M&G Investments

Comparing floating rate high yield income strategies

High yield FRNs vs. leveraged loans

March 2022

- High yield floating rate notes (HY FRNs) and leveraged loans are both potential sources of senior-secured, high yield income that aim to significantly reduce interest rate risk in an investor's portfolio.
- While investors may expect these strategies to achieve similar outcomes, there are still important differences between them.
- Although the market is smaller, HY FRNs typically offer better liquidity than loans, while potentially reducing cyclical risks and offering other diversification benefits.

The value and income from a strategy's assets will go down as well as up. This will cause the value of your investment to fall as well as rise. There is no guarantee the strategy will achieve its objective, and you may get back less than you originally invested. Please note that past performance is not a guide to future performance.

HY FRNs: a growing part of the global high yield bond market

HY FRNs are a small-but-growing subset of the global high yield bond universe. These debt securities, which have a higher yield than similar ones issued by entities with more solid credit reputations, pay periodic interest (coupons) that adjust in line with the movement of interest rates. High yield debt is rated below investment grade by credit rating agencies. In its purest form, the HY FRN market is around $60 billion in size, which compares to an estimated market capitalisation of around $2.6 trillion for fixed rate high yield bonds[1].

While HY FRNs represent a distinct potential opportunity set, the broader high yield bond universe remains relevant for HY FRN strategies, as high yield floating rate income can also be created synthetically using fixed rate bonds. This can be achieved using combinations of other instruments and derivatives, such as interest rate swaps and credit default swaps (CDS). Derivatives are instruments whose value and price depend on one or more underlying assets. Interest rate swaps are a type of swap where two parties agree to swap fixed and floating rate payments. Credit default swaps act more like insurance: they protect the buyer from the negative effect of a company ceasing to pay interest on its debt or repay the principal, in exchange for regular payments made to the seller. Theoretically, this strategy expands the investable universe to that of the entire global high yield bond market by allowing a portfolio manager to easily create floating rate exposure to high yield bonds that were not originally issued as HY FRNs.

HY FRNs are a global asset class, but the majority of issuance currently comes from Europe. In the US, high yield issuers are much more likely to access floating rate corporate borrowing through the country's extensive leveraged loans market, while Europe's leveraged loan market is much smaller. Leveraged loans are loans made to companies that already have a significant amount of debt. They are typically companies owned by private equity funds, which use debt to fund corporate mergers and acquisitions (M&A). Leveraged loans usually carry below investment grade credit ratings.

Investors may expect leveraged loans and HY FRNs to achieve a similar investment outcomes, but there are important distinctions between them. Here, we compare some of their key similarities and differences, with a view to helping investors understand the roles they can play in an investment portfolio.

Similarities

Floating rate coupons

Both asset classes pay floating rate coupons, which reset for each new payment period, based on a prevailing reference rate. Historically, the standard reference rate was an interbank offered rate (IBOR), the rate at which banks lend money to each other. Typically, that was three-month US dollar (USD) LIBOR (London interbank offered rate) for USD-denominated debt and EURIBOR for euro-denominated debt.

[1] Source: Bloomberg, M&G analysis, as at 9 Feb 2022.

Figure 1: Characteristics of global HY FRNs and senior loans

	Global HY FRNs	Leveraged loans
Similarities		
Coupons	Floating rate payments calculated using published reference rates, such as EURIBOR and SOFR, typically reset quarterly	Floating rate payments calculated using published reference rates, such as EURIBOR and SOFR, typically reset quarterly
Capital structure position	Typically senior-secured	Typically senior-secured
Credit risk level	High yield	High yield
Differences		
Liquidity	T+2 (days) settlement	US: T+5 to 10 (days); Europe: T+30 (days approx.) settlement
Diversification and market structure	Greater European exposure, less cyclical	Mainly US exposure, more cyclical
Accessibility	Available to most investors	Typically only available to institutional investors

In the US, LIBORs are being replaced with new reference rates, with some tenors having already ceased publication and three-month LIBOR expected to be retired in June 2023. In many cases, new issuances already use the recommended replacement, the Secured Overnight Financing Rate (SOFR). The Secured Overnight Financing Rate (SOFR) is a measure of the cost of borrowing cash overnight using US government bonds as collateral. SOFR is based on actual transactions and it is administered by the Federal Reserve Bank of New York. In Europe, EURIBOR will continue, but the process by which it is calculated has already been reformed. The transition so far has been smooth and we do not expect any noteworthy risks to arise from the ongoing process.

Seniority and security

HY FRNs and loans typically occupy a senior position in the capital structure. This characteristic may provide greater security to investors in the event of a default compared to junior debt and equity, and historical recovery rates for senior securities following a default have been higher than for subordinated securities[2].

Additionally, both types of debt are typically secured against the issuers' assets. This can be expected to further improve the chances of a recovery in a potential default scenario.

High yield income potential

Both asset types are of non-investment grade status, with credit ratings either explicit or inferred of BB+ or lower. They may be reasonably expected to offer greater potential reward than an investment grade equivalent (BBB- or higher), as the credit spread (the difference between the yields of government bonds and those of corporate bonds) is likely to be higher to reflect the additional risk they represent.

Differences

Liquidity

Perhaps the most material difference between the two asset classes is that HY FRNs typically offer greater liquidity than leveraged loans. In normal market

[2] Source: M&G, ICE BofA Merrill Lynch, Moody's Research, 31 March 2021. Calculated by Moody's from ICE Bank of America Merrill Lynch Global Floating Rate High Yield Index (3% Constrained) USD Hedged using 40% and 60% recovery rate assumptions.

conditions, FRNs may be expected to trade freely, with a standard T+2 days settlement period.

Synthetically created HY FRNs can also significantly increase overall portfolio liquidity, due to the greater size of the fixed rate high yield bond universe and extensive liquidity in derivatives markets.

Loans, meanwhile, are less liquid. In the US, they may trade with a settlement period T+5 to T+10, or potentially longer. In Europe, T+30 settlement for loans may be more likely. Loan managers and investors must therefore consider how these extended settlement periods will be accommodated when dealing with portfolio flows.

Diversification of cyclical risk

Compared to leveraged loans, the HY FRN universe, represented by the ICE BoA Global High Yield 3% constrained (USD hedged) index, is oriented more to European HY issuers. As a result, it will typically have less exposure to energy companies and greater exposure to financials. At the current stage of the economic cycle, it is worth noting that financial issuers can be well-placed to benefit from potential interest rate rises. Cyclical issuers – those whose performance follows closely the ups and downs of the wider economy -- may offer potential inflation protection, but at the same time, they can come under pressure if increases in interest rates undermine economic activity.

Our approach to managing HY FRN strategies seeks to further reduce risk when compared to the broader investment universe. In our view, the benchmark index can pose concentration risks, partly due to the relatively high minimum issue size required for inclusion. This means that the index is typically smaller than the broader market and offers a less diversified potential opportunity set, containing some relatively large weightings to higher beta credits. Some of these issuers have performed strongly over the past few years due to the low default environment, but they inherently present greater downside risks in market sell-offs.

The index is also tilted towards riskier, more leveraged credits, as is typically the case with credit indices, which are by nature weighted towards companies that issue larger amounts of debt. Our approach may involve maintaining underweight exposure to those credits. This more cautious positioning is deliberate and seeks to reduce the volatility associated with these names in pursuit of delivering a smoother return path for investors.

Accessibility for investors

The loans market has historically been the domain of institutional investors, which have a greater ability to trade and hold less liquid assets. Requirements for regular daily liquidity in funds have restricted the availability of loan products to wholesale investors. In contrast, by virtue of their typically higher liquidity, global HY FRN strategies can provide daily dealing, including in stressed market conditions, which makes potential floating rate high yield income accessible to a wider investor base.

Covenants and safeguards

In the past, leveraged loans were typically issued with covenants, which are contractual provisions written into a bond for the bondholder's protection. Maintenance covenants required borrowing companies to maintain a certain level of financial health, while incurrence covenants acted as hurdles to those borrowers taking out additional debt. These restrictions helped to safeguard the company's ability to service their debt and protected lenders.

However, over the past decade, investor demand for loans has grown significantly, which has enabled borrowers to access loans with fewer or no restrictions -- so-called 'cov-lite' loans. These now represent more than 90% of loan issuance in the US and Europe, having been almost non-existent in 2010. This means that both loans and HY FRNs, which are issued as bonds and therefore do not feature covenants, primarily rely on their senior-secured status to offer protection to investors.

Portfolio suitability

As we have explored, both HY FRNs and senior loans are potential sources of senior-secured, high yield income that seek to significantly reduce interest rate risk. Their varying characteristics mean that each can play a role in an investment portfolio, with HY FRNs arguably better suited to certain types of investors due to their greater liquidity and less cyclical exposure, which increase a client's ability to commit and withdraw capital throughout various stages of the economic and credit cycles.

At M&G, we have one of Europe's largest in-house credit research teams and have managed HY FRN strategies since 2014, which we believe leaves us well-placed to identify potential opportunities in this area, with a view to offering diversification, floating rate protection and high yield income for investors.

James Tomlins
Portfolio Manager
M&G Investments

Risks that could affect a strategy holding FRNs

- Investments in bonds are affected by interest rates, inflation and credit ratings. It is possible that bond issuers will not pay interest or return the capital. All of these events can reduce the value of bonds held by the strategy.
- High yield bonds usually carry greater risk that the bond issuers may not be able to pay interest or return the capital.
- The strategy may use derivatives to profit from an expected rise or fall in the value of an asset. Should the asset's value vary in an unexpected way, the strategy will incur a loss.
- The strategy's use of derivatives may be extensive and exceed the value of its assets (leverage). This has the effect of magnifying the size of losses and gains, resulting in greater fluctuations in the value of the strategy.
- Loans may be prepaid by issuers at short notice, as a result it may be difficult for the strategy to locate and reinvest capital at an attractive price or at all, which may affect the strategy adversely.

For Investment Professionals, Institutional Investors and Professional Investors only. Not for onward distribution. No other persons should rely on any information contained within.

This information is not an offer or solicitation of an offer for the purchase of shares in any of M&G's funds.

Distribution of this document in or from Switzerland is not permissible with the exception of the distribution to Qualified Investors according to the Swiss Collective Investment Schemes Act, the Swiss Collective Investment Schemes Ordinance and the respective Circular issued by the Swiss supervisory authority ("Qualified Investors"). Supplied for the use by the initial recipient (provided it is a Qualified Investor) only.

In Hong Kong, this financial promotion is issued by M&G Investments (Hong Kong) Limited, Office: Unit 1002, LHT Tower, 31 Queen's Road Central, Hong Kong; in Singapore, by M&G Investments (Singapore) Pte. Ltd. (Co. Reg. No. 201131425R), regulated by the Monetary Authority of Singapore; in Switzerland, by M&G International Investments Switzerland AG, Talstrasse 66, 8001 Zurich, authorised and regulated by the Swiss Federal Financial Market Supervisory Authority; elsewhere by M&G International Investments S.A. Registered Office: 16, boulevard Royal, L 2449, Luxembourg.

For Hong Kong only: If you have any questions about this financial promotion please contact M&G Investments (Hong Kong) Limited. For Singapore only: All forms of investments carry risks. Such investments may not be suitable for everyone. The information contained herein is provided for information purposes only and does not constitute an offer of, or solicitation for, a purchase or sale of any investment product or class of investment products, and should not be relied upon as financial advice. The Portuguese Securities Market Commission (Comissão do Mercado de Valores Mobiliários, the "CMVM") has received a passporting notification under Directive 2009/65/EC of the European Parliament and of the Council and the Commission Regulation (EU) 584/2010 enabling the fund to be distributed to the public in Portugal. M&G International Investments S.A. is duly passported into Portugal to provide certain investment services in such jurisdiction on a cross-border basis and is registered for such purposes with the CMVM and is therefore authorised to conduct the marketing (comercialização) of funds in Portugal.

For Taiwan only: The information contained herein has not been reviewed or approved by the competent authorities and is not subject to any filing or reporting requirement. The information offered herein is only permitted to be provided to customers of an offshore banking unit of a bank ("OBU")/offshore securities unit of a securities firm ("OSU") which customers reside outside the R.O.C. Customers of an OBU/OSU are not eligible to use the financial consumer dispute resolution mechanism under the Financial Consumer Protection Law. Products offered by M&G International Investments S.A. may be made available for purchase by Taiwan OBUs/OSUs acting on behalf of non-Taiwan customers of such units but may not otherwise be offered or sold in Taiwan.

693506_EUR_UK_Asia