BANK LOANS, 2023 PROGNOSTICATIONS, AND CHICKEN LITTLE: THE SKY DID NOT FALL

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Bank loans finished a great year, ending 2023 up by +13.17% (as represented by the J.P. Morgan Leveraged Loan Index) after finishing 2022 down -0.63%. Over the two-year period, bank loans are up approximately +12%. Given this, it's somewhat perplexing that many retail bank loan investors did not benefit from these higher yields. Retail redemptions in 2022 were -$12.7 billion, and in 2023, redemptions increased to -17.7 billion.

Two-Year Returns, 2022–2023

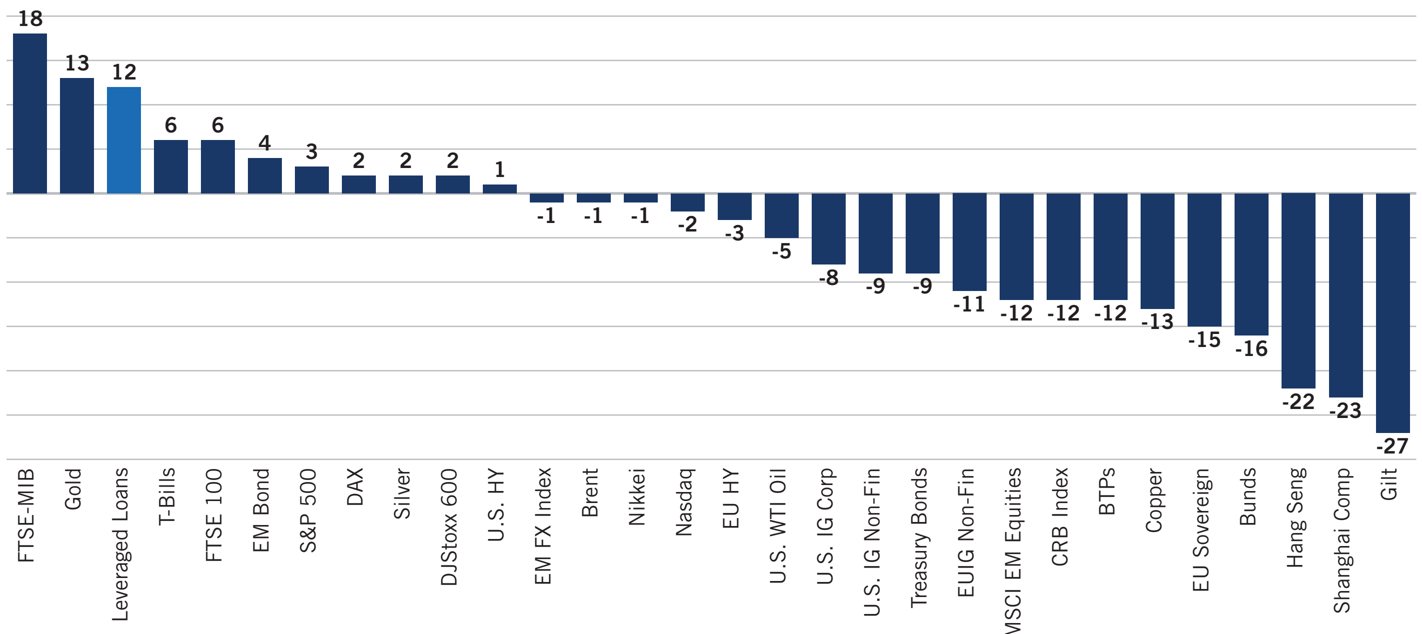
Bank Loans	S&P 500® Index	U.S. Treasury
+12%	+3%	-9%

Source: J.P. Morgan. As of December 31, 2023. **Past performance is no guarantee of future results.**

By contrast, the S&P 500® Index, while up 26.29% in 2023, was down -18.11% in 2022—giving it a two-year return of roughly 3%. The Bloomberg U.S. Aggregate Bond Index was up +5.53 in 2023, but down -13.01 in 2022. What makes loans even more attractive is the current distribution yield of over 9%. Coupons on loans have moved very little because the Federal Reserve (Fed) has yet to decrease rates.

CHART 1: LEVERAGED LOANS HAVE OFFERED ATTRACTIVE RELATIVE VALUE

Selected global total returns from the end of 2021 to the end of 2023 (%)



Past performance is not indicative of future results. Source: Deutsche Bank, Bloomberg Finance LP. Note: Cumulative total returns (USD terms). Equities, credit, and bonds shown on total return basis, FX and commodities shown on spot return basis.

The Sky Did Not Fall

Despite overstated gloomy prognostications for bank loans brought on by media reports and forecasts, default rates for 2023 were below historical averages. While projections were anywhere from 3% to over 10%, actual defaults for the year were only 2.10%. Additionally, on a total returns basis, bank loans have only experienced three down years since the inception of the index in 1992:

2015	2022	2008
-0.38%	-1.06%	-28.75%

Past performance is no guarantee of future results. Source: J.P. Morgan, J.P. Morgan Leveraged Loan Index.

Now, with distribution yields over 9%, investors may be more than compensated for the risk in bank loans. So, no—the sky is not falling.

And, what is the risk footprint of bank loans? Historically, a standard deviation of less than 40% of large-cap equities.

Loans and High Yield versus Equity Markets (1/1/92–12/31/23)

	Annualized Return	Standard Deviation	Return Per Unit of Risk	Rolling 3-Year Periods		
				Best	Worst	% Negative
Leveraged Loans	5.53%	5.35%	1.0	17.5%	-8.0%	3%
High Yield Bonds	7.27%	8.37%	0.9	26.1%	-7.6%	6%
Large Cap Equity	10.06%	14.80%	0.7	32.8%	-16.1%	17%
Small Cap Equity	9.17%	19.45%	0.5	29.6%	-17.8%	13%

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 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. Source: Credit Suisse, Standard & Poor's, FTSE Russell, Bloomberg.

The bank loan sector has matured and developed into a mostly institutional asset class as institutional investors saw the benefit of allocating to bank loans. Institutions tend to be "buy and hold" investors and understand the relationship between distribution yields, defaults, and total returns—remember the formula: distribution yield minus defaults plus recovery.

Institutional investors understand the consequences of return per unit of risk (see above chart). They also understand that historical defaults for the sector have hovered around 3% and that the right active manager has the potential to reduce the portfolio's default rate even further. Collateralized loan obligations (CLOs) make up most of the holders at approximately 66%, with the rest held by insurance companies, banks, hedge funds, and institutional SMA accounts. According to J.P. Morgan, only 9% of bank loans are owned by retail accounts. It is important to note that another technical factor powering the market is the decreasing size of the leveraged loan universe as the market decreased by roughly 4% last year. This decrease was driven by M&A loan takeouts, bond for loan takeouts, and some loans that were refinanced in the private debt market.

So, what is the next fear around bank loans? Some investors are concerned that the Fed is going to reduce rates—a disadvantage for a floating rate product. However, look at the starting yield: even if the Fed cuts rates 100 basis points, this brings the distribution yield for the sector down to about 8.25-8.50%—still a very healthy return (don't forget: money market rates would fall commensurately).

Investors are being paid for their risk—just ask institutional investors. It's time to rethink the asset class as rates have now normalized and the sector has demonstrated the potential to generate a healthy yield.

To learn more about Seix Investment Advisors, please visit seixadvisors.com. For information regarding our subadvised mutual funds, please visit virtus.com or call 1-800-243-4361.

Bank Loans: Bank loans may be unsecured or not fully collateralized, may be subject to restrictions on resale, may be less liquid and may trade infrequently on the secondary market. Bank loans settle on a delayed basis; thus, sale proceeds may not be available to meet redemptions for a substantial period of time after the sale of the loan.

A **Basis Point (bp)** is equal to 0.01%. **Collateralized Loan Obligations** are securities backed by a pool of assets, often low-rated corporate loans.

The **S&P 500® Index** is a free-float market-capitalization weighted index of 500 of the largest U.S. companies that measures the performance of the large-cap segment of the market. The index is calculated on a total return basis with dividends reinvested. The **J.P. Morgan Leveraged Loan Index** is designed to mirror the investable universe of U.S. dollar institutional leveraged loans, including U.S. and international borrowers. The **Bloomberg U.S. Aggregate Bond Index** is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS. The **Bloomberg U.S. Corporate High Yield Bond Index** measures fixed rate non-investment grade debt securities of U.S. corporations,calculated on a total return basis. The **Credit Suisse Leveraged Loan Index** is a market-weighted index that tracks the investable universe of the U.S. dollar denominated leveraged loans. 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 calculated on a total return basis, are unmanaged, and are not available for direct investment.

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