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The Resiliency of Leveraged Loans

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Higher interest rates have led to increased demand for assets that can help mitigate interest rate risk and potentially add value as rates rise. Leveraged loans, which are typically floating rate bank loans, can offer these attributes. They also may provide an opportunity to smooth overall volatility and further diversify investment portfolios.

We take a closer look at the argument for considering a consistent allocation to leveraged loans in an investment portfolio and discover some interesting comparisons to core bonds and the U.S. equity market along the way.

Leveraged Loans Compared to Bonds –It's Not Just About the Floating Rate

Investors seeking income have looked to leveraged loans for the possibility of greater yield and may view them as a tactical call on higher interest rates. However, maintaining a consistent exposure to leveraged loans throughout rate cycles and opportunistically allocating exposure when warranted may be a more modern approach to the credit allocation of a portfolio.

To make the argument for including leveraged loans along with traditional credit assets in a credit asset allocation, let's compare the performance of a benchmark for leveraged loans to a benchmark for the broader bond market. Over the long-term, loans can offer a compelling complement.

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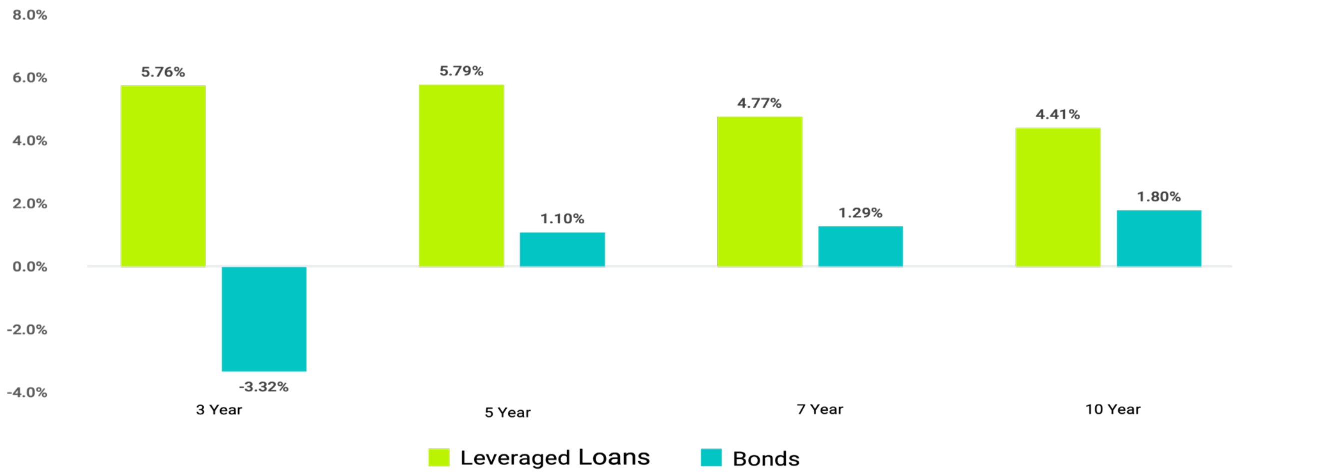
Leveraged Loans Have Outperformed Bonds



Annualized returns. Leveraged loans are represented by the Credit Suisse Leveraged Loan Index; Bonds are represented by the Bloomberg U.S. Aggregate Bond Index. It is not possible to invest directly in an index. Past performance is not indicative of future results. As of December 31, 2023

Leveraged loans are collateralized, senior secured debt, at the top of a company's corporate capital structure. While leveraged loans are typically below investment grade and may carry higher levels of risk than investment grade bonds, the historical average recovery rate for these types of securities is 76%, and the median is 95%, higher than many other types of higher-yielding debt.[1]

Finally, because leveraged loans have a relatively low correlation to bonds, adding leveraged loans to a core bond portfolio can provide portfolio diversification.

How Do Leveraged Loans Compare to Equities?

The recent tendency for bond and equity markets to move in tandem means investors may have lost a source of diversification. Looking at the S&P 500 as a proxy for the equity markets, from January 31, 2000, to December 31, 2023, the S&P 500 had 103 down months.

In 96 of these months, bank loans turned in better performance than equities. Translated to a percentage, 93% of the time, leveraged loans outperformed when equities (as represented by the S&P 500) had a downturn.

Over the same period, loans have had only two down years, in 2008 and then a slight negative performance in 2015. This long-term history of positive annual performance speaks to the resiliency of loans across market downturns.

Leveraged Loans Exhibit Resiliency Across Market Cycles

Source: Bloomberg. Data monthly from January 31, 2000 to December 31, 2023. Loans represented by the Credit Suisse Leveraged Loan Index (All loans). Past performance is not indicative of future results.

Do Higher Interest Rates Raise the Risk of Default?

Floating rates can be attractive due to the potential for the coupon payments on the loans to increase as rates go up. But this also means that the companies are paying higher debt service costs. This is an important consideration in the credit selection process.

Quality	Liquidity
Selecting higher-quality loans can help mitigate the risk of default.	Larger-sized loan tranches are typically more liquid as they are more appealing to large institutional investors.

The leveraged loan default rate, as measured by the S&P/LSTA Leveraged Loan Index, hit a record low in April 2022, and remained low through most of 2023, hitting 1.9% in October before rising somewhat. The long-term average default rate of the index is 2.77%, and S&P Global expects rates to potentially climb to 3% by September of 2024, before potentially dropping again in 2025.[2]

Does Consistent Investing Offer a Reward?

Leveraged loans could be an option for investors seeking increased yield and potential interest rate risk mitigation.

However, regarding them as only a tactical investment in a rising rate environment may miss some significant portfolio benefits. Beyond the yield premium, these assets may offer risk-adjusted returns that have the potential to beat the broad bond market. They may also offer portfolio diversification benefits of a less correlated asset class, and a consistency that may help smooth returns across market cycles.

To learn more, please contact your financial professional.

1 Fitch Ratings, U.S. Leveraged Finance Restructuring Series: Analysis of Ultimate Recovery Rates, March, 2023.

2. S&P Global Ratings Credit Research & Insights, December 2023.

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