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# A GUIDE TO FLOATING RATE BANK LOANS:

## An Attractive Investment for a Rising Interest Rate Environment

White Paper by Catalyst Capital Advisors & Princeton Advisory Group

### EXECUTIVE SUMMARY

Floating rate bank loans refer to senior secured debt instruments of corporations that pay floating interest rates, which are periodically reset at a spread over LIBOR. Floating rate bank loans are a particularly attractive investment opportunity in the current market environment because, unlike traditional bonds, floating rate bank loans actually benefit from a rising interest rate environment (see **Exhibit 1**).

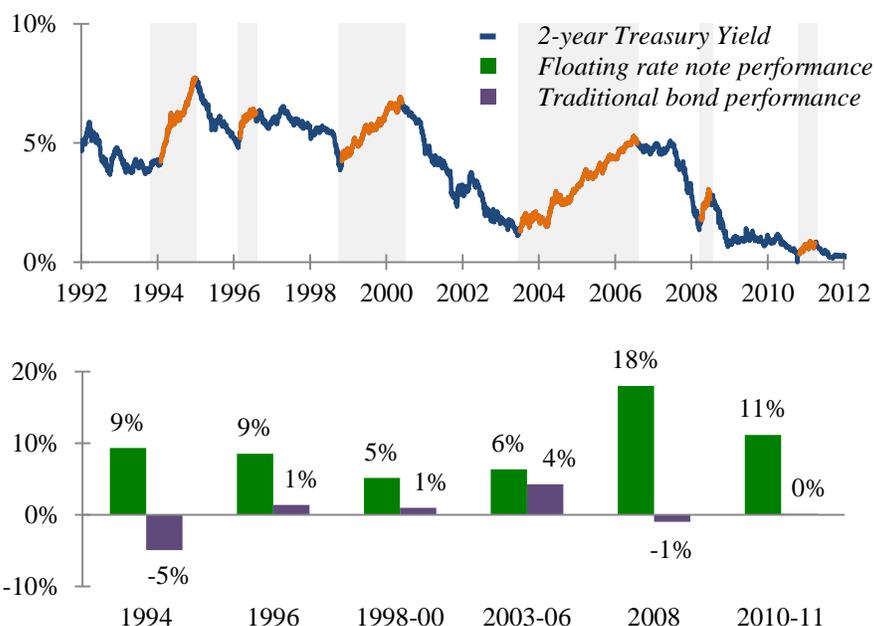
#### Floating rate bank loans offer investors:

- ✓ **Protection against rising interest rates**
- ✓ **Potential for high current income**
- ✓ **Low correlation to other asset classes**

#### Factors to consider when deciding to invest in this asset class include:

- ✓ Intensive research offered by active management, which can reduce credit risk and improve portfolio yields
- ✓ Size of fund, as smaller bank loan issues that provide more attractive opportunities are not practically accessible to very large funds
- ✓ Recent bank loan issues/recently launched funds are more likely to hold most if not all of their portfolio in bank loans with LIBOR floors, which provide protection in the event interest rates drop

**EXHIBIT 1:** Floating rate bank loans outperformed during periods of rising interest rates <sup>(1)</sup>



## AN INTRODUCTION TO FLOATING RATE BANK LOANS

**Floating rate bank loans refer to senior secured corporate debt instruments that pay a floating rate which is periodically reset at a spread to LIBOR**

The term “Floating Rate Bank Loans” refers to the asset class containing senior secured debt instruments of corporations, with maturities generally ranging from 3-7 years and which pay floating interest rates that are periodically reset at a spread over the London Inter-Bank Offered Rate (LIBOR). Floating rate bank loans actually benefit from increases in interest rates, as opposed to traditional bonds whose market value decreases when interest rates rise. The floating-rate feature appeals to investors who want to have an income component to their portfolios, but feel the current economic environment, with interest rates at 30-year lows and turning upward, is not an opportune time to be investing in fixed rate bonds.

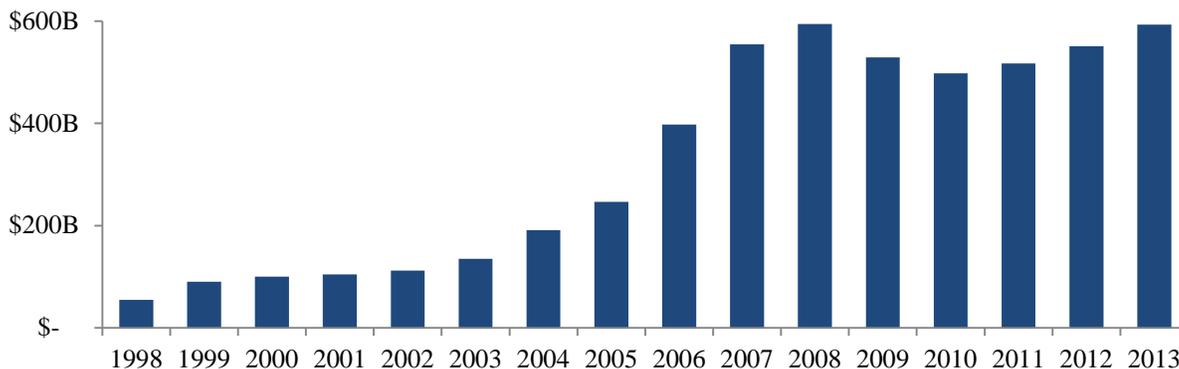
Floating rate bank loans are fairly liquid and usually classified as “high yield”, i.e., non-investment grade. Coupon rates historically have ranged between 3.0% and 6.0% over LIBOR reflecting their non-investment grade status. The interest rate of the loan is reset periodically, often taking place every 30, 60, 90 or 180 days. More recently issued loans also contain LIBOR floors, minimum values that prevent low interest rates from bringing the coupon of a loan below a predetermined value. Additionally, these loans are usually the senior most debt instrument of the company, secured by collateral and the first to be paid in the case of default.

## FLOATING RATE BANK LOAN CHARACTERISTICS

**The \$600B bank loan market consists of companies with an average credit rating of B+ to B and loans with slightly higher ratings as a result of their senior secured status**

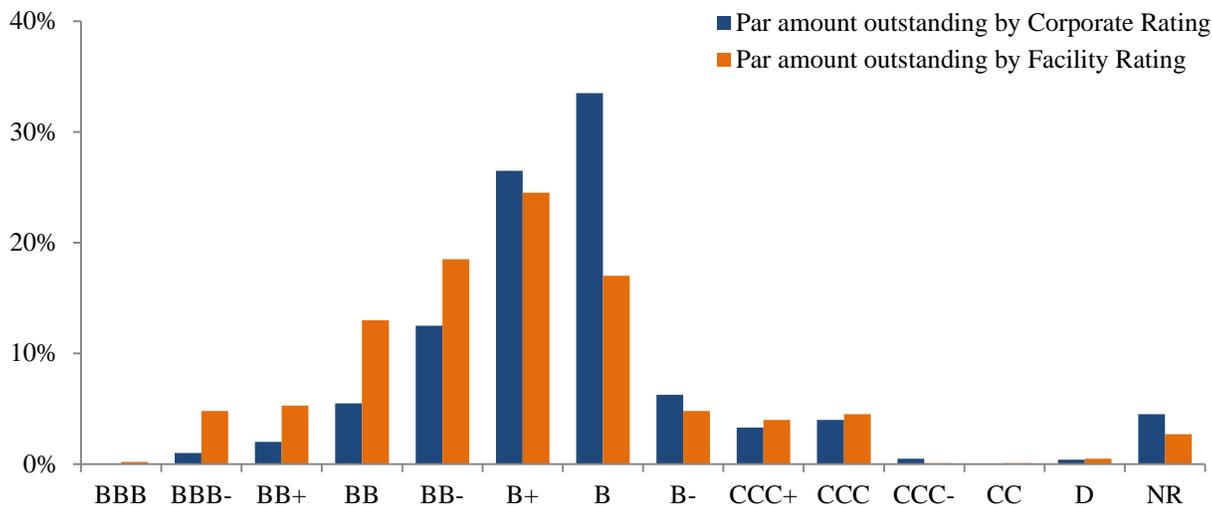
In the past decade, the floating rate bank loan market has grown dramatically (see **Exhibit 2**), creating a relatively new opportunity for investors. The size of the market as of June 2013 is approximately \$600 Billion.

**EXHIBIT 2:** Par amount of floating rate loans outstanding has swelled to almost \$600 billion <sup>(2)</sup>



Borrowing companies have an average credit rating of B+ to B. The ratings of the individual loans are generally slightly higher than the corporate ratings reflecting the loans’ senior secured status. **Exhibit 3** shows the breakout of credit ratings among borrowing companies and the loans as of June 2013.

**EXHIBIT 3:** Ratings of individual loans tend to be higher than the issuing companies due to the senior secured status <sup>(3)</sup>



## PERFORMANCE OF FLOATING RATE BANK LOANS

**Floating rate bank loans have performed consistently over time and particularly well during periods of rising interest rates**

The returns on floating rate bank loans have been relatively consistent over time (see **Exhibit 4**). 2008 and 2009 were the exceptions with prices of loans declining in 2008 due to liquidity issues during the financial crises and then values recovering strongly in 2009.

Because of their adjustable spreads, floating rate bank loans have performed particularly well in periods of rising interest rates.

**Exhibit 5** shows the periods in recent years when interest rates rose and the corresponding performance of bank loans and select debt instruments during those periods of rising rates. In all of the periods with rising rates, floating rate bank loans showed positive returns while other instruments, such as Treasuries and investment grade corporate bonds, generally declined.

**EXHIBIT 4:** Annualized returns of floating rate bank loans <sup>(4)</sup>

	1 year	3 years	5 years	10 years
Floating Rate Bank Loans	8.68%	6.76%	6.64%	5.73%
10-year Treasuries	2.54%	8.41%	6.39%	5.55%
Investment Grade Corporate Bonds	7.99%	8.31%	7.41%	6.25%
High Yield Corporate Bonds	14.40%	11.72%	10.72%	10.28%
S&P 500 Index	18.32%	14.72%	3.79%	7.77%

**EXHIBIT 5:** Annualized returns of floating rate bank loans during periods of rising interest rates <sup>(5)</sup>

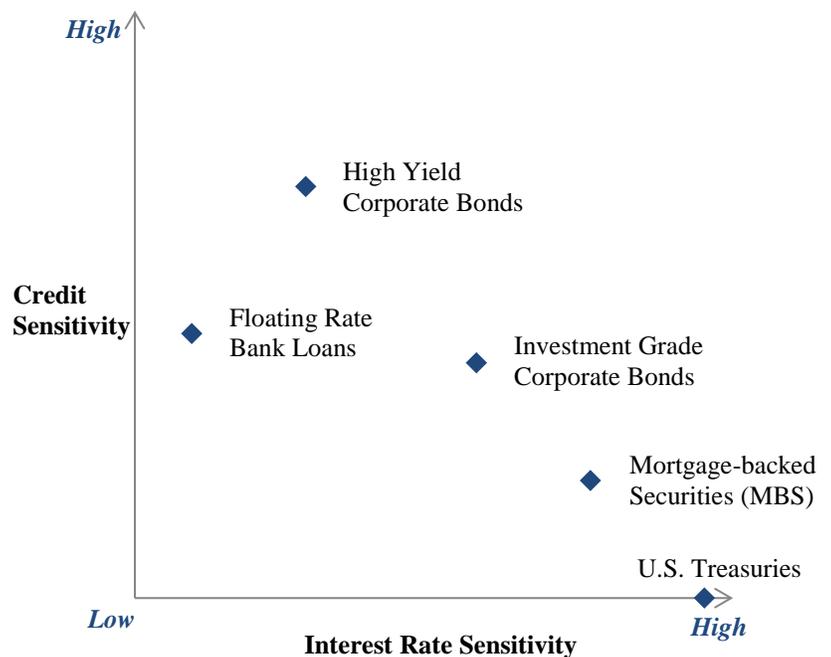
Period of Rising Rates	Change in 2-year Treasury Yield	Floating Rate Bank Loans	Investment Grade Corporate Bonds	High Yield Bonds	US Govt. Bonds
Feb-94 – Dec-94	+312 bps	9.33%	-6.27%	-3.41%	-5.09%
Mar-96 – Jul-96	+61 bps	8.56%	-0.51%	5.01%	-0.28%
Nov-98 – May-00	+227 bps	5.17%	0.22%	2.11%	0.68%
Jul-03 – Jul-06	+365 bps	6.35%	2.39%	8.73%	1.66%
Apr-08 – Jun-08	+72 bps	18.02%	-2.72%	7.23%	-7.44%
Nov-10 – Mar-11	+25 bps	11.16%	-2.09%	11.22%	-5.57%
<b>Average:</b>	<b>+177 bps</b>	<b>9.76%</b>	<b>-1.50%</b>	<b>5.15%</b>	<b>-2.67%</b>

## BENEFITS OF FLOATING RATE BANK LOANS

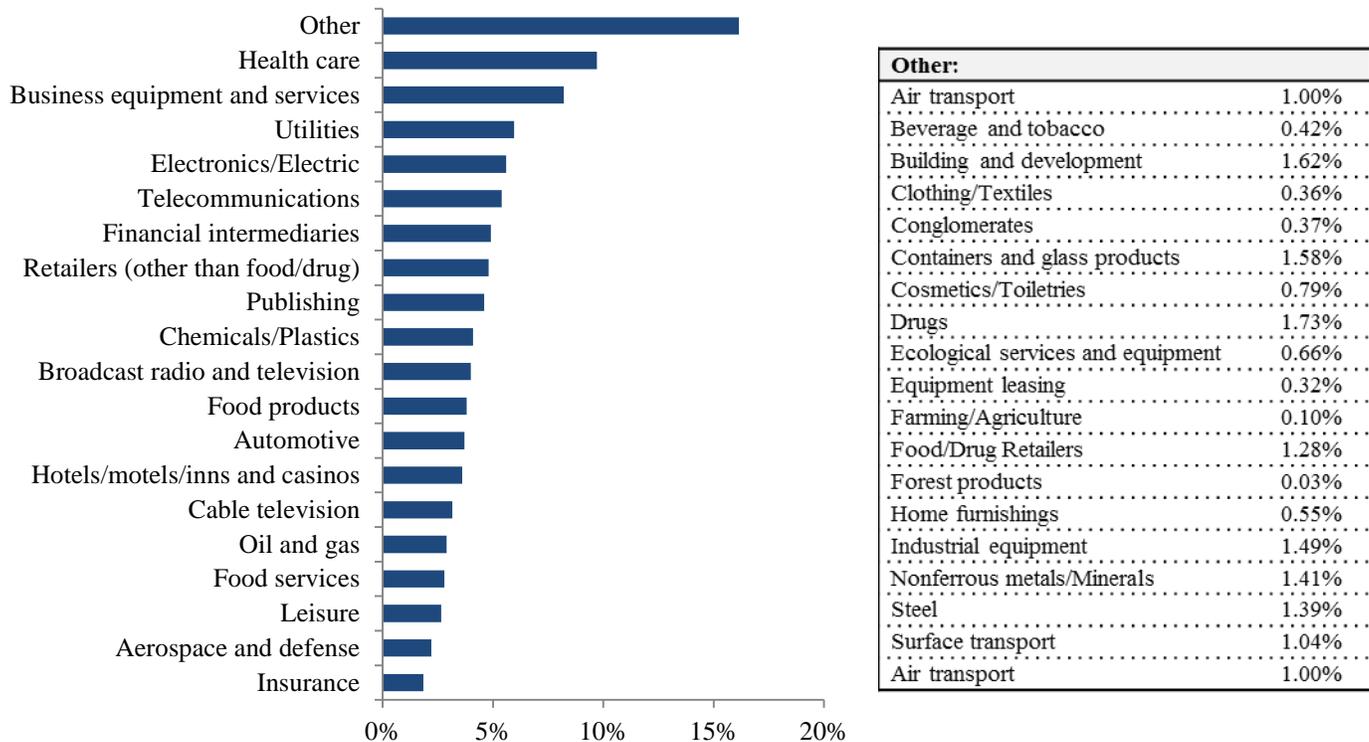
The floating rate bank loan market is a unique asset class that has the potential to reward investors with both current income and steady, long term capital appreciation

- ✓ **High Current Income Potential:** Because issuing companies usually have credit ratings below investment grade, high coupons are paid to compensate for risk. These coupons provide an attractive opportunity for income with lower risk than other debt instruments.
- ✓ **Downside Protection:** Because their coupons frequently adjust to changing interest rates, floating rate bank loans do not carry the same interest and inflationary risks as other debt instruments. They offer a relatively high yield, but do not require the investor to take interest rate (or duration) risk. Unlike other asset classes, floating rate loans have historically shown strong performance in periods of rising interest rates. Additionally, because they are the senior most debt instrument and are usually secured by the issuing company's assets, these loans have relatively high recovery rates, generally ranging from 60-70% and above. This minimizes losses in the event of a default, providing additional protection from credit risk. **Exhibit 6** shows the relative risks associated with floating rate bank loans in relation to other debt instruments.
- ✓ **Diversification:** Because floating rate bank loans have a low correlation to other asset classes, they can be an exceptional addition to diversify a portfolio, serving either as a hedge against unpredictable markets or a vehicle for returns. The floating rate bank loan market itself is also quite diverse -- issues come from companies from a large variety of industries, as seen in **Exhibit 7**.
- ✓ **Rate Protection:** LIBOR floors for floating rate bank loans create a guaranteed (ignoring credit risk) minimum yield in cases of unusually low interest rates. This allows investors to expect to maintain a steady flow of income by minimizing the risks of declining interest rates. Approximately 80% of outstanding loans now have LIBOR floors, a figure which has dramatically increased in recent years as market interest rates have reached all-time lows. LIBOR floors generally range from 0.50% to 1.50%.

**EXHIBIT 6:** Relative interest rate sensitivity and credit sensitivity for floating rate bank loans versus other debt instruments <sup>(6)</sup>



**EXHIBIT 7:** Floating rate bank loans are issued from a variety of industries, providing diversification benefits <sup>(7)</sup>



## NOW IS THE TIME TO INVEST IN FLOATING RATE BANK LOANS

**As the Fed tapers or stops bond purchases, the corresponding rising interest rates will allow floating rate bank loans to excel**

Floating rate bank loans are particularly attractive in the current environment. Interest rates are at a historic low and can be expected to rise dramatically in the near future. The Federal Reserve’s economic recovery-oriented monetary policy of buying \$85 billion of bonds each month can be expected to slow, stop or reverse at a point in the near future, and interest rates will inevitably rise. As history has demonstrated, floating rate bank loans can be expected to excel in these conditions, providing a reliable vehicle to take advantage of what is soon to come.

### 2008 drawdowns are unlikely to occur again:

As was true with nearly all asset classes, the bank loan market took a steep dip during the economic crisis of 2008, marking the first calendar year loss for the floating rate asset class. The cause, however, differs from that of other instruments and has since been mitigated. Amidst the panic and liquidity crisis, investors rushed to sell all assets including their holdings in senior secured loans. Because of the high leverage of many vehicles that held these loans at the time (such as hedge funds), the mass deleveraging caused prices to see a downward spike with increasing demand for liquidity. This may be unnerving for those with an uneasy outlook on future markets, but the structure of the market has changed. Much less leverage is used in vehicles that now typically hold these loans (such as mutual funds and ETFs) and more assets are used to cover newly issued loans, providing a cushion against similar losses in the future. It should be made clear that the fall in prices in floating rate loans in 2008 was primarily liquidity, not credit, driven.

## FACTORS TO CONSIDER WHEN INVESTING IN BANK LOANS

**Investors can find the best opportunity in a smaller, actively managed fund which has invested most or all of its assets in newer bank loan issues featuring LIBOR floors**

When searching for a medium for entering the floating rate bank loan market, investors should seek a portfolio which carefully considers the risks and yields of each loan, as well as market conditions. Active management where investment managers perform intensive research in making investments can add significant value.

Emerging smaller funds that can take advantage of all of the best opportunities, including smaller and new issues, are ideal. Very large funds are limited to only investing in the largest loan issues.

Investors should also look for portfolios investing in more recently issued floating rate loans containing LIBOR floors. This will offer more stable yields if interest rates remain low or even decline.

## CONCLUSION

**Floating rate bank loans can make a strong addition to a diverse portfolio enhancing performance in various market conditions. The unique structure allows investors to take advantage of conditions otherwise damaging to traditional debt instruments while maintaining a steady flow of income in most other conditions. When looking to invest, one should consider an actively managed portfolio to best take advantage of the asset class.**

## RISKS

Although several characteristics of floating rate loans serve to substantially decrease risks to investors, some risks inherent to all debt instruments remain that must be addressed.

- **Credit:** Should a lender go bankrupt and default, the price of the issued loans will drop to the recoverable value of the lenders assets. High recovery rates provide some protection in this situation, but purchasing loans only from thoroughly researched lenders remains the best protection.
- **Interest Rate Risk:** Yields on floating rate bank loans fluctuate with changes in interest rates. Changes in interest rates can result in yields less than expected.
- **Demand Risk:** In the past, floating rate loans have exhibited properties suggesting that they in some way follow the laws of supply and demand. As a result, a negative liquidity shock may influence prices and result in a loss.

## APPENDIX

This appendix provides additional information related to exhibits in the white paper.

- (1) The top portion of this chart presents interest rates, as represented by the 2-year Treasury yield. Areas of rising rates are highlighted. The bottom portion of the chart presents performance of floating rate notes and traditional bonds during periods of rising interest rates, corresponding to the highlighted areas in the top portion. Floating rate note performance is represented by the Credit Suisse Leveraged Loan Index. Traditional bond performance is represented by an arithmetic average of investment grade bonds (Barclays US Investment Grade Corporate Bond Index), high yield bonds (Barclays US High Yield Index) and U.S. government bonds (Barclays US Government Bond Index). Source: ING and U.S. Department of Treasury.
- (2) This chart is based on data found in the S&P/LSTA Leveraged Loan Index Monthly Review June 2013 Edition. It reflects total par amount outstanding of the loans that comprise the S&P/LSTA Leveraged Loan Index at the close of each year and at the end of June 2013.
- (3) Data from S&P/LSTA Leveraged Loan Index Monthly Review from June 2013 were used to recreate this chart showing corporate credit ratings of loan issuing companies and facility ratings of the loans themselves, as determined by the Standard & Poor's credit ranking system.
- (4) The data in this chart reflects data provided in the S&P/LSTA Leveraged Loan Index Monthly Review June 2013 Edition. It displays the annualized 1, 3, 5, and 10 year returns for select assets, including leveraged loans, 10-year Treasuries, investment grade corporate bonds, high yield corporate bonds, and the S&P 500 Index.
- (5) Data source: ING Floating Rate Senior Loan Summary
- (6) Data source: Catalyst Capital Advisors LLC and Princeton Advisory Group
- (7) Data source: S&P/LSTA Leveraged Loan Index Monthly Review June 2013 Edition

## DEFINITIONS

**Barclays Government Bond Index** is composed of the U.S. Treasury and U.S. Agency Indices. The U.S. Government Index includes Treasuries (public obligations of the U.S. Treasury that have remaining maturities of more than one year) and U.S. agency debentures (publicly issued debt of U.S. Government agencies, quasi-federal corporations, and corporate or foreign debt guaranteed by the U.S. Government). The U.S. Government Index is a component of the U.S. Government/Credit Index and the U.S. Aggregate Index.

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

**Barclays U.S. Investment Grade Corporate Bond Index** is an unmanaged index that measures the performance of investment-grade corporate debt and agency bonds that are dollar denominated and have a remaining maturity of greater than one year.

**Collateral:** Assets pledged by a borrower to secure a loan and subject to seizure if the borrower defaults.

**Correlation:** How securities or assets classes move and perform in relation to each other.

**Coupon Rate:** The stated interest rate on a debt security when it is issued.

**Credit Risk:** The risk that the issuer of a debt security will default on its commitment to pay interest and repay principal.

**Credit Suisse Leveraged Loan Index** is designed to mirror the investable universe of the \$US-denominated leveraged loan market. Loan facilities must be rated “5B” or lower. That is, the highest Moody’s/S&P ratings are Baa1/BB+ or Ba1/BBB+. If unrated, the initial spread level must be LIBOR plus 1.25% or higher. Only fully funded term loan facilities are included. The tenor must be at least one year. Issuers must be domiciled in developed countries; issuers from developing countries are excluded.

**Default Risk:** The risk companies will be unable to make required payments on their debt obligations.

**Duration:** The change in the value of a fixed income security that will result from a 1% change in interest rates. Duration is expressed as a number of years. The bigger the duration number, the greater the interest rate risk or reward for bond prices.

**Floating Rate Security/Senior Leveraged Bank Loan:** A debt obligation issued by a bank to a borrower with a below-investment grade credit rating. The loan is generally considered senior to other claims against the borrower, which means if the borrower declares bankruptcy, the senior bank loan is generally repaid first, before other pre-petition creditors and stockholders.

**Interest Rate Risk:** The risk that a bond’s price will fall when interest rates rise.

**London Interbank Offered Rate (LIBOR):** The rate of interest at which banks offer to lend money to one another in the wholesale money markets in London.

**Mortgage-backed Security (MBS):** A type of asset-backed security that is secured by a mortgage or collection of mortgages. These securities must also be grouped in one of the top two ratings as determined by an accredited credit rating agency, and usually pay periodic payments that are similar to coupon payments. Furthermore, the mortgage must have originated from a regulated and authorized financial institution.

**Recovery Rate:** The amount received on a defaulted bond or loan in bankruptcy.

**S&P/LSTA Leverage Loan 100 Index** consists of 100 facilities of the largest institutional leverage loans in an effort to reflect the most liquid side of the market.

**Standard & Poor’s 500 Index** is an unmanaged index of 500 selected common large capitalization stocks (most of which are listed on the New York Stock Exchange) that is often used as a measure of the U.S. stock market.