Invesco Fixed Income Investment Insights

Senior Secured Loans: Looking beyond interest rates

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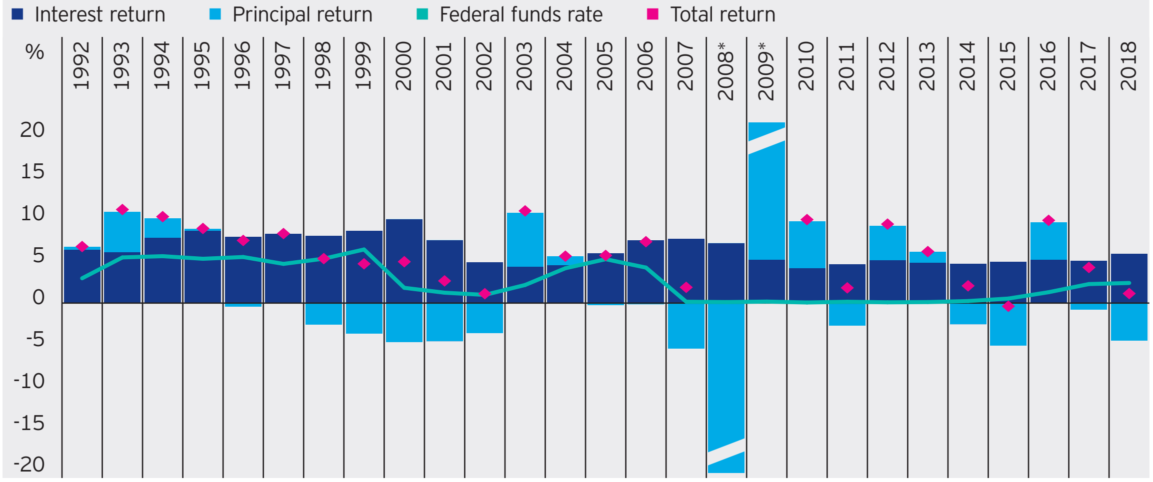
With the US Federal Reserve (the Fed) backing off its previously issued guidance for further rate increases in 2019, some investors have begun to question whether loans still belong in their portfolios amid a static, or potentially declining, interest rate environment. We would take this opportunity to remind investors that interest rates are not the primary driver of loan returns. The floating rate coupon feature is merely one attribute of the asset class. When investing through a cycle it is equally, if not more important, to consider: 1) the overall coupon level that loans pay, inclusive of both LIBOR and a credit spread, and 2) loans are senior secured, and thus typically exhibit lower volatility than junior ranking credit products, such as traditional high yield bonds.

Despite the shift in interest rate outlook since the end of 2018, senior secured loans have provided investors with a high level of income, relatively low volatility, and low duration thus creating potential diversification benefits when incorporated into investors' strategic asset allocation. Historically, senior secured loans' overall coupon - not net increases in reference rates - have been the primary driver of returns and have contributed to the overall stability of the asset class. In fact, dating back to 1992 loans have only produced two years of negative total returns (2008 and 2015) as the asset class' high coupon has more than compensated investors for price declines.[1] In both instances of negative returns, senior secured loans produced a strong rally the following year. We believe that loans' return profile consisting of a relatively high coupon rate, low volatility, and a low correlation to traditional asset classes supports the argument for loans to be a strategic allocation in investor's portfolios, with the opportunity to tactically position based on market conditions.

Figure 1: Senior secured loans have experienced two years of negative returns over 27 years

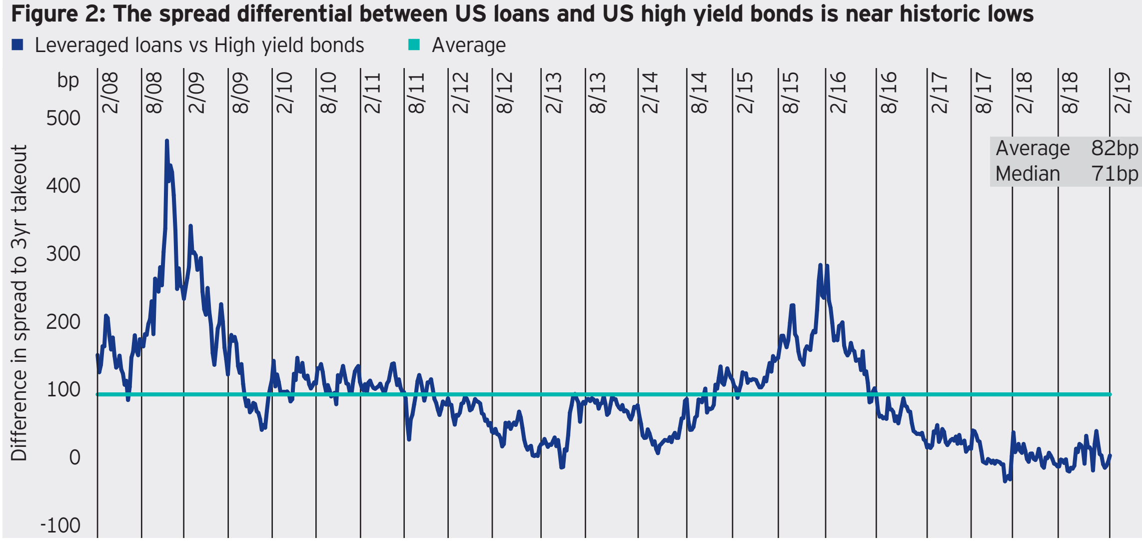


Source: CS LLI from 1992-2018.* 2008 and 2009 results are abridged for illustrative purposes. 2008 results for loans were -29.22%. 2009 loan returns were 51.69%. Past performance is not indicative of future results.

Relative value opportunity

Retail investment vehicles and ETF products have experienced significant outflows over the last several months, mostly driven by market sentiment and a perception – mistaken in our view – that loans have become less attractive as expectations for further interest rate increases have diminished. With global rates remaining near historic lows, and the supply of global bonds yielding below 0% eclipsing USD10 trillion in March,[2] investors have been forced to assume increased degrees of credit risk or duration risk in order to pick up yield. This hunt for yield poses amplified risks as the economic cycle continues to drift into its later stages. Senior secured loans can offer investors who are concerned about the length of the current US economic growth cycle a compelling high return / lower volatility opportunity. If the economy outperforms expectations in 2019 and the rate outlook consequently shifts upwards, loans stand to benefit from their short duration structure, and from the inflows that typically follow rising rate expectations. If the economy underperforms expectations, loans' defensive positioning within issuers' capital structures should help stabilize the asset class relative to other credit products, as occurred during a volatile 2018. In either scenario, loan yields – inclusive of the forward LIBOR curve – continue to best those of high yield bonds, despite the security of being at the top of the capital structure (Figure 2).

Figure 2: The spread differential between US loans and US high yield bonds is near historic lows



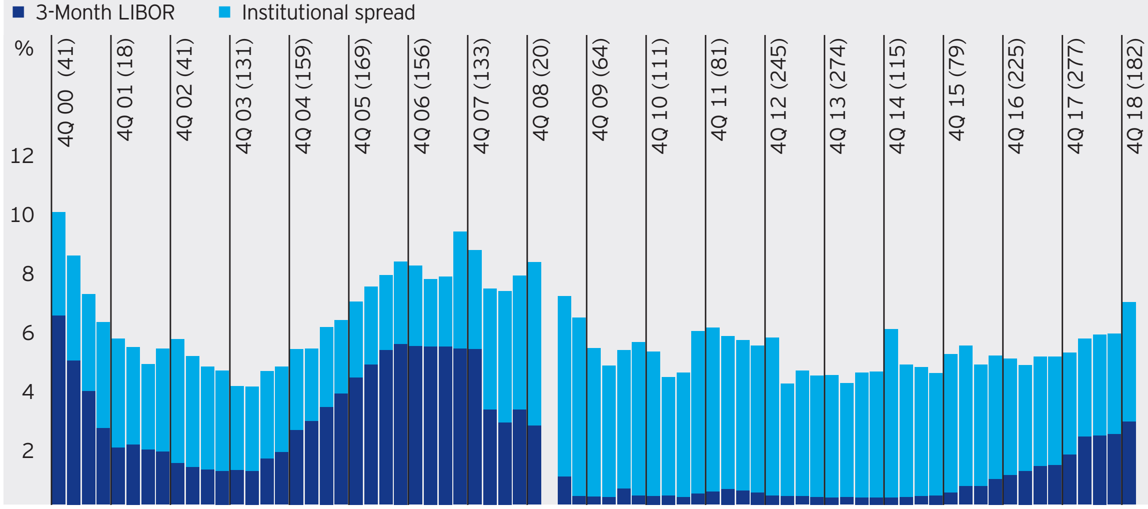
Source: JP Morgan Leveraged loan Index versus JP Morgan US HY Bond Index data as of Feb. 28, 2019. Historical average data from Feb. 1, 2007 to Feb. 28, 2019.

Stable coupon

Although the floating rate nature of loans' coupon may cause modest fluctuations, historically components of the coupon (LIBOR + credit spread) have been inversely related. As LIBOR increases, usually because of macroeconomic strength, strong demand for floating rate loans enables issuers to reprice or refinance their loans – resulting in a decline of the credit spread. Conversely, if LIBOR declines, usually amid macroeconomic weakness, credit spreads have increased to compensate investors for the additional perceived default risk. This dynamic has ultimately resulted in a relatively stable and high coupon rate, regardless of the direction of interest rates.

This inverse relationship was evident during and after the Global Financial Crisis of 2008. As shown in the chart below, LIBOR began to decrease in 1Q 2008 and the credit spreads of new issue loans increased as investors required a larger spread. More recently, as rates have elevated in conjunction with economic recovery, credit spreads have compressed. In summary, while the components of coupon may change, senior secured loans have historically delivered a relatively steady level of current income overall.

Figure 3: Current income: The inverse relationship of LIBOR and credit spreads



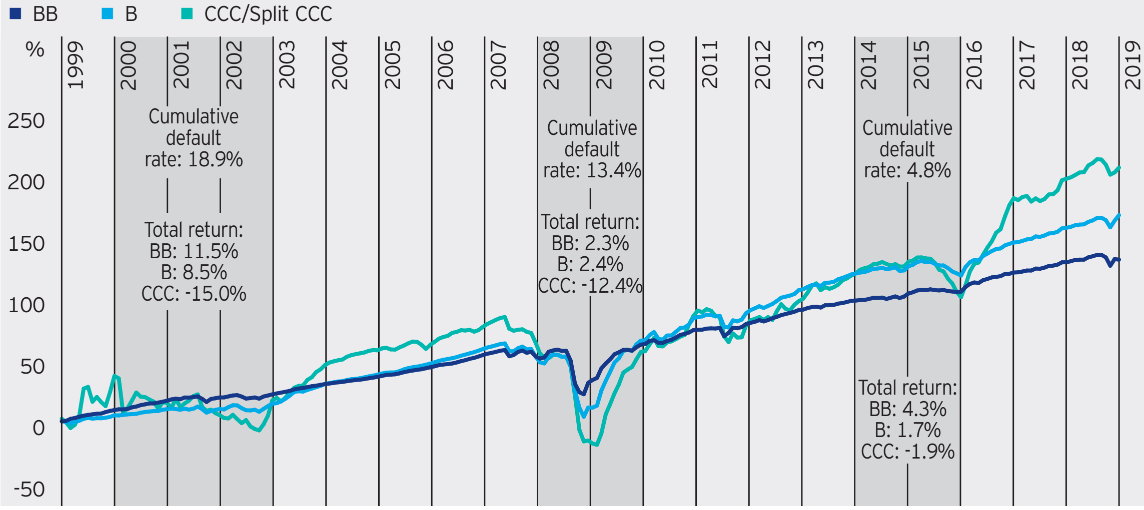
Source: Standard & Poor's LCD and S&P/LSTA Leveraged Loan Index Excludes facilities in default, Dec. 31, 2018. (#) on x-axis represents the number of observations in respective timeframe.

Defensively positioned

Loans' senior and secured status provides investors with a unique credit risk mitigation mechanism that has contributed to the asset class' low historical rate of volatility. As the senior ranking debt in the capital structure and secured by the collateral of the company's assets, interest and principal payments to loans take priority over most other forms of debt and equity. If a company faces financial hardship, loans have a priority claim on the company's assets and are to be repaid first. During instances of default, this translates to senior secured loans recovering 80% of principal on average over the last 30 years (compared to 48% for high yield bonds).[3] With a recovery rate of 80%, and a historical annual default rate of 3%,[4] the historical net credit loss of senior secured loans is a meager 0.6% on average.[5] While over the short term, technical influences can drive prices above or below intrinsic value based on market conditions, we believe it is important for investors to analyze the economic opportunity of the asset class while recognizing that the direction of interest rates is not the primary driver of returns. Prices and spreads can often imply a default rate that is unlikely to be realized, and thus create opportunity for long term investors.

The benefit of loans' senior secured status is further demonstrated when examining the performance of various credit rating categories during periods of economic turbulence and high default rates. As shown in the table below, BB and B rated loans (which comprise a vast majority of the index) have displayed relatively steady returns during periods of increased defaults. Conversely, CCC rated assets, which historically have averaged only 6% of the broader index, are subject to higher levels of volatility, as expected.[1]

Figure 4: Loans have weathered periods of elevated defaults



Source: Returns are from CS LLI from January 1999 to Feb. 28, 2019. Default rates are from S&P/LCD LLI.
Past performance is not indicative of future results.

Potential diversification benefits

Loans' relatively high-income stream, senior and secured structure (resulting in reduced volatility) and floating rate nature (duration of 0.25 years) can result in unique diversification benefits when incorporated alongside a portfolio of traditional fixed income and equities. As shown in the table below, loans have a negative correlation with Treasuries and very low correlation with both equities and investment grade corporate bonds.

Figure 5: Historically, senior secured loans have provided strong diversification benefits

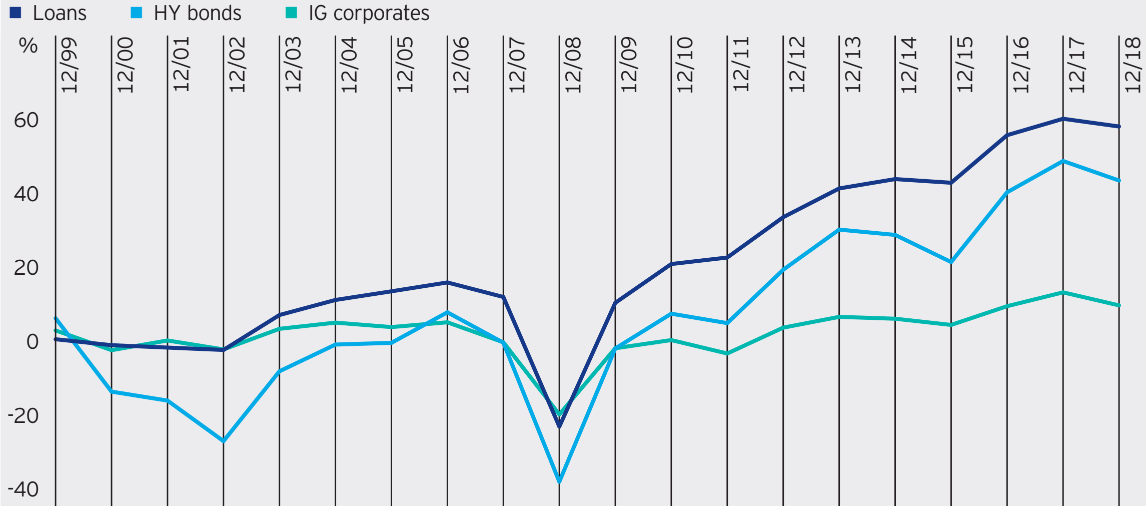
Correlation of assets from 1997-2018

Asset class	Senior secured loans	HY bonds	Treasuries	Equities	IG corporates
Senior secured loans	1.00	0.77	-0.35	0.44	0.34
HY bonds	–	1.00	-0.15	0.63	0.55
Treasuries	–	–	1.00	-0.27	0.62
Equities	–	–	–	1.00	0.22
IG corporates	–	–	–	–	1.00

Source: Standard & Poor's LCD and S&P/LSTA as of From January 1997- Dec. 31, 2018. Loans represented by the S&P/LSTA Leveraged Loan Index; HY Bonds represented by the BAML US High Yield Index; IG Corporates represented by the BAML US Corporate Index; Treasuries represented by the ML 10yr US Treasury Index; equities represented by the S&P 500. Past performance is not indicative of future results.

Diving deeper on the impact of interest rates on different asset classes, the following chart compares the cumulative "excess return" over the past 20 years for senior secured loans to its traditional corporate credit counterparts—investment grade and high yield bonds. After removing the duration component of returns within each asset class, bank loans outperformed investment grade and high yield on a cumulative basis. As expected, in only two of the last 20 years—2001 and 2008—did investment grade outperform loans and high yield on an excess return basis. Additionally, the excess return of loans has outperformed investment grade bonds in 16 of the past 20 years.

Figure 6: Cumulative excess returns



Source: Barclays as of Dec. 31, 2018. Loans represented by Credit Suisse Leveraged Loan Index; HY Bonds represented by Bloomberg Barclays US High Yield Index; IG Corporates represented by the Bloomberg Barclays US Corporate Credit Index. Past performance is not indicative of future results.

Furthermore, the investment grade bond market has experienced two significant shifts over the past decade: 1) the amount of BBB rated bonds has swelled to 50% of the index - lowering the overall quality of the investment grade market relative to its historic levels and 2) the duration of the investment grade bonds is near all-time highs.[6] Based on this, incorporating senior secured loans within a portfolio of investment grade bonds would decrease the overall duration risk, while potentially increasing the overall level of income.

In conclusion, as we progress towards a potential end to both the Federal Reserve's rate tightening cycle and the current economic cycle in the coming years, we believe that the case for including loans in a diversified portfolio remains intact:

- Loans have provided attractive current income through all market cycles — even stressed and defaulted loans typically pay current interest.
- Loans have exhibited less volatility than traditional assets — including fixed income.
- Loans have historically exhibited high risk adjusted returns.
- Loans are senior and secured and the first to get paid back — a comprehensive credit risk mitigation mechanism.
- Loans have had low correlation to traditional assets — providing potential benefits with portfolio diversification.
- Loans have minimal duration risk — providing a hedge against rising interest rates.

About risks

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

Many senior loans are illiquid, meaning that the investors may not be able to sell them quickly at a fair price and/or that the redemptions may be delayed due to illiquidity of the senior loans.

The market for illiquid securities is more volatile than the market for liquid securities. The market for senior loans could be disrupted in the event of an economic downturn or a substantial increase or decrease in interest rates. Senior loans, like most other debt obligations, are subject to the risk of default.

1 Credit Suisse Leveraged Loan Index as of March 31, 2019. Past performance is not indicative of future results.
2 Bloomberg Barclays Global aggregate Negative-Yielding Debt Index as of March 25, 2019.
3 Average ultimate recoveries, Moody's Research published February 2019.
4 S&P/LSTA Leveraged Loan Index as of Feb. 28, 2019.
5 Calculated by Invesco, as of March 31, 2019.
6 Bloomberg Barclays US Corporate Credit Index as of Feb. 28, 2019.

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