INVESTMENT INSIGHTS

Floating rate loans: Not all rates rise equally

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OVERVIEW

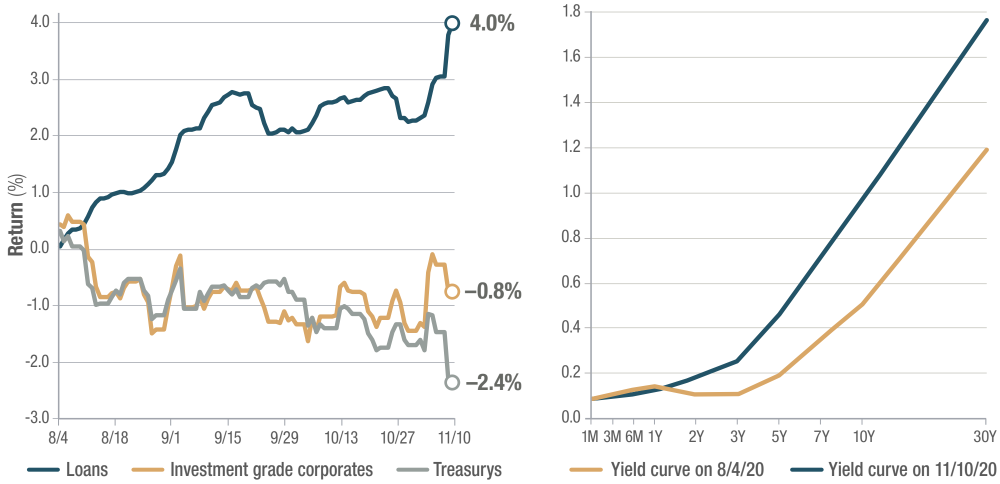
Loans can offer attractive yield potential, relative value opportunity, low interest rate risk, and diversification benefits when longer-term rates are rising — as they are today.

Adam Schrier, CFA
Product Management
New York Life Investments

While investors tend to gravitate towards floating rate loans only when short-term rates — as determined by Fed policy — are expected to increase, they can also benefit a portfolio when longer-term yields (i.e. 10-year Treasury) are rising given their near-zero duration. A small increase in longer-term yields can depreciate enough principal from longer duration assets, like core bonds, to offset a full year's worth of income. Playing defense against duration when the curve is steepening is just as important as playing offense when the Fed is increasing short-term rates.

From August through mid-November, the 10-year Treasury yield almost doubled from its record low of 0.52%, without much movement on the front end of the curve. During this 3-month period of curve steepening, U.S. Treasurys and investment grade corporates sold-off while floating rate loans appreciated in value.

Figure 1: Loans outperformed investment grade corporates as the U.S. Treasury yield curve steepened



Source: Factset and Morningstar, for the period 8/4/20 –11/10/20. Loans represented by the S&P/LSTA Leveraged Loan Index; Investment grade corporates represented by the ICE BofAML Corporate Index; Treasurys represented by the Bloomberg Barclays US Treasury Index. Past performance is no guarantee of future results, which will vary. It is not possible to invest directly in an index.

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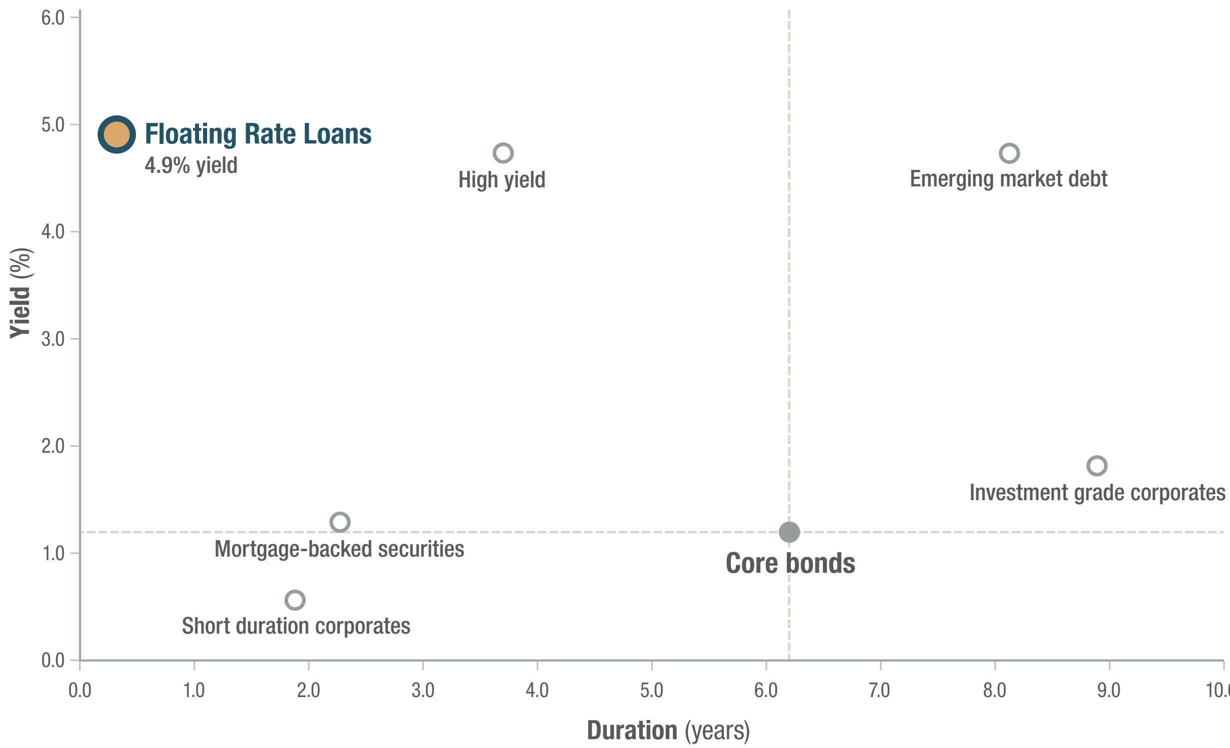
Challenging income environment

With core bonds yielding slightly over 1% and investment grade corporates at less than 2%, generating meaningful income is a challenge.[1] Comparatively, floating rate loans are yielding 4.9%, considerably more than investment grade bonds and comparable to other higher yielding asset classes, but with virtually no interest rate risk. Investors in longer duration asset classes have fared well over the last couple of years, but it is important not to chase yesterday's returns. Duration certainly hasn't been a problem, but it very well may be in 2021.

Figure 2: Floating rate loans offer income without duration



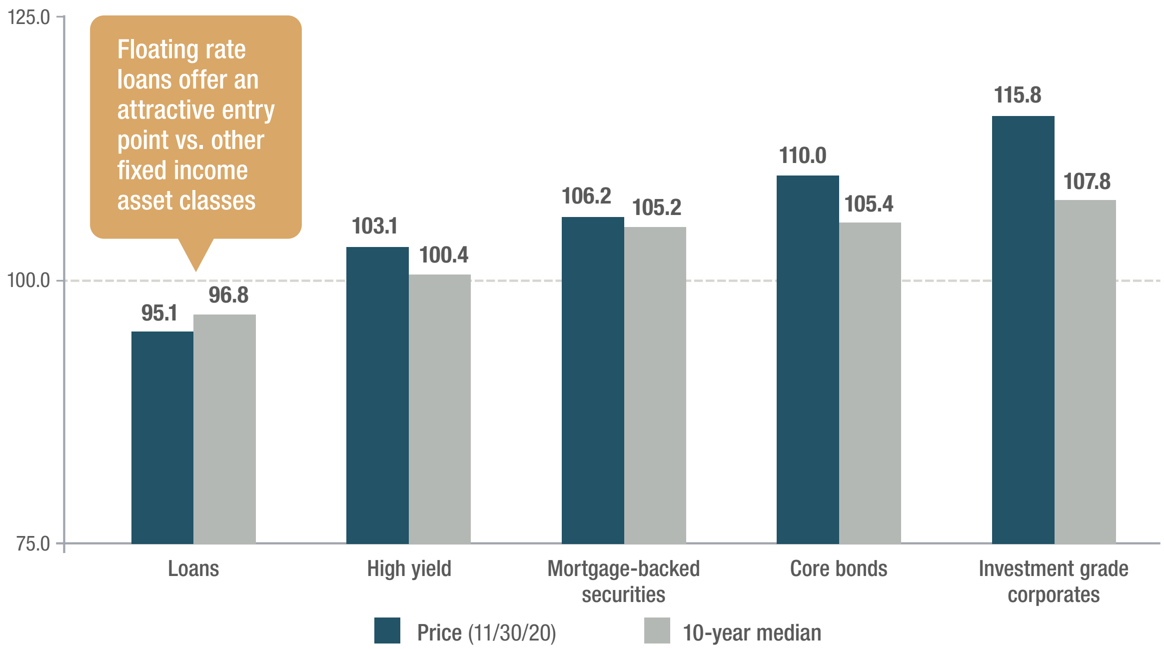
Source: S&P/LSTA, Bloomberg Barclays, ICE Indices, and JP Morgan as of 11/30/20. Loans represented by the S&P/LSTA Leveraged Loan Index; Short duration corporates represented by the Bloomberg Barclays US Corporate 1-3Y Index; Mortgage-backed securities represented by the Bloomberg Barclays US MBS Index; High yield represented by the ICE BofAML US High Yield Index; Core bonds represented by the Bloomberg Barclays US Aggregate Bond Index; Emerging market debt represented by the JPM EMBI Global Diversified Index; Investment grade corporates represented by the Bloomberg Barclays US Corporate Index. Past performance is no guarantee of future results, which will vary. It is not possible to invest directly in an index.

1. Source: Bloomberg Barclays, as of 11/30/20.

Attractive relative value

During the spring of 2020, risk assets responded very favorably to "unlimited quantitative easing" and the various credit facilities put into place to support financial markets. Notably, floating rate loans were not part of any of these programs. The asset class still benefited, as general confidence and a risk-on sentiment positively impacted the market. However, given the propensity of loans to only be in favor amid rising short-term rates, they were not bid up to the same degree as bonds. **Figure 3** compares the price of various fixed income sectors with their respective 10-year medians. Investment grade and high yield bonds are all trading above their 10-year medians while loans, at a five point discount to par, remain below their median.

Figure 3: Current discount to par may help enhance total return opportunity



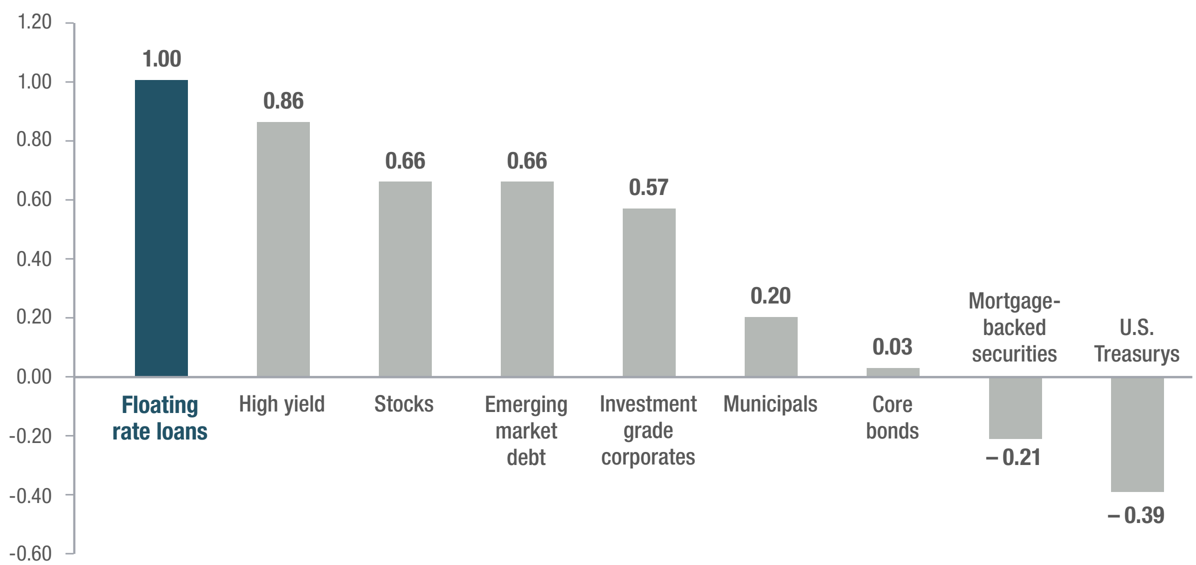
Source: S&P/LSTA and Bloomberg Barclays, for the period 12/31/10–11/30/20. Loans represented by the S&P/LSTA Leveraged Loan Index; High yield represented by ICE BofAML US High Yield Index; Mortgage-backed securities represented by the Bloomberg Barclays US MBS Index; Core bonds represented by the Bloomberg Barclays US Aggregate Bond Index; Investment grade corporates represented by the Bloomberg Barclays US Corporate Index. Past performance is no guarantee of future results, which will vary. It is not possible to invest directly in an index.

Floating rate loans in a portfolio context

The question often comes up, "Which is better, high yield or floating rate loans?" Fortunately, this does not have to be an either-or decision. There is room for both asset classes in a portfolio and loans can function as a complement to high yield bonds. Even though they are both non-investment grade, there are diversification benefits with regard to individual issuers. Many loan issuers don't issue bonds so a loan allocation can provide unique issuer exposures and vice versa. For example, energy is the largest sector in the high yield market at 13%, but it is only 3% of the loan market.

Similarly, fixed-income portfolios with a high exposure to investment grade bonds may benefit from a floating rate allocation. Loans are negatively correlated to U.S. Treasurys, have low correlations to core bonds and municipals, and are moderately correlated to corporates. By investing in loans, an investor may be able to generate incremental yield potential and reduce duration without increasing portfolio risk through diversification.

Figure 4: Floating rate loans can help diversify an investment grade bond portfolio



Source: Morningstar, for the period 12/31/10–11/30/20. Loans represented by the S&P/LSTA Leveraged Loan Index; High yield represented by the ICE BofAML US High Yield Index; Stocks represented by the S&P 500 Index; Emerging market debt represented by the JPM EMBI Global Diversified Index; Investment grade corporates represented by the ICE BofAML US Corporate Index; Municipals represented by the Bloomberg Barclays Municipal Bond Index; Core bonds represented by the Bloomberg Barclays US Aggregate Bond Index; Mortgage-backed securities represented by the Bloomberg Barclays US MBS Index; Treasurys represented by the ICE BofAML US Treasury Index. Past performance is no guarantee of future results, which will vary. It is not possible to invest directly in an index.

In the current environment, rather than considering floating rate loans only to participate in rate hikes, investors can think of the asset class as a defensive play against duration. Longer-term rates are likely to increase before short-term rates, which means reducing duration can mitigate the interest rate risk of a portfolio. By timing the market based on Fed expectations, investors may enter with the masses and lose value in the process. More so, they may see income depreciate as longer duration assets struggle against a steepening curve. Given the current attractive entry point, income generation potential, and reduction in interest rate sensitivity, floating rate loans represent a compelling income solution.

About Risk

Past performance is no guarantee of future results, which will vary. All investments are subject to market risk and will fluctuate in value.

Floating rate funds are generally considered to have speculative characteristics that involve default risk of principal and interest, collateral impairment, non-diversification, borrower industry concentration, and limited liquidity. Liquidity risk may also refer to the risk that the investment may not be able to pay redemption proceeds within the allowable time period because of unusual market conditions, unusually high volume of redemptions, or other reasons. To meet redemption requests, the investment may be forced to sell securities at an unfavorable time and/or under unfavorable conditions.

Foreign securities are subject to interest rate, currency exchange rate, economic, and political risks. These risks may be greater for emerging markets.

Funds that invest in bonds are subject to interest rate risk and can lose principal value when interest rates rise. Bonds are also subject to credit risk, in which the bond issuer may fail to pay interest and principal in a timely manner.

This material represents an assessment of the market environment as of a specific date; is subject to change; and is not intended to be a forecast of future events or a guarantee of future results. This information should not be relied upon by the reader as research or investment advice regarding the funds or any issuer or security in particular.

This material contains general information only and does not take into account an individual's financial circumstances. This information should not be relied upon as a primary basis for an investment decision. Rather, an assessment should be made as to whether the information is appropriate in individual circumstances and consideration should be given to talking to a financial advisor before making an investment decision.

The strategies discussed are strictly for illustrative and educational purposes and are not a recommendation, offer or solicitation to buy or sell any securities or to adopt any investment strategy. There is no guarantee that any strategies discussed will be effective.

Index definitions

Bloomberg Barclays Municipal Bond Index is a rules-based, market-value-weighted index engineered for the long-term tax-exempt bond market.

Bloomberg Barclays US Aggregate Bond Index is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed rate taxable bond market, including Treasurys, government-related and corporate securities, mortgage-backed securities (agency fixed rate and hybrid adjustable-rate mortgage pass-throughs), asset-backed securities, and commercial mortgage-backed securities.

Bloomberg Barclays US Corporate Investment Grade 1-3Y Index is publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity of 1-3 years, liquidity, and quality requirements. To qualify, bonds must be SEC-registered.

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Bloomberg Barclays US MBS Index is a component of the US Aggregate Index. The MBS Index covers the mortgage-backed pass-through securities of Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC).

Bloomberg Barclays US Treasury Index is a market-capitalization weighted index that measures the performance of public obligations of the U.S. Treasury that have a remaining maturity of one year or more.

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

ICE BofAML US High Yield Index tracks the performance of U.S. dollar-denominated below investment grade corporate debt publicly issued in the U.S. domestic market.

ICE BofAML US Treasury Index is an unmanaged index that tracks the performance of the direct sovereign debt of the U.S. Government.

JP Morgan EMBI Global Diversified Index include U.S. dollar-denominated Brady bonds, Eurobonds, and traded loans issued by sovereign and quasi-sovereign entities. The index only includes emerging markets issuers which are defined as countries with a combination of World Bank-defined per capita income brackets and each country's debt restructuring history.

S&P 500 Index is widely regarded as the standard for measuring large-cap U.S. stock market performance.

S&P/LSTA Leveraged Loan Index is a broad index designed to reflect the performance of U.S. dollar facilities in the leveraged loan market.

Definitions

Floating rate loans are commercial loans provided by a group of lenders. A loan is first structured, arranged, and administered by one or several commercial or investment banks, known as arrangers. It is then sold (or syndicated) to other banks or institutional investors. Floating rate loans can also be referred to as leveraged loans, bank loans, or senior secured credits.

Yield curves plot interest rates of bonds of equal credit and different maturities.

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