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Bank Loans May Not Have a Place in Your Portfolio.

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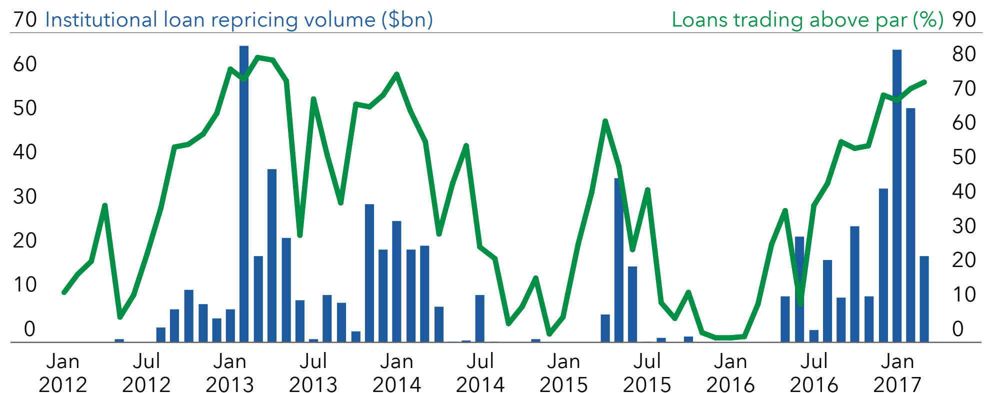
- The popularity of bank loans – floating-rate debt issued by below-investment-grade companies that is syndicated to allow a number of investors to buy a part – has risen in recent years.
- We believe bank loans are best used in a limited fashion within the context of a diversified high-yield portfolio.
- In a broader portfolio framework, bank loans should be viewed as part of an extended sector allocation within fixed income. Given their high correlation to equities, we do not view them as appropriate within the context of a core allocation to fixed income.
- Bank loans have tended to exhibit a correlation to equities similar to that of high yield, but without similarly high returns.
- Due to their lack of call protection, bank loans exhibit more reinvestment risk than high-yield bonds that provide that protection.
- Bank loans are much less liquid than high-yield bonds.

When a Large Number of Bank Loans Trade Above Par, a Refinancing Wave Often Follows



Sources: J.P. Morgan, Standard & Poor's Loan Syndications and Trading Association Index. As of March 9, 2017.

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In recent years, investors have gravitated toward bank loans in the belief that the sector provides broader portfolio diversification and protection in a rising rate environment. However, data shows their correlation to equities is actually not low, and, given the callable nature of bank loans, the potential for an increased coupon may be elusive absent a significant increase in rates. In our view, bank loans should be viewed as part of an overall high-yield portfolio in the extended sector/alternatives sleeve of a fixed income allocation, and not as a dedicated asset class.

Asset managers of high-yield funds with the flexibility to invest in bank loans can help mitigate the risks associated with the asset class, including lower liquidity and the callable nature of the loans. Moreover, valuations of specific credits can change quickly in a rising rate environment, and asset managers have the flexibility to shift between high-yield bonds and loans of issuers based on credit quality, call risk and other metrics.

What's in a Name?

Investment managers have been positioning what was once a little-known area of bond markets, owned primarily in collateralized loan obligations (CLOs), as a hedge against the impact of rising interest rates. This alternative has amassed many names: bank loans, leveraged loans, floating-rate loans, senior loans, senior secured loans and high-yield loans. For the purpose of this paper, I will refer to the asset class by its traditional name: bank loans.

Like high-yield bonds, bank loans are typically issued by companies rated below investment grade by the major rating agencies. Both are used for purposes such as financing acquisitions, refinancing existing debt and general corporate purposes.

Bank loans, though, are senior in the capital structure and are typically secured against a pool of the issuer's assets. They pay floating-rate interest. The interest rate for a bank loan is determined by a fixed spread that is paid quarterly along with a base rate, typically the London Interbank Offered Rate (Libor). While the aforementioned bank loan characteristics may seem appealing at face value, investors should also consider some of the risks associated with investing in bank loans.

Bank Loans Exhibit More Reinvestment Risk

Bank loans lack call protection, thus providing a bank loan issuer the free option of paying down, repricing or refinancing their bank loan at par value — at any time. As a result of the lack of call protection, bank loans typically will not trade meaningfully higher than their face value, or par. Additionally, upon a repricing or refinancing, the spread above Libor would be lower, potentially creating more volatility over the long term.

In contrast, high-yield bonds often offer investors strict call protection. When issuers do want to include the option to call a bond in its covenants, they typically pay an interest rate premium to investors over that of noncallable bonds. Hence, this contributes to callable bonds typically paying a higher coupon or premium than bank loans of similar quality.

With nearly 70% of loans trading above par as of early February, the current market suggests an environment that is ripe for a wave of refinancing by issuers. For example, 40% of the leveraged loan universe repriced during 2013's wave of retail inflows, according to data from J.P. Morgan.

Poor Diversification, Yield and Return Potential

Bank loans, like high-yield bonds, have exhibited a high correlation to equities. That contrasts with core bonds, represented by the Bloomberg Barclays U.S. Aggregate Index, which exhibit a low correlation to equities. This high correlation to equities of bank loans suggests that they should not be considered a short-term or core asset but rather an extended sector asset, like high-yield bonds. Thus, investors should seek long-term returns similar to other extended sector asset classes that seek higher returns than core funds.

Bank Loans and High-Yield Bonds Both Have High Correlations to Equities

10-Year Correlation to the S&P 500

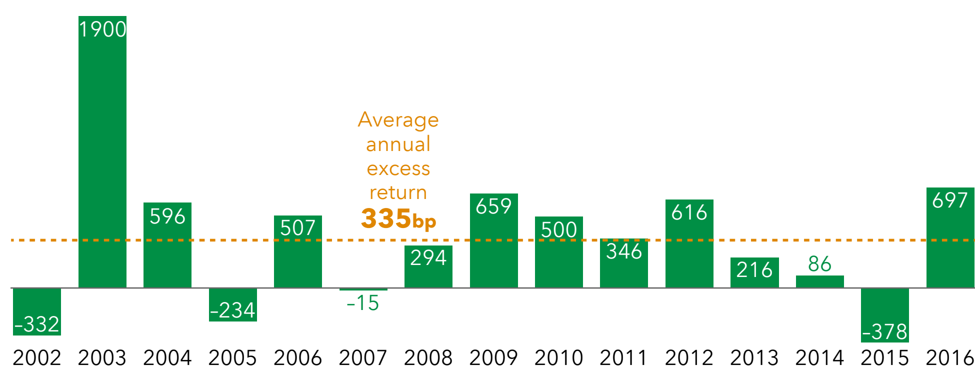
Sources: Bloomberg Index Services Ltd., Standard & Poor's. As of December 31, 2016.

Bank loans do not provide the same level of long-term total return potential as other extended sector asset classes, such as high-yield bonds. Let's consider the period since the year 2002, which included high default environments, periods of rising rates and the global financial crisis. During that time, high-yield bonds have outpaced bank loans in every calendar year but four, providing an average annualized excess return of 335 basis points.

Bank loans may outpace high-yield bonds during discrete periods in a market cycle; however, since 2002 they have never outpaced high-yield bonds in two consecutive years. Thus, a long-term allocation to high-yield bonds may benefit an investor's broader fixed income portfolio more than bank loans.

Since 2002, High-Yield Bonds Have Outpaced Bank Loans in All but Four Years

High-yield bonds annual excess return over bank loans (basis points)



Sources: Bloomberg Index Services Ltd., Standard & Poor's.

In this chart, high-yield bonds are represented by the Bloomberg Barclays U.S. Corporate High Yield Index and bank loans are represented by the S&P/LSTA Leveraged Loan Index.

Key Takeaways

- Some investors may be attracted to certain features of bank loans, like their floating-rate coupons. But individual investors may be better off with a high-yield bond fund allocation that can utilize these bank loans selectively as part of its broader strategy.
- Bank loans expose investors to reinvestment risk, because they can be refinanced or repriced at any time.
- They also maintain a similarly high correlation to equity as high-yield bonds, but without the added yield and return potential of high-yield bonds.
- Due to a lack of contractual settlement period, bank loans have lower liquidity than high-yield bonds.

High-Yield Bonds Exhibit Better Liquidity

While traditional corporate bonds settle in three days, bank loans lack a contractual settlement date. Instead, investors selling bank loans into the secondary market must rely on the purchaser to settle the trade.

On average, settlement times have ranged between 13 and 16 days, according to the Loan Syndications and Trading Association. As a result, dedicated bank loan mutual funds need to hold cash, have access to liquidity lines of credit or invest in high-yield bonds to increase liquidity.

Bank Loans in the Context of High-Yield Portfolios

Bank loans can play a role in the broader context of managing a high-yield portfolio, and many high-yield fund managers may make a small allocation to bank loans. The bank loan market can offer those managers the opportunity to express a view in a below-investment-grade credit that does not issue bonds or, at times, provide better potential risk-adjusted returns than an issuer's bonds. However, for the reasons outlined in this paper, we believe a high-yield bond fund will serve most investors' goals better than bank loans in most market environments.

What This Means for Investors

We understand that many investors are currently concerned about rising interest rates and volatility within their fixed income portfolio. However, the current environment does not appear likely to change from one marked by low asset price returns, low interest rates and moderate volatility, to one with much higher interest rates resulting from a significant move by the Fed.

Understanding investment options and the benefits of long-term investing should help provide a higher level of return compared with timing investment decisions around an anticipated change in interest rates. Therefore, I believe investors should continue to hold high-yield bonds within their extended sector allocation to benefit from their superior long-term return profile, better liquidity and call protection, rather than switch to a dedicated investment in bank loans.

Investors should carefully consider investment objectives, risks, charges and expenses. This and other important information is contained in the fund prospectuses and summary prospectuses, which can be obtained from a financial professional and should be read carefully before investing. Securities offered through American Funds Distributors, Inc.

Lower rated bonds are subject to greater fluctuations in value and risk of loss of income and principal than higher rated bonds.

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