# The case for floating rate loans

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### New York Life Investments

Our multi-boutique business model is built on the foundation of a long and stable history, which gives our clients proven performance managing risk through multiple economic cycles. With capabilities across virtually all asset classes, market segments, and geographies, our family of specialized, independent boutiques and investment teams allows us to deliver customized strategies and integrated solutions for our clients' needs.

Our investment managers offer deep domain expertise and diversity of thought, generating deeper insights alongside strong conviction to deliver positive outcomes. Our global capabilities combined with local presence drives a more nuanced perspective and a greater personal experience for our clients.

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### Making the case for floating rate loans

Given the recent increase in demand, it's hard not to notice that floating rate mutual funds and exchange-traded funds (ETFs) have experienced high calendar year inflow since 2013, and collateralized loan obligations (CLOs), the largest buyers of floating rate loans, attained record level issuance — meaning that overall demand has been exceptionally strong.

This paper will not only provide insight into the evolution of floating rate loans but will provide practical applications for how to take advantage of this asset class within a portfolio.

# Figure 1: The floating rate loan market has almost doubled since 2013



Source: Credit Suisse Leveraged Loan Index, as of 3/31/23. \* Market Value of Index.



Not FDIC/NCUA Insured	Not a Deposit	May Lose Value	
No Bank Guarantee	Not Insured by Any Government Agency		

### The evolution of the floating rate loan market

Beginning in the 1980s, banks started offering floating rate loans (also known as leveraged loans, bank loans, or senior secured loans) to large corporations in need of capital - thereby creating the floating rate loan market. Then, in the early 90s, commercial lenders syndicated loans among banks and more sophisticated investors to create access to capital for non-investment-grade companies considered to be higher risk.

### Figure 2: The floating rate loan market has evolved into a mature \$1.3 trillion asset class



The first floating rate loan closed-end mutual fund was launched, providing retail investors access to a market segment previously available only to large institutions and accredited investors. Without a developed secondary market, floating rate loans were generally considered illiquid; therefore, floating rate mutual funds did not gain significant market share relative to other fixed income securities.

### 1992

The Credit Suisse Leveraged Loan Index was created, providing a benchmark for floating rate loans. In 1995, Standard & Poor's and Moody's began rating floating rate loans, which are categorized as "noninvestment grade" due to their credit risk. The remainder of the 1990s saw steady growth in investor interest in floating rate loans - with assets nearly tripling by the end of the decade. The U.S. Securities and **Exchange Commission** directed bank fund managers to use "mark-to-market" data from third-party pricing services to determine the value of floating rate loans for portfolio-valuation purposes. Previously, most fund managers were valuing the loans based on their internal valuation processes. "Mark-to-market" pricing is based upon actual market levels which led to increased transparency and greater liquidity.

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The first senior floating rate loan open-end mutual fund with daily liquidity was offered — a major step forward since floating rate mutual funds introduced prior to that point were closed-end interval funds that offered only guarterly or monthly redemptions.

The banks syndicating these loans were highly disciplined and rule-oriented in their lending, and many aspects of these practices continue today within the floating rate market. For instance, most borrowers pledge assets such as inventories, receivables, plant property and equipment, and shares of stock as collateral. Since floating rate loans are backed by collateral and considered senior secured debt, they rank higher in the capital structure giving them seniority over unsecured debt or equity shareholders in the case of default.





### **Characteristics of floating rate loans**

Compared to bonds, floating rate loans are considered unique and interesting because of three main characteristics:

- Floating coupon. Floating rate loans pay a spread over a reference rate, which is a short-term rate that can reset every 30, 60, or 90 days. During a rising rate environment, this can be advantageous for investors since the income generated can increase as short-term rates rise (unlike fixed-coupon investments that are more likely to be exposed to duration risk and the associated price declines when rates rise).
- Capital structure seniority. As illustrated in Figure 3, floating rate loans are senior debt meaning they have the highest priority claims on the borrower's assets and seniority over subordinated debt, senior unsecured debt, and subordinated unsecured debt, as well as preferred and common stock.
- Secured lending. Floating rate loans are generally secured through the pledge of assets of the borrower. This pledge is specified in the Credit Agreement — a contract between the lender and the borrower that dictates the terms of the loan. Collateral may include inventory, real estate, receivables, intellectual property, and stock.

Due to both capital structure seniority and their secured nature, floating rate loans may help investors reduce the risk of credit loss. Since 2003, recovery rates for floating rates loans (the amount of principal that lenders and investors can receive in the event of a default) have averaged 65%, compared with 43% for high-yield bonds (see **Figure 4**).

### Figure 4: Historically, floating rate loans have had higher recovery rates than bonds Average recovery rates





### Two types of financial covenants – Incurrence and maintenance

Covenants are part of credit agreements and come in several forms. Recently, covenant-lite ("cov-lite") has become the norm in the floating rate loan market and, as such, it is important to understand what that means.

COMMON COVENANT EXAMPLES FOR FLOATING RATE LOANS					
Incurrence covenants	Maintenance covenants				
<ul> <li>These covenants place limits on the business decisions companies can make while the loan is outstanding, such as:</li> <li>Paying dividends or distributions</li> <li>Acquiring other companies</li> <li>Increasing their debt obligations</li> <li>Selling assets or using them as collateral</li> </ul>	<ul> <li>These covenants are tests the borrower must pass on a regular basis (e.g., quarterly) to remain in compliance with the credit agreement. Examples include:</li> <li>Maintaining maximum debt-to-EBITDA ratio</li> <li>Maintaining a minimum EBITDA-to-interest ratio</li> <li>Limiting capital expenditure spending</li> <li>Keeping a minimum tangible net worth ratio</li> </ul>				

A cov-lite loan lacks maintenance covenants but still has incurrence covenants. All high-yield bonds can be considered cov-lite because they too do not have maintenance covenants. The use of maintenance covenants is a holdover from the early days of the asset class when loans were held on a bank's balance sheets and not sold to investors. As the market matured, many floating rate loan investors were comfortable with cov-lite loans – perhaps since they were used to them from the bond market.

In today's market, the overwhelming majority of loans coming to market are cov-lite. In fact, close to 90% of the floating rate loan market does not have maintenance covenants.<sup>1</sup> This is in stark contrast to over a decade ago when only a quarter of the market was cov-lite. Typically, loans that require maintenance covenants are lower in quality and require stricter covenants in order to obtain financing.



Figure 5: Covenant lite is now the norm for floating rate loans

Source S&P Global Market Intelligence, as of 6/30/23.

Most importantly, covenants don't pay lenders their money back and are not a substitute for performing credit analysis. Since floating rate loan issuers are non-investment-grade, having an active manager with a disciplined process is critical. Active managers can assess the financial health of individual borrowers and discern potential return opportunities, as well as avoid weaker issuers who may run into problems.

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# Practical applications: Floating rate loans in a portfolio

### **Rising rate participation**

Over the last 30 years, there have been five periods of Fed rate hikes. Floating rate loans significantly outperformed investment-grade bonds in each of those periods, as shown in **Figure 6**. Since floating rate loans pay a fixed spread over a reference rate, the coupons paid to investors increase as the reference rate increases.

# Figure 6: Floating rate loans outperformed investment-grade bonds when the Fed hiked interest rates



	Periods of rising rates						
	2/3/94–2/1/95	6/30/99-5/16/00	6/29/04-6/29/06 12/17/15-12/20/18		3/17/22-9/29/23		
Floating rate loans	9.33%	3.09%	10.73%	16.04%	10.94%		
10-year Treasurys	-7.40	-0.09	3.37	0.74	-14.37		
Core bonds	-2.04	1.40	6.06	5.73	-9.06		
U.S. corporates	-2.78	-0.43	6.01	9.92	-7.73		
Fed Funds starting rate	3.00	5.00	1.00	0.50	0.50		
Fed Funds ending rate	6.00	6.50	5.25	2.50	5.50		
Rate increase	300 bps	150 bps	425 bps	200 bps	500 bps		

Sources: FactSet Research Systems and Morningstar, as of 9/30/23. 10-year Treasurys are represented by the ICE BofA Current U.S. Treasury 10-year Index. Core bonds are represented by the Bloomberg U.S. Aggregate Bond Index. Corporates are represented by the ICE BofA U.S. Corporate Index. Floating rate loans are represented by the Credit Suisse Leveraged Loan Index. Past performance is no guarantee of future results. An investment cannot be made directly into an index. Refer page 14 for the index definitions.

### Rates do not all rise equally

When rising rates are mentioned in the context of Fed policy, it is short-term rates that are being discussed. However, most core bond portfolios are exposed to longer-term rates, such as the 10-year U.S. Treasury. So, regardless of Fed policy, rising rates across the yield curve can negatively affect bond portfolios.

The most recent 10-year low was in the summer of 2021. From that low through 9/30/23, the 10-year increased nearly fourfold from 1.2% to 4.6% as inflation rose sharply following the COVID-19 pandemic. This put pressure on more rate sensitive asset classes such as core bonds and investment grade corporate bonds which both declined more than 15% over the period. Floating rate loans were up 11.4%, outperforming investment grade bonds by an astonishing 2700 bps. This highlights the importance of diversification and the need to balance risks within fixed income allocations.

# Figure 7: Floating rate loans were a rare bright spot amid sharply increasing Treasury yields



Source: FactSet, as of 9/30/23. Floating rate loans are represented by the S&P/LSTA U.S. Leveraged Loan 100 Index. High yield are represented by the ICE BofA U.S. Core bonds are represented by the Bloomberg U.S. Aggregate Bond Index. Corporate bonds are represented by the ICE BofA U.S. Corporate Index. Past performance is no guarantee of future results. An investment cannot be made directly into an index. Refer page 14 for the index definitions.

### Generating income while reducing portfolio duration

Floating rate loans usually generate considerably more yield than investment-grade asset classes without the duration. High-yield and emerging market debt have modestly higher yields, but like investment grade, they have longer durations and, therefore more interest-rate sensitivity. Floating rate loans are a potential way of generating income while reducing portfolio duration.



Figure 8: Floating rate loans offer a compelling yield per unit of duration

Source: FactSet, S&P Global Market Intelligence, as of 8/31/23. Yield is represented by Yield to Worst. Yield to Worst is an estimate of the lowest yield that you can expect to earn from a bond when holding to maturity, absent a default. Duration is represented by Modified Duration to Worst. Modified Duration to Worst calculates the yield change to the priced to worst date; generally used to reflect the behavioral characteristics of a bond as of a specific price/yield and date; always calculated to the priced to worst date, including all call features. Floating rate loans are represented by the S&P/LSTA Leveraged Loan Index. Core bonds are represented by the Bloomberg U.S. Aggregate Bond Index. Corporate bonds are represented by the ICE BofA U.S. Corporate Index. High yield is represented by the ICE BofA U.S. High Yield Index. Short duration corporates are represented by the ICE BofA 1-3 Year U.S. Cash Pay High Yield Index. Emerging market debt is represented by the JP Morgan EMBI Global Diversified Index. Past performance is no guarantee of future results. An investment cannot be made directly into an index. Refer page 14 for the index definitions.

# Maintaining a strategic allocation within a portfolio

In addition to attractive levels of income with virtually no duration, floating rate loans can be a welcome source of diversification given their historically low (or negative) correlation to nearly all other traditional asset classes.

The correlation coefficient indicates the strength and direction of the relationship between the movement of two investments. If two securities are perfectly correlated — that is, they have a correlation of 1.00 — their prices move in lockstep with one another. A correlation coefficient of -1.00 would indicate that two investments move in exactly the opposite direction from one another. Diversifying a portion of the portfolio with investments that are not highly correlated may help reduce volatility in a portfolio.

As **Figure 9** illustrates, the performance of floating rate loans over the last ten years has been markedly different from other fixed-income assets or even U.S. equities.

# Figure 9: Historically, floating rate loans have a low correlation to other traditional asset classes

Asset class' correlation to floating rate loans (ten-year period, from 8/31/2013–8/31/2023)							
	Municipal bonds	Treasurys	Core bonds	Corporate bonds	High Yield bonds	Stocks	Floating rate loans
Municipal bonds	1.00	0.71	0.85	0.81	0.51	0.31	0.29
Treasurys	0.71	1.00	0.92	0.65	0.09	0.01	-0.20
Core bonds	0.85	0.92	1.00	0.88	0.43	0.30	0.14
Corporate bonds	0.81	0.65	0.88	1.00	0.71	0.54	0.53
High Yield bonds	0.51	0.09	0.43	0.71	1.00	0.79	0.81
Stocks	0.31	0.01	0.30	0.54	0.79	1.00	0.61
Floating rate loans	0.29	-0.20	0.14	0.53	0.81	0.61	1.00

Source: Morningstar, as of 8/31/23. Correlation expresses the strength of relationship between distributions of returns between two data series. Municipal bonds are represented by the ICE BofA Current U.S. Treasury 10-Year Index. Core bonds are represented by the Bloomberg U.S. Aggregate Bond Index. Corporate bonds are represented by the ICE BofA U.S. Corporate Index. High yield bonds are represented by the ICE BofA U.S. High Yield Index. Stocks are represented by the S&P 500 Index. Floating rate loans are represented by the S&P/LSTA Leveraged Loan Index. Past performance is no guarantee of future results. An investment cannot be made directly into an index. Refer page 14 for the index definitions.

High-yield bonds are more closely correlated to floating rate loans, which makes sense given that many companies issue both bonds and loans. These two asset classes are more credit sensitive than rate sensitive and benefit from improving credit conditions. However, in recent years, the markets have become more bifurcated. Since 2007, the number of companies that issue both bonds and loans has modestly increased. On the other hand, the number of loan-only issuers has tripled since 2013. Since there are more unique issuers present in each market, the two asset classes can complement each other. Therefore, there is room for both bonds and loans in a portfolio — it doesn't have to be mutually exclusive.



Figure 10: Loan-only borrowers have grown rapidly over the past ten years

Source: JP Morgan, as of 6/30/23.

### Implementing a floating rate loan allocation

Mutual funds that focus on floating rate loans can offer an effective way to access the potential benefits of the asset class. These professionally managed portfolios can comfortably fit a floating rate loan allocation into nearly any size portfolio and offer all the conveniences of mutual fund investing — such as dividend reinvestment and daily pricing and liquidity. Careful investors will look for portfolio managers who have deep expertise within this unique market, a disciplined investment process, and a proven track record through multiple economic cycles.

With floating rate loans, managing for credit risk is often more important than interest rate or duration risk in seeking opportunities for return. Active managers have an advantage in this market because of their ability to assess the financial health of individual borrowers and discern potential return opportunities where risk is mispriced.

Passive investment vehicles, such as ETFs, may offer easy and inexpensive access to the floating rate loan market. However, they are potentially at risk for underperforming active managers. Credit selection is just one area where active floating rate managers may shine. Active managers are also able to diversify their portfolio holdings by issuer or sector to help control exposure to risk. Trading and portfolio management processes can also be key points of differentiation.

For more information on investing in floating rate loans and asset allocation tips for constructing a more resilient portfolio within a rising rate environment, visit us at: <u>newyorklifeinvestments.com</u>

# The New York Life Investments Approach

At New York Life Investments, we believe that aggressively positioned portfolios have underperformed more in times of credit stress than they outperformed during times of credit prosperity. Therefore, we construct portfolios with a quality bias because they likely result in a less volatile, more attractive return profile.

We entered the floating rate loan market in 1994 and currently manage \$7.7 billion in floating rate loans for both retail and institutional investors — including the general account of New York Life Insurance Company. Because of our heritage, there is an ingrained conservatism through our entire investment process — from credit analysis of individual loans through building and managing portfolios, to continually monitoring risk in portfolios after positions are added.

Even if lower-quality loans don't default, they are much more volatile than the rest of the market. In fact, not only do CCCs have more downside capture than upside capture over the last ten years, but their downside capture is twice that of the market (see **Figure 11**).





Source: LCD, 6/30/13 – 6/30/23. Loans represented by the Credit Suisse Leveraged Loan Index. Down-capture ratio measures how the fund performed relative to the index during periods when index has fallen. It is not possible to invest directly in an index. Past performance does not guarantee future results.

Since it is our view that less volatile and consistent returns provide a more favorable outcome for clients, we generally avoid CCCs. Even when CCC prices are depressed, we remain disciplined in our process that consists of in-depth credit analysis, allowing us to underwrite loans in which we have high conviction in the issuer's long-term prospects. Through careful credit selection and an investment process that incorporates risk management at every step of the way, we believe attractive long-term risk-adjusted returns may be achieved.

#### Definitions

Bloomberg U.S. Aggregate Bond Index is a broad base, market capitalization-weighted bond market index representing intermediate-term investment-grade bonds traded in the United States.

Bloomberg U.S. Municipal Index tracks the U.S. dollar-denominated long-term tax-exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds, and prefunded bonds.

Credit Suisse Leveraged Loan Index represents tradable, senior-secured, U.S. dollar-denominated non-investment-grade loans.

ICE BofA 1-3 Year U.S. Cash Pay High Yield Index is a subset of ICE BofA U.S. Cash Pay High Yield Index. It includes all securities with a remaining term to final maturity of less than three years.

ICE BofA Current U.S. Treasury 10-year Index measures the total return performance of U.S. Treasury bonds with an outstanding par that is greater than or equal to \$25 million. The maturity range of these securities is greater than ten years.

ICE BofA U.S. Corporate Index tracks the performance of U.S. dollar-denominated investment-grade corporate debt publicly issued in the U.S. domestic market.

ICE BofA 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. Qualifying securities must have a below investment grade rating (based on an average of Moody's, S&P, and Fitch), at least 18 months to final maturity at the time of issuance, and at least one year remaining term to final maturity as of the rebalancing date.

JPMorgan EMBI Global Diversified Index is a market capitalization weighted, total return index tracking the traded market for U.S. dollar-denominated Brady Bonds, Eurobonds, traded loans, and local market debt instruments issued by sovereign and quasi-sovereign entities.

S&P 500 Index is a stock market index tracking the stock performance of 500 of the largest companies listed on stock exchanges in the United States. It is widely regarded as the standard for measuring large-cap U.S. stock market performance.

S&P/LSTA Leveraged Loan Index is a market value-weighted index designed to measure the performance of the U.S. leveraged loan market based upon market weightings, spreads, and interest payments.

#### **Index Definitions**

Active investing (also called active management) is an investment strategy involving ongoing buying and selling actions by the investor. Active investors purchase investments and continually monitor their activity to exploit profitable conditions. Active management typically charges higher fees.

A **basis point** is one one-hundredth of one percent.

**Bond ratings** are expressed as letters ranging from AAA, which is the highest grade, to C ("junk bonds"), which is the lowest grade. Different rating services use the same letter grades but use various combinations of upper- and lower-case letters to differentiate themselves. To illustrate the bond ratings and their meaning, we'll use the Standard & Poor's format: AAA and AA = high credit-quality investment grade; AA and BBB = medium credit-quality investment grade; BB, B, CCC, CC, C = low credit-quality (non-investment grade), or "junk bonds"; D = bonds in default for non-payment of principal and/or interest.

Diversification is a risk management strategy that mixes a wide variety of investments within a portfolio.

The U.S. 10-year Treasury Note is a debt obligation issued by the United States government with a maturity of ten years upon initial issuance.

1. Source: S&P Global Market Intelligence, 6/30/2023.

#### **Important Disclosures**

All investments are subject to market risk, including possible loss of principal. Diversification cannot assure a profit or protect against a loss in a declining market.

The information presented herein is current as of the date of this report. Any forward-looking statements are based on assumptions concerning future events, and although we believe that the sources used are reliable, the information contained in these materials has not been independently verified, and its accuracy is not guaranteed. The information discussed is strictly for illustrative and educational purposes and is not a recommendation, offer, or solicitation to buy or sell any securities or to adopt any investment strategy. There is no guarantee that any information discussed will be effective or that market expectation will be achieved.

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