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Floating Rate Loans: A Complement to Fixed Income Strategies

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Floating rate loan funds date back to the late 1980s (as a by-product of the Savings and Loan crisis), but it wasn't until the early 2000's that investors began to pay serious attention to them as a key component of a fixed income strategy. Among other benefits, it is the asset class's ability to provide a hedge against rising short-term rates that make it appealing as a complement to a fixed income portfolio.

Described also as "loan participation," "bank loan", "senior loan", "leveraged loan", or "prime rate" funds, floating rate loan funds invest in senior loans made to a variety of corporate borrowers. The majority of these borrowers are smaller companies seeking funds for operational expenses but that do not necessarily have the capital to access the high yield market. Additionally, a number of larger borrowers, who are often below investment grade companies, utilize the bank loan market in order to finance leveraged buyouts or other restructuring activities. The initial interest rate on floating rate loans has averaged 3.64% above the London Interbank Offered Rate (LIBOR), which resets every 60 to 90 days.[1] Although floating rate loans have terms ranging from one to nine years, they are frequently repaid or refinanced as soon as 30 to 90 days and seldom extend longer than two to four years.[2] Their short-term nature and their floating rate feature make duration and interest rate risk virtually meaningless. However, floating rate loan investors are vulnerable to reinvestment risk in declining rate environments.

In a rising interest rate environment, investors that hold a typical fixed income security will realize diminishing returns as the market flocks to new issuances with higher coupons – resulting in declining prices (and yields) of older securities. Since the vast majority of floating rate loans are tied to LIBOR, they offer investors a strategy to protect their assets against interest rate risk as their monthly payments are fixed to the prevailing rates.

When examining the historical performance of floating rate loans over the last 18 years[*], it is important to breakout the performance into three distinct time periods: pre-credit crisis (1992- Q2 2008), mid-credit crisis (Q3 2008 – Q1 2009), and post-credit crisis (Q2 2009 – Q1 2010). This allows us to more clearly ascertain how floating rate loans performed through normal market cycles as well as through a dramatic recession and the subsequent "recovery."

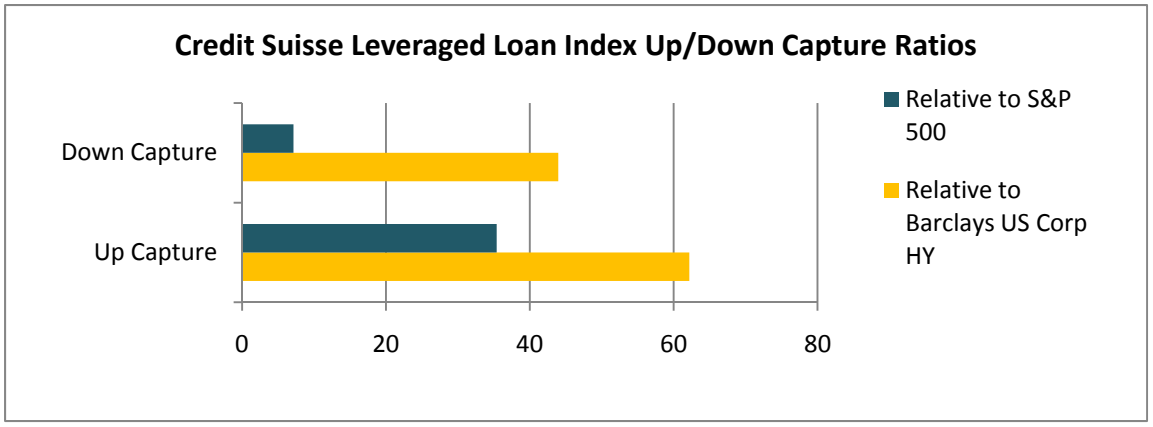
From its launch on 1/1/1992 through Q2 2008, the Credit Suisse Leveraged Loan Index (the "Index") has underperformed the S&P 500 ("S&P") with an annualized return of 6.09% compared to 9.14% for the S&P. During the same time period, the Index also underperformed the Barclays US Corporate High Yield ("High Yield") index by 1.6%. Even though the Index underperformed relative to both indices over this period, it did so while providing much higher risk-adjusted returns. Between its inception in January 1992 and Q2 2008, the Index only posted six quarters of negative returns; whereas, the S&P and High Yield indices posted 19 and 15 quarters of negative returns, respectively. Furthermore, the worst calendar year return that the Index experienced during this stretch was 1.11% in 2002.

From Q2 2008 through Q1 2009 the Index was not immune to the credit crisis that devastated the rest of the economy and it posted its largest negative quarter since inception with a -22.92% return in Q4 2008. Subsequently, the Index also posted a 2008 annual return of -28.75%, its first ever negative calendar year return. Although the Index outperformed the S&P by 8.25% during this timeframe, it still underperformed the High Yield index by 2.61%. Some market analysts attribute this underperformance to highly-levered investors (mainly hedge funds) who attempted to take advantage of the historically low volatility of the asset class by leveraging their positions. When the credit crisis erupted and margin calls ensued, the highly-levered investors were forced to liquidate floating rate loans for as low as 60.5 cents on the dollar.[3]

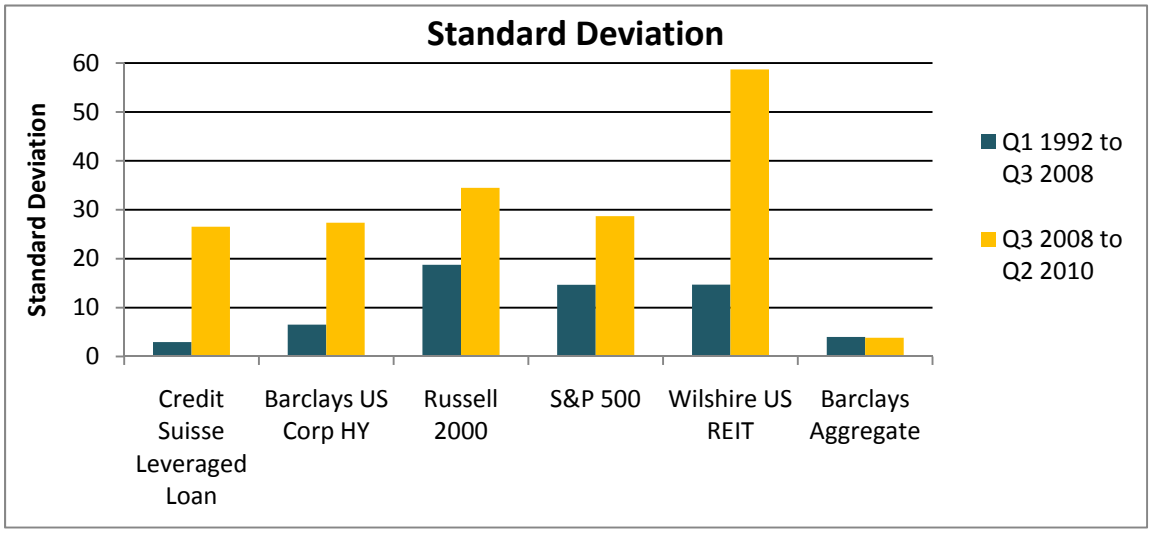
From Q2 2009 through Q1 2010, the Index's performance was mostly in line with the performance of other markets and it posted large gains as investors felt a bottom had been reached. However, it underperformed relative to the S&P and High Yield indices. This lag comes as no surprise as the Index has historically trailed the S&P and the High Yield indices since its inception.

[*] For the purpose of this paper Prima utilized the Credit Suisse Leveraged Loan Index (the "Index") as a proxy for the bank loan asset class. The Index was created on 1/1/1992.

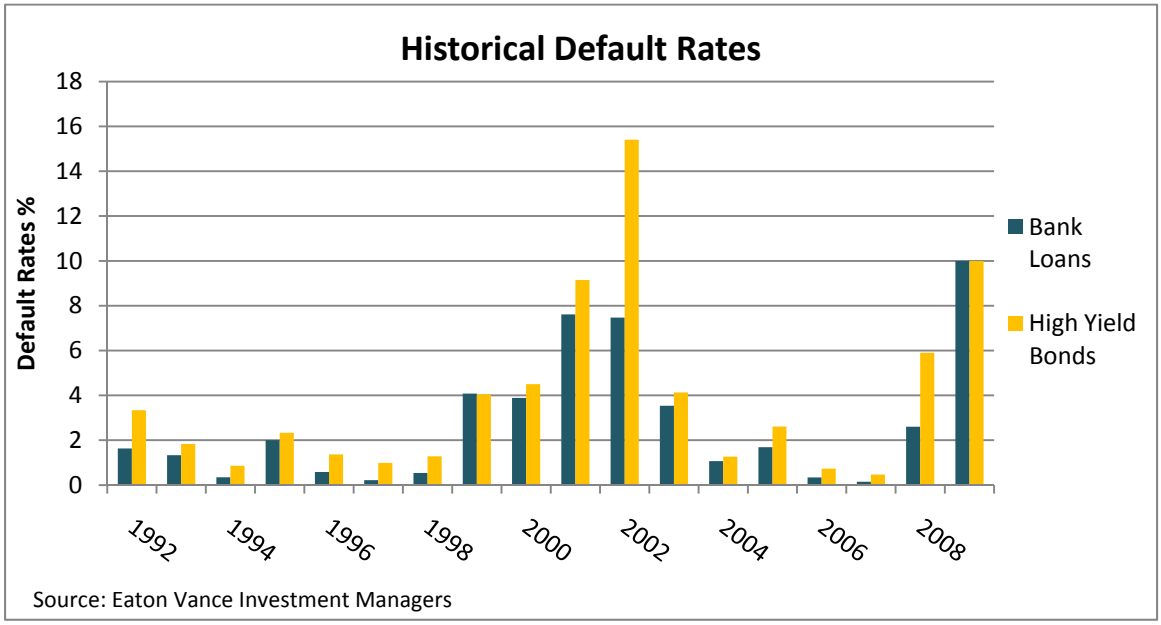
The Index has a 35% up capture relative to the S&P and 62% up capture relative to the High Yield index over its 18-year history. Conversely, the Index has historically provided more bear market protection as exhibited by its 7% down capture relative to the S&P and 44% down capture relative to the High Yield index. In addition to the capital preservation that floating rate loans can provide in down markets, they also offer a number of other benefits that merit inclusion into a portfolio as an asset class.



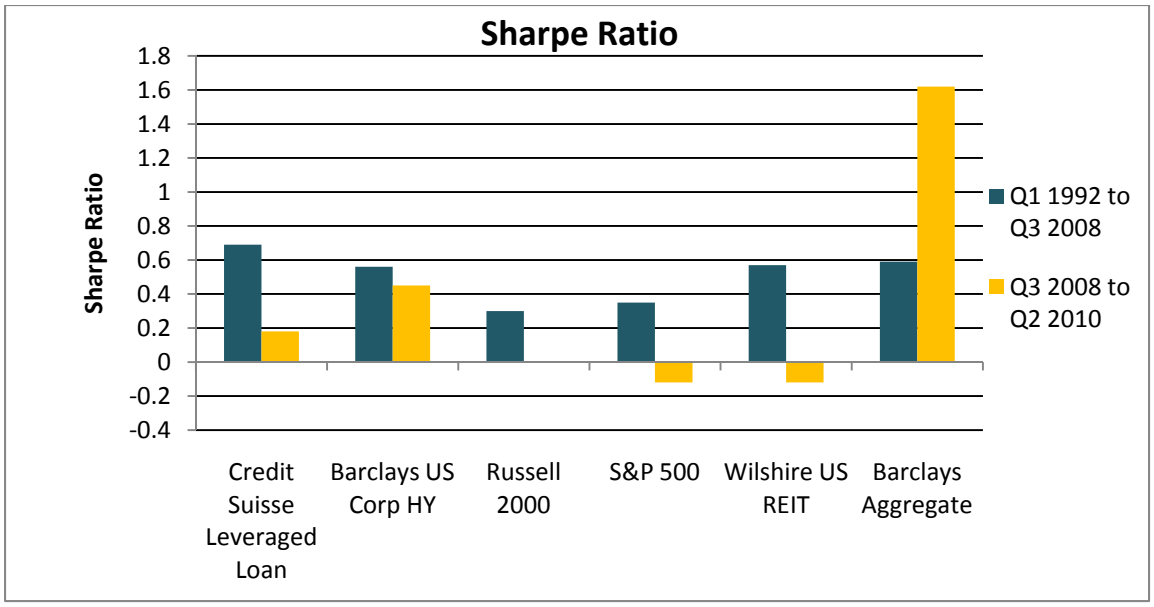
While the asset class's volatility, as measured by standard deviation of the Index, has spiked since the credit crisis (26.55% since Q2 2008), historically it has been exceedingly low thanks to the short-term nature of the loans. Prior to the credit crisis, the Index's standard deviation was 2.94%, which compares to 14.66% for the S&P, 6.52% for the High Yield index, 18.76% for the Russell 2000 ("Russell"), 14.68% for the Wilshire US REIT ("Wilshire"), and 4% for the Barclays Aggregate ("Aggregate"). Over the Index's 18-year history, the standard deviation has been 8.17% annualized.



In terms of historical default rates, floating rate loans also have an advantage over similar debt securities such as high yield bonds. Default rates on floating rate loans have averaged 2.7% since 1992 while high yield bond default rates averaged 3.9%; however, the range can be fairly high.[4] For example, floating rate loan default rates were only 0.2% in 2007, but they were as high as 13% during Q4 2008.[5]

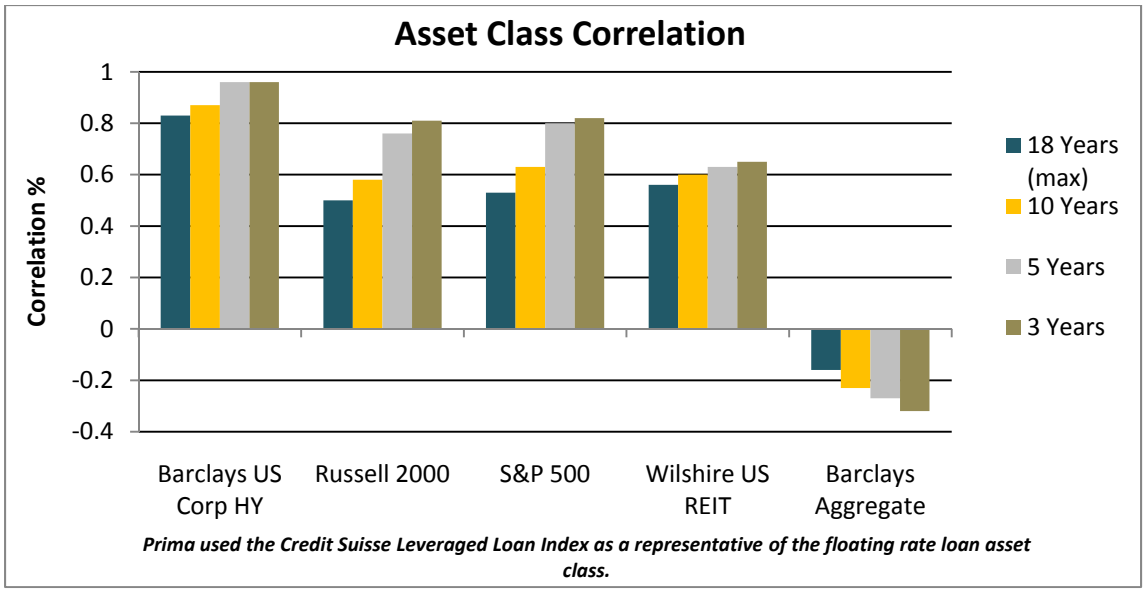


In the event of default, floating rate loans are also at an advantage due to the fact that they are often secured by cash or other collateral. Because floating rate loan funds invest primarily in senior loans, which take precedence over other debt, floating rate loan holders will realize higher rates of recovery than bond holders in the event of a default. As a result, floating rate loans offer better downside protection than high yield bonds in terms of credit rating downgrades or defaults. However, it should be noted that a large portion of floating rate loans are non-rated due to the high fees that ratings agencies charge for the service. Historically, floating rate loan funds have asset recovery rates of approximately 70% to 80% as compared to 45% to 55% for high yield bonds.[6] However, according to Fitch Ratings, floating rate loan recovery levels through 2010 are expected to remain below their historical averages as a result of the some of the low quality loans made during 2006-2007 and the borrowers' inability to refinance out of them.[7]



On a risk-adjusted basis, floating rate loans have performed relatively well when compared to other asset classes. In the 16 ½ years prior to the credit crisis, the Index had a Sharpe ratio of 0.69, which was approximately 15% better than the High Yield, Wilshire, Aggregate indices and approximately 50% better than S&P and the Russell indices. In the time after the credit crisis, the Index has not fared nearly as well. While the Aggregate index has a Sharpe ratio of 1.62 since Q3 2008 (due to its allocations to government bonds and other high grade paper), and the High Yield index has a Sharpe ratio of 0.45 (due to the high spreads on junk bonds during 2009), the Index had a Sharpe ratio of just 0.18. However, the Index's Sharpe ratio during this timeframe did best the Russell, S&P, and Wilshire indices by 18, 30, and 30 basis points, respectively.

In terms of a diversification perspective, floating rate loans as an asset class can serve as a relatively lower-volatility complement to the high yield slice of a fixed income portfolio. As one might expect, when looking at a number of different asset classes over 18, 10, 5, and 3 year periods, floating rate loans correlate the strongest with high yield bonds. Over the last 18 years the Index has had a moderate correlation to the mid cap, large cap, and REIT spaces while it has experienced a moderate negative correlation to the Aggregate index.



Prima used the Credit Suisse Leveraged Loan Index as a representative of the floating rate loan asset class.

Floating rate loans also make sense from an investment perspective as an alternative option to high yield bonds when high yield bonds are trading at historically low spreads, as they were until Q2 2008. In general, floating rate loans will outperform high yield bonds during down equity markets, but underperform treasuries and core bond holdings. In rising equity markets, floating rate loans will likely underperform high yield bonds, but outperform treasuries and core bond holdings.

Besides some of the disadvantages mentioned earlier, such as reinvestment risk and low up capture, floating rate loans or more specifically floating rate loan *funds* have several other drawbacks. One of those drawbacks is the high cost of credit research.

Due to the arcane legal terminology contained in a typical floating rate loan agreement, teams of legal experts are needed to sift through the legalese and decide if the terms of a particular loan are favorable enough to warrant investment. Furthermore, research teams familiar with the asset class are needed to perform deep credit analysis on borrowers in order to determine things such as free cash flow generation, what part of the business cycle the borrower is in, whether they are in defensive or cyclical industries, and how much debt they have incurred. Considerable time is also spent analyzing the loan's collateral and in determining the enterprise value of a company. Because of these high operational costs floating rate loan funds typically have higher expense ratios – the average expense ratio is 1.25% as compared with 1.0% for the average intermediate-bond fund.

Floating rate loan fund performance is hard to track relative to indices because of the difficulty that managers experience when trying to replicate a benchmark. For example, the S&P LSTA Leveraged Loan Index, one of the most common benchmark indices for the asset class, is comprised of 1,007 holdings.[8] It can also be difficult for a manager to match a sector allocation due to the potential lack of debt offerings in a particular sector.

Floating rate loan funds can also be restrictive in terms of liquidity as they have redemption periods that vary from daily to quarterly. Those with a quarterly redemption period tend to offer higher yields though, so there is a trade-off between the need for liquidity and the desire for yield.

The consensus amongst economists seems to be that the economy is realizing a slower pace of growth and there is still concern regarding the uncertainty of the Euro-zone debt crisis. This has contributed to June 2010 loan issuance dropping to $16.4 billion from $24.3 billion in May, which is the largest one-month drop since November 2007.[9] Furthermore, according to Bloomberg, in June 2010, the average spread to maturity over the three-month LIBOR was 4.98% (the highest it's been YTD).

In the near-term, with current interest rates near all-time lows, it's reasonable to assume that it is only a matter of time before they start to rise again. Once the Fed decides that the economy is well on its way to recovery, it will begin to implement rate hikes, and older bonds with lower coupons will begin to trade at steeper discounts. In order to offset the resulting depreciation in bond prices and the diminishing value of coupon payments, investors can allocate a portion of their fixed income portfolio to floating rate loans for capital protection. Along with the asset class's ability to provide an interest-rate hedge, the historically high spreads and low volatility currently make a fairly convincing case for investors wishing to diversify their fixed income portfolio.

All market statistics (e.g. Sharpe Ratio, standard deviation, and up/down capture) were produced by Prima Capital, Morningstar.

All index return figures are calculated in terms of total return and are licensed from Standard and Poor's, Russell Investments, Barclays Capital, Credit Suisse, and Dow Jones.

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