# THREE VIEWS ON VALUE IN TODAY'S FLOATING RATE LOAN MARKET


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Floating-rate loans have proven themselves as potentially valuable additions to traditional fixed-income portfolios. They may improve portfolio efficiency and mitigate the impact of rising rates, thanks to near-zero duration and yields that historically have been second only to high-yield bonds, among US fixed-income sectors. However, following sub-par performance in 2014, we feel it is a good occasion to address several questions on value and credit quality. Our belief is that this market offers good tactical opportunities to establish or add to a core strategic floating-rate portfolio allocation.

### "WHAT HAPPENED IN 2014? THE YIELD WAS 5% BUT TOTAL RETURN WAS JUST 1.6% – LESS THAN THE 5% 10-YEAR AVERAGE."

A growing risk aversion on the part of retail investors last year broadly affected credit risk sectors like floating-rate loans and high-yield bonds, as mutual funds for both sectors experienced net outflows. Floating-rate loan prices fell by 2.4%, partially offsetting income gains, and reducing total return.

In our view, last year's negative sentiment was at odds with the strengths of the floating-rate loan market in a broadly improving US economy. We see three broad reasons why floating-rate loans offer value:

#### Fundamental:

- **Cash flow coverage is high** – At 4.4x, cash flow coverage is at its highest level in 10 years, over which it has averaged 3.2x *(See Figure 1)*.
- **Leverage has fallen** – At 5.7x EBITDA[1], is down from its recent peak of 6.9% in the third quarter of 2012, and below its 10-year average of 6.0x *(See Figure 1)*.
- **Defaults are down significantly** – For the trailing 12 months as of 28 February 2015, the number of defaults is at 0.7% of issuers, compared with the 2.2% average of the past 10 years

#### Valuation:

- **Attractive yield** – Among US sectors, the 5.2% yield on the S&P/LSTA Index as of 28 February 2015, is second only to high yield.
- **Spreads are above median** – At 492 basis points (bps) above Libor, the spread of the S&P/LSTA Index is wider than the 10-year median of 483 bps. It's modestly tighter than the 516 bps 10-year average, but that figure is distorted by the financial crisis in which spreads were over 1,000 bps for seven months. And loans today offer substantially better value than the pre-crisis market, in which spreads averaged 347 bps above Libor from 2000 to 2007.

#### A history of income-driven returns:

- Total return for floating-rate loans historically has been driven mostly by income. That helps explain why, since 2002, we have seen years with price losses followed by price gains three times: 2002-2003, 2008-2009, and 2011-2012. The 2008-2009 financial crisis was the biggest example.

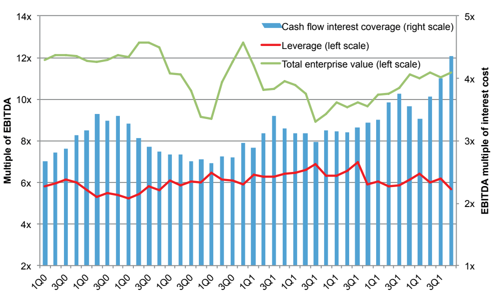
Will 2015 also be a rebound year? We believe that the fundamental, valuation and historical factors all suggest it will.

### "HOW WOULD LOANS LIKELY FARE IN DIFFERENT YIELD CURVE SCENARIOS?"

One of the fundamental strengths of floating-rate loans, in our view, is that investors can be indifferent to changes in the yield curve. For example:

- **No change in curve** - The 5.2% yield on the S&P/LSTA Index as of 28 February 2015 was more than five times that of the Barclays Global Aggregate ex-U.S. Index. Rates don't have to rise for loans to be a valuable component of a fixed-income portfolio.
- **Rates rise at the short end** – This scenario has become increasingly likely in the US as its economy has gained traction and the US Federal Reserve has indicated its willingness to begin raising rates. By definition, most floating-rate loan yields rise with Libor, which has been highly correlated with changes in the fed funds rates.[2]
- **Rates rise at the long end** – With the European Central Bank embarking on major monetary policy easing, we feel that low global long-term rates are likely to stay low and also keep long-term US rates anchored. However, loans historically have been positively correlated with 10-year US Treasury yields – i.e., they have had positive returns when long-term rates have risen.

**Figure 1:** The ability of issuers to service debt has never been stronger, as leverage has fallen




Source: S&P Capital IQ LCD, Eaton Vance as of 31/12/14. For illustrative purposes only.

### "WHAT ARE YOUR VIEWS ON VALUE IN MIDDLE MARKET VS. LARGE CORPORATE ISSUERS?"

Middle market loans in the S&P/LSTA Index are defined as those with EBITDA under $50 million annually. As of 28 February 2015, middle market issuers offered an average spread of 204 bps over large corporate issues in the Index. While this kind of potential income advantage may be tempting, as risk-averse investors we do not find that it represents good value, and do not invest materially in middle-market companies. In our opinion, such issuers tend to have single-business lines without the resilience to adapt in stressed markets. For example, as companies sought to regain footing in 2010 and 2011 after the financial crisis, middle market default rates averaged 6.44% - more than 2.5 times the level of large corporate loans.

By comparison, Eaton Vance portfolio holdings have EBITDA in a range of $600 million to $800 million – about 10 times larger than middle market. We find such financial strength more attractive in the floating-rate loan market, with a risk/reward profile more suitable for our investors.

**FOOTNOTES**

1 EBITDA refers to earnings before interest, taxes, depreciation and amortization and is a common measure of cash.

2 The widespread use of Libor "floors" in the loan market will likely introduce a lag in the upwards adjustment of loan rates once Libor rates start to rise, because the floors in such loans mean that investors are already being paid as if Libor were 100 bps.