A Compelling Case for Leveraged Loans

EXECUTIVE SUMMARY

In the current market environment, there are a number of compelling reasons to invest in leveraged loans.

- In a situation where most assets are trading near historically high levels, loans remain attractive on a risk-adjusted basis compared to other asset classes. In particular, the senior position of loans within the capital structure helps to mitigate risk.
- Leveraged loan fundamentals generally are positive. For the issuer universe overall, debt service metrics are strong and defaults have been lower than the historical average (please see Exhibit 3 on page 3). Furthermore, steady economic growth in the U.S. and other favorable indicators may provide a supportive backdrop.
- Technical conditions – supply and demand – are in balance and provide further support to the leveraged loan market. Issuance hit record-high levels in 2017 while strong demand driven by the collateralized loan obligation market (CLO) has offset softer retail flows.
- In a rising interest rate environment, such as the present time, leveraged loans may provide some protection against rising rates. As a floating-rate product, coupon rates on leveraged loans typically reset every 90 days. Unlike conventional fixed income assets, loan prices are unlikely to fall when interest rates climb. All else being equal, rising rates could be a tailwind for leveraged loans and a headwind for other asset classes.

ATTRACTIVE RELATIVE VALUATIONS

Leveraged loan valuations, like many other asset classes today, are at historically high levels. On a risk-adjusted basis, however, loans are attractive compared to other asset classes including equities and high yield bonds (please see Exhibit 1 below). The lower volatility of loans can be attributed to some extent by their position at the top of the capital structure, which mitigates risk in the face of defaults.

EXHIBIT 1: HIGH YIELD AND LOANS VS. EQUITIES – 1/1/92-12/31/17

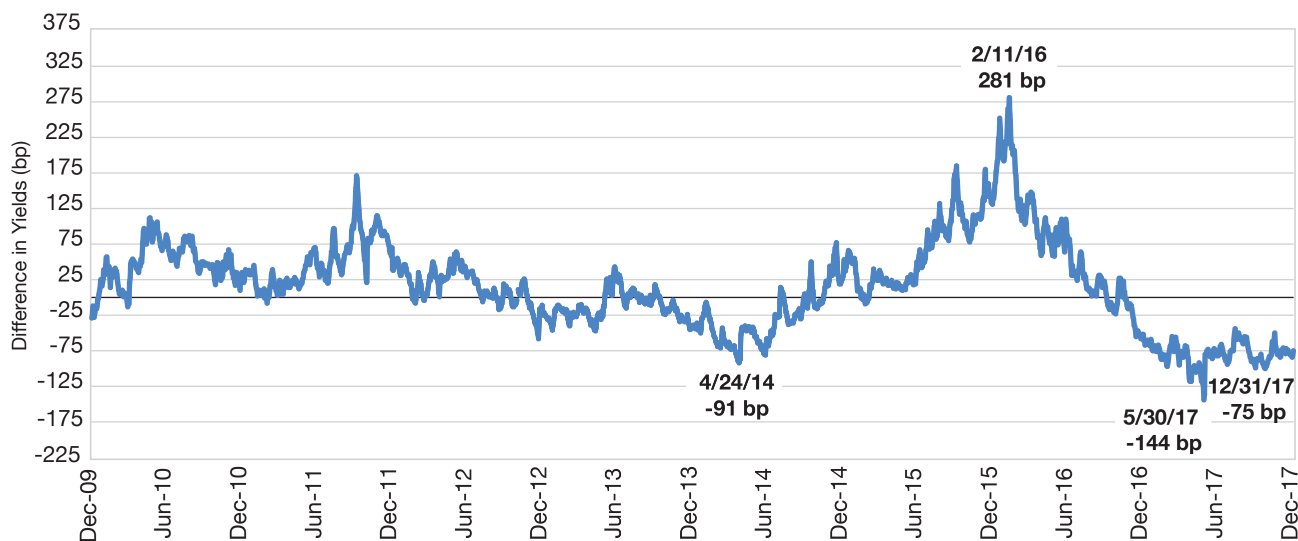
	Annualized Return	Standard Deviation	Return per Unit of Risk	Rolling 3-Year Periods		
				Best	Worst	% Negative
High Yield Bonds	7.98%	8.26%	1.0	26.1%	-7.6%	8%
Leveraged Loans	5.70%	5.01%	1.1	17.5%	-8.0%	4%
Large-Cap Equity	9.61%	13.96%	0.7	32.8%	-16.1%	21%
Small-Cap Equity	9.88%	18.44%	0.5	29.6%	-17.8%	16%

Past performance is not indicative of future results.

The High Yield, Leveraged Loan, Large-Cap Equity, and Small-Cap Equity markets are represented by the Bloomberg Barclays U.S. Corporate High Yield Bond Index, Credit Suisse Leveraged Loan Index, S&P 500® Index, and Russell 2000® Index, respectively. Returns were calculated using monthly data and begin with the inception of the Credit Suisse Leveraged Loan Index on 1/1/92. Indexes defined on page 7. Data sources: Credit Suisse, Standard & Poor's, FTSE Russell, Bloomberg Barclays

Notably, the yield differential between high yield bonds and leveraged loans suggests that an attractive entry point for loans may exist.

EXHIBIT 2: YIELD DIFFERENTIAL BETWEEN HIGH YIELD (YTW) AND LOANS (YTM) – 12/31/09-12/31/17



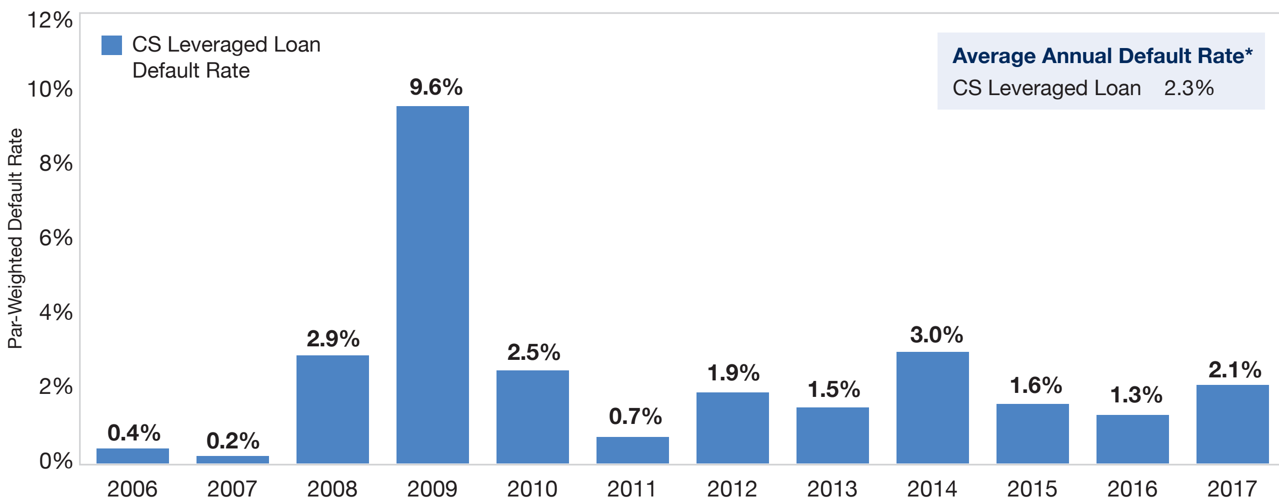
Data source: ICE BAML High Yield Cash Pay Index (J0A0) effective yield; CS Leveraged Loan Index YTM

POSITIVE FUNDAMENTALS

Broad-based fundamentals for the leveraged loan issuer universe are positive, including leverage, interest coverage, and corporate cash levels.

Default activity has been modest and default rates are expected to remain below their historical average for the foreseeable future. The default forecast for 2018 is projected to be 2.5%[1], a small increase from 2017's low level.

EXHIBIT 3: LEVERAGED LOAN DEFAULT RATES ARE EXPECTED TO REMAIN BELOW HISTORICAL AVERAGE



*2006 to 12/31/17. **Past performance is not indicative of future results.** Data source: Credit Suisse

The energy and metals & mining sectors dominated default activity throughout much of 2016 and into 2017 as slumping prices for oil and other commodities took their toll on company revenues. While these sectors have rebounded, the retail sector is currently undergoing an increasing amount of stress and headline risk as evidenced by the notable bankruptcy of Toys "R" Us in September 2017.

With respect to issuance, low interest rates have been beneficial to corporate fundamentals. Companies have taken advantage of the current environment to refinance existing debt at lower spreads, thus improving their financial health by reducing the burden of interest expense.

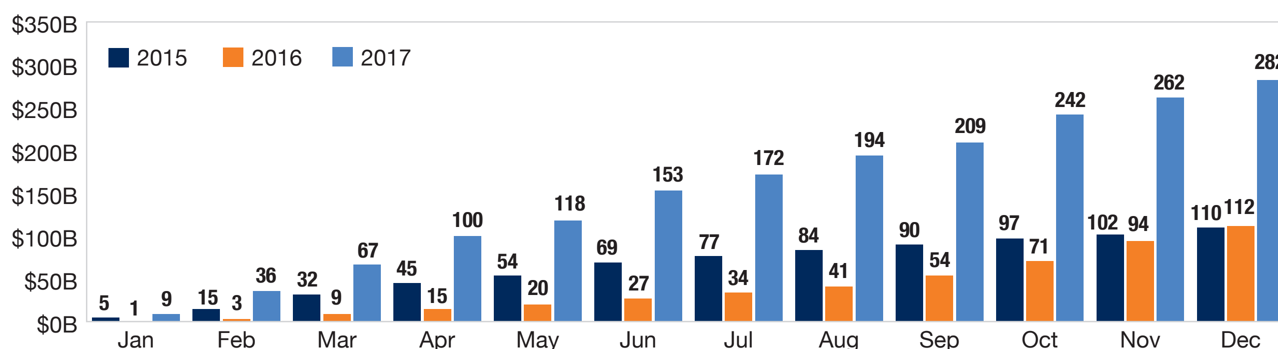
For the broader economy overall, the U.S. continues to exhibit steady growth with annualized GDP growth of 3.2% in the third quarter of 2017, following 3.1% growth in the second quarter. Coupled with a strong labor market, lower corporate tax rates, expectations of reduced regulations, and other favorable economic indicators, the fundamental backdrop bodes well for leveraged loans.

[1]JPMorgan Securities – as of 12/31/17

SUPPORTIVE TECHNICAL CONDITIONS

2017 was one of the strongest years on record for leveraged loan issuance. Gross issuance totaled approximately $974 billion and net issuance (excluding repricings and refinancings) was roughly $230 billion. While leveraged loan retail fund inflows were solid at $13.5 billion for all of 2017, institutional demand through the CLO market continued at a rapid pace and complemented retail fund flows.

EXHIBIT 4: 2017 CUMULATIVE MONTHLY U.S. CLO GROSS ISSUANCE

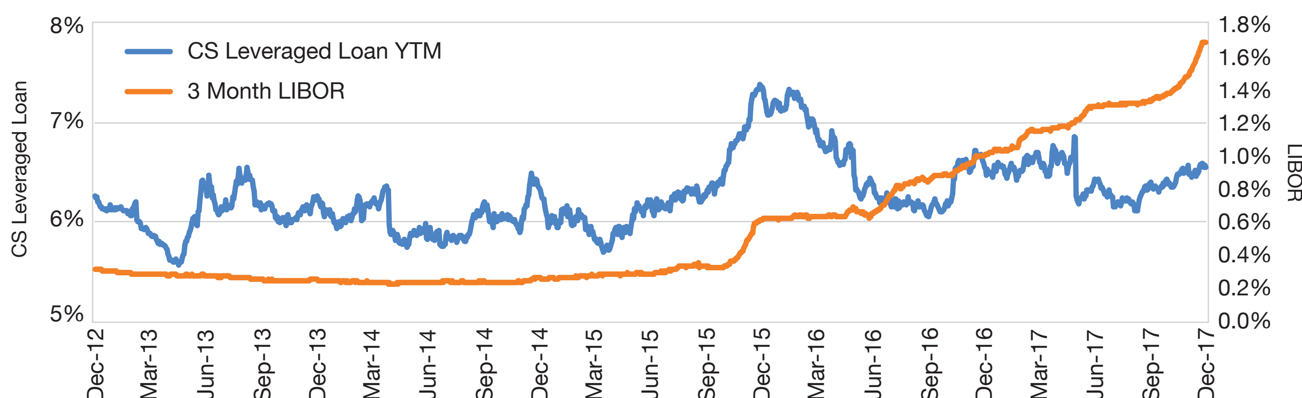


As of 12/31/17. Data source: JPMorgan

Favorable market conditions and strong institutional demand motivated issuers to refinance their debt. Indeed, refinancings and repricings made up roughly 76% of gross loan issuance in 2017.

Leveraged loans offer coupons that periodically reset in relation to a base rate, usually the London Interbank Offered Rate (LIBOR). LIBOR has been moving steadily higher, initially as a result of new regulations on prime money market funds (effective October 2016), but more recently as a result of the Federal Reserve's (Fed) decisions to raise rates. As of December 31, 2017, LIBOR stood at 1.69%, up from 1.00% at the end of 2016. Despite a large robust new issue calendar consisting of strong refinancing activity that resulted in lower initial yields, LIBOR rose in tandem, providing an offset to this initial yield decline.

EXHIBIT 5: CS LEVERAGED LOAN INDEX YIELD VERSUS LIBOR – 12/31/12-12/31/17



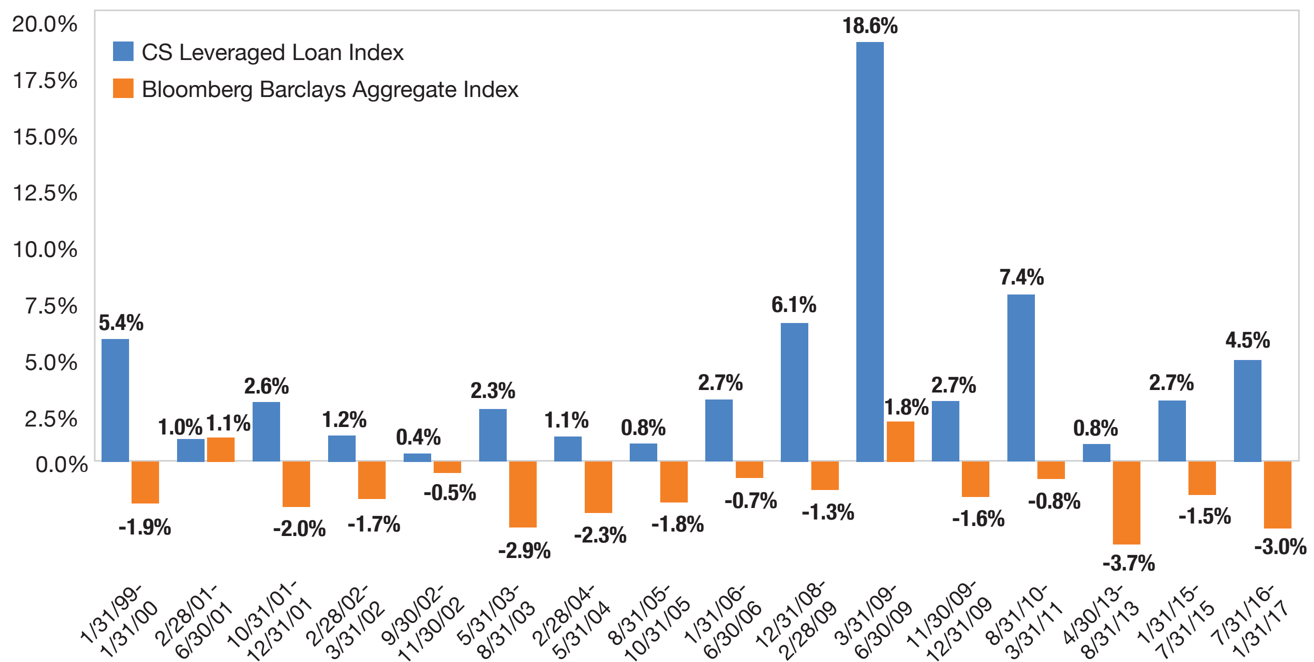
Data source: Credit Suisse, Federal Reserve Bank of St. Louis

A POTENTIAL ADVANTAGE IN A RISING RATE ENVIRONMENT

Since the current tightening cycle began in December 2015, the Fed has raised its key short-term interest rate four additional times based on its confidence in a strengthening U.S. economy. As widely expected, the most recent hike came in December 2017 when the Fed raised its benchmark rate another 25 basis points to a range of 1.25%–1.50%. At the same time, the Fed projected three hikes in 2018. If higher interest rates prevail, investors would be wise to consider leveraged loans.

Because of their floating rate feature, loans are typically valued for their ability to protect investors during periods when the Fed raises short-term rates. Historically, leveraged loans have performed well when interest rates start to ascend.

EXHIBIT 6: IN RISING INTEREST RATE ENVIRONMENTS, LEVERAGED LOANS POSTED POSITIVE RETURNS IN 16 OUT OF 16 PERIODS



Time periods since 6/30/97 when month end 10-Year Treasury yields rose at least 50 basis points.
Past performance is not indicative of future results. Data source: Credit Suisse

Because leveraged loans reset on a quarterly basis, they have little interest rate duration risk (sensitivity of a loan's price to a 1% change in interest rates). Leveraged loans are thus unlikely to see the price declines that conventional fixed income assets experience when interest rates rise. As a result, higher payouts, combined with relatively stable prices, suggest leveraged loans could outperform other fixed income assets as interest rates climb.

CONCLUSION

There are a number of factors that support leveraged loans as an attractive investment option. While all asset classes appear to be trading at unprecedented premiums, leveraged loans continue to offer attractive income and return on a risk-adjusted basis. Fundamentally speaking, issuers continue to show improvement while the economy provides a sound backdrop. Finally, the Fed raised rates three times in 2017 with the expectation of three additional hikes in 2018. The reality of rising rates may spur demand by retail investors who have stayed on the sidelines for much of the second half of 2017, but now seek some insulation from falling prices on interest rate-sensitive sectors.

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About Seix Investment Advisors LLC

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BofA Merrill Lynch High Yield Cash Pay Index is an unmanaged index consisting of all domestic and Yankee high-yield bonds maturing over one year. The quality range is less than BBB-/Baa3 but not in default (DDD1 or less).

Bloomberg Barclays U.S. Corporate High Yield Bond Index is an unmanaged market value-weighted index that covers the universe of fixed rate, non-investment grade debt.

Credit Suisse Leveraged Loan Index is a market-weighted index that tracks the performance of institutional leveraged loans.

The S&P 500® Index is a free-float market capitalization-weighted index of 500 of the largest U.S. companies. The index is calculated on a total return basis with dividends reinvested.

The Russell 2000® Index is a market capitalization-weighted index of the 2,000 smallest companies in the Russell Universe, which comprises the 3,000 largest U.S. companies. The index is calculated on a total return basis with dividends reinvested.

The indexes are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and are not available for direct investment.

A Basis Point (bp) is equal to 0.01%.

Average Coupon is the weighted average coupon (annual rate of interest on the bond's face value that the issuer agrees to pay the holder until maturity) of all the securities in a fund.

Collateralized Loan Obligations are securities backed by a pool of assets often low-rated corporate loans.

Modified Duration is a measure of the sensitivity of the price (the value of principal) of a fixed income investment to a change in interest rates, expressed as a number of years.

Spread is the difference between the yields of sector types and or maturity ranges.

Yield-to-Maturity (YTM) of a bond is the internal rate of return earned by an investor who buys the bond today at the market price, assuming that the bond will be held until maturity, and that all coupon and principal payments will be made on schedule. Yield to maturity is an estimation of future return.

Yield to Worst (YTW) is the lowest potential yield that can be received on a bond without the issuer actually defaulting. The YTW is calculated by making worst-case scenario assumptions on the issue by calculating the return that would be received if the issuer uses provisions, including prepayments, calls or sinking funds.

The commentary is the opinion of the subadviser. This material has been prepared using sources of information generally believed to be reliable; however, its accuracy is not guaranteed. Opinions represented are subject to change and should not be considered investment advice or an offer of securities.

IMPORTANT RISK CONSIDERATIONS:
Bank Loans: Loans may be unsecured or not fully collateralized, may be subject to restrictions on resale and/or trade infrequently on the secondary market. Loans can carry significant credit and call risk, can be difficult to value and have longer settlement times than other investments, which can make loans relatively illiquid at times. **Credit & Interest:** Debt securities are subject to various risks, the most prominent of which are credit and interest rate risk. The issuer of a debt security may fail to make interest and/or principal payments. Values of debt securities may rise or fall in response to changes in interest rates, and this risk may be enhanced with longer-term maturities. **Foreign & Emerging Markets:** Investing internationally, especially in emerging markets, involves additional risks such as currency, political, accounting, economic, and market risk. **High Yield-High Risk Fixed Income Securities:** There is a greater level of credit risk and price volatility involved with high yield securities than investment grade securities.

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