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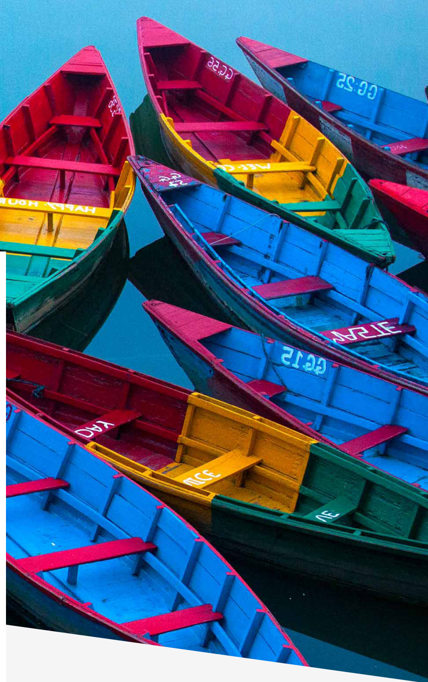


Uncovering an overlooked benefit to floating-rate loans

April 30, 2019

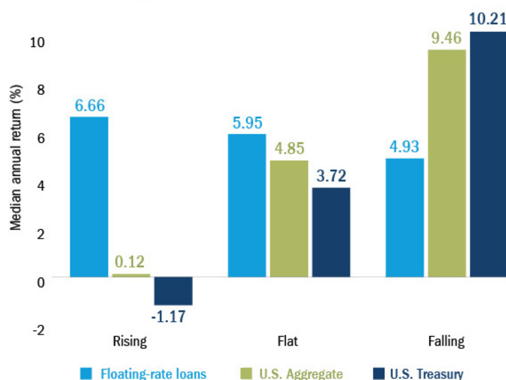
The appeal of floating-rate loans usually peaks when interest rates are rising. But they may help diversify your portfolio in any environment.

Columbia Threadneedle Investment Team

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 their cash flows, 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, 60 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 there tends to be a significant uptick in how much is flowing into the asset class 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 aren't rising.

Past performance gives this approach credibility. When rates are rising, the median annual return for floating-rate loans, as gauged by the Credit Suisse Leveraged Loan Index, has been more than 6% higher than for U.S. Treasuries and the Bloomberg Barclays U.S. Aggregate Bond Index. 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 such a significant component of total return, floating-rate loans also have outperformed U.S. Treasuries and the Bloomberg Barclays Aggregate Bond Index when rates are flat. It's only when rates fall that we have seen floating-rate loans become a relative "underperformer."

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



Source: Credit Suisse and Bloomberg Barclays 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 12/31/18. Past performance is not a guarantee of future results.

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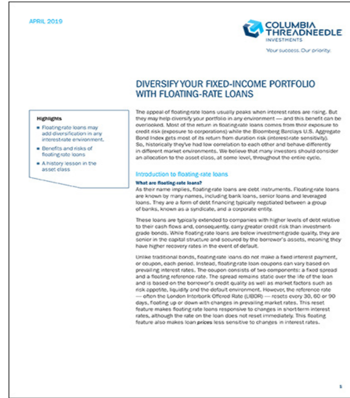
Floating-rate loans may add diversification in any interest-rate environment.

Although their interest-rate-related benefits 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 Barclays 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.

We can illustrate the benefit of adding floating-rate loans to an otherwise all-traditional, investment-grade, fixed-ratebond portfolio by drawing an efficient frontier. At a 65% Bloomberg Barclays U.S. Aggregate Bond Index/35% floating-rate loans split, a portfolio's overall volatility is lower and the return is higher because sources of risk are diversified, and there is more yield in the portfolio. A 35% allocation to floating-rate loans is pretty significant and higher than we would recommend, but it's meant to help illustrate the diversifying power of floating-rate loans. Other factors, such as where we are in the credit cycle, valuation and the market's appetite for risk must be considered when investing in bank loans. We believe that many investors should consider an allocation to the asset class, at some level, throughout the entire cycle.

Want to learn more about the benefits and risks of floating-rate loans?

GET THE WHITE PAPER



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Your success. Our priority.

DIVERSIFY YOUR FIXED-INCOME PORTFOLIO WITH FLOATING-RATE LOANS

Highlights

- Floating-rate loans may add diversification in any interest-rate environment.
- Benefits and risks of floating-rate loans
- A history lesson in the asset class

The appeal of floating-rate loans usually peaks when interest rates are rising. But they may help diversify your portfolio in any environment — 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 Barclays 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. We believe that many investors should consider an allocation to the asset class, at some level, throughout the entire cycle.

Introduction to floating-rate loans

What are floating-rate loans?

As their name implies, floating-rate loans are debt instruments. Floating-rate loans are known by many names, including bank loans, senior loans and leveraged loans. They are a form of debt financing typically negotiated between a group of banks, known as a syndicate, and a corporate entity.

These loans are typically extended to companies with higher levels of debt relative to their cash flows and, consequently, carry greater credit risk than investment-grade bonds. While floating-rate loans are below investment-grade quality, they are senior in the capital structure and secured by the borrower's assets, meaning they have higher recovery rates in the event of default.

Unlike traditional bonds, floating-rate loans do not make a fixed interest payment, or coupon, each period. Instead, floating-rate loan coupons can vary based on prevailing interest rates. The coupon consists of two components: a fixed spread and a floating reference rate. The spread remains static over the life of the loan and is based on the borrower's credit quality as well as market factors such as risk appetite, liquidity and the default environment. However, the reference rate — often the London Interbank Offered Rate (LIBOR) — resets every 30, 60 or 90 days, floating up or down with changes in prevailing market rates. This reset feature makes floating rate loans responsive to changes in short-term interest rates, although the rate on the loan does not reset immediately. This floating feature also makes loan **prices** less sensitive to changes in interest rates.

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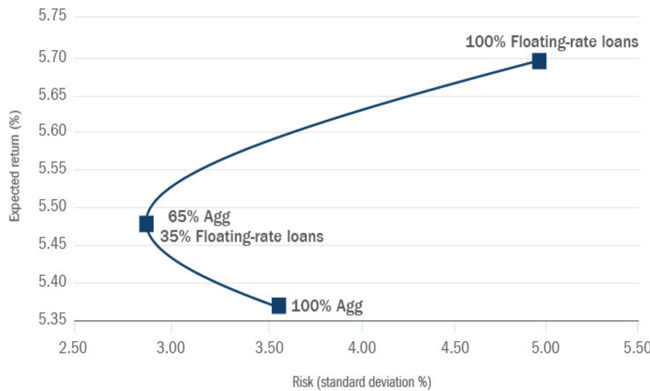
Floating-rate loans' diversification benefit



Source: Credit Suisse and Columbia Threadneedle Investments. Efficient frontier uses monthly returns of the Bloomberg Barclays U.S. Aggregate Index and Credit Suisse Leveraged Loan Index from 01/31/92 to 03/31/19.

Bottom line

Floating-rate loans are popular when interest rates are rising, but they may have diversification benefits in any interest-rate environment.

The **Bloomberg Barclays 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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