Portfolio Update: Senior Loans

March 20, 2020

Executive Summary

- This week, we saw the largest single-day point drop ever for the Dow (nearly 3,000) and the largest percentage decline since 1987 at nearly 13%. Certain sector moves were much more significant and we triggered another circuit breaker almost immediately after opening.
- Secondary trading levels were understandingly under heavy pressure, most notably in the travel and entertainment-related sectors, in addition to energy, as oil prices went into a free fall to last week.
- Similar to the 2015 oil crisis, the loan market's exposure to the energy sector remains relatively low at ~3% (market value, S&P/LSTA Leveraged Loan Index), compared to the high-yield market's exposure of ~11% (market value, Credit Suisse High Yield Index).
- There is no question that the magnitude of lost output from the COVID-19 virus spread will hit more industries than we envisioned a month ago (those with obvious direct impact such as hotels/gaming, airlines, travel, etc.) and will certainly lead to a medium-term recessionary impact.
- We remain cautiously optimistic that the accommodative monetary policy being implemented, supplemented by an aggressive fiscal stimulus that is at play, will help expedite the recovery once the virus containment gets underway.
- From this perspective, our most effective risk management tool continues to be our broad portfolio diversification across industries and issuers and our continued underweight to the highest risk tails of our market.

Portfolio Performance: Year-to-Date as of March 18, 2020

Uncertainty surrounding the Coronavirus has caused significant selling pressure across virtually all risk-related asset markets. Plummeting oil prices have exacerbated volatility, after talks between OPEC and non-OPEC members failed to reach an agreement on production cuts.

Like other risk assets, senior loans have sold off. We have seen four of the eight worst trading days in the loan market over the past two weeks (with the rest in October 2008). The magnitude of the current sell-off in the loan market is unprecedented and has been exacerbated by a material pick up in selling via retail loan funds preparing for redemptions and aggressive low bids by credit opportunities funds.

Year-to-date through March 18, the S&P/LSTA Leveraged Loan Index returned -14.79%, outperforming the -16.67% return for the high yield index. Over this period, Voya's senior loan strategy, on a gross basis, outperformed the loan index, primarily due to an underweight to Oil & Gas and cash held to meet liquidity needs.

Portfolio Positioning: How We Are Managing this Volatile Environment

Assessing the Coronavirus

Our central case is that meaningful and forceful monetary and fiscal stimulus will help the U.S. and the world recover from the economic fallout related to efforts to contain the spread of the coronavirus. To date, the U.S. Federal Reserve has done its part, taking significant steps to ensure liquidity in the U.S. Treasury market. The latest measures taken by the Federal Reserve will clearly provide a degree of needed tailwind to issuer liquidity; the effectiveness of LIBOR floor structures are being broadly analyzed as part of this equation. From an issuer perspective, while lower rates mean lower borrowing costs, we don't envision the most recent cut, or those to come prospectively, as having a material impact on debt service ability for the typical portfolio issuer.

Proposed fiscal measures seem to be forthcoming and appear to be appropriately aggressive. It is up to lawmakers to decide how fast that process can unfold.

As we consider this context for our own portfolios, we note that the sell-off has been relatively uniform across ratings cohorts/credit quality. In portfolios, this means that, at least in the short-term, it's nearly impossible to discern performance from a ratings or quality perspective given the broader liquidity-driven pricing pressure across ratings cohorts. Further, the larger, more actively-traded loans in the market, which our strategy emphasizes in order to support execution in times of stress, are under pressure. We continue to focus on long-term through cycle performance, and events like this reaffirm our focus on liquidity.

We believe that this environment may create a unique opportunity to buy heavily discounted Ba/BB credits, allowing for a large pull-to-par potential when the market recovers. On average, BB loans are now trading in the low-80s, down over 15 points since the beginning of the year. The yield/discount margin profile has not looked that attractive for strong issuers since the summer of 2011 when similar rated loans were trading at least 5-7 points higher than current levels.

As a result, we believe that dislocated environments, like the one we are enduring, may allow for the construction of relatively defensive portfolios for those investors who share our risk-adjusted, long-term mindset. In particular, we believe patient investors may be able to allocate at attractive prices to issuers with: favorable long-term business models, stronger balance sheets/liquidity, relatively low to manageable leverage, favorable valuation, ratings cushions (with ability to withstand downgrade pressure), no medium term maturity/need for access to capital markets, and minimal default risk. If fundamentals deteriorate further from here onwards, stronger rated loans will fare better, are likely to have better subordination and better recovery rates over the long term.

Energy outlook

Energy prices have come under immense pressure in response to the news that the Saudi/Russian standoff failed to moderate production. The nature of oil reserves in Saudi Arabia and Russia will allow them to deal with this short-term price decline. However, the decline in energy prices is accelerating stress in the U.S. shale space. The impact will be felt more acutely among upstream issuers (e.g., shale) and also in midstream pipelines should the downturn is prolonged. There is increased probability of both higher default and downgrade activity in a bear commodity price case; we believe, however, that may be priced in already in many cases.

From a risk management perspective, the good news is that we have seen this play out before. Reminder: oil is a notoriously volatile commodity. Recent oil price ranges include ~$105 per barrel in September 2014 to ~$25 per barrel in Feb 2016, and ~$75 per barrel in October 2018 to below $30 per barrel through this latest market volatility. In addition, similar to the 2015 oil crisis, the loan market's exposure to this sector remains relatively low at ~3% (market value), compared to the high-yield market's exposure of ~11% (market value, Credit Suisse High Yield Index). Voya's exposure to Oil & Gas is very small (~1%). At ~2%, our exposure to other commodity-related sectors (Nonferrous Metals/Minerals and utilities) is also small.

Market volatility is likely to persist in the near term and we will continue to provide updates. In the meantime, if you have any questions or would like to walk through anything in more detail, please do not hesitate to contact us.

Past performance is no guarantee of future results.
Risk is inherent in all investing. The following are the principal risks associated with investing in senior loans. Credit risk: Senior loans are below-investment-grade instruments that carry a higher than normal risk that borrowers may not make timely payments of principal and interest. Failure by borrowers to make such payments may cause the yield and/or the value of your investment to decline. Interest rate risk: The yield on senior loans is directly affected by changes in market interest rates. If such rates fall, the yield may fall. Also, if overall interest rates on loans decline, the yield may fall and the value of the assets may decrease. When market interest rates rise, there may be a delay in the rise in the yield due to a lag between changes in such rates and the resetting of the floating rates on the loans. Limited secondary market for loans: Loans do not trade on an established exchange. There is a limited secondary market for loans. Demand for loans: An increase in demand for loans may adversely affect the rate of interest payable on new loans, and it may also increase the price of loans in the secondary market. A decrease in the demand for loans may adversely affect the price of loans, which could cause the value of loans to decline. Use of leverage: The strategy may engage in leverage for some portfolios.

The use of leverage in a portfolio may have a magnifying effect on the returns for a portfolio, both positively and negatively. Foreign currency: The strategy may invest in loans denominated in currencies other than the U.S. dollar. While the strategy seeks to hedge foreign currency risk to the greatest extent practicable, such hedging may not be effective.

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