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Revisiting the case for senior loans amid market turmoil

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Floating-rate income and the secured nature of senior loans may provide a valuable defense against both rising rates and higher default risk for investors able to stomach short-term volatility.

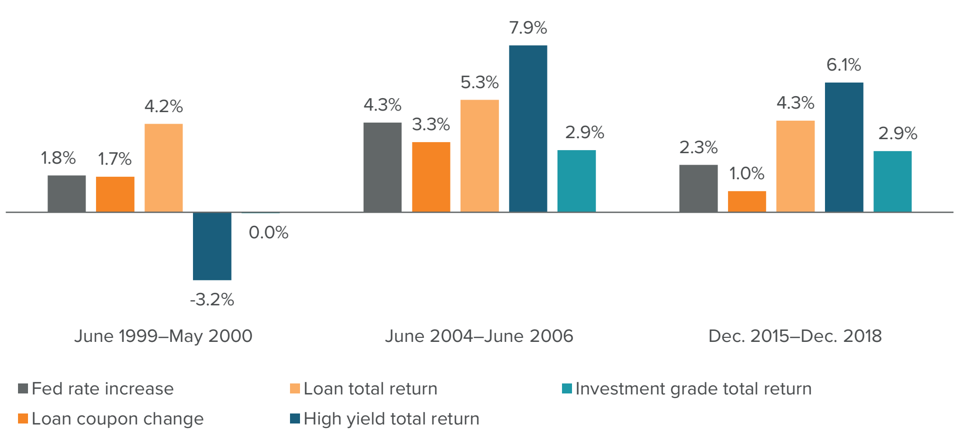
- Though floating-rate loans have not been immune to recent macro volatility, they have been among the best relative performers year to date, with virtually zero duration exposure and the potential to benefit from rising rates.
- With the Federal Reserve aggressively raising interest rates 75 basis points (bps) this week, and with additional hikes in the cards, we believe loans should continue to offer compelling yields and accretive distribution levels to investors seeking a hedge on rising interest rates.
- Shorter-term bouts of volatility have historically created attractive entry points for longer-term investors who remain appropriately watchful of increasing credit risk on the horizon, providing opportunities to enhance diversification in fixed income portfolios.

Loans have delivered solid performance in past rising-rate periods

Although every rate cycle has its own context and extenuating circumstances, loans have generally benefited from tightening policies. In each of the rising-rate periods of 1999–2000, 2004–2006 and 2015–2018, the average coupon of the S&P/LSTA Leveraged Loan Index increased by at least 1% and the Index posted attractive total returns, particularly relative to conventional fixed-rate investment grade debt (Fig. 1). High yield bonds did outperform loans in the last two rate cycles, as the hikes in those periods were small, well telegraphed, and not adjacent to sustained deterioration in credit conditions.

Year to date through June 14, 2022—in the face of what is expected to be a much steeper interest rate cycle, and perhaps a pickup in overall credit sensitivity—loans have substantially outperformed both the high yield and investment grade indexes, returning –2.90% versus –13.03% and –16.07%, respectively.

Figure 1. Senior loans delivered solid performance during the last three rising-rate periods



Source: Bankrate, S&P/LCD, Bloomberg, Voya Investment Management. Loans: S&P/LSTA Leveraged Loan Index; high yield: Bloomberg U.S. High Yield 2% Issuer Cap Index; investment grade: Bloomberg U.S. Corporate Index. **Past performance is no guarantee of future results**. Investors cannot invest directly in an index.

Default risk from higher borrowing costs appears manageable

Rapidly rising short-term rates will, all other things being equal, increase borrowing costs for issuers of debt with floating coupons. Therefore, an aggressive rate hike cycle could pressure interest coverage ratios, particularly if earnings potentially begin to degrade in a recessionary environment. While this risk has risen, we believe company earnings, cash flow generation and liquidity appear supportive overall.

As of March 31, 2022, the average interest coverage ratio for public loan issuers tracked by LCD remained healthy at 3.8x, supported by 1Q22 EBITDA growth of approximately 15%. In our view, the majority of issuers have reasonable headroom to absorb increased borrowing or a decline in earnings should the economy enter a mild to moderate recession. A prolonged recession would likely increase defaults (which are near zero at this point), particularly in certain sectors and among the most leveraged issuers. But we believe a portion of that "loss-given-default" risk is already priced into the market.

Current dislocation likely more severe than fundamentals warrant

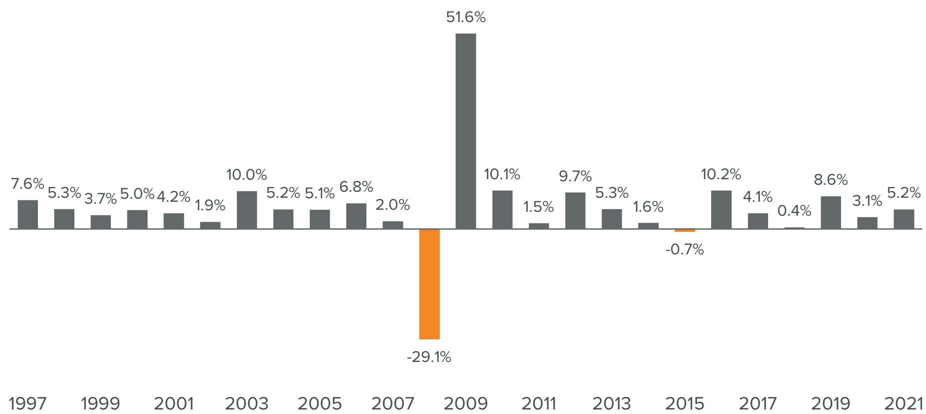
While loans have outperformed other risk assets year to date, there have been episodes of sharp volatility. May was one of the worst months on record for the asset class, and the single-day loss of 0.84% on June 13 was the index's worst daily return in two years. Most surprisingly, this drawdown came on the eve of a 75 bp rate increase. However, while the timing may be surprising, volatility is not new to the loan market.

Senior loans tend to sell off directionally with broader risk markets, particularly if negative sentiment is anything but short-lived. However, we believe the recent decline in loan prices is more severe (and arguably earlier in the cycle) than current fundamentals would warrant. Such dislocations historically have created attractive entry points for longer-term investors.

We believe the current environment offers investors similar opportunities, given the average index bid reading of 93.99 and the forward yield estimate based on rate expectations, with markets pricing in a fed funds rate projection of 3.5% or higher in 2023. In fact, the current average index bid is on par with the levels of late 2020, when macro conditions were arguably more challenged by the shuttering of global economies. While today's historically low default activity is bound to tick up at some point, we do not see indications that the increase will be widespread, and we believe stress will be concentrated in certain sectors.

Moreover, the senior and secured nature of the asset class has historically supported total returns over the long term. Being senior and secured, performing loans tend to retrace market value losses quickly after periods of technically driven dislocations. Meanwhile, defaulted loans typically experience better recoveries than subordinated and unsecured assets, as they have the backing of borrower collateral and priority of payment in the borrower's capital structure. This dynamic has resulted in negative total returns in only 2 of the last 25 calendar years (Fig. 2).

Figure 2. Senior loans have delivered positive returns in most years



Source: S&P/LCD, S&P/LSTA Leveraged Loan Index. **Past performance is no guarantee of future results**. Investors cannot invest directly in an index.

A potential defense against rate and credit risk

- The combination of floating-rate income and the secured nature of senior loans may help defend portfolios against the effects of rising interest rates.
- Priority liens against the borrower's assets offer a degree of downside protection from potentially higher default rates.
- We believe senior loans, while not immune to broad market volatility, remain a compelling component of any broader fixed income allocation and offer an attractive yield opportunity in today's rising-rate environment.

Disclaimer

Risks of investing in senior loans: Below investment grade loans involve a greater risk that borrowers may not make timely payment of interest and principal on their loans. They also involve a greater risk that the value of such loans could decline significantly. If borrowers do not make timely payments of the interest due on their loans, the yield on a portfolio invested will decrease. If borrowers do not make timely payment of the principal due on their loans, or if the value of such loans decreases, the value of a portfolio invested will decrease. **Demand for loans**: An increase in demand for loans may adversely affect the rate of interest payable on new loans acquired by a portfolio invested, 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 in a portfolio invested, which could cause such portfolio's value to decline.

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