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As interest rates rise, investors may look to floating-rate funds

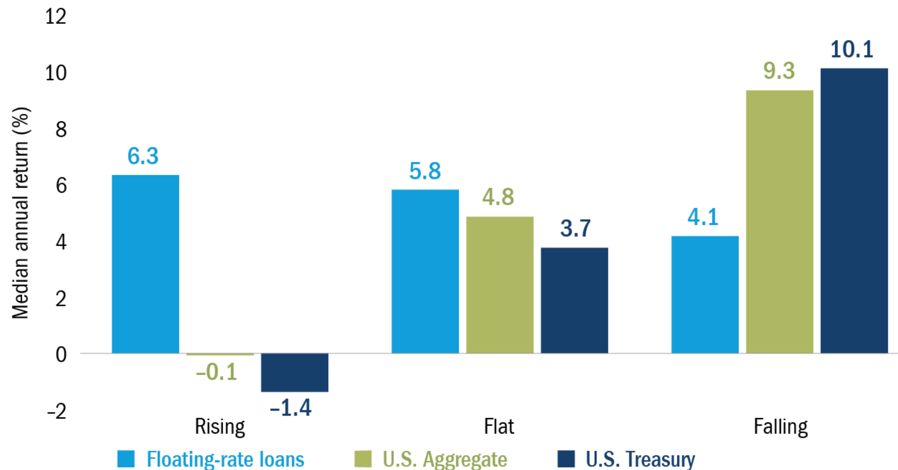
April 26, 2023

The appeal of floating-rate loans usually peaks when interest rates are rising. But they may help diversify portfolios in any environment.

Floating-rate loans are known by many names, including bank loans, senior loans and leveraged loans. They're typically extended to companies with higher levels of debt relative to cash flow, and because of this, they carry greater credit risk than investment-grade bonds. But unlike traditional bonds, floating-rate loans don't make a fixed-interest payment, or coupon, each period. Instead, their coupons reset every 30 or 90 days, floating up or down with the changes in prevailing interest rates. This floating feature makes loan prices less sensitive to shifts in interest rates, so flows into floating-rate loan funds tend to increase when the Federal Reserve is actively raising rates in response to a growing economy and improved labor market. And, as you can guess, this trend tends to reverse when rates are falling.

Historically, floating-rate loans have outperformed in rising and flat interest-rate environments. When rates are rising, the median annual return for floating-rate loans, as gauged by the Credit Suisse Leveraged Loan Index, has exceeded the return on U.S. Treasuries and the Bloomberg U.S. Aggregate Bond Index by more than six percentage points since 1993. But what's possibly overlooked is that floating-rate loans have also delivered attractive absolute and relative performance regardless of the broader interest-rate environment. Because yield is a significant component of total return, floating-rate loans also have outperformed U.S. Treasuries and the Bloomberg Aggregate Bond Index when rates are flat. It's only when rates fall that we have seen floating-rate loans underperform.

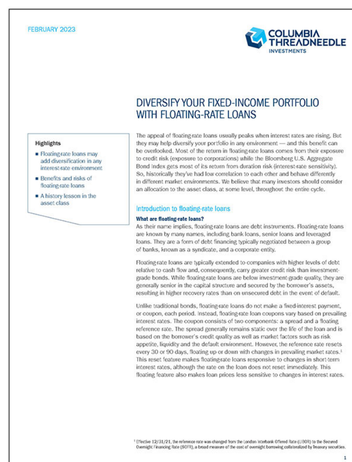
Floating-rate loans in rising, flat and falling rate environments



Source: Credit Suisse and Bloomberg Indices. "Rising" indicated by an increase of more than 50 bps. "Falling" indicated by a decrease of more than 50 bps. Data reflects rolling 12-month periods from 01/31/93 through 12/21/22. **Past performance is not a guarantee of future results.**

Floating-rate loans may add diversification in any interest-rate environment.
Although their interest-rate-related characteristics are what drive investors' flows into and out of the asset class, floating-rate loans can help diversify a portfolio at any time — and this benefit can be overlooked. Most of the return in floating-rate loans comes from their exposure to credit risk (exposure to corporations), while the Bloomberg U.S. Aggregate Bond Index gets most of its return from duration risk (interest-rate sensitivity). So, historically they've had low correlation to each other and behave differently in different market environments.

Bottom line
Floating-rate loans tend to be popular when interest-rates are rising, but they may have diversification benefits in any interest rate environment.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DISCLOSURES

Diversification does not assure a profit or protect against loss.

Floating rate loans typically present greater risk than other fixed-income investments as they are generally subject to legal or contractual resale restrictions, may trade less frequently and experience value impairments during liquidation.

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The Bloomberg U.S. Aggregate Bond Index is a market-value-weighted index that tracks the daily price, coupon, pay-downs and total return performance of fixed-rate, publicly placed, dollar-denominated and non-convertible investment-grade debt issues with at least $250 million par amount outstanding and with at least one year to final maturity.

The Credit Suisse Leveraged Loan Index tracks the investable market of the U.S.-dollar-denominated leveraged loan market. It consists of issues rated "5B" or lower, meaning that the highest rated issues included in this index are Moody's/S&P ratings of Baa1/BB+ or a1/BBB+. All loans are funded term loans with a tenor of at least one year and are made by issuers domiciled in developed countries.

Indices shown are unmanaged and do not reflect the impact of fees. It is not possible to invest directly in an index.

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