.

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What about going forward? Bank loans offer certain characteristics that may be appealing in today's environment:

1. **Income** — While floating rate coupons have come down as short-term rates have declined, the average index coupon of 5.7% still provides high current income relative to certain other asset classes. With an average dollar price of $95.4, the index yield on the benchmark Credit Suisse Leveraged Loan Index is higher than most fixed income sectors, including high yield bonds. (All data as of October 24, 2019.)

2. **Portfolio diversification** — Loans provide exposure to credit while core bond allocations are primarily exposed to moves in rates. As a result, a blended portfolio of loans and core bonds historically has had lower volatility than the U.S. Aggregate index on its own. With negative correlation to core bonds, and low correlation with equities, an allocation to bank loans may provide additional portfolio diversification.

3. **Relative value** — Below investment grade credit has done relatively well in 2019, as the market recovered from the risk-off environment seen in late 2018. While spreads have compressed across credit sectors, the move in loans has lagged the move in high yield. Because of this dynamic, the Credit Suisse Leveraged Loan Index now offers a pick-up of over 100 bps in credit spread (see Chart 1) over high yield bonds. This is unusual, especially when considering loans have senior, secured position over unsecured bonds.

Beyond the relative value across bank loans and high yield, there have been interesting moves within the loan market. While spreads have compressed this year, that has been driven by the largest, most liquid names in the market.

Table 1. Spreads Have Compressed But We Believe There is Opportunity in the Lower-Tier Credit Quality Segment
As of October 24, 2019

BANK LOAN SPREADS			
By Rating	**12/31/2018**	**10/24/2019**	**Change**
CS Loan Index	550	507	-43
Upper Tier	391	264	-127
Middle Tier	573	540	-33
Lower Tier	1,203	1,446	+243

Source: CS Leveraged Loan Index. (Spreads indicated by 3-year DM.) Tiers are brackets of credit scores used by financial institutions.

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Heightened concerns over liquidity risk and credit risk have led to a large divergence in returns within both the high yield and bank loan markets creating what we believe are interesting opportunities for active managers. Moving into lower credit ratings brings on higher levels of credit risk. But when the additional compensation to move into those segments of the market reaches elevated levels, potential for outsized excess returns can present themselves. Of course, rigorous fundamental credit research—a key feature of actively managed bank-loan strategies—is required to navigate this segment of the market.

The fund flow data would suggest that many retail investors have largely turned their backs on this asset class, basing their allocation on their call on the direction of interest rates. It is important to remember that mutual funds make up a very small segment of the market: now less than 10% of a $1.2 trillion market. The overwhelming majority of the market is held by collateralized loan obligations (CLOs) and other institutional investors that have much longer investment horizons. With net issuance of loans down by over 35% year-to-date versus the same period last year (according to JP Morgan, as of October 25, 2019), and healthy demand from CLOs, there remain positive supply/demand circumstances for loans.

Summing Up

We believe that there is a lot of pessimism priced into many segments of the market, and the low real yields in the market are pricing in a much more negative outcome than, in our opinion, we are likely to experience. From our perspective, we believe the U.S. economy is not in imminent danger of recession, which leads us to see better opportunity in equity and credit markets than in duration or rates. For investors looking for a source of potential high income and low correlation to certain other asset classes – regardless of their view on rates –another look at bank loans may be in order.

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. 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. 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.

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.

This *Market View* may contain assumptions that are "forward-looking statements," which are based on certain assumptions of future events. Actual events are difficult to predict and may differ from those assumed. There can be no assurance that forward-looking statements will materialize or that actual returns or results will not be materially different from those described above.

Glossary

Basis point is a financial unit of measurement that is 1/100th of 1%.

Collateralized loan obligations (CLOs) are structured finance securities collateralized predominantly by a pool of below investment grade, first lien, senior secured, syndicated bank loans, with smaller allocations to other types of investments such as middle market loans and second lien loans. CLO debt issued to investors consists of several tranches, or layers, with different payment priorities and, in turn, differing credit quality and credit ratings.

Correlation is a statistic that measures the degree to which two securities move in relation to each other. A perfect positive correlation means that the correlation coefficient is exactly 1. This implies that as one security moves, either up or down, the other security moves in lockstep, in the same direction. A perfect negative correlation means that two assets move in opposite directions, while a zero correlation implies no relationship at all.

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

A **discount margin (DM)** is the average expected return earned in addition to the index underlying, or reference rate of, the floating rate security.

An **Option Adjusted Spread (OAS)** is the measurement of the spread of a fixed-income and the risk-free rate of return, which is adjusted to take into account an embedded option.

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.

Spread is the percentage difference in current yields of various classes of fixed-income securities versus Treasury bonds or another benchmark bond measure. A bond spread is often expressed as a difference in percentage points or basis points (which equal one-one hundredth of a percentage point).

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.

A **yield spread** is the difference in yield between two bonds, usually of similar maturity but different credit quality.

The **yield to worst (YTW)** is the lowest potential yield that can be received on a bond without the issuer actually defaulting

Yield to average life lets the investor estimate the actual return from a bond investment, regardless of the bond's exact maturity date. The yield to average life calculation assumes that the bond matures on the day given by its average life and at the average redemption price instead of the par price.

The **Bloomberg Barclays Global Aggregate Bond Index** is a broad-based measure of the global investment-grade, fixed-income markets.

The **Bloomberg Barclays U.S. Aggregate Bond Index** is an unmanaged index composed of investment-grade securities from the Bloomberg Barclays Government/Corporate Bond Index, Mortgage-Backed Securities Index and the Asset-Backed Securities Index.

The **Bloomberg Barclays U.S. Corporate Bond Index** includes all publicly held issued, fixed-rate, nonconvertible investment-grade corporate debt.

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

The **ICE BofAML U.S. High Yield Constrained Index** is a capitalization-weighted index of all US dollar denominated below investment grade corporate debt publicly issued in the U.S. domestic market.

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The **S&P 500® Index** is widely regarded as the standard for measuring large cap U.S. stock market performance and includes a representative sample of leading companies in leading industries.

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MV-10-28-19