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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.

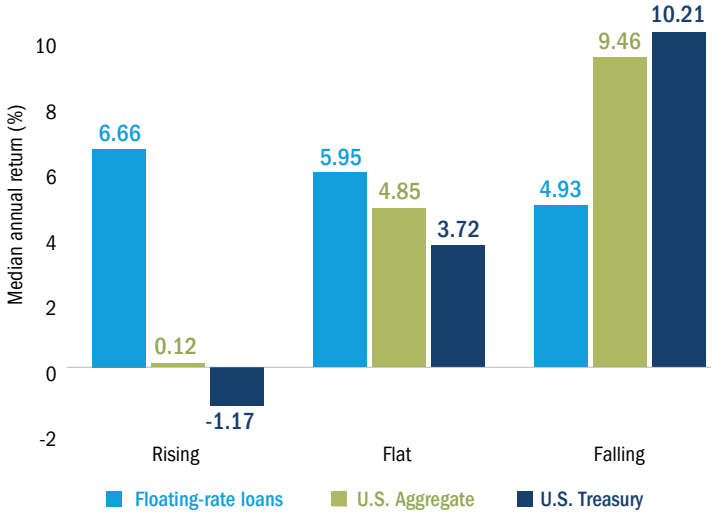
Unlike traditional bonds, floating-rate loans do not make a fixed interest payment, or coupon, each period. Instead, floating-rate loan coupons can vary based on prevailing interest rates. The coupon consists of two components: a fixed spread and a floating reference rate. The spread remains static over 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.

Benefits of floating-rate loans

There tends to be a significant uptick in how much flows into this 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 have also outperformed U.S. Treasuries and the Bloomberg Barclays U.S. Aggregate Bond Index when rates are flat. It's only when rates fall that we've seen floating-rate loans become a relative "underperformer" (Exhibit 1).

Exhibit 1: 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.**

Compelling income generation

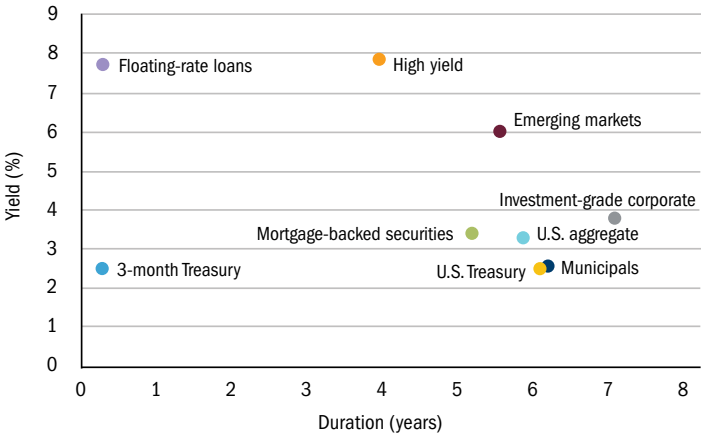
Floating-rate loans are lower credit quality than investment-grade bonds and consequently must pay higher coupons to attract investors. In addition, yields on floating-rate loans keep pace with changing markets due to their regularly resetting coupon feature. When interest rates rise, floating-rate loan coupons increase as the market index ticks up, while fixed-income bond coupons remain the same. LIBOR traditionally has had a high correlation to Fed action, making the resetting feature particularly compelling when the Fed is raising interest rates.

Attractive yield/duration trade-off

When interest rates rise, principal stability becomes a heightened concern for traditional bond investors. Shortening portfolio duration can make a fixed-income portfolio less sensitive to interest rate changes — and consequently reduce the risk of price declines — but, in most cases, a shorter duration also results in a lower yield. Floating-rate loans are an exception to this rule.

Regularly resetting coupons give floating-rate loans an extremely short duration — generally no longer than the time between reset dates. Yet despite the short duration of floating-rate loans, their yields tend to be relatively high to remain commensurate with their credit risk (Exhibit 2).

Exhibit 2: Yield versus interest rate risk across the fixed-income landscape[1]



Source: Bloomberg Barclays and Credit Suisse as of 12/31/18.

[1] Asset classes identified with the following indices: Floating-rate loans (Credit Suisse Leveraged Loan Index), High yield (Bloomberg Barclays U.S. High Yield Corporate Index), Emerging markets (Bloomberg Barclays Emerging Market USD Aggregate Index), Mortgage-backed securities (Bloomberg Barclays MBS Index), U.S. aggregate (Bloomberg Barclays U.S. Aggregate Bond Index), Investment-grade corporate (Bloomberg Barclays U.S. Corporate Index), Municipals (Bloomberg Barclays Municipals Index), U.S. Treasury (Bloomberg Barclays U.S. Treasury Index).

Seniority in capital structure

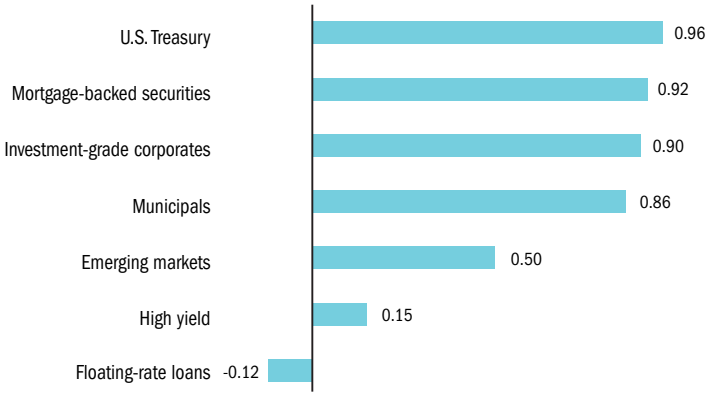
Floating-rate loans are typically the most senior source of capital in a company's capital structure, meaning that loan investors have the highest claim to a company's assets in the event of bankruptcy or liquidation (Exhibit 3). Additionally, floating-rate loans are secured by the borrower's assets, which can be converted into cash to repay loan investors. While floating-rate loans are still exposed to the greater credit risk that accompanies below-investment-grade rated debt, as an asset class, they have had a much higher recovery rate in default situations compared with other types of high-yield securities.

Exhibit 3: Corporate capital structure

Portfolio diversification

Floating-rate loans have displayed historically low correlations with traditional asset classes, which can help to reduce overall volatility in an investor's portfolio. While there are exceptions — floating-rate loans have shown a higher correlation with high-yield bonds, since they both represent debt of lower quality companies — floating-rate loans have had a negative correlation with traditional investment-grade bonds, such as Treasuries. This is because they are sensitive to different risks; floating-rate loans are more sensitive to credit risk, while investment-grade bonds are more sensitive to interest rate risk. This results in a low correlation of floating-rate loans to the aggregate bond index (Exhibit 4). This characteristic also makes floating-rate loans an attractive investment alternative for investors concerned about the prospects for government bonds.

Exhibit 4: Correlation to Bloomberg Barclays U.S. Aggregate Bond Index[2]



Source: Morningstar as of 12/31/18. Diversification does not assure a profit or protect against loss.

Risks with floating-rate loans

Greater credit risk

Despite carrying less credit risk than some fixed-rate, high-yield bonds, floating-rate loans carry greater credit risk than investment-grade bonds. Floating-rate loans serve as a major source of financing for companies looking to refinance existing debt, recapitalize their balance sheets or finance leveraged buyouts. Since these companies tend to have lower credit quality, their loans carry greater potential for default or loss. The risk profile of floating-rate loans is, in fact, more akin to risk assets such as traditional high-yield bonds and equities than it is to high-quality bonds.

Vulnerability to changes in risk appetite

While changes in interest rates exert a minimal effect on the price of floating-rate loans, their value tends to fluctuate with the market's appetite for risk. This characteristic was particularly pronounced in 2008, when rising defaults, lower corporate earnings and the subprime credit crisis contagion resulted in a flood of large-scale sales of riskier assets. As copious supply met with weak demand, floating-rate loans posted their worst one-year performance in history (Exhibit 5). By 2009, demand resumed and prices rebounded; however, investors should be aware that floating-rate loans have the potential to generate steep losses under extreme market conditions.

[2] Asset classes identified with the following indices: Floating-rate loans (Credit Suisse Leveraged Loan Index), High yield (Bloomberg Barclays U.S. High Yield Corporate Index), Emerging markets (Bloomberg Barclays Emerging Market USD Aggregate Index), Mortgage-backed securities (Bloomberg Barclays MBS Index), U.S. aggregate (Bloomberg Barclays U.S. Aggregate Bond Index), Investment-grade corporate (Bloomberg Barclays U.S. Corporate Index), Municipals (Bloomberg Barclays Municipals Index), U.S. Treasury (Bloomberg Barclays U.S. Treasury Index).

Exhibit 5: 2008 was worst one-year performance in history of floating-rate loans

Source: Credit Suisse Leveraged Loan Index, as of 12/31/18.

Liquidity risk

Settlement times for floating-rate loans tend to be longer than for other asset classes, subjecting them to heightened liquidity risk. Unlike traditional bonds that trade over-the-counter and settle in about three days, floating-rate loans trade as private transactions. Mutual funds, exchange-traded funds (ETFs), collateralized loan obligations (CLOs) and other institutional buyers and sellers negotiate directly with each other to establish the price at which each loan will trade as well as the length of time it will take to close the transaction.

During periods of heightened market volatility, settlement periods may stretch as along as 14–20 days. This creates specific challenges for loan funds that must be able to sell their holdings and receive cash proceeds quickly to meet investor redemptions. This risk is exacerbated when redemption activity is high. To deal with a potential mismatch of cash flows, a portfolio manager may establish a line of credit to meet redemptions in extreme cases, such as in 2008 when hedge funds, CLOs and other institutional investors were forced to sell large quantities of loans and a lack of willing buyers caused prices to plummet.

Limited price appreciation

While floating-rate loans are susceptible to price depreciation brought on by a liquidity crunch or a credit event, loans trading at par tend not to experience further price appreciation. This is because most of the floating-rate loan market is continually callable, meaning that issuers can repay their loans at any time prior to maturity and refinance them at lower interest rates. When credit conditions improve, issuers can also reprice their loans, renegotiating the spread component of the coupon to reduce interest cost. A loan originally issued with a coupon of LIBOR +400 bps, for example, could be repriced to LIBOR +350 bps, reducing the income paid to investors. Such flexibility to repay or reprice debt benefits issuers of floating-rate loans, of course, but it effectively caps the potential upside of the securities themselves. As a result, returns for the asset class have historically consisted solely of coupon income, with a negligible effect from price appreciation outside of periods of distress.

Conclusion

Floating-rate loans may be an attractive asset class for many investors. Floating-rate loans can act as a hedge against rising interest rates and higher inflation while offering overall portfolio diversification and greater income relative to many other types of bonds. In addition, their extremely short duration and senior position in the capital structure make floating-rate loans an attractive alternative to fixed-rate, high-yield bonds.

Like any asset class, however, floating-rate loans have drawbacks as well as benefits. Most notably, they carry greater credit risk than high-quality bonds and may decline in value if the market loses its appetite for risk securities. They also have limited price appreciation potential and higher liquidity risk due to their longer settlement times. Despite these risks, floating-rate loans have exhibited relative stability over the long term, outside of the great financial crisis. Floating-rate loans have also performed well in rising-rate environments and have exhibited low correlations with most other fixed-income sectors. For these reasons, we view floating-rate loans as worthy contenders in an overall asset allocation strategy.

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* In U.S. dollars as of December 31, 2018. Source: Ameriprise Q4 Earnings Release. Contact us for more current data.

The **Bloomberg Barclays Emerging Market USD Aggregate Index** is an unmanaged index that tracks total returns for external-currency-denominated debt instruments of the emerging markets.

The **Bloomberg Barclays Municipal Index** is an unmanaged index considered representative of the tax-exempt bond market.

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 **Bloomberg Barclays U.S. Corporate Index** measures the investment-grade, fixed-rate, taxable, corporate bond market.

The **Bloomberg Barclays U.S. High Yield Corporate Index** is a market-value-weighted index which covers the U.S> non-investment-grade fixed-rate debt market.

The **Bloomberg Barclays U.S. Mortgage-Backed Securities Index** measures the performance of investment-grade, fixed-rate, mortgage-backed pass-through securities.

The **Bloomberg Barclays U.S. Treasury Index** includes public obligations of the U.S. Treasury.

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 Ba1/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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