

March 21 2017

BANK LOANS CHECK IN

Matthew E. Peterson *Chief Wealth Strategist, LPL Financial*

Colin Allen, CFA *Assistant Vice President, LPL Financial*

KEY TAKEAWAYS

Bank loans may be positioned well for today's environment of gradually higher trending short-term interest rates.

Bank loans' senior position in the capital structure has shown value in the form of higher historical recovery rates relative to high yield.

Despite the optimistic outlook, bank loans are below investment grade, still exhibit credit risk, and should not be viewed as a replacement for high-quality fixed income.

Bank loans are loans issued by below investment-grade companies for short-term funding purposes with higher yield than short-term debt and involve risk.

High yield/junk bonds (grade BB or below) are not investment grade securities, and are subject to higher interest rate, credit, and liquidity risks than those graded BBB and above. They generally should be part of a diversified portfolio for sophisticated investors.

Bank loans may be positioned well for today's environment of gradually higher trending short-term interest rates. Bank loans and high yield have much in common. Both represent debt of riskier companies, thus both carry higher credit risk for which investors are compensated with additional yield. One way to help gauge the relative value between bank loans and high yield is to examine the yield differential between the two sectors. High yield has usually enjoyed a yield advantage to bank loans. However, that trend has reversed as of late with bank loans generating a greater yield to end 2016 [Figure 1].

CAPITAL STRUCTURE: HIGHER IS BETTER

In the event of a default, bank loan investors have historically recouped more of their money, relative to high-yield investors. Default forecasts for below-investment grade fixed income are quite good for 2017, with rating agencies

1 BANK LOANS OUT-YIELD HIGH YIELD FOR FIRST TIME SINCE 2014



Source: LPL Research, Bloomberg 03/20/17

Indexes shown: Bloomberg Barclays Capital High Yield Index, Credit Suisse Leveraged Loan Index.

Indexes are unmanaged and cannot be invested into directly.

Past performance is no guarantee of future results.

forecasting a 3.0–3.5% high yield default rate at the end of this year and slightly lower for bank loans. Despite this optimistic outlook, defaults generally become more important to credit-focused investors later in the business cycle (see our [Recession Watch Dashboard](#) for where we are currently in the business cycle), when defaults start to materialize. Just as important as the overall rate of default is the recovery rate. The recovery rate is the overall percentage of capital that is recovered and returned to investors in the event of a default. An important difference between bank loans and high yield is the debts' place within the capital structure. Bank loans are senior-secured debt, meaning that these loans have a first lien claim on specific assets belonging to the corporation. This helps provide added protection in the event of bankruptcy. They also generally include contractual covenants like control of cash flows, maintenance of certain financial ratios, etc., which can help to protect investors further. The impact of this can be seen in the differential in recovery rates, historically about 80% for bank loans, while high yield has been about half that, near 40%.

ENERGY: A LINGERING CONCERN

As we discussed in our recent *Bond Market Perspectives*, "[Happy Anniversary High Yield and Oil](#)," the price of oil is still an important driver of high-yield performance. That has been a boon for investors ever since mid-February 2016, as oil's recovery has led to high yield's dramatic performance year. High-yield investors were reminded of the other side of that coin recently as oil traded below \$48/barrel for the first time since November 28, 2016, with corresponding weakness in high-yield bonds. Investors who are skittish about oil's influence on high-yield performance can take some solace in the fact that bank loan indices have far less exposure to energy than high yield indices do. As of February 28, 2017, the energy sector represented about 14% of the overall high-yield market, but just 3% of the bank loan market.

INTEREST RATE SENSITIVITY

Both high yield and bank loans tend to outperform higher-quality sectors in rising rate environments, but sometimes for different reasons. Generally, rising interest rate environments are ones in which growth and inflation rates are picking up due to improving economic conditions. High yield has historically outperformed higher-quality fixed income in those periods, partially due to its lower interest rate sensitivity. Importantly, some of the outperformance is attributable to high yield's equity-like performance characteristics. Improving economic fundamentals usually translate to lower default rates and investors thus require less additional compensation above and beyond the yield offered by high-quality fixed income (spread tightening). Bank loans tend to do well in those environments too, partially because of their similarly economically-sensitive nature, but also due to the floating rate coupons on the bank loans themselves. Bank loans are sometimes referred to as "floating rate securities" because their coupon payments are tied to a reference rate like 3-month London Interbank Offered Rate (Libor, a global market-determined reference rate). Libor generally moves with other short-term rates, thus when short-term rates rise, coupons rise, creating a tailwind for the bank loan sector relative to high-quality fixed income [\[Figure 2\]](#).

CREDIT RISK IS STILL SIGNIFICANT

In times of economic (and equity market) weakness, the higher recovery rates of bank loans can aid in performance, but significant credit risk still exists within the asset class. Like high yield, the asset class is below-investment grade and should not be misconstrued for high-quality fixed income. Despite a lower historical standard deviation than high yield, bank loans will nonetheless generally share similar equity-like performance characteristics. This is especially evident in sharply down, or up, years for equity

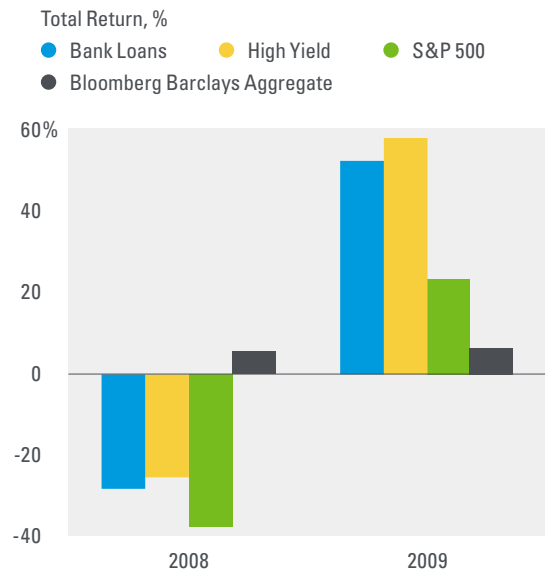
markets, when bank loans and high-yield performance bear little resemblance to high-quality fixed income [Figure 3].

As the performance in Figure 3 indicates, bank loans have the potential to be a good yield enhancer for portfolios or a good alpha generation tool relative to the high-quality Bloomberg Barclays Aggregate benchmark. However, large positions in lower-quality fixed income can be a double-edged sword: alpha generation in good times, but increased potential for downside risk in bad times. Investors should understand their own tolerance for risk, and just as importantly, think critically about the goals of their fixed income allocation.

CONCLUSION

We believe the absence of a recession in 2017 would bode moderately well for lower-quality fixed income. Low forecast default rates and relatively stable lending conditions mean that absent an

3 BANK LOAN PERFORMANCE CAN VARY FROM HIGH-QUALITY FIXED INCOME DRAMATICALLY



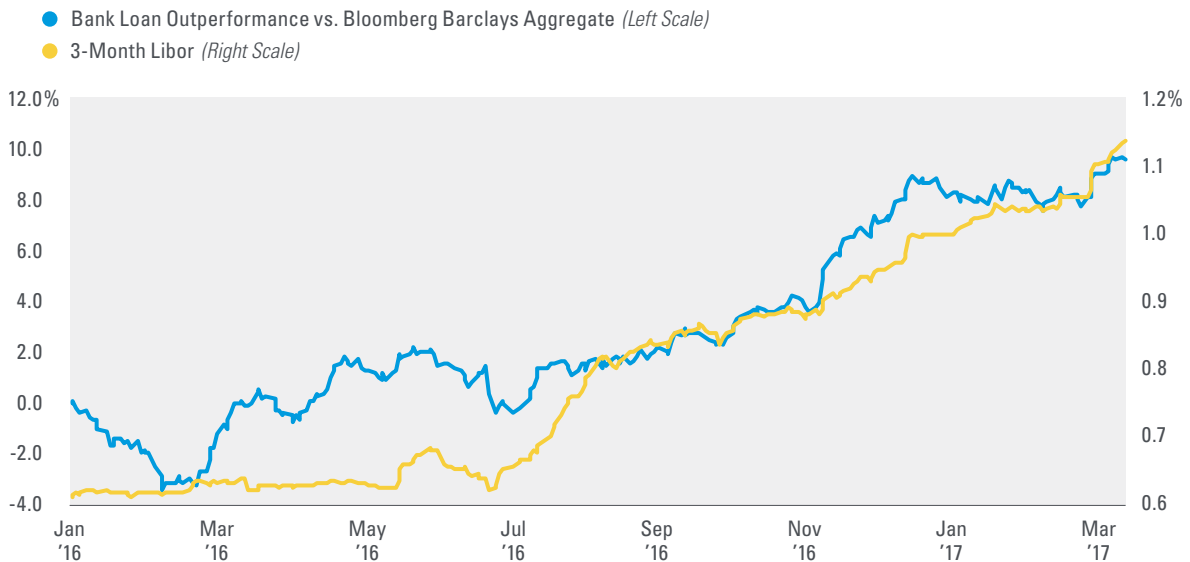
Source: LPL Research, Bloomberg 03/20/17

Past performance is no guarantee of future results.

Indexes: High Yield shown is Bloomberg Barclays Capital High Yield Index; Bank Loans shown is S&P U.S. Leveraged Loan 100 Index Total Return.

Indexes are unmanaged and cannot be invested into directly.

2 RISE IN LIBOR HAS BEEN A TAILWIND FOR BANK LOANS



Source: LPL Research, Bloomberg 03/20/17

Indexes: Bank loan outperformance shown is S&P U.S. Leveraged Loan 100 Index Total Return

Indexes are unmanaged and cannot be invested into directly.

Past performance is no guarantee of future results.

unforeseen shock to the market, low-quality, below-investment grade fixed income may enjoy a good year, mostly driven by the yield component of return. Within lower credit quality fixed income,

we maintain a slight preference for bank loans over high yield due to the potential for higher yields, seniority in the capital structure, and lower interest rate sensitivity. ■

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indexes are unmanaged and cannot be invested into directly.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values and yields will decline as interest rates rise, and bonds are subject to availability and change in price.

Bank loans are loans issued by below investment-grade companies for short-term funding purposes with higher yield than short-term debt and involve risk.

The fast price swings in commodities and currencies will result in significant volatility in an investor's holdings.

Credit quality is one of the principal criteria for judging the investment quality of a bond or bond mutual fund. As the term implies, credit quality informs investors of a bond or bond portfolio's credit worthiness, or risk of default.

Yield spread is the difference between yields on differing debt instruments, calculated by deducting the yield of one instrument from another. The higher the yield spread, the greater the difference between the yields offered by each instrument. The spread can be measured between debt instruments of differing maturities, credit ratings, and risk.

Standard deviation is a historical measure of the variability of returns relative to the average annual return. A higher number indicates higher overall volatility.

Alpha measures the difference between a portfolio's actual returns and its expected performance, given its level of risk as measured by beta. A positive/negative alpha indicates the portfolio has performed better/worse than its beta would predict.

DEFINITIONS

London Interbank Offered Rate (Libor): An interest rate at which banks can borrow funds, in marketable size, from other banks in the London interbank market. The Libor is fixed on a daily basis by the British Bankers' Association. The Libor is derived from a filtered average of the world's most creditworthy banks' interbank deposit rates for larger loans with maturities between overnight and one full year.

The Bloomberg Barclays U.S. Aggregate Bond Index is a broad-based flagship benchmark that measures the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS (agency and non-agency).

The Bloomberg Barclays Capital High Yield Index covers the universe of publicly issued debt obligations rated below investment grade. Bonds must be rated below investment grade or high yield (Ba1/BB+ or lower), by at least two of the following ratings agencies: Moody's, S&P, and Fitch. Bonds must also have at least one year to maturity, have at least \$150 million in par value outstanding, and must be U.S. dollar denominated and nonconvertible. Bonds issued by countries designated as emerging markets are excluded.

The S&P 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

S&P U.S. Leveraged Loan Indexes (S&P LL indexes) are capitalization-weighted syndicated loan indexes based upon market weightings, spreads and interest payments.

The Credit Suisse Leveraged Loan Index is designed to mirror the investable universe of the U.S. dollar-denominated leveraged loan market. Loan facilities must be rated "5B" or lower. That is, the highest Moody's/S&P ratings are Baa1/BB+ or Ba1/BBB+. If unrated, the initial spread level must be Libor plus 125 basis points or higher. Only fully funded, term loan facilities are included. The tenor must be at least one year. Issuers must be domiciled in developed countries; issuers from developing countries are excluded.

This research material has been prepared by LPL Financial LLC.

To the extent you are receiving investment advice from a separately registered independent investment advisor, please note that LPL Financial LLC is not an affiliate of and makes no representation with respect to such entity.

Not FDIC or NCUA/NCUSIF Insured | No Bank or Credit Union Guarantee | May Lose Value | Not Guaranteed by Any Government Agency | Not a Bank/Credit Union Deposit

RES 5827 0317 | Tracking #1-592590 (Exp. 03/18)