5 Charts: Why It’s Time to Pursue a ‘Game of Loans’ for Income Generation

Market Commentary

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Declines in oil prices roiled the energy-laden high yield market at the end of 2015, but high yield debt bounced back in 2016, posting a 17% return. This enabled the high yield market to keep its streak alive with no reports of back-to-back years of losses. But in 2017, is high yield the most appropriate allocation for income generation? Or by flocking to high yield, are investors chasing income without taking credit risk into account?

The following five charts illustrate why we believe an allocation to senior loans may be a compelling tool for the credit sensitive portion of a portfolio, allowing investors to potentially generate income while keeping a cautious eye on risk.

High Yield: Price Appreciation May Be Limited

History is not on the side of investors looking for double-digit returns from high yield this year. The chart below shows how high yield credit spreads stood 32% below their 20-year average at the end of the first quarter. Credit spreads may be susceptible to any mean reversion if the market strikes a more “risk off” tone.

Look to Senior Loans as Credit Spreads Widen

In today’s tight credit spread environment, senior loans warrant consideration not only for their income generation opportunities but also for their ability to potentially mitigate cyclical credit risks and any negative effects from spread-widening.

The illustration below shows that since 1994, senior loans have outperformed high yield bonds by an average of 0.59% during months when credit spreads widened. In the 20 months in which spreads widened the most, senior loans had been impacted far less, generating negative performance that was above the lesser performing high yield asset class — ultimately preserving more yield in a portfolio’s speculative grade credit bucket.

As Rates Rise, Senior Loans May Offer an Advantage

Senior loans offer a floating rate coupon that resets every three months, a structure that has allowed senior loans to outperform traditional fixed rate high yield in rate hike cycles like the one we’re in today. In the last three rising interest rate periods, senior loans have returned an average 6.5%, while, as the chart below shows, high yield bonds have returned an average of just 2%.

Figure 1: High Yield Credit Spreads Tighten Well Below Average

OAS Basis Points

Figure 2: Senior Loans vs. High Yield: Returns During Different Spread Environments

As of December 2017.

Past performance is not a guarantee of future results. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss, and the reinvestment of dividends and other income.
Senior Loans May Provide Yield with Less Volatility

Senior loans are typically more senior in the capital structure, taking precedence over most high yield bonds in the instance of a credit event by an issuer. This means senior loans are potentially less risky than bonds issued by the same company. At the same time, senior loans carry the potential to generate elevated levels of income because they are still deemed to be speculative grade credit. The average yield on senior loans over the last 15 years has been 4.99\%.\(^4\)

The following chart highlights the lower volatility profile of this floating rate, high income-producing segment relative to fixed rate high yield. Based on rolling 12-month holding periods, senior loans have historically had less volatility than high yield bonds, exhibiting an average reduction of volatility of 2.48% over the last 15 years.

Don’t Go It Alone in the “Game of Loans”

The chart above also captures an anomaly — a period of time where the rolling volatility of loans exceeded that of high yield. This is due to the fact that the chart shows the performance of a passive exposure, and a passive exposure to senior loans will simply mirror the size and liquidity preference of an index without concern for credit quality. But credit quality is one of the most important attributes in senior loan investing — even more so in these later credit cycle innings.

Given this, investors should seek a more judicious approach to this asset class and consider an actively managed ETF like the SPDR® Blackstone / GSO Senior Loan ETF (SRLN).

As shown below, active management allows for rigorous security selection, providing the potential to avoid loans of poor quality that may be included in a passive fund. For instance, relative to the S&P®/LSTA U.S. Leveraged Loan Index, SRLN’s portfolio has a higher allocation to securities that have not declined in value.
In the quest for income, today’s investors have to contend with the realities of rising interest rates and below average credit spreads. However, immediately turning to high yield may not be the answer. In addition to the rising rates and widening credit spreads, high yield issuers, unlike the Lannisters, do not always pay their debts, a fact underscored by the 4.7% default rate in 2016 and a projected 3% rate in 2017 by Fitch — which remains higher than the long term non-recessionary average of 2.3%.

In today’s environment, investors who are in the pursuit of income but are weary of risk may want to play senior loans in the “Game of Loans” over high yield with the actively managed SRLN.

1 Bloomberg Finance L.P., as of 12/31/2016, based on the BoFA Merrill Lynch US High Yield Index.
2 Bloomberg Finance L.P., as of 12/31/2016, based on the BoFA Merrill Lynch US High Yield Index.
4 Bloomberg Finance L.P., as of 3/31/2017, based on the BoFA Merrill Lynch US High Yield Index.
5 In reference to the unofficial motto of House Lannister, from the pop-culture Book/TV series, “Game of Thrones” by George R. R. Martin.
6 Fitch Ratings, as of 1/31/2017.
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Investments in Senior Loans are subject to credit risk and general investment risk. Credit risk refers to the possibility that the borrower of a Senior Loan will be unable and/or unwilling to make timely interest payments and/or repay the principal on its obligation. Default in the payment of interest or principal on a Senior Loan will result in a reduction in the value of the Senior Loan and consequently a reduction in the value of the Portfolio’s investments and a potential decrease in the net asset value ("NAV") of the Portfolio.

Investing in high yield fixed income securities, otherwise known as “junk bonds”, is considered speculative and involves greater risk of loss of principal and interest than investing in investment grade fixed income securities. These Lower-quality debt securities involve greater risk of default or price changes due to potential changes in the credit quality of the issuer.

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