Senior Loan ETFs: A Strong Case for Active Management

Active managers of senior loans with long-term records of strong risk-adjusted returns have the potential to weather diverse market conditions.

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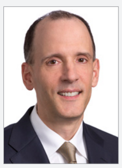

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Virtus Seix Senior Loan ETF

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Key Points

- We believe senior secured, floating-rate leveraged loans present a compelling opportunity for every ETF investor's fixed income portfolio, regardless of the direction of interest rates. Trouble is, there isn't much choice. Of the seven ETFs available, over half the assets are in the largest passively managed ETF, which has underperformed the Morningstar Bank Loan Category Average by over 50 bps annually since inception.
- While passive strategies strive to replicate indexes, regardless of market conditions, active managers have the ability (and agility) to adjust to credit, liquidity, and trading risks that come with leveraged loans at different parts of the business cycle.
- With attractive relative valuations, and loan prices below par, now may be an opportune time to reconsider passive exposure and switch to an active manager with experience spotting relative value in what seem likely to be more challenging market conditions.

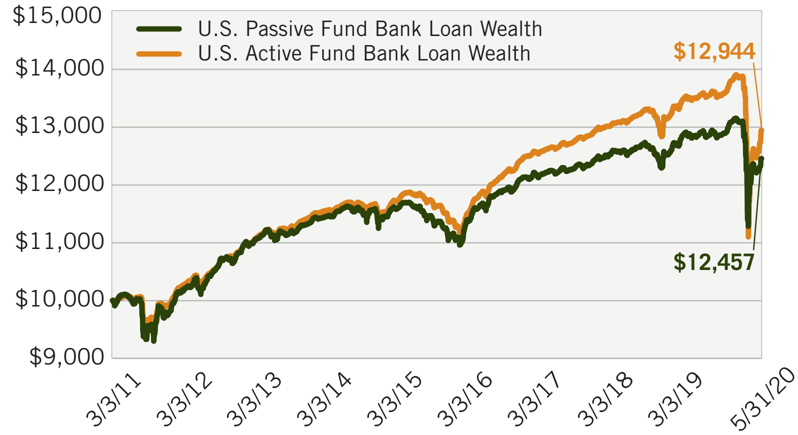
Deconstructing Passive

Much has been written about the advantages of passive investing outperforming active managers with generally lower fees and expenses. But unlike equity indexes, which are market-cap weighted, fixed income indexes are debt-weighted, meaning companies with the most debt have the greatest weight. Unlike equity indexes that reward companies for stock price increases, perversely, fixed income indexes comprise the most indebted borrowers, which aren't necessarily the best investments, especially in periods of historic volatility when credit selection matters most.

Within the leveraged loan space, strategies focused on the largest loan facilities may not provide a better investment outcome. The broader Credit Suisse Leveraged Loan Index consists of approximately 1,600 loans, mirroring the entire investable universe. In contrast, the narrower S&P/LSTA Leveraged Loan 100 Index consists of 100 of the largest loans and weights them by market value, regardless of credit risk.

HOW ACTIVE MANAGEMENT HAS TRUMPED PASSIVE BANK LOANS: HYPOTHETICAL GROWTH OF $10,000[1]

Morningstar Bank Loan Category averages, actively managed vs. passive strategies, 3/3/2011-5/31/2020



Past performance is no guarantee of future results.
Source: Morningstar.

Exploring a larger opportunity set can often yield better results, particularly when you want to adjust risk levels at different points in the cycle. In other words, sometimes it pays to take on higher or lower credit risk in certain environments, and a narrow passive index strategy doesn't discriminate between credit quality levels. Furthermore, the largest leveraged loan ETF has underperformed its own benchmark by significantly more than its expense ratio over longer periods of time, due to liquidity and trading issues, which has increased tracking error relative to its index.

Another issue with passive senior loan ETFs is that when markets sell off, they have the potential to effectively capture 100% of the downside, since they track the index. By their nature, they may be more vulnerable to default risk and liquidity constraints in distressed markets.

Why Active

We believe it takes veteran professionals to navigate the loan space. That's because loans are generally less liquid. While investors are compensated for that liquidity risk on a relative basis, loans don't trade on an exchange; they trade over the counter. All of this underscores the importance of performing fundamental analysis and/or assessing credit quality, since loan prices don't always reflect their true value.

In terms of assets under management, more than half of the senior loan ETFs are passive and have a history of underperforming the Morningstar Bank Loan Category average over the long term.

For all the popularity of passively managed investment strategies, passive loan ETFs, especially ones with concentrated bets on the most heavily leveraged companies, took a big hit from forced trades to meet heavy redemptions, leaving their remaining investors in the lurch. Investors in passively managed senior loan ETFs who sold in December of 2018's rising rates sell-off or the recent Covid-19 induced drawdown (in favor of cash equivalents or ultra-short duration funds earning far more modest returns) missed the sharp rebound in performance. In a market that doesn't move much, that is a sizable opportunity cost.

[1]U.S. Active Fund Bank Loan includes only active funds and ETFs, while U.S. Passive Fund Bank Loan includes only passive funds and ETFs in the broader Morningstar Bank Loan Category. There are only two leveraged loan ETFs in the passive fund bank loan category (BKLN and SNLN). There are seven leveraged loan ETFs in the active fund category, including the recently launched Virtus Seix Senior Loan ETF. Investment objectives, fees, risks, benchmarks, and vehicles may vary.
Like indexes, the aforementioned Morningstar Bank Loan Categories are unmanaged, but their returns do reflect fees. The categories mentioned do not reflect expenses or sales charges, and are not available for direct investment nor are they meant to represent the performance of the security described in this paper.
Performance is not illustrative of the Virtus Seix Senior Loan ETF performance, which can be found by visiting virtus.com.

Of course, timing the market can be rife with uncertainty, but the key point here is that credit risk and relative value are much more important than the trajectory of rates. Generally speaking, active managers are not forced to "own the market" which we believe is especially important as we continue to experience challenging market conditions. After all, the institutionalization of the loan market has led to a larger issuance of loan-only deals without subordination and extensive add backs to EBITDA, which active managers' credit discipline seek to avoid.

Why Seix

Led by two portfolio managers with a combined 56 years of industry experience, the Virtus Seix Senior Loan ETF (NYSE Arca: SEIX) actively invests in senior-secured, floating rate leveraged loans, seeking to generate high levels of current income. Time-tested, fundamental research targets what Seix believes to be the strongest and most undervalued credits, aiming to capture upside potential while limiting downside risk in a more cost-efficient manner than passive competitors. You don't have to pay up for good active management anymore.

There is risk that the Fund's objective may not be achieved or maintained, but its portfolio managers have been battle tested, running leveraged loan strategies in mutual funds and separately managed accounts for more than 13 years with $8.7 billion in assets under management.[2] We believe such established presence in the leveraged loan market gives Seix an advantage, reflects our deep relationships across broker/dealers and private equity sponsors, access to management teams and deal flow, and the ability to be selective in purchasing the better credits.

All that translates to a multi-faceted approach that searches for value and aims to maximize portfolio return per unit of risk and avoid permanent loss of capital by focusing on business models that can weather volatile business cycles.

An Actively Managed Approach to the Asset Class

- A consistent focus on issuers with significant asset protection in the non-investment grade senior loan market—with an emphasis on BB- and B-rated loans with strong asset coverage, solid free cash flow generation, and management teams that have a balanced approach to both their debt and equity holders.[3]
- Balancing the ability to take constructive risks while equally focusing on capital preservation.
- Astute credit selection during times of stress or volatility, with an eye toward misunderstood industries and credits that can survive through challenging environments.
- The potential to earn their coupon when rates rise or stay the same while limiting downside risk through rigorous fundamental analysis and a strict sell discipline.
- Focusing on the capital structure with an eye toward credits that have subordination behind the loan in the form of a high yield bond or second-lien loan.

[2]As of 3/31/20.
[3]Although loan investments are generally subject to certain restrictive covenants in favor of the investor, many of the loans in which the Fund will invest may be issued or offered as "covenant lite" loans, which have no financial maintenance covenants. "Financial maintenance covenants" are those that require a borrower to maintain certain financial metrics during the life of the loan, such as maintaining certain levels of cash flow or limiting leverage. These covenants are included to permit the lender to monitor the borrower's performance and declare an event of default if breached, allowing the lender to renegotiate the terms of the loan or take other actions intended to help mitigate losses. It is important note, however, that defaults have been running well below their historical average, according to Standard & Poor's.

The Bottom Line

Senior loans historically have generated positive returns in rising rate environments, but they also have tended to fare well[4] on a risk-adjusted return basis when rates do not rise. At this point in the business cycle, investors would be wise to consider recalibrating their exposure to senior loans overseen by highly experienced managers who have weathered diverse market conditions.

BANK LOANS HAVE GENERATED ONE OF THE HIGHEST RISK-ADJUSTED RETURNS SINCE 1992

Leveraged Loans vs. High Yield and Equities (1/1/92-3/31/20)

	Annualized Return	Standard Deviation	Return per Unit of Risk	Rolling 3-Year Periods Best	Worst	% Negative
Leveraged Loans	5.04%	5.46%	0.9	17.5%	-8.0%	3%
High Yield Bonds	7.27%	8.35%	0.9	26.1%	-7.6%	7%
Large-Cap Equity	8.85%	14.25%	0.6	32.8%	-16.1%	19%
Small-Cap Equity	8.08%	18.94%	0.4	29.6%	-17.8%	14%

Past performance is not indicative of future results. The High Yield, Leveraged Loan, Large-Cap Equity, and Small-Cap Equity markets are represented by the Bloomberg Barclays U.S. Corporate High Yield Bond 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. Sources: Credit Suisse, Standard & Poor's, FTSE Russell, Bloomberg Barclays.

Note: with relatively low interest rates on investment grade corporate bonds, Treasury bonds, and municipal bonds, some investors have sought higher levels of income from leveraged loans and high yield bonds while assuming more interest rate risk and market risk than investment grade debt, which trade on exchanges and offer more liquidity. Bank loans and certain high yield bonds are sub-investment grade, but default rates remain low, according to Credit Suisse. Large cap equities offer the potential for dividend income and capital appreciation and tend to be more liquid than small cap stocks. Small caps, while generally considered somewhat riskier than large caps, may also offer dividends. Whereas large caps and small cap stocks both trade on sophisticated electronic platforms and are subject to market risk, lack of liquidity can be a struggle for some small stock stocks. In contrast, electronic loan trading volume still comprises a fraction of overall activity. As a result, most loan trades are made over the phone, which means settlement can take some time to complete. High yield bonds tend to have better liquidity, more transparency, and faster settlement. While there are material differences between the risks and objectives of the aforementioned asset classes, data above is meant to compare risk-adjusted returns over a significant time period.

About Seix Investment Advisors LLC

Seix Investment Advisors is an investment management boutique focused exclusively on managing fixed income strategies since 1992. Seix seeks to generate competitive absolute and relative risk-adjusted returns over the full market cycle through a bottom-up focused, top-down aware process. Seix employs multi-dimensional approaches based on strict portfolio construction methodology, sell disciplines, and trading strategies with prudent risk management as a cornerstone.

About Virtus Investment Partners

Virtus Investment Partners (NASDAQ: VRTS) is a distinctive partnership of boutique investment managers singularly committed to the long-term success of individual and institutional investors. The company provides investment management products and services through its affiliated managers and select subadvisers, each with a distinct investment style, autonomous investment process, and individual brand.

VIRTUS ETFs

To learn more about Virtus ETFs, visit Virtus.com or call 1-800-243-4361.

[4] "Leveraged Loans: Rates Not Rising? Don't Let That Sway You," Seix Investment Advisors, April 2019.

The commentary is the opinion of the Seix Investment Advisors. 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.

INDEX AND INVESTMENT TERM DEFINITIONS

The **Morningstar Bank Loan** category primarily invests in floating-rate loans instead of bonds. In exchange for their credit risk, these loans offer high interest payments that typically float above a common short-term benchmark such as the London Interbank Offered Rate, or LIBOR.

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. **Credit Suisse Leveraged Loan Index** is a market-weighted index that tracks the investable universe of the U.S. dollar denominated leveraged loans. The index is calculated on a total return basis, is unmanaged and not available for direct investment. **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. **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. The indexes are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and are not available for direct investment.

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. A **Basis Point (bp)** is equal to 0.01%. **EBITDA** refers to a company's earnings before interest, taxes, depreciation, and amortization. It is calculated using a company's net earnings, before interest expenses, taxes, depreciation, and amortization are subtracted, as a proxy for a company's current operating profitability. **Standard Deviation** is a statistical measurement of dispersion about an average, which depicts how widely returns varied over a certain period of time. **Tracking Error** is the standard deviation of the difference between a fund return and its benchmark index return. It is a measure of is the volatility of a fund return's in excess of its benchmark.

IMPORTANT RISK CONSIDERATIONS

Exchange-Traded Funds (ETF): The value of an ETF may be more volatile than the underlying portfolio of securities it is designed to track. The costs of owning the ETF may exceed the cost of investing directly in the underlying securities. **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. **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. **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. **Foreign & Emerging Markets:** Investing internationally, especially in emerging markets, involves additional risks such as currency, political, accounting, economic, and market risk. **Market Price/NAV:** At the time of purchase and/or sale, an investor's shares may have a market price that is above or below the fund's NAV, which may increase the investor's risk of loss. **Market Volatility:** Local, regional or global events such as war, acts of terrorism, the spread of infectious illness or other public health issue, recessions, or other events could have a significant impact on the fund and its investments, including hampering the ability of the fund's portfolio manager(s) to invest the fund's assets as intended. **Prospectus:** For additional information on risks, please see the fund's prospectus.

The Fund is an exchange-traded fund ("ETF"). The "net asset value" (NAV) of the Fund is determined at the close of each business day, and represents the dollar value of one share of the Fund; it is calculated by taking the total assets of the Fund, subtracting total liabilities, and dividing by the total number of shares outstanding. The NAV of the Fund is not necessarily the same as its intraday trading value. Fund investors should not expect to buy or sell shares at NAV because shares of ETFs such as the Fund are bought and sold at market price (not NAV) and are not individually redeemed from the Fund. Thus, shares may trade at a premium or discount to their NAV in the secondary market. Brokerage commissions will reduce returns. NAV returns are calculated using the Fund's daily 4:00 pm NAV, and include the reinvestment of all dividends and other distributions (reinvested at the Fund's NAV on distribution ex-date). Market price returns are calculated using the 4:00 pm midpoint between the bid and offer, and include the reinvestment of all dividends and other distributions (reinvested at the 4:00 pm bid/offer midpoint on distribution ex-date). Market price returns do not represent the return you would receive if you traded at other times. The Fund is an actively managed exchange-traded fund and does not seek to replicate the performance of a specified index. The Fund may have a higher portfolio turnover than funds that seek to replicate the performance of an index.

Please consider the Fund's objectives, risks, charges, and expenses before investing. Contact us at 1.800.243.4361 or visit www.virtus.com for a prospectus, which contains this and other information about the Fund. Read the prospectus carefully before investing.

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