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COLUMBIA THREADNEEDLE INVESTMENTS®

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 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.

Floating-rate loans are typically extended to companies with higher levels of debt relative to cash flow and, consequently, carry greater credit risk than investment-grade bonds. While floating-rate loans are below investment-grade quality, they are generally senior in the capital structure and secured by the borrower's assets, resulting in higher recovery rates than on unsecured debt 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 vary based on prevailing interest rates. The coupon consists of two components: a spread and a floating reference rate. The spread generally 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 resets every 30 or 90 days, floating up or down with changes in prevailing market rates.[1] 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.

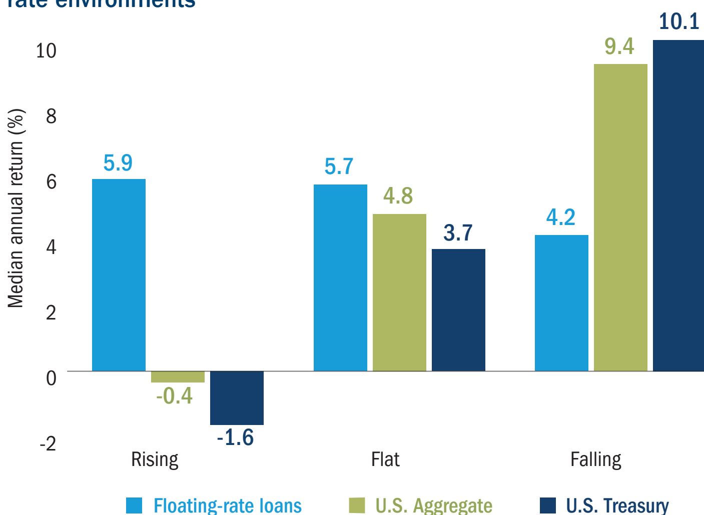
[1] Effective 12/31/21, the reference rate was changed from the London Interbank Offered Rate (LIBOR) to the Secured Overnight Financing Rate (SOFR), a broad measure of the cost of overnight borrowing collateralized by Treasury securities.

Benefits of floating-rate loans

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 on the Bloomberg U.S. Aggregate Bond Index by more than six percentage points. 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 U.S. Aggregate Bond Index when rates are flat. It's only when rates fall that we've seen floating-rate loans underperform (Exhibit 1).

Exhibit 1: 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 12/31/23. **Past performance is not a guarantee of future results.**

Compelling income generation

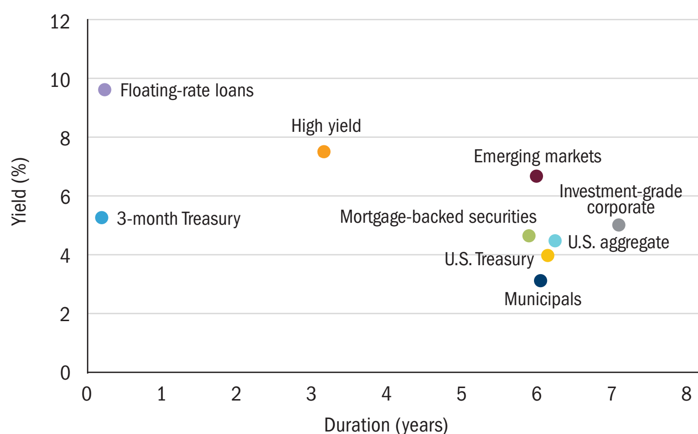
Floating-rate loans are of lower credit quality than investment-grade bonds and consequently must pay higher coupons to attract investors. In addition, yields on floating-rate loans keep pace with changing markets due to coupons that regularly reset. When interest rates rise, floating-rate loan coupons increase as the market index ticks up, while fixed-income bond coupons remain the same. Reference rates such as SOFR traditionally have been tightly correlated with short-term rates, 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 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.

Coupons that regularly reset 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, commensurate with their credit risk (Exhibit 2).

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



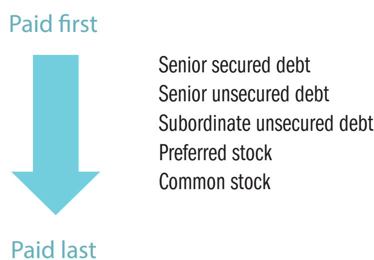
Source: Bloomberg and Credit Suisse as of 12/31/23.

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

Seniority in capital structure

Floating-rate loans typically rank senior in a company's capital structure, resulting in loan investors having one of the highest claims 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 allow loan investors the ability to recover principal in the event of default. 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.

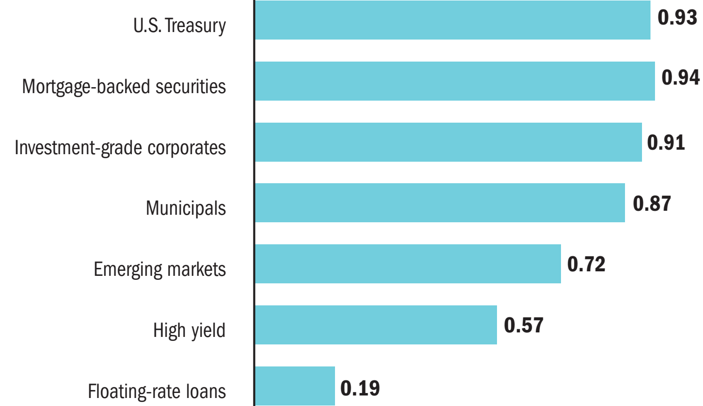
Exhibit 3: Corporate capital structure



Portfolio diversification

Historically, floating-rate loans have displayed low correlation with traditional asset classes, helping to reduce overall volatility in an investor's portfolio. While some exceptions exist — e.g., floating-rate loans have been more highly correlated with high-yield bonds since they both represent debt of lower quality companies — floating-rate loans have been negatively correlated with traditional investment-grade bonds, including Treasuries. This negative correlation is due to sensitivities 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 Bloomberg U.S. Aggregate Bond Index (Exhibit 4).

Exhibit 4: Five-year return correlation to Bloomberg U.S. Aggregate Bond Index[3]



Source: Morningstar as of 12/31/23. Five-year return correlation is shown for the period (01/01/18–12/31/23). Correlation ranges from +1 to -1. Positive correlation indicates returns moving in the same direction, negative correlation indicates returns moving in opposite directions, and a correlation of 0 would indicate no relationship between the movement of the two returns.

Risks with floating-rate loans

Greater credit risk

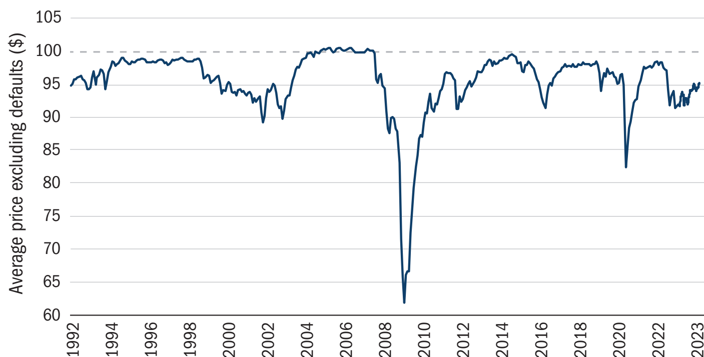
Despite generally carrying less credit risk than high-yield bonds, floating-rate loans carry greater credit risk than investment-grade bonds. Floating-rate loans serve as a major source of financing for companies looking to refinance existing debt, recapitalize their balance sheets or finance leveraged buyouts. Because 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 than it is to high-quality bonds. Despite the risk profile, floating-rate loans have a history of significantly higher recoveries than high-yield bonds in events of default.

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 large-scale sell-off of riskier assets. As a copious supply of loans met weak demand, floating-rate loans posted their worst one-year performance in history (Exhibit 5). By 2009, demand and consequently prices rebounded with the asset class recovering all of its 2008 losses and ending the two-year period in positive territory. However, investors should be aware that floating-rate loans have the potential to generate steep losses under extreme market conditions.

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

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



Source: Credit Suisse Leveraged Loan Index, as of 12/31/23.

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 are not securities and require longer settlement times. Mutual funds, exchange-traded funds, collateralized loan obligations and other institutional buyers and sellers negotiate directly with each other to establish the trading price as well as the length of time it will take to close the transaction.

During periods of heightened market volatility, settlement periods may stretch up to 14–20 days, creating challenges for funds that need to sell holdings and generate 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 certain funds 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 due to a liquidity crunch or a credit event, loans tend to experience limited price appreciation, given loans are generally callable; i.e., issuers can repay their loans at any time prior to maturity at the stated call price (commonly 101% or 100% of par). Additionally, when credit conditions improve, issuers can seek an amendment to reprice their loans, renegotiating the spread component of the coupon to reduce interest cost. For example, a loan originally issued with a coupon of LIBOR +400 bps could be repriced to LIBOR +350 bps, reducing the income paid to investors. Such flexibility to repay or reprice loans benefits issuers of floating-rate loans, of course, but it effectively caps loan-price appreciation. As a result, returns for the asset class have historically consisted primarily of coupon income, with a negligible effect from price changes outside of periods of heightened volatility.

Conclusion

Floating-rate loans may be an attractive asset class for many investors. In a rising interest-rate and high-inflation environment, floating-rate loans can act as a hedge against other fixed-rate bonds while offering overall portfolio diversification and potentially greater income. Further, 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 investment-grade bonds and may decline in value if the market loses its appetite for risk securities. Floating-rate loans also have limited potential for price appreciation and higher liquidity risk, and the asset class has historically underperformed in periods of falling interest rates. Despite these risks, floating-rate loans have exhibited relative stability over the long term, aside from the Great Recession. Floating-rate loans have also performed well in rising and flat interest-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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*Source: Columbia Threadneedle Investments as of December 31, 2023.

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

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

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

The **Bloomberg 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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