COLUMBIA THREADNEEDLE INVESTMENTS

A focus on floating-rate loans

December 10, 2018

Investors expect interest rate increases to slow down and are moving away from floating-rate loans. What to know about this income-producing asset class:

Recently, disappointing returns in the floating-rate loan sector have caused investors to question its prospects in 2019. The flow of money out of the asset class has been abrupt, and this pressure caused loan prices to decline almost 2% since late October.[1]

Q: Why are the outflows occurring?

As the name suggests, 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 short-term interest rates. This floating feature makes loan prices less sensitive to shifts in interest rates, so there tends to be a significant uptick in flows when the Federal Reserve is actively raising rates, and the trend reverses when rates or rate expectations stop rising (or decline).

An equally important consideration that's sometimes overlooked is the financial health of floating rate issuers. Our research team sees underlying credit fundamentals as sound, and we don't expect defaults to increase in a significant way from historically low levels of 1%-2%. But the sector is not immune to macro or geopolitical concerns about potential slower economic growth, trade and tariffs, China's growth and Brexit. There are also expectations that the Federal Reserve policy will pause or reach a conclusion to interest rate increases by early or mid-2019, and investors have responded by retreating from the floating-rate loan market.

Q: Will outflows affect the floating-rate loan market?

We acknowledge the asset class may face continued selling pressure in the short-term. Like everyone else, we're watching activity in some of the bigger benchmark-tracking floating-rate loan ETFs very closely because flows in and out of those products tend to be a leading indicator of activity and future floating-rate loan prices.

On the positive side, market liquidity remains reasonably solid with active buyers. This appears to be fueled by continued demand from the largest component of the loan market, collateralized-loan obligations (CLOs). The strong CLO pipeline helps diversify the investor base to include institutional managers and potentially

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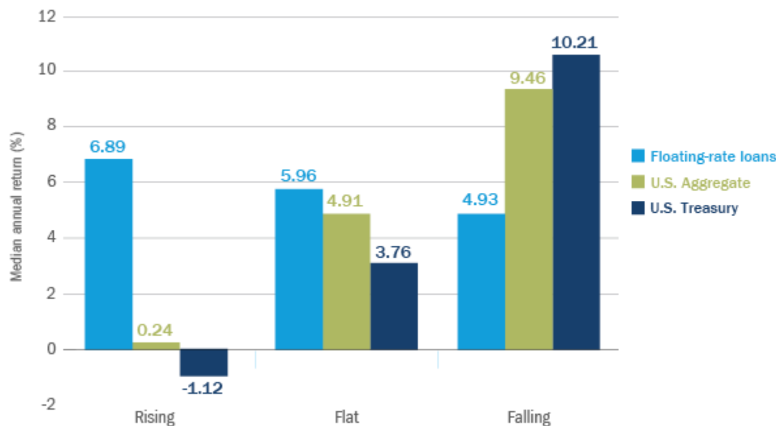
mitigates the risk of sizable outflows from retail investors. Our floating-rate loan group is a large issuer and manager of CLOs, and we continue to be active in the market.

Q: How will a slowdown in interest-rate increases affect floating-rate loans?

The appeal of floating-rate loans usually peaks when interest rates are rising, but they could help diversify your portfolio in any environment. When rates are rising, the median annual return for floating-rate loans, as gauged by the Credit Suisse Leveraged Loan index, is 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've seen floating-rate loans become a relative underperformer — although we still see positive returns.

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



Source: Credit Suisse and Bloomberg Barclays Indices. "Rising" indicated by an increase of more than 50bps. "Falling" indicated by a decrease of more than 50bps. Data reflects rolling 12-month periods from 03/31/92 through 08/31/18.

Bottom line

We acknowledge the asset class may face continued pressure in the short-term. And we respect the need to provide liquidity for investors who may want to reduce exposure. We believe it's warranted to maintain a defensive position in floating-rate loan portfolios and hold higher cash balances. In times like this, experience has taught us to be proactive about liquidity, to favor higher quality securities and to reduce focus on higher risk segments such as CCC-rated loans and second-lien loans (which have a subordinated claim on assets in the case of a default).

[1]Source: Columbia Threadneedle Investments.

Past performance is not a guarantee of future results. 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.
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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CTBPEK1A (12/18) 2336706