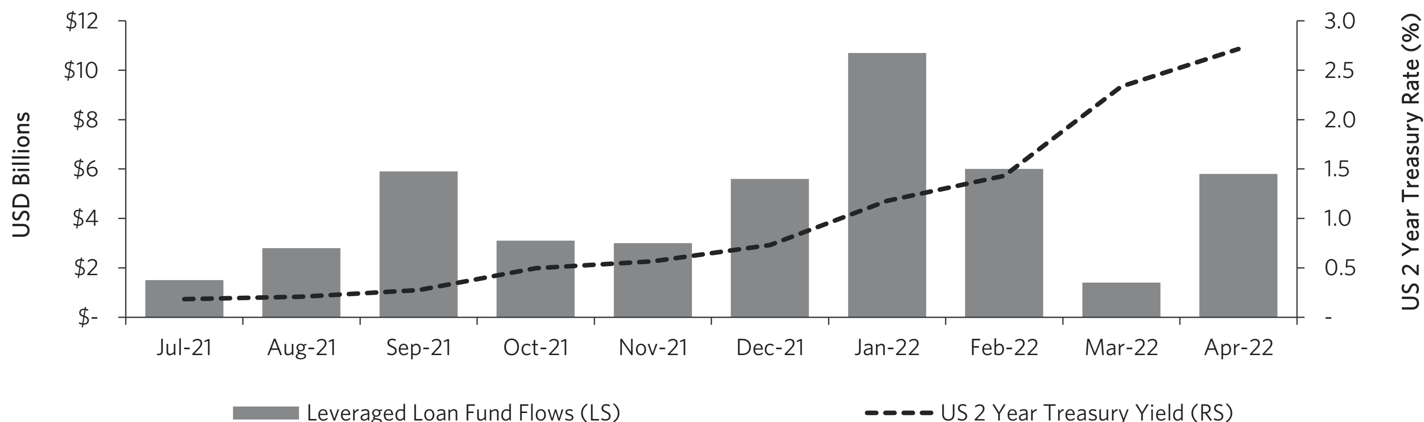
CIBC

LEVERAGED LOANS & HIGH YIELD: FLOATING OR FIXED INTEREST RATE – OR SOMEWHERE IN BETWEEN?

By Aaron Young, CFA, Vice-President, Fixed Income

With the onset of tighter monetary policy in 2021/22, investors allocated considerable assets to floating-rate instruments to help protect their portfolios against the impact of rising interest rates. This often took the form of leveraged loans, given their floating-rate nature and attractive yield levels. The rotation helped a portion of investors' portfolios to avoid the drawdown experienced in fixed-rate bonds. Leveraged loans declined 0.77% in 2022, while high yield declined 11.72%, of which nearly 70% was driven by interest-rate risk.

Large inflows to leveraged loans during rising rates benefited total returns versus fixed-rate high yield



Sources: Pitchbook; Morningstar; Bloomberg
leveraged loans = Morningstar LSTA Leveraged Loan Index
high yield = Bloomberg Barclays US High Yield Bond Index.

With the future direction and velocity of rate changes in question, floating-rate instruments may no longer be the go-to asset class. We argue that investors are best served by a balanced approach that combines fixed-rate high-yield, and floating-rate leveraged loans, to gain exposure to sub-investment-grade markets.

Key considerations for leveraged loans now that interest rates are much higher

When investors first allocated to leveraged loans in 2022, base rates for these instruments averaged 5 basis points (bps). The same base rate hit 487 bps in March 2023, a near 10x increase. This has led to attractive yields in leveraged loans, which hit 9.23% in March. However, investors should consider that the incremental yield they are capturing is the incremental financing cost borne by the borrower. We believe this is important because interest-rate costs for leveraged-loan borrowers may have reached a point where credit quality can be undermined.

Given this context, we believe that allocations to leveraged loans should be driven by active managers who stress-test portfolios for prolonged rates at these levels, or even for higher rates to come. This includes the impact on key credit-quality metrics such as debt servicing coverage, debt-to-EBITDA, cash interest coverage, and other ratios.

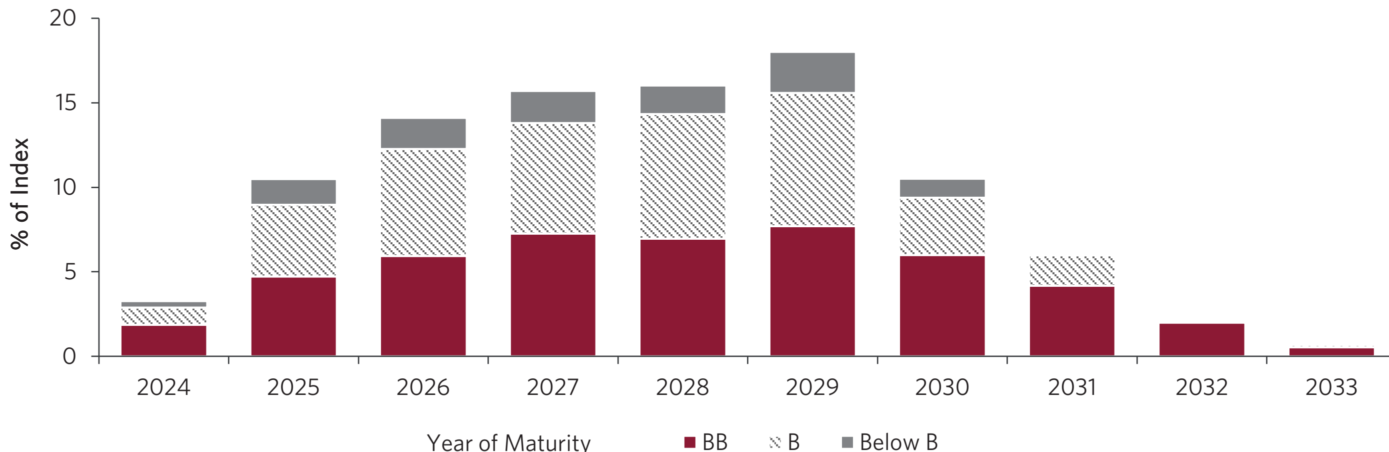
Investors should also pay close attention to sector allocations within their leveraged-loan exposures. Sector decisions will play a key role in risk management going forward, as borrowers positioned in overly cyclical sectors could face declining revenues against heightened financing costs. A preference for fewer cyclical industries should benefit leveraged-loan portfolios.

Key considerations for investing in high yield

While high-yield markets are not immune to the risks we have listed for leveraged loans, their fixed-rate structure does provide advantages, including a known interest cost for the terms of their outstanding bonds. Given that the average maturity of high-yield bonds is 5.3 years, this provides a certain level of flexibility to issuers who choose the fixed-rate route over a floating-rate loan. In fact, many high-yield issuers took advantage of the low fixed financing costs available to them in 2020/21, refinancing their outstanding debt early to lock in a lower rate for a longer period.

In 2021, nearly 60% of new high-yield issuance was for refinancing, and the current maturity wall shows that the majority of refinancing is still four or more years out. A re-focus on downside protection may mean these issuers are best positioned to weather an economic slowdown and persistently high interest rates. At this juncture in the interest-rate cycle, fixed-rate high yield may provide advantages over similar quality leveraged loans.

The maturity wall for high yield is spread out over the next few years



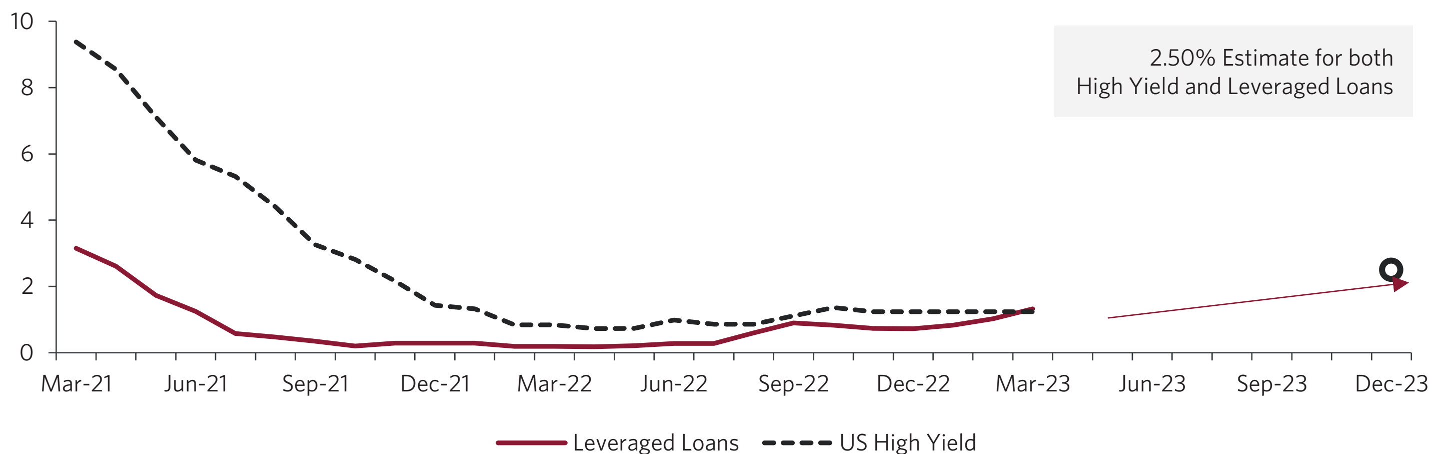
Source: Bloomberg
Based on Bloomberg US High Yield Bond Index

Why this may be a closing of the gap between high-yield and leveraged loans

This relative advantage in credit quality may be beginning to show in the default trends of both markets. Leveraged loans historically have offered lower default rates than high- yield markets—a function of both higher seniority in the capital structure and lower funding costs at a time when base rates were near zero. However, this relationship may be reversing as leveraged loan borrowers face higher financing costs, stressing their ability to effectively manage their overall business.

This stress may be occurring at a time when the proliferation of covenant-lite loans will not help investors realize the same recovery values they have in the past, undermining the perceived security of these instruments. Projections for default levels by the end of 2023 reflect a closing of the gap. Both high-yield and leveraged loans are estimated to have the same 2.50% default rate by year end. The market is also showing interesting dynamics in recovery rates (how much of principal is returned post-default). Loan-only issuers who do not also have debt outstanding in high yield markets have hit a cycle low recovery rate of 34.5% versus those issuers who diversified their funding through both loans and high yield bonds. Their recovery rate nearly doubles to 66.5%.

Default rates between leveraged loans and high yield are converging



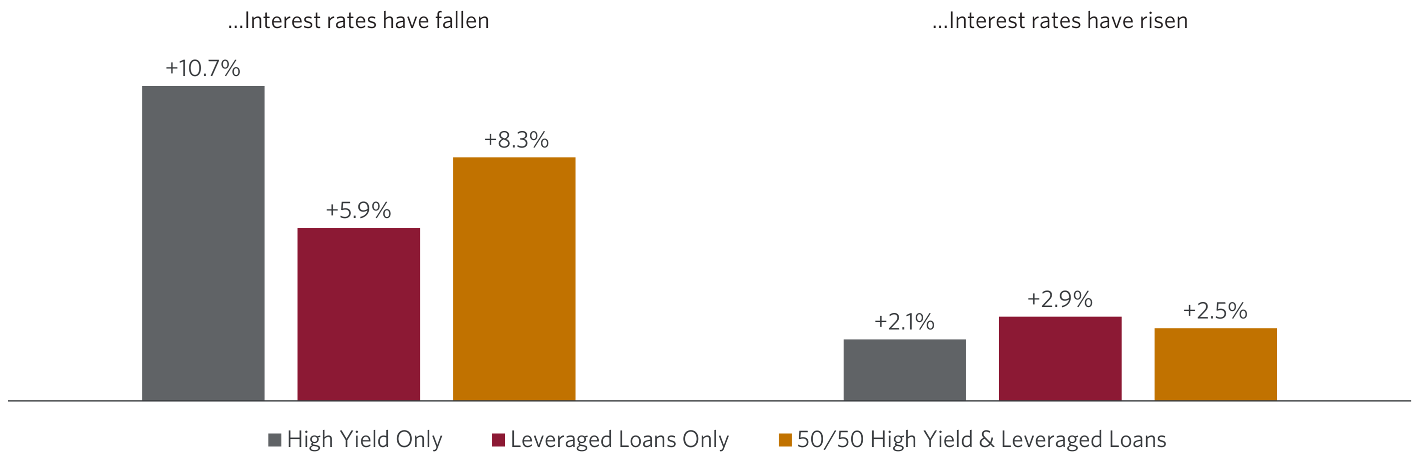
Source: Pitchbook, Morningstar, Bank of America Merrill Lynch

Is floating or fixed interest rate exposure better?

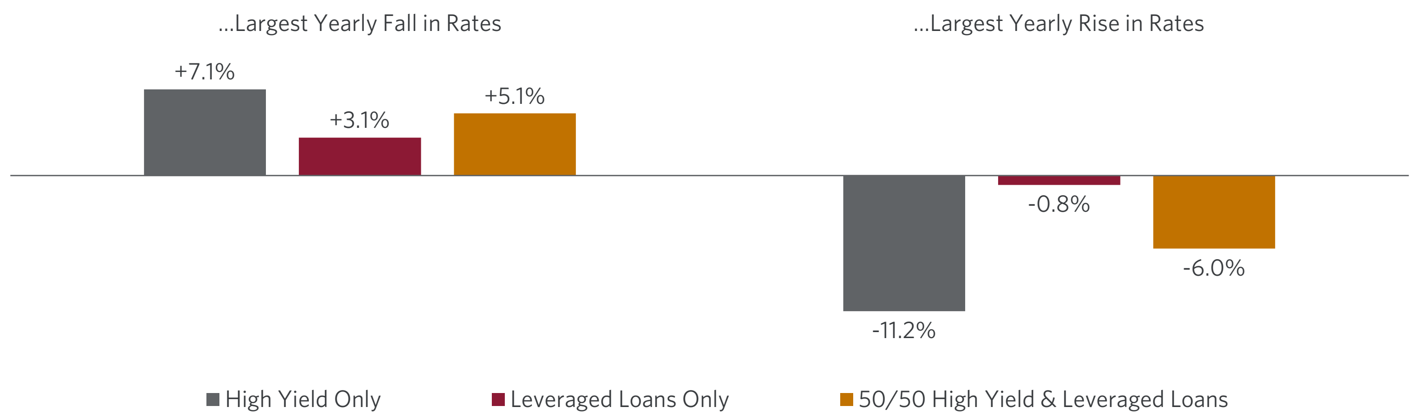
Timing rate movements and toggling between floating- and fixed-rate exposure can be hard, as predicting the future direction of interest rates is a difficult exercise. Like most things in investing, diversification is key. For this reason, we believe that investors may be best served by a combination of both floating-rate and fixed-rate exposures within their sub-investment-grade holdings or finding managers that can toggle between the two.

As shown below, the return profiles of leveraged loans and high yield can help offset each other in both periods of rising rates and periods of falling rates. This could potentially result in a more consistent return profile over the longer term.

Average 1-year total returns across loans and high yield when...



1-year total returns across loans and high yield during the...



Source: Pitchbook, Morningstar, Bloomberg
leveraged loans = Morningstar LSTA Leveraged Loan Index
High yield = Bloomberg Barclays US High Yield Bond Index
interest rate increases / decreases based on US 2-year treasury rates
Based on data from May 2013 to April 2023

Why investors are best served by maintaining a well balanced portfolio

Given the relative trade-offs between high-yield and leveraged loans at this juncture in the interest-rate / credit cycle, we believe that investors are best served by maintaining a balanced exposure across both floating-rate securities and fixed-rate debt. This positioning provides an overall profile that positions investors for the risks of further increasing interest rates against a return to the lower interest-rate levels we saw before the pandemic. Leveraged loans will continue to offer attractive carry and lower exposure to interest-rate risk if rates continue to climb.

High yield should provide some relative credit quality as borrowers face less interest-cost pressures, and further potential upside if rates do reverse course, while locking-in a portion of a portfolio's carry without the worry of coupons falling. All-in-all, we believe a combination of both asset classes is the right answer to the fixed versus floating question.

About the authors

Aaron Young, CFA
Vice-President, Fixed Income
CIBC Asset Management

About CIBC Asset Management

At CIBC Asset Management, we believe every customized investment solution begins with research and rigour. We specialize in a variety of investment solutions such as equities, fixed income, currency management, liability-driven investments, asset allocation and responsible investments.

Across a spectrum of investment solutions, we commit to best-in-class research. Dedicated sector and regional analysts focus on industry research and security-specific idea generation. Our investment professionals leverage deep and diverse expertise by sharing proprietary research across asset class teams. By sharing insight across asset class teams, we maximize opportunities to add value to our client portfolios.

We provide our clients with our research insights and expertise on industry issues and themes that matter most to them.

Contact us any time

To learn more about CIBC Asset Management and our investment solutions, please contact your advisor.

For more insights, connect with us on LinkedIn and Twitter.

The views expressed in this document are the views of CIBC Asset Management Inc. and are subject to change at any time. CIBC Asset Management Inc. does not undertake any obligation or responsibility to update such opinions. This document is provided for general informational purposes only and does not constitute financial, investment, tax, legal or accounting advice nor does it constitute an offer or solicitation to buy or sell any securities referred to. Individual circumstances and current events are critical to sound investment planning; anyone wishing to act on this document should consult with his or her advisor. All opinions and estimates expressed in this document are as of the date of publication unless otherwise indicated and are subject to change.

Certain information that we have provided to you may constitute "forward-looking" statements. These statements involve known and unknown risks, uncertainties and other factors that may cause the actual results or achievements to be materially different than the results, performance or achievements expressed or implied in the forward-looking statements.

Hypothetical performance results have many inherent limitations, some of which are described below. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. In fact, there are frequently sharp differences between hypothetical performance results and the actual results subsequently achieved by any particular trading program. One of the limitations of hypothetical performance results is that they are generally prepared with the benefit of hindsight. In addition, hypothetical trading does not involve financial risk, and no hypothetical trading record can completely account for the impact of financial risk in actual trading. For example, the ability to withstand losses or adhere to a particular trading program in spite of trading losses are material points which can also adversely affect actual trading results. There are numerous other factors related to the markets in general or to the implementation of any specific trading program which cannot be fully accounted for in the preparation of hypothetical performance results and all of which can adversely affect actual trading results.

CIBC Asset Management and the CIBC logo are trademarks of Canadian Imperial Bank of Commerce (CIBC), used under license.

The material and/or its contents may not be reproduced without the express written consent of CIBC Asset Management Inc.

"Bloomberg®" is a service mark(s) of Bloomberg Finance L.P. and its affiliates, including Bloomberg Index Services Limited ("BISL"), and has been licensed for use for certain purposes by CIBC Asset Management Inc. Bloomberg is not affiliated with CIBC Asset Management Inc., and Bloomberg does not approve, endorse, review, or recommend any CIBC Asset Management Inc. products. Bloomberg does not guarantee the timeliness, accurateness, or completeness of any data.

The CIBC logo and "CIBC Asset Management" are trademarks of CIBC used under license.