PACIFIC FUNDS insights

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BANK LOANS: WHAT WE LOOK FOR AND WHAT WE AVOID

Floating-rate loans have attracted increased investor attention given the search for income amid an uncertain interest-rate environment. Here's why.

Client Portfolio Manager Peter Farmer, CFA, sat down with JP Leasure, senior managing director of Pacific Asset Management (PAM), and Michael Marzouk, CFA, managing director of PAM, to get their insights on the growing bank-loan asset class. Leasure and Marzouk are portfolio managers for PAM's Corporate Loan and Collateralized Loan Obligation (CLO) strategies. PAM is sub-advisor to Pacific Funds' fixed-income funds, including Pacific Funds Floating Rate Income fund.

Q: Can you walk us through the creation of the bank-loan asset class? How has it evolved over the years?

A: JP Leasure

The broadly syndicated bank-loan market really got its start in the go-go days of leverage buyouts back in the 1980s. You had the Michael Milken era with high-yield bonds, but right alongside those high-yield bonds were bank loans. You typically had your money center banks underwriting a transaction and then syndicating it out. And that, in essence, became the broadly syndicated loan market.

But it really didn't grow up, I'll use that term, until the 1990s, and that was when you had more institutional interest in the asset class. Bank loans used to be just bought and held by the banks themselves on their balance sheets. Then you started to see some of the banks and institutional investors begin to trade the loans.

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Initially there wasn't a lot of trading, and mostly it was loans trading near par, hence the term par loans, which is often used for the asset class. But since that mid- to late-1990s dynamic of trading, it really has evolved in the past 20 years into a true capital-market instrument.

It's every bit as liquid as high-yield bonds, and I would make a case that it's even more liquid than high-yield bonds. It is a market where a banker or a number of institutions underwrite a transaction. They bring it to market — they syndicate it out. Investors such as Pacific Asset Management and other institutional investors buy a portion of that syndicated loan, and it's traded. And when we talk about broadly syndicated loans, the bid-ask can be relatively tight. It can be as tight as an eighth of a point to maybe one full point on some loans. But the asset class has really evolved into a true capital-market instrument these days.

Q: Where do bank loans sit in the capital structure, and what's the role of company assets as collateral in loans versus the high-yield bond market?

A: JP Leasure

It would probably be helpful to start at the beginning and describe what exactly is a bank loan. Your typical issuer will have a bank loan and an unsecured high-yield bond below it. These are typically below investment-grade issuers. I think bank loans have a mysterious aura about them, but it's important for everyone to know that almost all issuers — investment grade or high-yield issuers (below investment grade) — have bank loans in their capital structure. They are companies such as Burger King, Sprint (before it was acquired by T-Mobile), Aramark and Hilton. So, it's not

just your small privately held companies; it's also issuers that you see in the stock market every day.

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A bank loan is senior secured, placing it higher up in the capital structure than a high-yield bond, which is typically unsecured — and these are all generalizations, of course. A bank loan is floating rate in the sense that its coupon is calculated off a benchmark rate, so that can either be LIBOR, SOFR, prime or Fed funds. Typically, it's LIBOR plus the spread. So, it's floating rate secured. Your security is effectively a blanket lien on the assets of the business, as well as the stock of the business. In other words, you are secured by the entire business itself. Taking a step back, the bank-loan piece of the capital structure might be anywhere from 40% to 60%, with the balance being high-yield bonds and equity.

Q: Amid the interest-rate volatility, we've seen renewed flows into the bank-loan asset class. Can you describe the rate-resetting process for loans, and how it's been a built-in hedge in prior rising-rate scenarios?

A: Michael Marzouk

In terms of how rates work, if you think about a typical high-yield bond, it's a stated fixed coupon. Let's say it's 4%, 5%, or 6%, and it stays at that coupon for the life. Bank loans are different in that they are floating rate. If short-term rates go up, the rates and the interest that you receive on the loans will go up or potentially they could go down if short-term rates go down. The one great thing about loans in today's market is that typically their benchmarked off the three-month LIBOR, which recently has been less than 25 basis points.

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Given what the Fed has done with interest rates, short-term rates will probably not go much lower than where they currently sit. It's expected that short-term rates have room to go up as you look out into the future. Floating-rate loans have the benefit of an increased coupon as rates go up. I'd also point out that a lot of bank loans these days have a floor on the short-term rate or LIBOR. These loans will have, let's say, a 50-basis-point or 75-basis-point floor, which effectively secures you minimum interest payments as long as the borrower is making payments.

Q: Let's get a little bit more granular. You look at the loan market through three different lenses. Let's start with relative value compared to other fixed-income asset classes. What are you looking for?

A: Michael Marzouk

We live in a world today that is yield starved. As long as you believe the economy is performing and defaults will remain low, anything with spread tends to get a decent amount of demand. As to relative value, let's first look at investment-grade bonds. For those, you tend to have a lot more duration, and they quite frankly don't have much yield. With the 10-year Treasury at current levels, there's just not much yield or return potential on investment-grade bonds unless there's a big move in interest rates to your benefit, and obviously it could really hurt investors if rates go up.

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As for high-yield bonds, yields have hovered around 4% recently. Those coupons are fixed, so if rates go up, it will not be the best environment for high-yield bonds. Now to bank loans. Yields have hovered around 4.5% recently — and it's not often where bank loans have more yield than high-yield products on an index basis. As we sit in the second quarter of 2021, you can get comparable or more yield by investing in bank loans than you can in high-yield. With the economy rebounding, the expectation is for interest rates to rise over time. Plus, the default-rate environment is, at this point, in the low

single digits, which is quite good.

So looking at relative value, bank loans look quite attractive, and, remember again, they are senior secured. If things deteriorate, you are first in line for repayment. Recoveries typically for bank loans average 60 to 70 cents on the dollar. And unsecured high-yield bonds typically recover anywhere from 20 to 40 cents on the dollar. So, you have better recovery potential in bank loans just because you are secured. On a multitude of factors, bank loans look quite attractive versus not only high-yield bonds, but also may complement a core fixed-income or investment-grade bond portfolio.

Q: The second lens looks at a company's fundamentals. How do the fundamentals look for the bank-loan asset class?

A: JP Leasure

We started 2020 in pretty good shape. Companies seemed to be pretty well geared up for some growth. Then the pandemic hit, and the rating agencies reacted very quickly, which is quite a bit different from how they reacted in the Global Financial Crisis back in 2009. In 2020, the rating agencies acted very quickly with downgrades. I would say that the companies themselves also reacted very quickly. They got lean and mean, pulled back on their capital expenditures, got rid of any ancillary costs, and went into cash-preservation mode. Yes, 2020 was a difficult year, but I would say toward the back end of the year, with the support of the Fed and government, the markets embraced a lot of risk.

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What's also important to understand is that the market had sufficiently dropped total-return expectations. Assuming we get back to a normal level, the economy is going to be quite good. The markets embraced the fact that companies during the pandemic were all able to access the markets, both on the equity and debt side.

Now, when we look forward, liquidity is pretty good for the broad-based market. Again, for our universe — the broadly syndicated loan market — default rates peaked at around 5% to 6%, and I think there were expectations that we were going back to the days of the Global Financial Crisis, when you had default rates up to 14%. Well, we didn't get there this time. The economy has come back, companies have become quite lean, and with the support of the fiscal and regulatory authorities, the outlook is looking pretty good.

When you fast forward to where we sit today after the first quarter of 2021, the default rates are around 3%, and expectations are that default rates are even going lower per J.P. Morgan. — maybe down to even the 2% range while the historical average is around 3.5%. That is pretty amazing when you think about it considering we've just gone through a pandemic. We have lower default rates today than we do on average, and they're projected to go lower. Companies have done a really nice job of accessing the capital markets as needed, many of them have brought their leverage to realistic levels, and they're in pretty good shape. And the expectations right now are that a lot of the companies that are more levered will grow into their capital structure as the course of the year progresses.

Q: The third lens is the technical backdrop for the bank-loan market, meaning supply and demand. On the supply side, what are the trends around new issuance?

A: Michael Marzouk

On the supply side, the markets have been quite robust. There's definitely been demand on the lending side, and there's also been demand on the borrowing side. It's mainly fueled by mergers and acquisitions and leveraged buyouts. We've seen a handful of companies this year taken private. It's a private equity firm buying the company and then raising money to effectively fund that purchase price — and they'll throw in some equity

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as well. There's also a lot of refinancing and opportunistic transactions, potentially dividend deals and things of the like. So, supply is quite good and quite healthy.

Q: What about the demand side?

There are really three pillars on the demand side for loans. The biggest pillar is collateralized loan obligations (CLOs), and CLOs comprise about two-thirds of the demand of the asset class. The asset class is about $1.2 trillion. CLO buyers comprise about two-thirds of the demand, which tends to be a very healthy demand spot. There's typically around $100 billion of CLO issuance every year. We're well on the way to that number this year. There was almost $40 billion printed in the first quarter of 2021, so that machine keeps going.

> ...overall the supply and demand picture looks quite good and quite favorable.

Another source of demand is institutional buyers. These are insurance companies, pension funds, etc., and they comprise roughly 20% of the demand of the asset class, and those investments tend to be quite sticky as well. They are looking to invest in the asset class to get yield, but also to diversify their own portfolio.

The third pillar of the bank-loan asset-class demand equation comes from retail mutual funds, and that group roughly makes up 10% of the demand of the asset class. Retail inflows this year have been quite strong. When you look at 2020, that was an environment where money came out of the asset class. This year has been a reverse. We've already seen over $10 billion of inflows into the retail loan mutual-fund asset class, and we're not even halfway through the year. So, overall the supply and demand picture looks quite good and quite favorable.

Q: Looking at the number of corporate issuers represented in the major bank-loan indices, we're talking more than 1,300 companies in some cases. What matters to you when you're lending to a company, and how would you summarize your process navigating that market?

A: JP Leasure

Maybe it helps to frame our style a bit and really our differentiator at Pacific Asset Management. We want to very much actively manage this asset class, and to do so, we focus on the broadly syndicated loan market. For us, that means the larger issuers within that market. It's term loan facility sizes of $300 million and up in companies that have EBITDA of $100 million and up.

We want to be able to actively move in and out of positions. There are a number of long managers who are buy and hold, but that's not us. Our first and foremost differentiator is that we very much actively manage the assets. Our second differentiator is that we are very selective. We tend to have around 125 positions in each of our loan portfolios, and I think what's important there is not only our ability but our willingness to sell positions that don't offer relative value. That's how historically we've been able to perform well in different market environments.

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The third differentiator is a focus on minimizing defaults. The universe that we're looking at are typically all below investment-grade companies. For us, it's an asymmetric asset class. It's pre-payable at par, which is quite a bit different from high-yield and investment-grade bonds, which can move up to a $107, $108 price, where loans are more or less kept at par. And for that reason, when you have a mistake and you have a loan that drops from par, let's call it 100 down to 70, it's hard to make up that 30-point loss elsewhere in the portfolio. For us, we want to avoid deteriorating situations, and we've done well with that. Our

institutional track record goes back to 2007, and we've had just three defaults since inception, and, in those three defaults, we've had par recoveries on two of them.

What's an important distinction for us is that we are very mindful of secularly declining businesses. For example, we try to stay away from traditional telecom wireline businesses, and radio broadcasting would certainly be a secularly declining business that we'd typically stay away from. Also, retailers that are suffering from the Amazon effect, and coal companies that are having difficult times due to renewables. All those issuers make up the 1,300-plus issuers in the market, and we are very cognizant of companies going down a secularly declining path.

Now what do we look for in a business? First and foremost, is it a good business or a bad business? That's paramount for us. And we always say to ourselves, we'd rather lend to a highly leveraged good business than a lowly levered bad business. That highly levered good business is typically going to be able to figure out the business model, do whatever they need to do, raise capital as needed to keep the business alive. The problems facing a declining bad business tend to get exacerbated in downturns and lead to poor recoveries should it go down the default scenario.

There are many other factors to consider. What's the leverage? Obviously, that's very important. What are valuations in the space? When you lend to a company at four to five times leverage, with an enterprise valuation of 10, 11, 12 times, that's important to know that you have implicit subordination below you. But it's also about the collateral. And are there headwinds, tailwinds? Is there debt below you in the capital structure? What's the management team like? Have they done a good job in the past or have they had some other problems in the past? All that frames whether we like the business or not, and then you take a look at the relative value and all those other components to see whether an investment makes sense.

Q: Michael, anything on your end you'd like to add on our process or the philosophy?

A: Michael Marzouk

I would just emphasize that the way we approach the asset class is very much about minimizing defaults. We're looking for single and doubles. This is not an asset class where you can really hit too many home runs anyway. It's really not what you own, but what you don't own that really differentiates ourselves from other managers. Our selective approach produces about 125 names in the portfolio and not 300 or 400 names.

Pacific Funds Floating Rate Income Top-10 Holdings (Weight %) as of 3/31/21

Jaguar Holding Co.	1.55	Clear Channel Outdoor Holdings, Inc.	1.32
Applied Systems, Inc.	1.47	Sunshine Luxembourg VII	1.29
Epicor Software Corporation	1.37	Uber Technologies, Inc.	1.26
Finastra Group Holdings	1.35	Sophia LP	1.21
SRS Distribution, Inc.	1.33	Athenahealth, Inc.	1.21

Fund holdings and sector allocations are subject to change at any time and should not be considered recommendations to buy or sell any security.

Definitions

One **basis point** is equal to 0.01%.
A **collateralized loan obligation (CLO)** is a single security backed by a pool of loans, collected into a marketable instrument via process known as securitization.
EBITDA, or Earnings Before Interest, Tax, Depreciation, and Amortization, is a measure of a company's profits before any of these net deductions are made.
Enterprise valuation is a measurement of a company's total value.
LIBOR (London Interbank Offered Rate) is the benchmark reference for interest rates that banks charge each other for debt i nstruments and loans.
SOFR (Secured Overnight Financing Rate) is a broad measure of the cost of borrowing cash overnight collateralized by Treasury securities.

High yield/high risk securities are typically issued by companies that are highly leveraged, less creditworthy or financially distressed and are considered to be mostly speculative in nature (high risk), subject to greater liquidity risk, and subject to a greater risk of default than higher rated securities. High yield/high risk securities (including loans) may be more volatile than investment grade securities.
Floating rate loans (or bank loans) are usually rated below investment grade and thus are subject to high yield/high risk or "junk" securities risk. The market for floating rate loans is a private interbank resale market and thus may be subject to irregular trading activity, wide bid/ask spreads and delayed settlement periods. Purchases and sales of loans are generally subject to contractual restrictions that must be fulfilled before a loan can be bought or sold. These restrictions may hamper a fund's ability to buy or sell loans and negatively affect the transaction price.

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