LEVERAGED LOANS AND HIGH YIELD BONDS:

Hedging Inflation in Retirement Plans

IN BRIEF

- With inflation on the rise, participants in defined contribution (DC) plans need options for preserving purchasing power in retirement.
- Traditional inflation hedges are often highly correlated with fixed income.
- Retirement investors may wish to opt for non-traditional inflation hedges like high yield bonds and leveraged loans which offer lower to little duration risk, respectively, and a low correlation to investment grade bonds.
- High yield bonds and leveraged loans offer additional benefits, including enhanced diversification, relatively attractive yields, lower volatility than equities, and the potential to generate strong risk-adjusted returns.
- Credit conditions have improved and defaults are expected to remain below average in both the high yield and leveraged loan markets.

With wages rising and unemployment near record lows, pricing pressures appear to be building, and inflation could become a greater threat to portfolios over the next few years than it was in the previous decade.

Collision Course: Inflation and the Retirement Glidepath

Rising inflation presents a particular challenge to participants in defined contribution plans who are retired or nearing retirement. Typically, at this point, they are expected to allocate a larger share of their portfolio to fixed income to reduce their risk levels. For portfolios invested in lifecycle or target date funds, the fixed income allocations are typically increased as the target date approaches. But often these holdings consist only of government securities and high grade corporate bonds, which offer little or no protection against inflation.

Portfolios that are heavy with bonds are also more vulnerable to interest rate risk. Given the current environment, with inflation is rising and the Federal Reserve is raising interest rates, more retirees and near-retirees are shifting into an asset class that appears likely to face headwinds over the near term.

To hedge against inflation and reduce interest rate risk, investors would be wise to consider a multi-pronged approach. In addition to making use of one or more traditional inflation protections, which have some drawbacks, investors should consider complementing these with high yield bonds and floating rate loans, also known as leveraged loans or bank loans. Both have performed well as hedges against inflation over the past two decades, and they are less encumbered by interest rate risk and other drawbacks that hurt the effectiveness of more traditional hedges.

Traditional Inflation Hedges: Pros and Cons

To protect against inflation, investors have traditionally opted for one or more of the following: commodities, real estate, and Treasury Inflation Protected Securities (TIPS). Each of these has drawbacks for participants in DC plans.

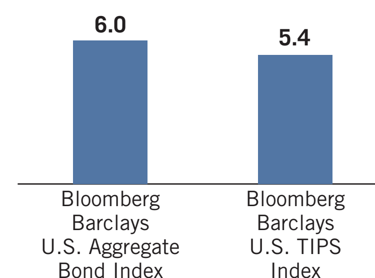
DC plans have used commodities as an inflation hedge, but the record of this asset class is mixed. Research has shown that precious metals, for example, are ineffective. A study cited by Morningstar demonstrated that while agricultural commodities, industrial metals, and energy are positively correlated with inflation, precious metals have exhibited negative correlations with the Consumer Price Index (CPI).[1] Commodity prices in general tend to be volatile and highly subject to the supply and demand dynamics of the market, independent of inflationary trends. Adding these to a portfolio can also mean taking on higher fees than with other asset classes.

Real estate can function well as an inflation hedge, but for most investors it is impractical. Direct investment in property is not an option typically included in DC plans, and often it is too expensive for individual investors. Diversification can present a problem as well. If a property is concentrated in a particular region or segment, such as retail, a downturn in that segment can bring a risk that is difficult to offset. Investors may opt for real estate investment trusts (REITs) instead, but like other equities, these are subject to stock market volatility and like TIPS, are sensitive to changes in interest rates. As a "bond alternative," they often suffer declines when interest rates rise, just as bonds do.

TIPS may be the most common means of addressing inflation risks in DC portfolios. While they may offer protection, they also are highly sensitive to changes in interest rates. The Bloomberg Barclays U.S. TIPS Index currently has a duration of 5.4 years. This means that a rise in interest rates of one percentage point would result in a drop of approximately 5.4% in the value of the TIPS security.

TIPS are also highly correlated with Treasury bonds and other fixed income securities, limiting their diversification benefits. According to Morningstar, over the 20-year period ended January 2017, TIPS had a correlation of 0.66 with Treasuries and 0.72 with the investment grade corporate bond market, as represented by the Bloomberg Barclays U.S. Credit Index.[2]

EXHIBIT 1. DURATION FOR TIPS VS. INVESTMENT GRADE BONDS AS OF 9/30/18



Source: Bloomberg Barclays

EXHIBIT 2. TIPS ARE HIGHLY CORRELATED WITH TREASURIES AND THE BROADER U.S. BOND MARKET

TIPS Correlations

	Bloomberg Barclays U.S. Credit	Bloomberg Barclays U.S. MBS	Bloomberg Barclays U.S. Treasury 1987	Bloomberg Barclays U.S. Treasury U.S. TIPS	Citi Treasury Bill 3 Month	S&P GSCI	U.S. BLS CPI All Urban NSA 1982-1984
Bloomberg Barclays U.S. Credit	1.00	0.69	0.66	**0.72**	0.01	0.11	-0.13
Bloomberg Barclays U.S. MBS	0.69	1.00	0.83	**0.63**	0.18	-0.09	-0.13
Bloomberg Barclays U.S. Treasury 1987	0.66	0.83	1.00	**0.66**	0.14	-0.12	-0.19
Bloomberg Barclays U.S. Treasury U.S. TIPS	**0.72**	**0.63**	**0.66**	**1.00**	**0.04**	**0.22**	**0.09**
Citi Treasury Bill 3 Month	0.01	0.18	0.14	**0.04**	1.00	0.05	0.09
S&P GSCI	0.11	-0.09	-0.12	**0.22**	0.05	1.00	0.35
U.S. BLS CPI All Urban NSA 1982-1984	-0.13	-0.13	-0.19	**0.09**	0.09	0.35	1.00

Past performance is no guarantee of future results. Source: Morningstar, as cited in "20 Years In, Have TIPs Delivered?," April 11, 2017. https://www.morningstar.com/articles/801922/20-years-in-have-tips-delivered.html.

[1]Gordon Rose, "Inflation Hedging: Myth and Reality, www.morningstar.uk.com, March 21, 2013.

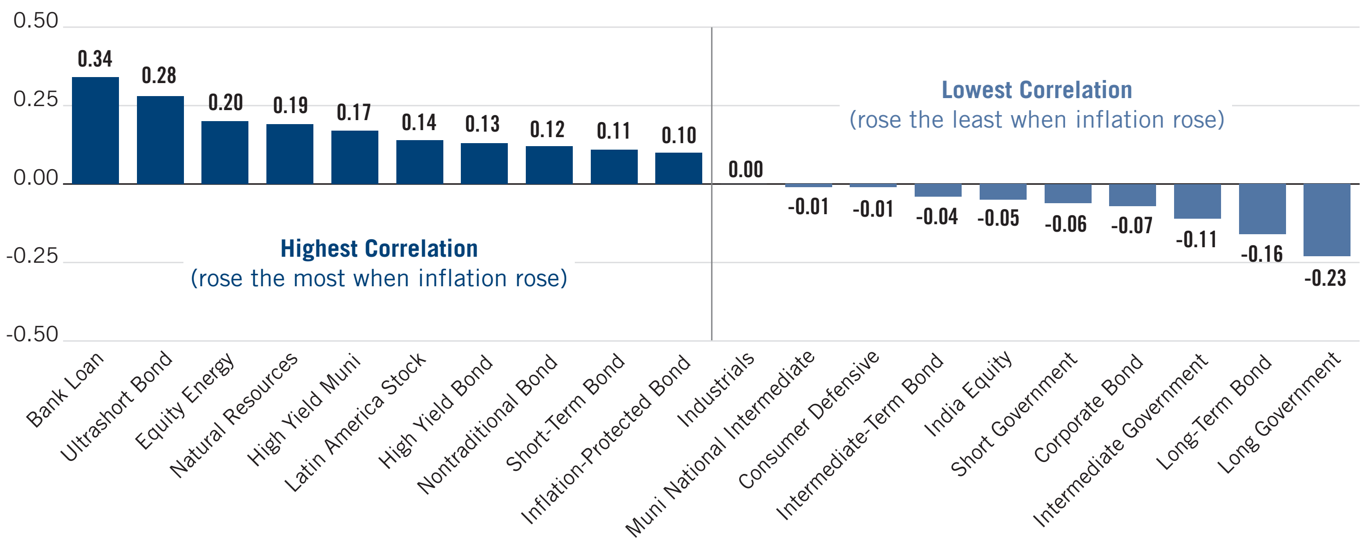
[2]High Yield Bond and Leveraged Loan Market Monitor, J.P. Morgan, July 2, 2018.

Leveraged Loans and High Yield Bonds Rank Among the Best Inflation Hedges

Though TIPS and real estate are widely believed to be effective hedges, leveraged loans and high yield bonds appear to offer better protection. In an analysis of nearly 100 asset classes and strategies over the 20 years ended September 30, 2018, **Morningstar found that bank loans and high yield bonds ranked first and seventh, respectively, in their correlations with inflation, while inflation-protected bonds and real estate ranked 10th and 32nd, respectively (Exhibit 3).** This means that the values of bank loans and high yield bonds have kept pace with inflation better than all or nearly all other asset classes and strategies.

EXHIBIT 3. LEVERAGED LOANS AND HIGH YIELD BONDS SHOW HIGH CORRELATION WITH INFLATION

Correlation of Asset Classes/Strategies to Inflation (20 years ended 9/30/18)



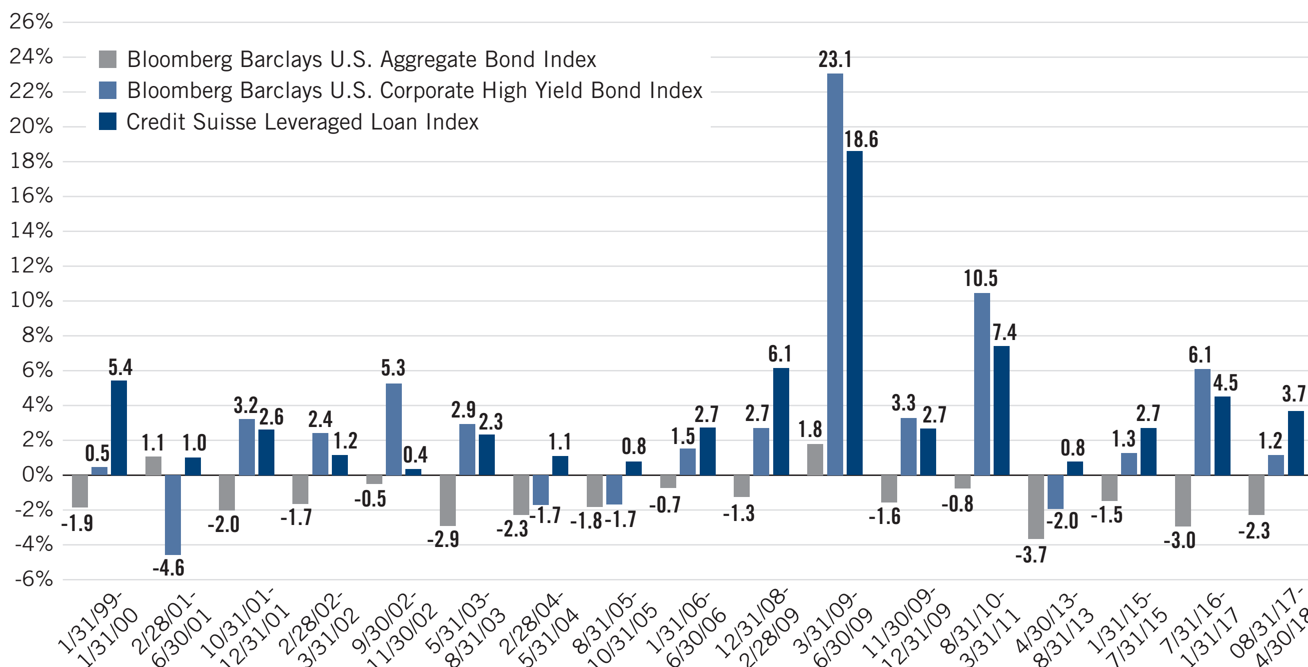
Past performance is no guarantee of future results. Source: Virtus Performance & Analytics, using Morningstar data as of 9/30/18. Inflation is represented by the Morningstar/Ibbotson SBBI Inflation Index, which tracks U.S. inflation. Asset classes are represented by Morningstar categories.

In the case of bank loans, the reason for this high correlation may be obvious. Typically, a bank loan will have a coupon rate that is tied to the London Interbank Offered Rate (LIBOR), with a coupon that is 3-month LIBOR plus a spread (200 to 300 basis points). In addition, this rate will reset every 90 days, so when LIBOR rises, the rate on the bank loan rises as well. LIBOR is highly correlated with the Fed Funds rate, so in an environment of growing inflationary pressure, as the Federal Reserve seeks to keep prices in check by raising the Fed Funds rate, the coupon payment on a bank loan increases.

Exhibit 4 shows that in the 17 periods since January 1999 when the 10-year Treasury bond yield rose 50 basis points or more, bank loans performed positively in all 17. High yield bonds performed almost as well, turning in positive performance in 13 of these periods. With high yield bonds, the reason for their outperformance during periods of rising rates may be less straightforward, but when inflation and interest rates are climbing, it is often because the economy is improving. And when this happens, certain asset classes that depend on a strong economic environment outperform, including high yield bonds. A more robust economic environment boosts corporate revenues, which makes debt servicing easier and reduces the risk of default, and most often leads to narrower spreads.

Performance of both leveraged loans and high yield bonds during periods of rising rates is also enhanced by a lower duration, making the market value of their principal less vulnerable to increases in interest rates. Finally, the generous yields on both high yield bonds and leveraged loans help to offset the negative impact of rising rates or prices.

EXHIBIT 4. LEVERAGED LOANS AND HIGH YIELD BONDS HAVE POSTED POSITIVE RETURNS WHEN RATES RISE



Past performance is no guarantee of future results. Shows time periods since 1/31/99 when month-end 10-Year Treasury yields rose at least 50 basis points. Sources: Bloomberg, Bloomberg Barclays, Credit Suisse.

Additional Benefits of High Yield Bonds and Leveraged Loans

As inflation hedges, high yield bonds and leveraged loans stand up well to traditional alternatives. They also carry these benefits: enhanced diversification, relatively attractive yields, lower volatility than equities, and attractive risk-adjusted returns.

Enhanced Diversification – Unlike TIPS, high yield bonds and leveraged loans are negatively correlated with Treasuries (Exhibit 5). This means that in addition to outperforming TIPS in terms of inflation protection, they aren't hindered by the weakness of TIPS in a rising rate environment, and can provide additional diversification benefits.

EXHIBIT 5. LEVERAGED LOANS AND HIGH YIELD BONDS ARE NEGATIVELY CORRELATED WITH TREASURIES

Total Return Correlations (1/1/92 – 9/30/18)

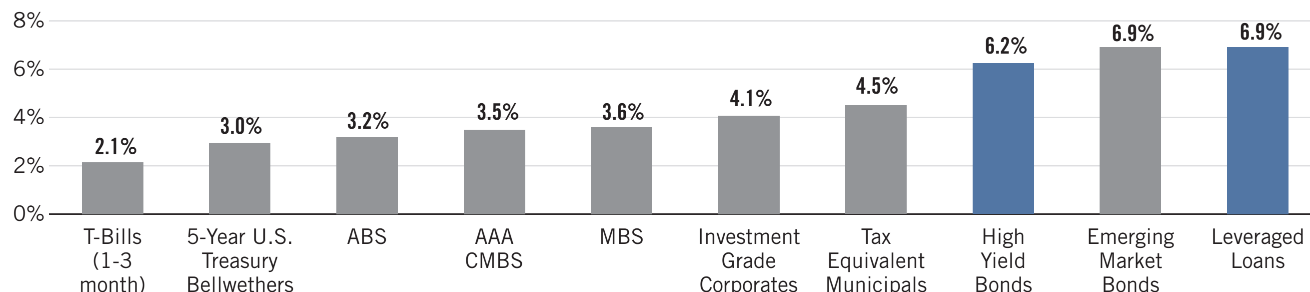
Index	Credit Suisse Leveraged Loan	Bloomberg Barclays High Yield	Bloomberg Barclays Corporate	Bloomberg Barclays Aggregate	Bloomberg Barclays Treasury	Bloomberg Barclays Gov't.	S&P 500	Russell 2000	Dow Jones Equity REIT Total Return
Credit Suisse Leveraged Loan	1.00								
Bloomberg Barclays High Yield	0.74	1.00							
Bloomberg Barclays U.S. Corp.	0.28	0.53	1.00						
Bloomberg Barclays Aggregate	-0.02	0.22	0.88	1.00					
Bloomberg Barclays Treasury	-0.29	-0.09	0.69	0.93	1.00				
Bloomberg Barclays Government	-0.26	-0.06	0.71	0.94	1.00	1.00			
S&P 500	0.42	0.61	0.25	0.04	-0.17	-0.15	1.00		
Russell 2000	0.43	0.61	0.16	-0.07	-0.25	-0.23	0.80	1.00	
Dow Jones Equity REIT Total Return	0.47	0.59	0.35	0.19	0.01	0.03	0.54	0.61	1.00

Past performance is no guarantee of future results. Sources: Credit Suisse, Bloomberg Barclays, Standard & Poor's, FTSE Russell, Bloomberg.

Relatively Attractive Yields – In today's low interest rate environment, leveraged loans and high yield bonds offer more attractive income than other alternatives (Exhibit 6). As of September 30, 2018, both asset classes were offering yields well above 6%. For DC plan participants who are in retirement, an allocation to one or both of these offers the possibility of enhancing their income stream.

EXHIBIT 6. LEVERAGED LOANS AND HIGH YIELD BONDS OFFER HIGHER YIELDS

Fixed Income Yields as of 9/30/18



Past performance is no guarantee of future results. Sources: Bloomberg Barclays, J.P. Morgan, Credit Suisse. The 1-3 Month T-Bill, 5-Year U.S. Treasury Bellwethers, Asset-Backed Securities (ABS), AAA Commercial Mortgage-Backed Securities (CMBS), Mortgage-Backed Securities (MBS), Investment Grade Corporates, Tax-Equivalent Municipals, High Yield, Emerging Market Bond, and Leveraged Loan Markets are represented by the Bloomberg Barclays U.S. Treasury Bills 1-3 Months Index, Bloomberg Barclays U.S. Treasury Bellwethers 5 Year Index, Bloomberg Barclays Asset-Backed Securities Index, Bloomberg Barclays CMBS Investment Grade Aaa Index, Bloomberg Barclays U.S. Mortgage Backed Securities Index, Bloomberg Barclays U.S. Corporate Investment Grade Index, Bloomberg Barclays Municipal Bond Index (assuming 37% tax rate), Bloomberg Barclays U.S. High Yield Index, J.P. Morgan Emerging Markets Bond Index Plus, and Credit Suisse Leveraged Loan Index, respectively.

Lower Volatility – Although high yield bonds and leveraged loans are considered high risk, their returns have consistently been less volatile than those of equities. Historically, their standard deviations have been significantly lower than those of equities, and their maximum drawdowns have also been smaller and much less frequent.

Attractive Risk-Adjusted Returns – Compared with the risk-adjusted performance of other asset classes typically included in retirement portfolios, high yield bonds and leveraged loans stack up well. Historically, the returns on high yield bonds and leveraged loans have lagged those of equities, but their risk, as measured by standard deviation, has also been much lower. In fact, as Exhibit 7 illustrates, their return per unit of risk exceeds that of both large- and small-cap equities.

EXHIBIT 7. LEVERAGED LOANS AND HIGH YIELD BONDS HAVE DISPLAYED LESS VOLATILITY

High Yield and Loans vs. Equities (1/1/92-9/30/18)

	Annualized Return	Standard Deviation	Return Per Unit of Risk	Rolling 3-Year Periods		
				Best	Worst	% Negative
High Yield Bonds	7.89%	8.16%	1.0	26.1%	-7.6%	7%
Leveraged Loans	5.70%	4.94%	1.2	17.5%	-8.0%	3%
Large-Cap Equities	9.74%	13.87%	0.7	32.8%	-16.1%	21%
Small-Cap Equities	10.04%	18.25%	0.5	29.6%	-17.8%	15%

Past performance is no guarantee of future results. Sources: Credit Suisse, Standard & Poor's, FTSE Russell, Bloomberg Barclays. The High Yield, Leveraged Loan, Large-Cap Equity, and Small-Cap Equity Markets are represented by the Bloomberg Barclays U.S. Corporate High Yield Index, Credit Suisse Leveraged Loan Index, S&P 500® Index, and Russell 2000® Index, respectively. Returns were calculated using monthly data and begin with the inception of the Credit Suisse Leveraged Loan Index on 1/1/92.

Leveraged Loans and High Yield Bonds: Myths and Realities

Although leveraged loans and high yield bonds are less volatile than equities, a common objection to including them in retirement portfolios is their risk level. And, indeed, as standalone investments they do carry higher risks than investment grade bonds.

One of those is credit risk, given that leveraged loans and high yield bonds are primarily rated below investment grade. However, investors are afforded protections via covenants that restrict the issuer from taking certain actions and that require the issuer to meet certain financial conditions. In the case of leveraged loans, investors are protected by the nature of these instruments, which are secured by collateral. They also sit at the top of the capital structure, meaning that equity and subordinated levels of debt will absorb losses before this more senior level.

Many issuers often have a revolving line of credit that comes with a provision requiring a net leverage test if more than 35% of that facility is tapped. This means that in addition to the covenants on bank loans, investors in these cases are afforded protections associated with the revolver.

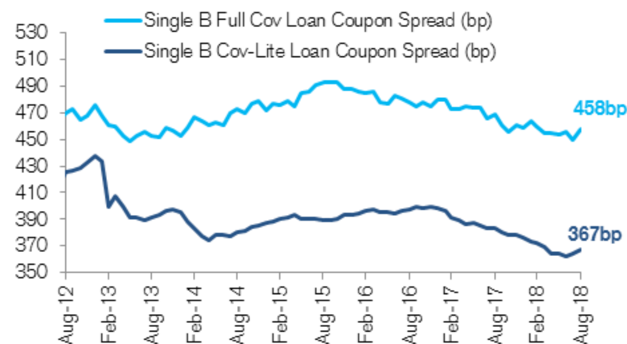
A common objection to leveraged loans in today's market pertains to the weakening of covenants. Covenants fall into two broad categories. Incurrence covenants require a borrower to meet financial tests in order to take particular actions, such as paying a dividend or issuing new debt that is senior to its other bonds or loans. In contrast, maintenance covenants, found on full-covenant loans, are more restrictive, forcing a borrower to meet certain financial tests every quarter, whether it wants to take a particular action or not.

Covenants have become less restrictive as economic expansion has lengthened. So-called covenant-lite ("cov-lite") loans, which maintain incurrence covenants but have dropped maintenance covenants, make up a majority of the loan issuance market (over 85%), and restrictive financial covenants are found only on the riskiest loans. Exhibit 8 shows, that for several years now, coupon spreads of full covenant loans have been greater than those on cov-lite loans, indicating full covenant loans carry greater risk. This is because investors require full covenants only from issuers with less healthy fundamentals.

Although maintenance covenants appear to offer greater protection than incurrence covenants, they can be a double-edged sword. If a company is forced into bankruptcy because it violated a maintenance covenant, having to keep financial ratios within strict limits may prevent it from effectively restructuring its balance sheet and spurring what could have been a strong rebound. In fact, cov-lite loans have historically exhibited lower default loss rates (Exhibit 9). This could possibly be due to less restrictive covenants that may have allowed issuers to restructure more easily.

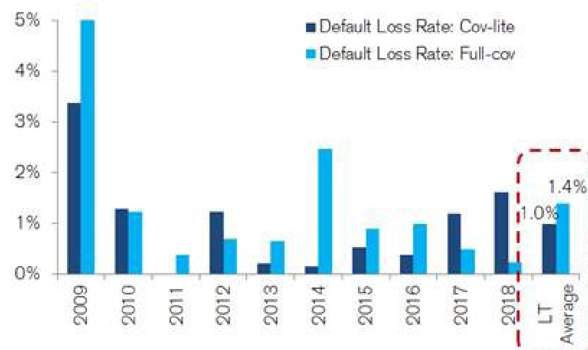
The riskiness of a leveraged loan or a high yield bond depends on a variety of factors, including the nature of the issuer's capital structure, the issuer's financial health, and its ability to recapitalize, if necessary. All these factors underscore the paramount importance of diligent credit research.

EXHIBIT 8. COUPON SPREADS ON FULL COVENANT LOANS ARE HIGHER



Past performance is no guarantee of future results.
Source: Credit Suisse.

EXHIBIT 9. COV-LITE LOANS HAVE EXHIBITED LOWER DEFAULT LOSS RATES



Past performance is no guarantee of future results.
Source: Credit Suisse.

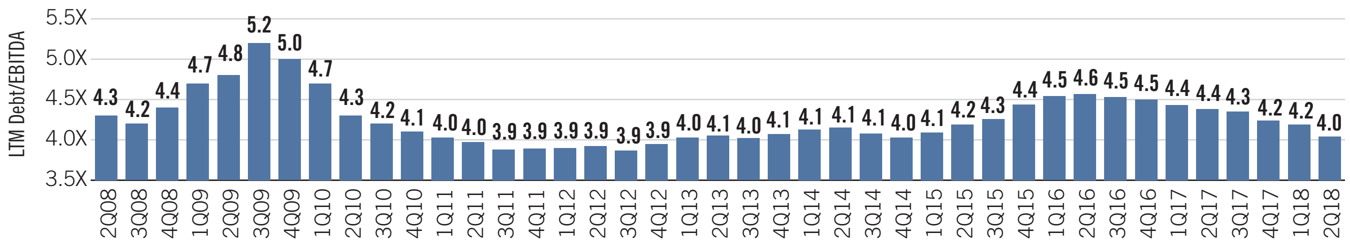
Today's Credit Environment

This is not to say that the risks associated with leveraged loans and high yield bonds are negligible. Issuers of these instruments typically face greater threats when the economy, or their particular industry, is sluggish. These companies are smaller, less diversified, or weaker financially than investment grade issuers, and they may operate in highly cyclical sectors.

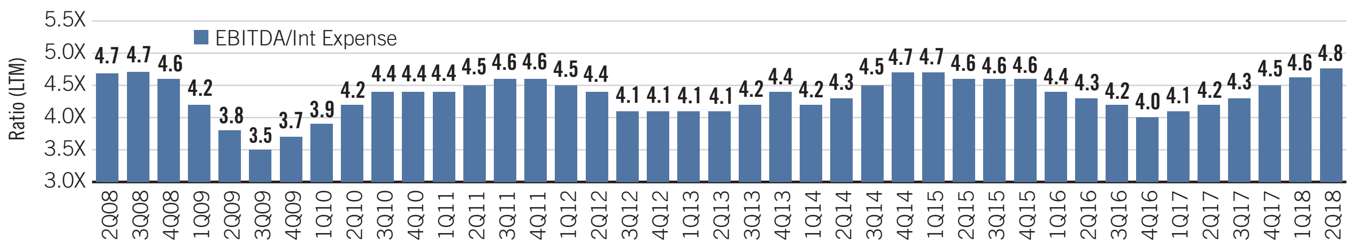
Nevertheless, in today's environment of rising rates and above-trend economic growth, the risks associated with high yield bonds and leveraged loans are expected to be low relative to their history. Leverage ratios have declined and interest coverage ratios have risen, reducing the risk of default. J.P. Morgan projects that defaults in both markets will amount to just 2.5% by 2018 year-end. It also expects 2019's default rates to decline to 2.0%, well below the 3.5% long-term average.[2]

EXHIBIT 10. CREDIT CONDITIONS HAVE IMPROVED

Leverage Ratios Continue to Improve After 2016's Energy-Related Increase – 4/1/08-6/30/18



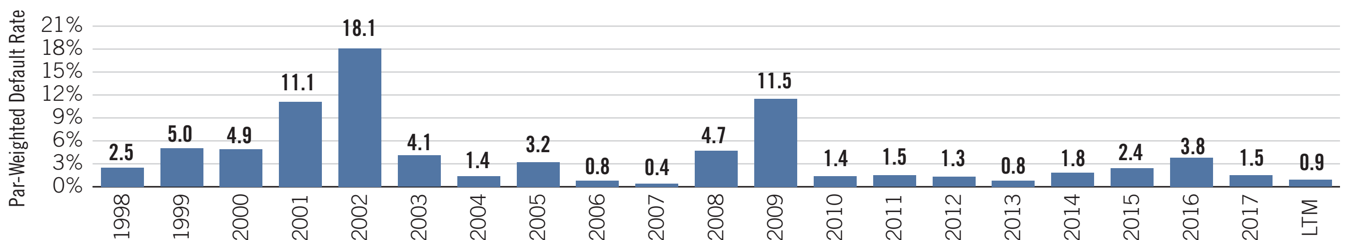
Interest Coverage Remains More Than Sufficient – 4/1/08-6/30/18



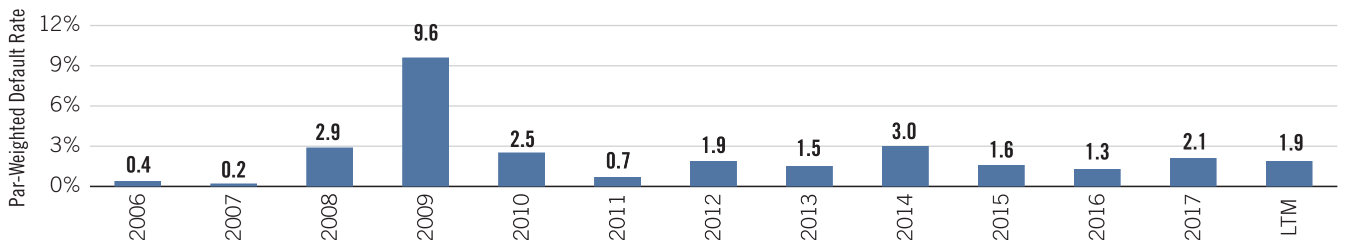
Past performance is no guarantee of future results. Source: J.P. Morgan.

EXHIBIT 11. DEFAULT RATES REMAIN BELOW THE HISTORICAL AVERAGE

BAML High Yield Bond Default Rate



CS Leveraged Loan Default Rate



Past performance is no guarantee of future results. Source: BAML; Credit Suisse.

[2]High Yield Bond and Leveraged Loan Market Monitor, J.P. Morgan, July 2, 2018.

Conclusion

With inflation on the rise and an increasing number of DC plan participants nearing or in retirement, inflation protection is becoming more crucial than it has been in years. Moreover, given that traditional inflation hedges have interest rate risk and offer little in the way of diversification benefits, it is necessary to find alternative ways to combat the erosion of retirees' purchasing power. Leveraged loans and high yield bonds, with their diversification benefits, relatively low volatility, attractive yields, and respectable risk-adjusted returns, provide a means for DC plan participants to continue to shift out of relatively risky equities and into less volatile fixed income assets without taking on the interest rate risk associated with traditional fixed income.

Information about Virtus retirement products and plan resources, is available at Virtus.com/Retirement-Center.

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INDEX AND INVESTMENT TERM DEFINITIONS

Bloomberg Barclays U.S. Aggregate Bond Index measures the U.S. investment grade fixed rate bond market. The index is calculated on a total return basis.

Bloomberg Barclays U.S. Corporate High Yield Bond Index is an unmanaged market value-weighted index that covers the universe of fixed rate, non-investment grade debt.

Bloomberg Barclays U.S. Corporate Investment Grade Bond Index measures performance of investment grade corporate bond funds. The index is calculated on a total return basis.

Bloomberg Barclays U.S. Credit Index measures the investment grade, US dollar-denominated, fixed-rate, taxable corporate and government related bond markets. It is composed of the US Corporate Index and a non-corporate component that includes foreign agencies, sovereigns, supranationals and local authorities.

Bloomberg Barclays U.S. Government Bond Index is comprised of the US Treasury and US Agency Indices. The index includes US dollar-denominated, fixed-rate, nominal US Treasuries and US agency debentures (securities issued by US government owned or government sponsored entities, and debt explicitly guaranteed by the US government).

Bloomberg Barclays U.S. Mortgage-Backed Securities (MBS) Index measures agency mortgage-backed pass through securities (fixed-rate and hybrid ARM) issued by GNMA, FNMA, and FHLMC. The index is calculated on a total return basis.

Bloomberg Barclays U.S. Treasury Bill 3-6 Month Index measures performance of U.S. Treasury bills with a remaining maturity from one up to (but not including) 12 months. The index excludes zero coupon strips. The index is calculated on a total return basis.

Bloomberg Barclays U.S. Treasury Inflation-Linked Bond Index measures the performance of the US Treasury Inflation Protected Securities (TIPS) market.

BofA Merrill Lynch High Yield Cash Pay Index is an unmanaged index consisting of all domestic and Yankee high-yield bonds maturing over one year. The quality range is less than BBB-/Baa3 but not in default (DDD1 or less).

Consumer Price Index (CPI) is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care.

Credit Suisse Leveraged Loan Index is a market-weighted index that tracks the performance of institutional leveraged loans.

Russell 2000® Index is a market capitalization-weighted index of the 2,000 smallest companies in the Russell Universe, which comprises the 3,000 largest U.S. companies. The index is calculated on a total return basis with dividends reinvested.

Personal Consumption Expenditures (PCE) Price Index reflects changes in the prices of goods and services purchased by consumers in the United States.

S&P 500® Index is a free-float market capitalization-weighted index of 500 of the largest U.S. companies. The index is calculated on a total return basis with dividends reinvested.

The indexes are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and are not available for direct investment.

A **Basis Point (bp)** is equal to 0.01%.

Average Coupon is the weighted average coupon (annual rate of interest on the bond's face value that the issuer agrees to pay the holder until maturity) of all the securities in a fund.

Correlation Coefficient is a measure that determines the degree to which two variables' movements are associated. The correlation coefficient will vary from -1 to +1. A -1 indicates perfect negative correlation and +1 indicates perfect positive correlation.

Credit Ratings noted herein are calculated based on S&P, Moody's and Fitch ratings. Generally, ratings range from AAA, the highest quality rating, to D, the lowest, with BBB and above being called investment grade securities. BB and below are considered below investment grade securities. If the ratings from all three agencies are available, securities will be assigned the median rating based on the numerical equivalents. If the ratings are available from only two of the agencies, the more conservative of the ratings will be assigned to the security. If the rating is available from only one agency, then that rating will be used. Ratings do not apply to a fund or to a fund's shares. Ratings are subject to change.

Default Rate is most commonly referred to as the percentage of loans that have been charged off after a prolonged period of missed payments. Defaulted loans are typically written off from an issuer's financial statements and transferred to a collection agency. In some cases a default rate may also be a higher interest rate charged to a borrower after a specified number of missed payments occur.

Interest Coverage Ratio is a debt ratio and profitability ratio used to determine how easily a company can pay interest on its outstanding debt.

Leverage Ratio is any one of several financial measurements that look at how much capital comes in the form of debt (loans), or assesses the ability of a company to meet its financial obligations.

Modified Duration is a measure of the sensitivity of the price (the value of principal) of a fixed income investment to a change in interest rates, expressed as a number of years. Spread is the difference between the yields of sector types and or maturity ranges.

Real Estate Investment Trust (REIT) is a company that owns, operates or finances income-producing real estate.

Spread is the difference between the yields of sector types and or maturity ranges.

Standard Deviation is a statistical measurement of dispersion about an average, which depicts how widely returns varied over a certain period of time.

Treasury Inflation Protected Securities (TIPS) refer to a treasury security that is indexed to inflation in order to protect investors from the negative effects of inflation.

Yield-to-Maturity (YTM) of a bond is the internal rate of return earned by an investor who buys the bond today at the market price, assuming that the bond will be held until maturity, and that all coupon and principal payments will be made on schedule. Yield to maturity is an estimation of future return.

The commentary is the opinion of the Virtus. This material has been prepared using sources of information generally believed to be reliable; however, its accuracy is not guaranteed. Opinions represented are subject to change and should not be considered investment advice or an offer of securities.

IMPORTANT RISK CONSIDERATIONS:

Bank Loans: Loans may be unsecured or not fully collateralized, may be subject to restrictions on resale and/or trade infrequently on the secondary market. Loans can carry significant credit and call risk, can be difficult to value and have longer settlement times than other investments, which can make loans relatively illiquid at times. **Credit & Interest**: Debt securities are subject to various risks, the most prominent of which are credit and interest rate risk. The issuer of a debt security may fail to make interest and/or principal payments. Values of debt securities may rise or fall in response to changes in interest rates, and this risk may be enhanced with longer-term maturities. **Foreign & Emerging Markets**: Investing internationally, especially in emerging markets, involves additional risks such as currency, political, accounting, economic, and market risk. **High Yield-High Risk Fixed Income Securities:** There is a greater level of credit risk and price volatility involved with high yield securities than investment grade securities.

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