

# Dispelling Myths About Bank Loans

**Negative headlines notwithstanding, active managers of floating rate bank loans with long-term records of strong risk-adjusted returns have shown they can weather historic volatility and economic uncertainty.**

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## Key Points

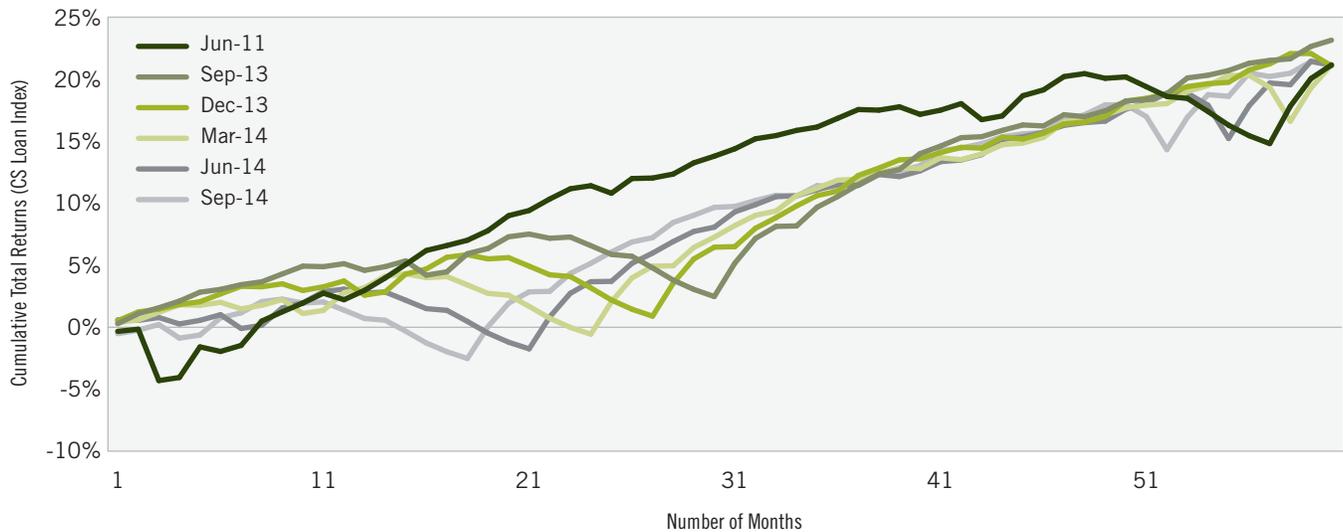
- › We believe senior secured, floating-rate leveraged loans deserve space in every investor's fixed income portfolio, regardless of the direction of interest rates.
- › Now may be an opportune time to reconsider passive exposure and switch to an active manager with experience spotting relative value in challenging market conditions.
- › While passive strategies are designed 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.
- › Against that backdrop, we feel compelled to address a number of misconceptions about this enduring asset class, which offered the best relative value of any fixed income asset class as of March 31, 2020, according to Credit Suisse.

## Myth #1: Low LIBOR Means Low Returns

Yes, floating rate bank loans are typically pegged to the London Interbank Offered Rate (LIBOR), which is low now, but it was also low from 2010 to 2016. Returns today will be driven by a pull to par, not LIBOR. In addition, new issues will come with bigger coupons to offset lower LIBOR and more discount to par to further boost returns. It's important to note that even in a declining rate environment (such as the prior decade), loans have generated positive total returns (See Exhibit 1).

## EXHIBIT 1. LOANS HAVE GENERATED POSITIVE RETURNS IN A DECLINING RATE ENVIRONMENT

Historical Loan Returns when 3M LIBOR < 25 bps



Past performance is not indicative of future results.

Source: Credit Suisse.

### Myth #2: Call Risk Limits Upside Potential

Limited upside because of call risk is more relevant when loans are trading above par, not 11 points below par (as of May 27). We would like nothing more than to get called out of a loan trading in the high 80s or low 90s today.

### Myth #3: Weak Protection

Loans protected significantly more on the downside than other risk asset classes in March and even year-to-date continue to outperform high yield (as represented by the Bloomberg Barclays U.S. Corporate High Yield Index). Note: for the year to date, high yield total return was -8.81% vs. -7.28% for leveraged loans (as represented by the Credit Suisse Leveraged Loan Index).

### Myth #4: Limited Liquidity

Contrary to popular belief, loan funds and ETFs had zero liquidity issues in 2008, August 2011, 4Q15, 4Q18, and March and April of this year. Loan settlement times are steadily improving. The reality is that collateralized loan obligations (CLOs) have been, and will continue to be, the primary driver for loan demand in our market—about two-thirds of total loan demand, while retail funds have declined to only 5%. CLOs serve a very important purpose in downturns in particular, as the vehicles typically do not experience outflows and thus are a natural buyer when funds are selling, mitigating selling pressure. In other words, CLOs comprise a very long-term institutional investor base, in sharp contrast to investors with shorter time horizons who may be forced to sell as their holdings are marked to market. Even so, CLO issuance in April was \$3.6 billion, well below average issuance volume, as investors remained focused on existing exposure and the impact of further downgrades and defaults on portfolio distributions.

### Myth #5: All Borrowers Are Inordinately Risky

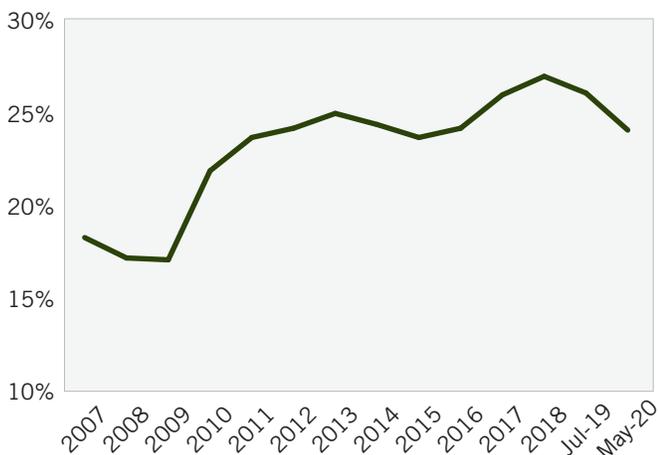
Of course, there is risk involved with leveraged loans, but that underscores the importance of active management with a history of being compensated for taking such risk. Blanket statements that leveraged loans are “extended to risky borrowers” can be misleading, since prudent managers often focus on considerably less risky BB borrowers, especially during recessions.

## Myth #6: Loan-only Capital Structures Are Pervasive

While JPMorgan has suggested 75% of loan issuers are now loan-only (up from one-fourth going into 2008), we disagree with the underlying methodology. JPMorgan defines “loan-only” as loans without underlying high yield bonds. Standard & Poor’s, on the other hand, defines “loan-only” as first-lien loans without any underlying “debt cushion,” and their “loan-only” figure is closer to 25% (See Exhibit 2). Through that lens, a first-lien loan with underlying second-lien subordination would not be considered loan-only. In addition, Exhibit 3 shows that smaller loans tend to be the ones with less debt cushion. We typically focus on larger deals.

### EXHIBIT 2. OUTSTANDING LOANS WITHOUT A DEBT CUSHION\* ARE STILL A DISTINCT MINORITY

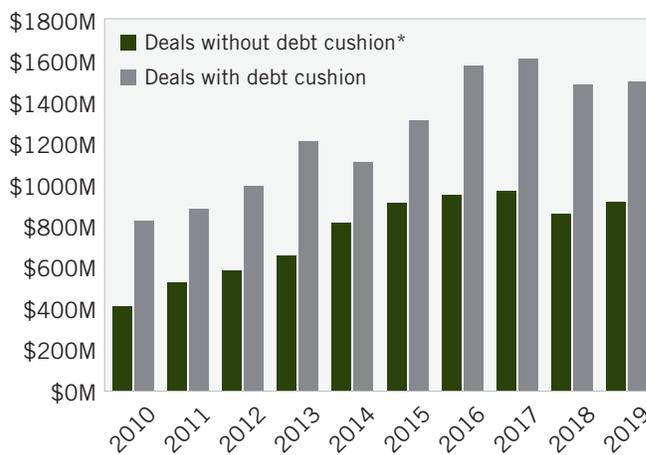
Share of Outstanding Loans without a Debt Cushion\*



Data as of May 31, 2020. \*Based on pro forma financials at closing of each loan; debt cushion represents share of debt that is subordinated to first-lien term loans. Sources: S&P/LSTA Leveraged Loan Index; LCD, an offering of S&P Global Market Intelligence.

### EXHIBIT 3. DEALS WITH DEBT CUSHION DWARF DEALS WITHOUT SUCH CUSHION

Average Size of First-Lien Term Loans



\*Loans without any debt subordinated to first-lien term loans. Source: LCD, an offering of S&P Global Market Intelligence.

## Myth #7: Recoveries Are Pains in Arrears

Lower recoveries are likely given higher leverage and less subordination, but according to S&P, the average discounted recovery varies by sub-debt cushion (See Exhibit 4). At present, investors are being well compensated for that. Active management and a higher-quality portfolio that focuses on companies with more sub-debt cushion may help to mitigate that risk.

## Myth #8: Loans Are Solely an Interest Rate Hedging Tool

Let’s be clear: the loan market is also an income asset class and should be considered [more than a rate hedge](#). As mentioned earlier, it is relatively attractive to other spread, income-producing asset classes, namely its cousin, the high yield market. Investors need to view the loans category like they do other fixed income sectors – for ballast relative to equities and income.

### EXHIBIT 4. MORE SUB-DEBT CUSHIONS HAVE LED TO HIGHER RECOVERY RATES

Recoveries by Sub-debt Cushion

	Average Discounted Recovery	Coefficient of Variation (CV)
<b>All Facilities</b>		
More than 75% cushion	91%	0.24
51-75% cushion	82%	0.33
26-50% cushion	68%	0.50
25% or less cushion	48%	0.77
<b>All Bank Loans</b>		
More than 75% cushion	94%	0.18
51-75% cushion	86%	0.27
26-50% cushion	73%	0.44
25% or less cushion	69%	0.49

Data as of 12/31/19. Sources: S&P Global LossStats; LCD, an offering of S&P Global Market Intelligence. **Coefficient of variation:** In probability theory and statistics, the coefficient of variation, also known as relative standard deviation, is a standardized measure of dispersion of a probability distribution or frequency distribution. It is often expressed as a percentage, and is defined as the ratio of the standard deviation to the mean.

## Myth #9: Passive Loan Strategies Are Less Risky than Active

Within the leveraged loan space, strategies focused on the largest loan facilities may not provide for a better investment outcome. The broader Credit Suisse Leveraged Loan Index consists of approximately 1,600 loans designed to mirror 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. When markets sell off, passive senior loan ETFs effectively capture 100% of the downside, and they may be more vulnerable to default risk and liquidity constraints in distressed markets.

## Myth #10: Leveraged Loans Aren't Resilient

Loans snapped back in every material downturn since the global financial crisis of 2008-09, and battle-tested active managers were able to spot attractive relative values in those difficult periods. While the market will no doubt reprice risk as it did in 2008, we continue to believe in the axiom that "the best deals will be done in the worst times." For additional perspective, see our recent piece on how large drawdowns have historically led to higher future return potential for leveraged loans.

## Myth #11: Cov-lite Is a Blight

Last but not least is the distorted alarmism over cov-lite loans. Let's define some terms:

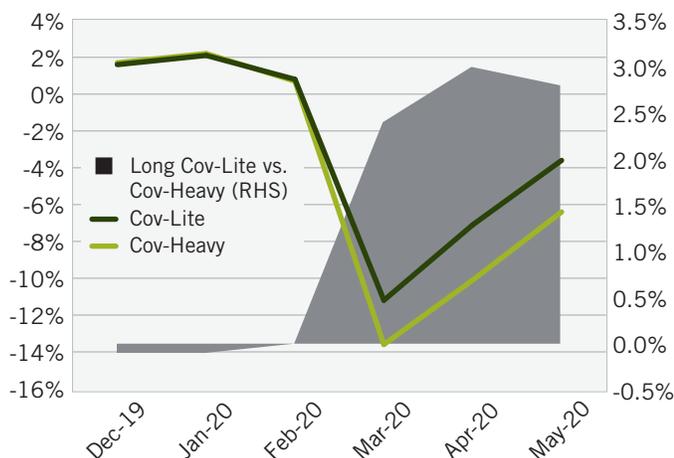
Cov-heavy refers to loans with maintenance covenants which require issuers to meet pre-determined credit metrics to avoid paying penalties. The bulk of loan issuance was pre-2009 and more onerous than incurrence covenants. (An incurrence covenant is tested only if an issuer takes an action, such as issuing debt or making an acquisition.)

Cov-lite refers to loans without maintenance covenants. These loans have become more like the high yield bond and corporates market, which have less restrictive covenants that are only triggered by specific corporate actions by the issuer.

Cov-lite now represents 82% of the overall loan market, up from 17% at the end of 2009. This shift represents a maturing of the loan asset class to move from bank holders to institutions, similar to its cousin, the high yield bond market.

Although cov-lite loans are often portrayed in a negative light, in reality, they have meaningfully outperformed their cov-heavy peers year-to-date (see Exhibit 5).

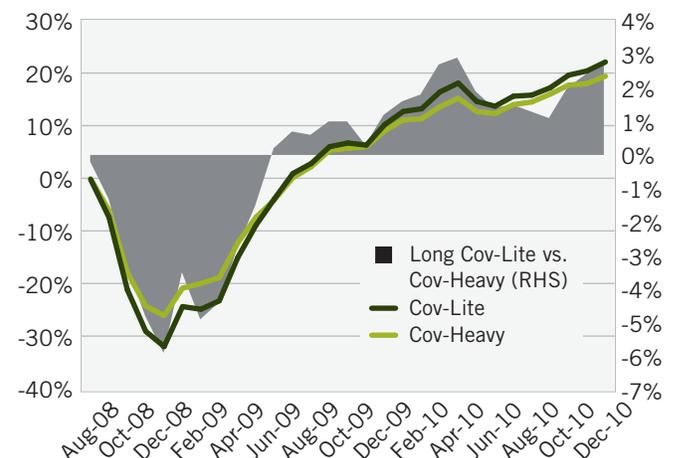
**EXHIBIT 5. CUMULATIVE TOTAL RETURNS ON COV-LITE VS. COV-HEAVY LOANS**



**Past performance is not indicative of future results.**

Sources: Goldman Sachs, S&P/LSTA Leveraged Loan Index; LCD, an offering of S&P Global Market Intelligence.

**EXHIBIT 6. FROM 9/2008 TO 12/2009, COV-LITE LOANS HAVE OUTPERFORMED COV-HEAVY LOANS BY 3%**



**Past performance is not indicative of future results.**

Sources: Goldman Sachs, S&P/LSTA Leveraged Loan Index; LCD, an offering of S&P Global Market Intelligence.

Also note that cov-lite loans underperformed at the height of the global financial crisis in 4Q 2008, but outperformed in 2009 (see Exhibit 6).

The flexibility offered to cov-lite issuers also resulted in lower default rates throughout the global financial crisis. The default rate from 2008-2014 stood at 20% for B-rated cov-heavy loans vs. 11% for cov-lite issuers, according to Goldman Sachs.

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### INDEX AND INVESTMENT TERM DEFINITIONS

The **Bloomberg Barclays U.S. Treasury Bill 1-3 Month Index** includes all publicly issued zero-coupon U.S. Treasury Bills that have a remaining maturity of less than 3 months and more than 1 month, are rated investment grade, and have \$250 million or more of outstanding face value. In addition, the securities must be denominated in U.S. dollars and must be fixed rate and non convertible. The **Bloomberg Barclays U.S. Treasury Bellwethers indices** track on-the-run US Treasury issuance for the 3m, 6m, 2y, 3y, 5y, 10y, and 30y issues. The **Bloomberg Barclays Asset-Backed Securities Index** include pass-through, bullet, and controlled amortization structures. The **ABS Index** includes only the senior class of each ABS issue and the ERISA-eligible B and C tranche. The **Bloomberg Barclays CMBS Investment Grade Aaa Index** is the Aaa component of the CMBS: Erisa Eligible index, which includes investment grade securities that are ERISA eligible under the underwriter's exemption. The **Bloomberg Barclays U.S. Mortgage Backed Securities 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. The **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. The **Bloomberg Barclays Municipal Bond Index** is a market capitalization-weighted index that measures the long-term tax-exempt bond market. The index is calculated on a total return basis. The **Bloomberg Barclays U.S. Corporate High Yield Bond Index** measures fixed rate non-investment grade debt securities of U.S. corporations, calculated on a total return basis. **J.P. Morgan Emerging Markets Bond Index Plus (EMBI+)** is a traditional, market capitalization weighted USD denominated sovereign emerging markets index with a unique liquidity ranking methodology to provide investors with the most liquid set of issues within the asset class. **Credit Suisse Leveraged Loan Index** is a market-weighted index that tracks the performance of institutional leveraged loans. The **J.P. Morgan Leveraged Loan Index** is designed to mirror the investable universe of U.S. dollar institutional leveraged loans, including U.S. and international borrowers. The indexes are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and are not available for direct investment.

**London Interbank Offered Rate (LIBOR):** A benchmark rate that some of the world's leading banks charge each other for short-term loans and that serves as the first step to calculating interest rates on various loans throughout the world.

A **Basis Point (bp)** is equal to 0.01%. **Call Risk** (or prepayment risk) is the risk involved with the premature return of principal on a loan.

### IMPORTANT RISK CONSIDERATIONS

**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. **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. **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. **Liquidity:** Certain securities may be difficult to sell at a time and price beneficial to the fund. **Leverage:** When a fund leverages its portfolio, the value of its shares may be more volatile and all other risks may be compounded. **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. **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. **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.

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