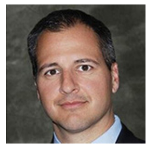
Market Outlook: Senior Loan Edition

Summary:

- Despite higher interest rates and negative returns in most fixed income asset classes, there are solid opportunities within fixed income that typically benefit from rising rates. Senior loans pay a floating rate of interest and have returns that are negatively correlated with traditional rate sensitive fixed income (The Bloomberg Barclays Aggregate Index)
- A strong U.S. economy provides a healthy backdrop for corporate fundamentals and a low corporate default rate. Solid GDP growth should continue to support below investment grade credit fundamentals
- All indices are not created equally, especially as it pertains to passive investing. When evaluating fixed income opportunities, consider an actively managed approach. While a passive index is simply representative of all of the risk and opportunity in the market, a disciplined active approach can manage risk and seek the best opportunities available

CEFA was joined by Bill Housey, Senior Portfolio Manager for the Leveraged Finance Investment Team at First Trust.

The following Q&A recaps a discussion about the senior loan sector and overall U.S. economy. As part of CEFA's podcast series, the podcast audio can be heard here.



Bill Housey

Libby Hastert

Announcer: **Welcome and thanks for joining the Closed-End Fund Association (CEFA) for another discussion. Today we will hear from an industry expert who shares insight on a timely issue affecting the closed-end fund space.**

LH: **Good afternoon. I'm Libby Hastert and today we're talking with Bill Housey, Senior Portfolio Manager for the Leveraged Finance Investment Team at First Trust. Before we get started, I'd like to quickly touch on Bill's background.**

Bill has been in the industry for 22 years and has extensive experience in portfolio management of both leveraged and unleveraged credit products, including senior loans, high-yield bonds, and more. Bill, welcome to the CEFA podcast. Did I miss anything? Anything you'd like to add?

BH: No, that's terrific. Thank you, Libby. Thank you for having me.

LH: **Absolutely. We're definitely looking forward to gleaning some insight from you about the senior loan sector, closed-end funds, and then of course, the overall outlook for the U.S. economy. We've got a lot to cover, so let's just go ahead and get started.**

BH: Perfect.

LH: **Bill, can you give us an explanation of some of the key characteristics of senior loans and the benefits and risks that they present to investors?**

BH: Sure, so when I think about senior loans, one of the easiest ways to understand what a loan is, is to really just think about it as a loan to a corporation. So these are loans made by banks. Typically the loans we participate in are originated by some of the largest banks in the world and these loans are just made to corporations. What makes these loans unique are a couple of things.

First, the loans are senior secured. When I talk about security, what I'm referring to is the fact that these loans are typically backed by the assets of the company. So if the company pledges cash, receivables, inventory, things like property or plants and equipment, those are all generally things that are included in a collateral package that backs a senior secured loan.

The second thing that makes a senior loan unique is the fact that it's typically floating rate. Now, most fixed income is typically what we're for to as fixed rate. So it has a stated coupon and that coupon is just paid, typically semiannually, but in the case of senior loans, it's a quarterly payment and it's tied to LIBOR. Now, LIBOR is a floating rate benchmark, so a company might issue a senior loan and it would have a spread to compensate investors for the risk in that company and then it would have a base rate that is just effectively LIBOR, so that LIBOR rate is typically adjusting based on the current interest rate environment.

And that's very important because when we see interest rates moving, for example, recently we've seen interest rates moving higher. Traditional rate-sensitive fixed income sells off or goes down, while these floating rate instruments tend to benefit and actually go higher in terms of the interest that we receive.

So it really has a negative relationship or correlation with what we would refer to as regular rate-sensitive fixed income. And so that means essentially these loans that we're participating in, while they have credit risk because they're loans made to companies, so there's risks that that company might not be able to pay back the loan, but you tend not to have interest rate risks.

And these types of companies that we're investing in are companies like Dell Computer or Valeant Pharmaceuticals or even Caesar's Resorts. These are just some examples of the loans we participate in.

LH: Thanks. It sounds like there's a lot of moving parts and considerations to make, which brings me into my next question. How important is active management to the performance of this senior loan sector, particularly when you're looking at the evaluation of credit quality?

BH: Sure. Well, that's a really good question, Libby. In fact, one of the things that's really not well understood is how different these indices for passive investing are created when you move across various asset classes. So for example, if you invest in an equity index, a lot of times those index products that are wrapped around those indices themselves are typically market cap weighted. So the idea is simply that you are investing in companies that the largest companies in that given index are the most represented, and so oftentimes people would look at that and say, "Well, that market cap tells me something about that business."

So for example, it might be Apple or Exxon or GE, those types of companies, they're large for a reason. They have good financial health. When it comes to debt investing, the index is not tied to a market cap weighting.

It is tied instead to a debt cap weighting. And what I mean by that is that it's basically tied to the more debt a company issues. The more debt an industry takes on, the larger its weighting in that index is. So if you stop and think about that intuitively, you're not exactly likely to go out and lend money to a friend or a family member who's seriously indebted.

Instead, you might want to ask questions like, "Hey, how much money do you make? When do you think you'll be able to pay me back?" Those are all very reasonable things that someone who is lending money might want to know. Well, in a passive index, none of that is done. There's really not a merit-based criteria when it comes especially to below investment grade credit investing, so whether that's a senior loan or it's a high yield bond, those types of passive indices don't really reflect any fundamental health of companies. It's simply, hey, these are companies that have participated in the debt markets and accessed a lot of debt and so they get a large waiting and then the passive approach ends up over-weighting those.

We think that active is paramount to drive really solid long-term, risk-adjusted returns and really that comes down to discipline. That means researching companies and identifying which ones have the highest probability of repaying that debt, so they might generate the strongest and healthiest cashflow or have very good asset value to back that loan or back that high yield bond, for example.

And those are things we think are really important in terms of what one should be looking at. And that's why we would only recommend actively managed strategies within the below investment grade segment of the market, including both senior loans and high yield bonds.

LH: And you know, with this being the CEFA podcast, I've got to ask. Do you find the closed-end fund structure to be advantageous in managing a portfolio of senior loans? What does that look like for you?

BH: Yeah, I mean certainly from a portfolio manager's perspective, it's really one of the best. And when I think about it, as a fund manager, here I have this captive pool of capital that I can invest in the direction I think basically gives me the best risk-adjusted return with that pool of capital without consideration of flows in or out of the product. And I think from a fund manager's perspective, it's really difficult to paint a better scenario than that.

When it comes to managing other strategies, for example, open-end mutual funds or exchange-traded funds, those all allow for those flows in and out of the product. And as a result, you're typically not only managing in terms of what assets you like, but you're also continuously aware of the fact that you have these outer demands on the product that might come from inflows or outflows, and so they might affect your positioning.

Whereas when you're in a closed-end strategy and you're able to just invest solely with the purpose of generating the best risk-adjusted returns without really the concerns of having these outside forces and demands in terms of inflows and outflows, I think it really can lead to some very good results. And then for those reasons, I think from a fund manager's perspective, it's really a good strategy.

LH: Great. And you know, if we could pivot over to the U.S. economy, obviously this has been top of mind for investors and it's been strong, but as we've seen, the Federal Reserve is expected to continue raising interest rates. So what stage do you see us being in during the economic cycle?

BH: Yeah. You know, it's really important, Libby, I think that we talk about this, especially in the context of senior loan investing, because where we fit in the cycle is probably the most important driver of returns for this asset class.

And so a typical business cycle can be compartmentalized really into four categories. Either you're in contraction, where you're cycling down, or you're moving into recovery where things are stabilizing or you're expanding and you're moving back up or you're slowing down and that means you're beginning to roll back over.

What's been interesting about this long cycle that we've had is that a lot of investors have had this mindset, really for the last nine years, that we're at the end of this expansion and it's about to roll over any day. We're ready to roll the marble off the table at any moment... But that really hasn't been the case. We're solidly in expansion; we're not later in expansion yet. We're still in my opinion, in the middle innings, if you will, of the game as far as the expansion is concerned. We entered expansion in the summer of 2016, and the reason I know that is because, to give us an indication of where we are, we actually can simply look at which broad asset classes are doing well and those that aren't.

Now, typically when you're in expansion, what happens? Interest rates begin to move higher, so your traditional rate-sensitive fixed income goes lower. And, in fact, if we look at returns for the Bloomberg Barclays Agg, which is simply investment grade corporates, treasuries and mortgages, all what we would consider to be safe fixed income, but with a lot of interest rate risk. That basket or that index going back to the summer of '16 actually has a negative return through today. And yet at the same time, despite the recent equity volatility that we've seen, equities stir up very solidly, commodities have actually bounced.

You have oil up something like 50% from that area. You might recall commodities troughed in about February 2016. So we've seen a nice recovery in some of the hard commodities. I still actually think there's more of that to come in this cycle. We typically see a big commodity rally as you move later in the cycle. We haven't seen that yet.

But it's important to recognize that things like senior loans and even high yield bonds tend to be more correlated with equities and commodities. And while we're in this expansionary part of the cycle, loans tend to be a very attractive asset class because they're correlated with assets like equities and commodities and negatively correlated with the traditional rate-sensitive fixed income. So while traditional rate-sensitive fixed income assets are returning negative returns, senior loans are actually generating positive returns and we think that's very important in this part of the cycle.

And finally I would just say we look at indicators like the yield curve. The difference between the 2-year treasury yield and the 10-year treasury yield tends to be a very good leading indicator. It's upward sloping today, and what I mean by that is that the 10-year yield is above the 2-year yield. Typically, we'll see that 10-year fall below the 2-year yield in what we refer to as an inverted yield curve to signal that about 18 to 24 months from now, we may be heading into a recession.

We're not there right now. And in fact, we've actually seen that yield curve steepen from some of the really low levels we saw a month ago or even two months ago recently as rates have begun to move higher. And I think that's very important, because that's a healthy indicator that this economic expansion continues and we should be aware of that.

LH: **Sure, and you know, I think you kind of touched on this, but are there any opportunities in senior loans that are, you know, really exciting you right now? Anything that you think investors should pay special attention to?**

BH: Well, I do think senior loans are very well positioned. So here we are in this rate-increasing environment. You know, you've got Chairman Powell talking about this idea of continuing to move interest rates higher. We believe that will continue to flow through to LIBOR, which will continue to benefit these senior loans. So it really comes down to relative positioning. So when we look at the market of fixed income securities today, we say, "Look, for your safe fixed income, what's ordinarily considered safe from a credit risk perspective; that area has a lot of interest rate risk." So we like the positioning of senior loans in this part of the cycle.

Corporate defaults within senior loans are very low, and so what we typically say is, you know, we want to watch that default cycle because as you move later in the business cycle and the economy begins to slow down, some companies may have some trouble repaying their debt, including their loans or high yield bonds. And so we want to be ... or have a very good understanding, if you will, of where you are in that cycle. I think we're in a very good part of that cycle right now for these companies to continue to service that debt and that tends to bode very well for those returns. Certainly when you're in an environment when rates are moving higher and these companies, their debt is floating up to adjust for that, so that allows them to outperform in this environment and actually generate positive returns while those other areas of the market are generating negative returns.

LH: And since you're also managing high yield bond portfolios at First Trust, what opportunities are you seeing in that sector?

BH: Sure. Well, had you asked me at the end of September, I would have said there's really a tight relationship between senior loans and high yield bonds as you think about, you know, the difference in yield.

Let's remember, high yield bonds are unsecured and they pay a fixed rate coupon, whereas the senior loans, and again these are largely made to the same types of companies so Dell Computer, has senior loans and high yield bonds. So there's a relationship that exists there. And what we typically are looking at is how wide or how narrow that relationship is between the senior secured yield and the unsecured yield? And we want that to be a healthy difference. We want there to be good compensation for going down the capital structure into the high yield bond.

So as we've moved from the end of the third quarter into October here, we've actually had some equity market volatility. Interest rates ran up. We saw that 10-year treasury yields moved up. Actually, we saw rates across the curve move higher. As those rates moved higher, it caused some volatility in fixed income, including high yield bonds. That has allowed those prices to fall and create a better entry.

So as we talk this afternoon, you know, I look at this and say the opportunity in high yield is actually improved quite a bit since the end of the third quarter because again, corporations are doing very well from a fundamental perspective. Corporate health is very good. Defaults are low. We just saw a very narrow relationship between the secured and unsecured and that typically tells us, move up into the secured debt, but now we're seeing some volatility and that's allowing us to actually step down into some high yield bonds, looking for value there.

LH: And then if we could wrap things up, I'd like to hear your thoughts about how you think an allocation of senior loans can best be positioned for an investor who's looking to have a diversified portfolio. Can you speak to that, Bill?

BH: Sure. Well, senior loans do offer tremendous benefits to a diversified portfolio in fixed income, and the reason is, as I mentioned earlier, your senior loans tend not to move in the same direction as everything else that you typically carry within fixed income because those loans are negatively correlated with what we would consider to be your safe rate sensitive fixed income. It is credit risk, so we want to be mindful of that and we want to understand that senior loans might tend to move more directionally with where equities are going, albeit with less volatility typically because the loans are secured, whereas the equity is just the bottom of the capital structure and moves around.

So when I think about a well-diversified fixed income portfolio, I always think it's important to recognize that we should consider risk tolerance. So an investor who's willing to assume credit risk might consider blending, for example, a 60% safe fixed income portfolio with 40% credit risk at this part of the cycle to get a well-diversified fixed income portfolio.

But again, it really does come down to risk tolerance. The more risk an investor's willing to take, the higher you could take that senior loan exposure. Of course, if you have an investor that's very risk averse, you'd want to really reduce that credit risk-sensitive part of the diversified portfolio.

But I do believe that, you know, senior loans can be a very attractive component and I also think that it's important to blend both un-levered products with some levered products. So the way I tend to think about that is if you own senior loans in closed-end funds, that are very helpful, but I tend to think about them as very good tools in a core satellite methodology. This might mean you'd have a core piece of your senior loan exposure in an un-levered, actively managed fund and then use closed-end funds as the satellite to drive that return higher, drive that yield higher or that risk-adjusted return higher. And that would also help manage the overall volatility piece of that segment of the portfolio.

LH: **Is there anything else you'd like to leave investors with today?**

BH: Well, I think just a quick summary to suggest that you know, at this point in the cycle, a lot has been written about senior loans and oftentimes I think that the narrative doesn't really fit what's happening. And that means simply that companies are on good, sound financial footing today.

Corporate health is really solid. We had a terrific tax package. Unemployment is very low in the economy. Businesses are performing very well and I think that just really continues to set the stage well for an area like senior loans to continue to outperform that traditional, rate-sensitive fixed income as we continue along this path of the expansion cycle. And we'll be watching very closely for when that cycle is reaching those later stages, so that we can be prepared for when it might roll over and the default rate would ultimately increase. I just don't think we're there today, Libby.

LH: **Okay, well Bill, thank you. It's been an absolute pleasure. For all of those listening in, First Trust is our newest member over at the Closed-End Fund Association, so Bill I'm really looking forward to continuing the discussion as things play out. Thank you.**

BH: Terrific. Thank you very much.

Announcer: **Thank you for joining us. We hope you will stop by again for news on this ever changing space. Until next time, connect with us on Twitter @CEFAssociation or by searching for the Closed End Fund Association on LinkedIn and YouTube.**