The Case for Non-Traditional Fixed Income in Every Rate Environment

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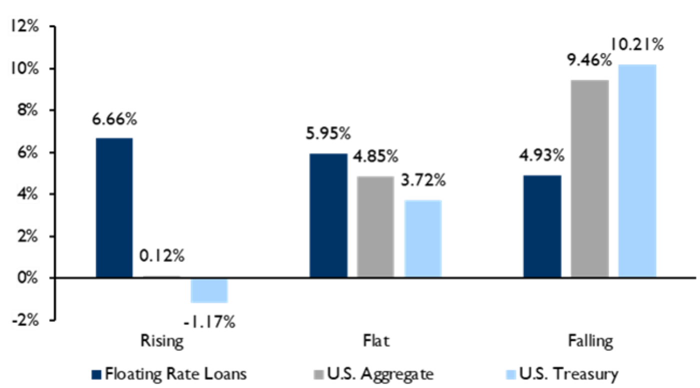
Introduction

In this case study we will take a close look at the large, liquid and mature $1.2 trillion U.S. senior secured corporate loan market. In this study, we present our case for loans in every rate environment. A decade of headlines have been written offering unknowledgeable opinions, selective facts and ultimately, an incomplete picture of the loan asset class. This is at a time when investors are rightfully seeking more information and solutions on how to navigate an unprecedented landscape of historically low interest rates and yields. The availability of income producing assets continues to dwindle as the headwinds of secular challenges grow. One of the key messages that has been inaccurately communicated to investors time and time again is that senior secured loans, given their floating rate nature, only perform when interest rates are increasing. As is often the case, opinion and emotion are ubiquitous while facts and analysis can be difficult to find.

Floating-Rate Loans in Rising, Flat, and Falling Rate Environments



To illustrate our case, consider the chart above which demonstrates the performance of senior secured corporate loans, as well as traditional, rate sensitive fixed income products such as U.S. Treasurys and the Barclay's U.S. Agg Index in periods of rising, falling and flat interest rate environments over the last 27 years. The data and analysis, those necessary counterweights to opinion, show strong positive returns for loans in every rate environment. In fact, loans have demonstrated their ability to deliver positive returns not only in different rate environments but also in the varying macroeconomic and market backdrops that tend to accompany those periods, including low growth and slightly recessionary conditions.

How Do Interest Rates Impact Loan And Bond Returns?

An observation from our study is that loans do enjoy a tailwind from rising interest rates, generally outperforming traditional fixed income because as interest rates rise, so do floating rate coupons.

However, that is only part of the story. What drives this performance? As a reminder, the coupon rate or yield on loans is derived from a current, short term reference rate, usually 1-month or 3-month LIBOR (the rate banks charge to lend money to each other) plus a spread or risk premium for lending money. As rates rise, the reference rate adjusts periodically to reflect the changing conditions and generates a higher coupon payment to an investor.

Traditional corporate bonds have a reference rate too, usually the "risk-free", longer term, 5-year or 10-year U.S. Treasury. Bonds likewise possess a risk premium spread. As the name implies, these instruments fix their coupon rate for a longer term. This coupon does not adjust no matter what happens to interest rates. This is the rate sensitive part of traditional fixed income and one that exposes investors to duration. Duration is defined as the risk that the value of a bond will decline or rise as a result of a change in interest rates. Specifically, when yields rise, a bond's price will fall by an amount approximately equal to the change in the yield, multiplied by the duration of the bond. For example, if the yield on a bond with a duration of five years rises by 100 basis points (e.g. from 3% per annum to 4% per annum) the price of the bond could be expected to fall by 5% (e.g. from $100,000 per bond to $95,000 per bond). It is important to remember that yields and prices move in opposite directions so as yields fall bond prices rise and vice versa.

Clearly, rising interest rates create a headwind for traditional fixed income investors, who would now be able to obtain a theoretical

> ***"Our case study data suggests positive returns for loans in every rate environment."***

1. Source: Credit Suisse and Bloomberg Barclays Indices. "Rising" indicated by an increase of more than 50 bps. "Falling" indicated bya decrease of more than 50 bps. Data reflects rolling 12-month periods from January 1993 through December 2018.

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higher rate of return elsewhere, than the one they locked in at purchase. On the other hand, a front-end asset class such as senior secured loans practically eliminate the risk of duration, given their short-term nature. Additionally, loans possess base rate floors. This means loans cannot generate a negative yield like bonds can at times.

So, what happens when interest rates are falling? Or are flat? Loans keep paying coupon income just like bonds. In fact, we do not have to go far back in history for a case study on loan performance in a decreasing rate environment. Throughout 2019, the Federal Reserve carried out three interest rate cuts, reducing its policy rate by a cumulative 0.75% from 2.50% to 1.75%. Against this backdrop, and much as the above chart would suggest, loans generated a positive return of over 8%.

"We are in an unprecedented economic environment and the traditional fixed income landscape presents unique challenges for investors"

The "New Normal" & The Problem With "Traditional"

We are in an unprecedented economic environment and the traditional fixed income landscape presents unique challenges for investors. We believe this will continue for years to come. In response to a global pandemic and in the span of a fiscal quarter the Federal Reserve has slashed interest rates in the U.S. to effectively zero, expanded its balance sheet by a head-spinning $3.02 trillion, committed unlimited ammo to its quantitative easing program and became an active risk taker in the credit markets. These historic actions have pulled forward a key secular trend; low rates. Pronounced investor concerns about future economic prospects have also contributed to plummeting yields.

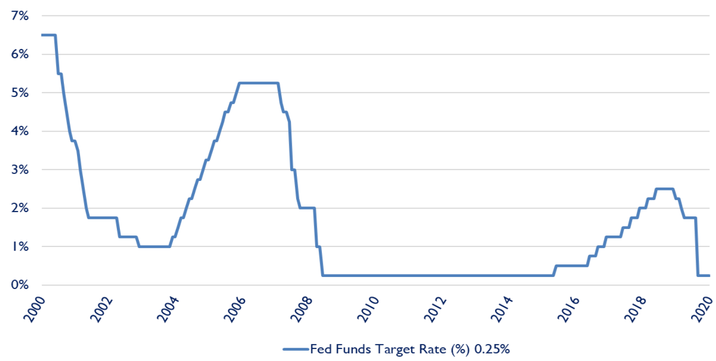
The zero-yield world was ushered in much faster than many anticipated. Investors now must weigh novel risks and conundrums, not the least of which is significantly adjusting investment return expectations and ultimately meeting performance and income goals.

The other is discarding the perceived sense of peace of mind and feeling of stability that has not been provided by traditional fixed income asset classes. It is all a bitter pill to swallow after rates have already been falling for the past four decades.

The Case For Non-Traditional Fixed Income

Today, the yield curve is lower and flatter than it has ever been.

Historically Low Fed Funds Rate



Indeed, the "Japanization" of developed market bond markets is upon us and appears to be here to stay. What does this mean? Investors are simply not being paid to take on the duration risk associated with traditional fixed income. Consider that 10-year U.S. rates sit at around 0.60% and 5-year rates are in line with 3-month LIBOR at 0.27%. There is little to no room left for rates to move down to produce the necessary tailwinds needed for traditional fixed income outperformance.

We believe that the U.S. Aggregate Bond Index will probably only earn ~1% in the coming years and therefore investors will have to transition more to new generation income producing alternatives, such as senior secured corporate loans and other parts of the credit markets to compliment and diversify their fixed income portfolios. The days and role of traditional fixed income in an investment portfolio have changed immensely. Investors must assess how they need to respond to this new world.

"Investors are seeking solutions on how to navigate low rates and yields"

From CIFC

We welcome your comments and questions. Please feel free to contact us at IR@cifc.com. Also, we encourage you to visit our website www.cifc.com for recent news and activities.

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The Barclays High Yield Very Liquid Index is designed to measure the performance of publicly issued U.S. dollar denominated high yield corporate bonds with above-average liquidity. The Index includes publicly issued U.S. dollar denominated, non-investment grade, fixed-rate, taxable corporate bonds that have a remaining maturity of at least one year, regardless of optionality, are rated high-yield (Ba1/BB+/BB+ or below) using the middle rating of Moody's Investors Service, Inc., Fitch Inc., or Standard & Poor's, Inc. Respectively, and have $500 million or more of outstanding face value.