AEGON
Asset Management

Fixed income
July 2023

AEGON **INSIGHTS**

Why floating-rate loans?

Fixed income investors are facing a conundrum amid rising rates and elevated uncertainty. Against this backdrop, leveraged loans may be worth a closer look.

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In a class of their own

Leveraged loans—also known as floating-rate loans, bank loans or senior secured loans—are made by financial institutions to corporate borrowers. The loans are then syndicated to institutional investors as income-producing investments and are generally rated below investment grade.

Benefits of investing in leveraged loans

Leveraged loans can provide many potential benefits for fixed income investors looking to minimize interest-rate risk, pursue higher yields and achieve greater diversification.

1. **Potential interest-rate protection:** Adjustable coupon rates may limit duration to near zero. As a result, leveraged loans tend to perform well in rising-rate environments while many other fixed income assets could be prone to price declines.

2. **Attractive yields:** Yields on leveraged loans generally fall between yields on investment grade and high yield bonds. Leveraged loans also exhibit lower or limited duration risk due to their floating coupon rates, which often result in a higher yield per unit of duration compared to other fixed income assets (Exhibit 1).

3. **Senior and secured:** Many leveraged loans are senior in the borrower's capital structure and secured by assets, contributing historically to lower volatility and higher recovery rates on defaulted loans than high yield bonds.

4. **Diversification:** Contrary to many other fixed income assets, leveraged loans have historically had a negative correlation with US Treasuries, providing diversification opportunities for fixed income investors. When added to a broader portfolio, floating-rate loans' weak correlations to other asset classes may reduce overall portfolio volatility.

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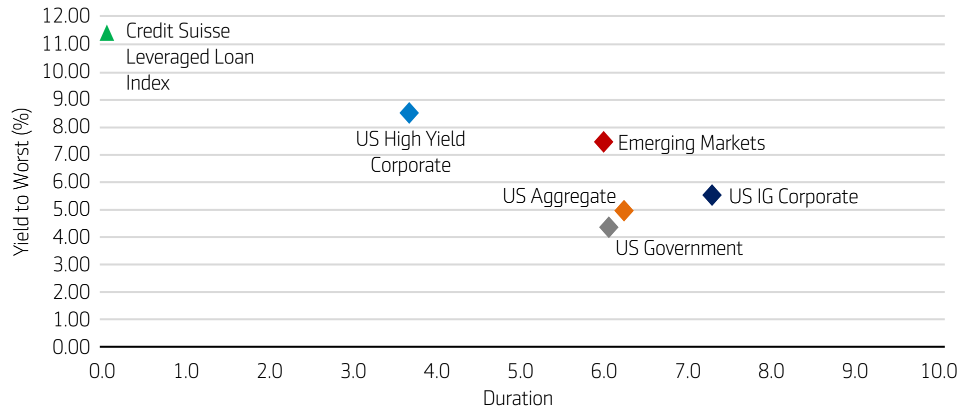
Exhibit 1: Leveraged loans provide opportunities for enhanced yield with lower duration risk

Yield vs. duration—Fixed income indices



Past performance is not indicative of future results. As of June 30, 2023. Reflects index data from the Bloomberg US Government, Bloomberg US Corporate, Bloomberg EMD USD Aggregate, Bloomberg US Aggregate, Bloomberg US High Yield Corporate, and the Credit Suisse Leveraged Loans index.

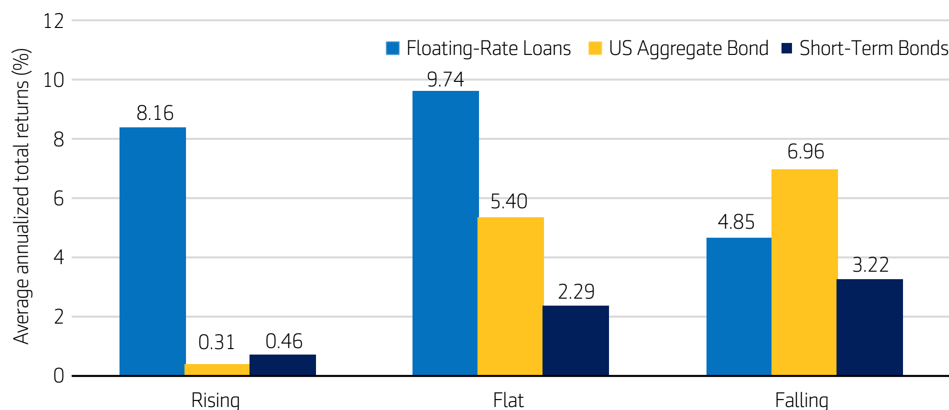
Despite elevated macro risks and increasing rates, leveraged loans may be worth a closer look.

Three factors favoring leveraged loans now

#1 Leveraged loans tend to outperform in rising-rate environments

Although the Fed opted to forego another interest rate increase at its June meeting, Chairman Jerome Powell has indicated that policy makers remain open to such a move in the future. While rising rates are a reason for concern for fixed income markets, leveraged loans tend to perform well in such environments. The floating-rate nature of loans can limit interest-rate risk, as coupons reset with climbing rates. As a result, leveraged loans have historically outperformed the broader aggregate bond market and short-term bonds (Exhibit 2). That's why in rising-rate environments, we favor leveraged loans over many other fixed income assets.

Exhibit 2: Floating-rate loans have outperformed in rising-rate environments



Past performance is not indicative of future results. Data from August 2004 through June 2023. Sources: Aegon AM and Morningstar. Reflects index data based on month data and rate changes over the trailing 12 months. Based on Bloomberg indices and the Credit Suisse Leveraged Loans index. Falling periods are described as when the Barclays US Treasury bellwether 10-year yield fell more than 0.25% since the last period. Rising periods were when the 10-year yield increased more than 0.25% since the last rolling period. Flat periods are described as when the 10-year yield did not increase or decrease by 0.25% since the last period.

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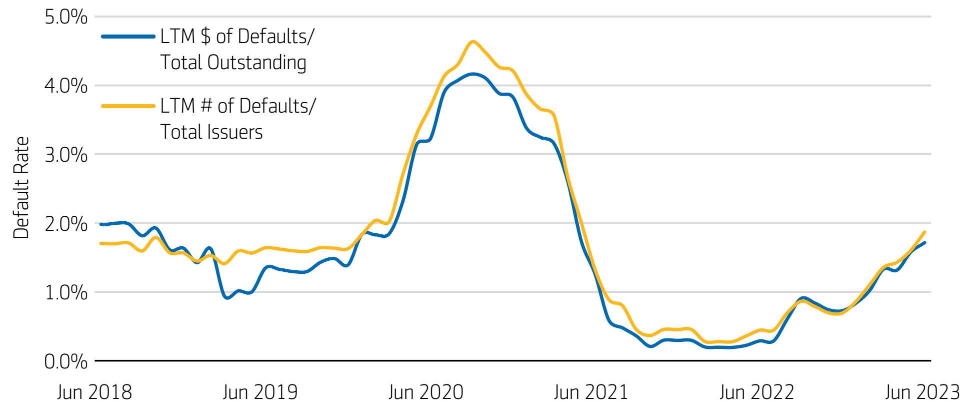
#2 Mixed company fundamentals, moderate defaults

Despite the macro headwinds, company fundamentals are in a decent spot. Many companies have returned to pre-pandemic earnings and leverage levels, however interest coverage ratios are under pressure from higher interest rates, i.e. the offset to higher coupons available to investors means less cash flow coverage for corporate borrowers. Even with mixed fundamentals, default rates remain contained (Exhibit 3).

Exhibit 3: S&P/LSTA leveraged loan default rates



Past performance is not indicative of future results. Sources: Leveraged Commentary & Data (LCD); S&P/LSTA Leveraged Loan Index

Looking ahead, we expect fundamentals to remain consistent in 2023 and defaults to remain around or slightly above historical averages. Ultimately, we expect investor returns to climb a wall of worry as starting valuations remain very attractive. However, nagging inflationary pressures are a key headwind we are watching closely. High inflation could put pressure on margins and erode fundamentals. That said, most leveraged loan issuers have been able to pass these higher input costs through to end consumers while maintaining revenue stability. If inflationary pressures persist, we expect more company dispersion. Against this backdrop, we remain focused on more defensive companies with healthy balance sheets in stable or growing industries.

#3 High Coupon Available and Low Index Price Relative to History

Entering the second half of 2023, starting valuations are quite attractive (Exhibit 4), but there are fundamental headwinds including interest coverage as mentioned above. Defaults are likely to rise closer to historical averages throughout the year (3% area) and slowing GDP in the United States will likely stall out revenue growth for most sectors. Certain low single-B names and the CCC ratings category are expected to struggle. Still, with starting coupons at 8.93% at the end of the second quarter, according to the Credit Suisse Leveraged Loan Index, and a relatively low average index price of $93.55, bank loans offer an attractive potential return. We expect some price volatility as the macro outlook remains choppy and uncertain, potentially creating some interesting entry points.

Exhibit 4: Leveraged loan valuations have become more compelling

Data through June 30, 2023 Sources: Leverage Commentary & Data (LCD); S&P/LSTA Leveraged Loan Index

Volatility creates opportunities

Amid the plethora of uncertainties and macro risks, markets will likely continue to be choppy during the remainder of 2023. However, volatility can also create opportunities. Using a research-intensive process with a focus on bottom-up security selection, we aim to minimize downside risk while focusing on high-conviction ideas to pursue competitive returns.

About us

We are active global investors. In a complex world we think and act across traditional boundaries. We organize our teams globally by asset class, to bring the breadth and depth of our investment and research capabilities together for clients across the world. We call it investing beyond borders.

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