Hedging Inflation with Senior Loans

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Given soaring U.S. government debt levels, fixed income investors may be concerned about the potential for higher interest rates — and the increased inflation that often accompanies them — in the coming years. Due to their unique reaction to changes in inflation and market interest rates, senior loans may be an appropriate investment for those investors looking to mitigate the impact of rising rates on their portfolios.

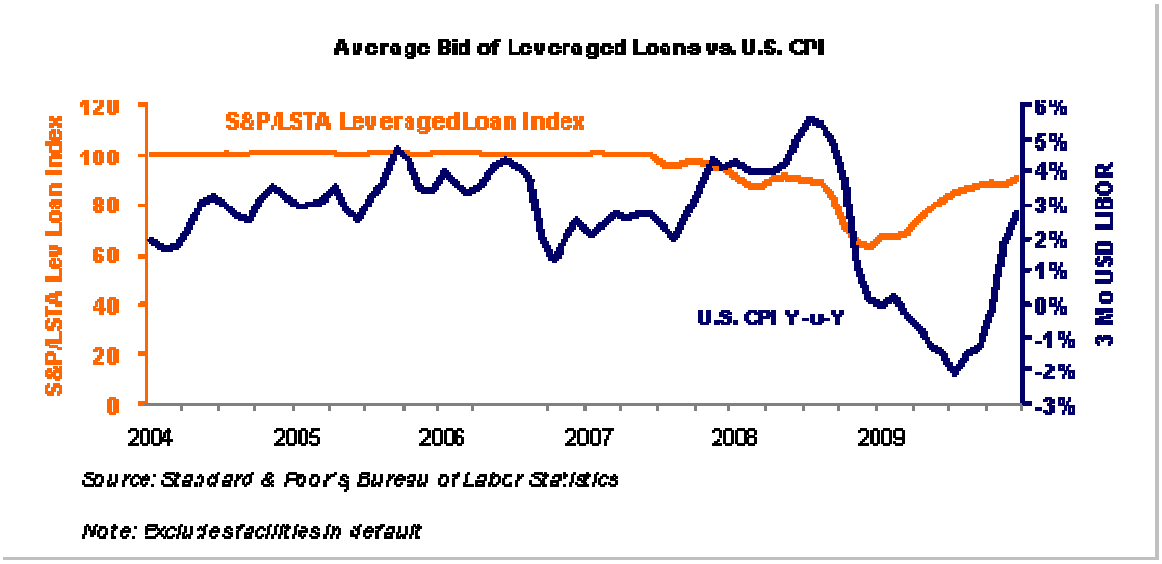
Senior loans — secured corporate loans made to non-investment grade companies, also known as "floating-rate loans" and "leveraged loans" — generate floating-rate income linked to a base rate, the most prevalent of which is the London Inter-Bank Offered Rate (LIBOR). The interest rate on a senior loan is expressed as a spread over LIBOR; while LIBOR may change daily in response to market conditions, the spread on a senior loan is typically a fixed amount on top of the base rate. Unless there is a fundamental change in the creditworthiness of the particular borrower, the spread amount typically never changes.

Generating LIBOR-based returns is an effective way for a portfolio to deliver a return linked to realized inflation. LIBOR and other inter-bank lending rates are related to the short-term rates set by central banks plus a modest spread to account for counterparty credit risk. Generally speaking, central banks raise short-term interest rates to combat rising inflation or inflationary pressures, and reduce rates to stimulate economic growth and activity. Regardless of whether a central bank's policy stance is hawkish or dovish at a particular moment, interbank lending rates are usually higher than the current rate of inflation and correlate well with movements in the headline CPI rate. Further, because policymakers cannot set nominal rates below zero, LIBOR-based returns can be attractive in both inflationary and deflationary environments. Our research shows that inter-bank lending rates

a) almost always outperform realized inflation,
b) have lower volatility than other inflation-hedging instruments, and
c) have high and stable correlations with realized inflation.

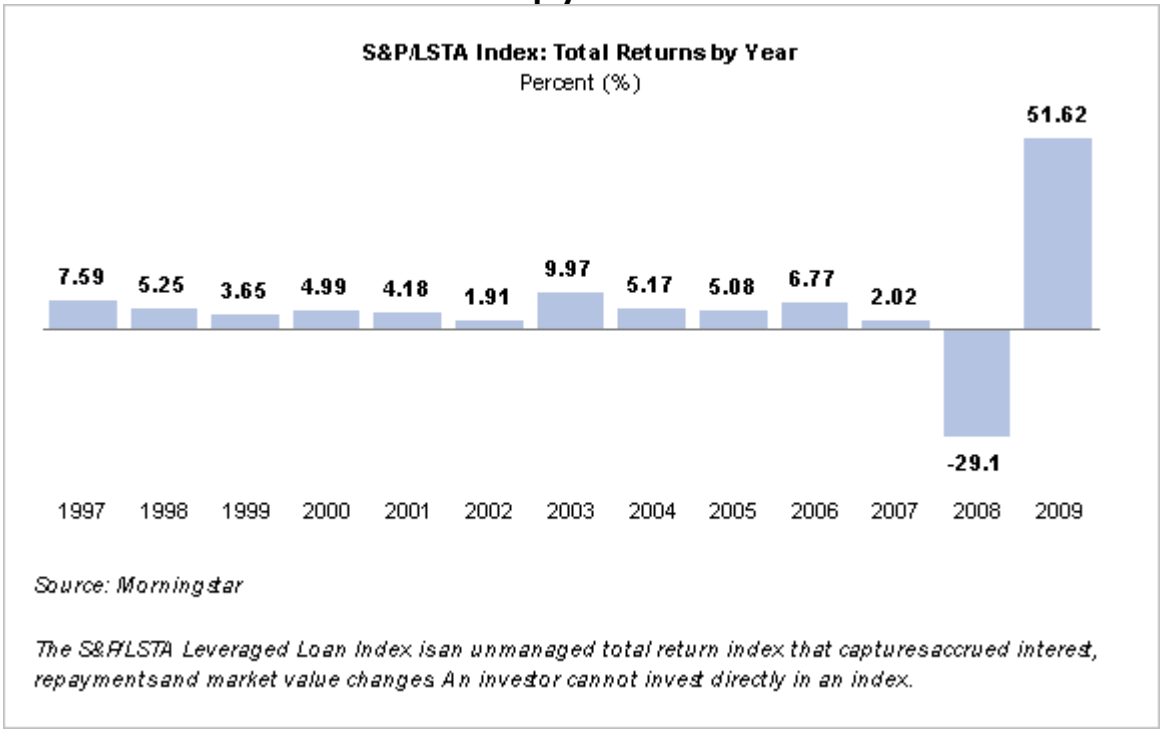
As an example of the interaction of senior loans and inflation, refer to graph below. As you can see, U.S. inflation rates fluctuated dramatically from 2004–07, while the prices of senior loans stayed fairly constant over that period. The decline in senior loan prices during 2008 was not due to inflation but rather the unprecedented breakdown in the credit markets, which forced selling of senior loans even though the fundamentals were sound and default rates stayed in line with those of 2001 and 2002.

Loans sold off in 2008 despite sound fundamentals…



Furthermore, senior loans have historically provided steady returns in a variety of market environments. The S&P/LSTA Leveraged Loan Index has generated a positive return every year since its 1997 inception, aside from during the aforementioned credit disruptions of 2008. As you can see in the graph below, 2008's steep decline was more than offset by record returns in 2009.

...but index returns rebounded sharply in 2009



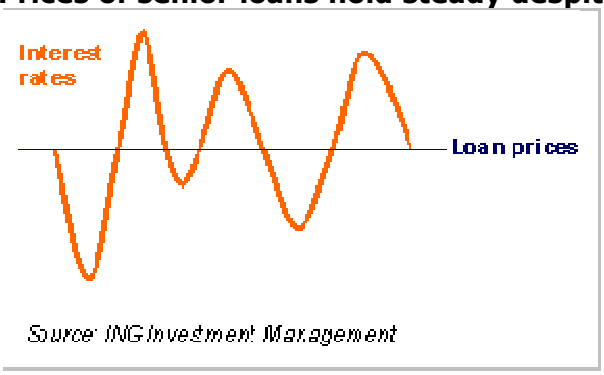
Distinctive Characteristics of Senior Loans Offer Advantages

Due to their unique characteristics, senior loans can serve as a natural hedge against rising inflation and interest rates. Below, we discuss two of the defining traits of senior loans, which may be of particular interest given the current environment of historically low and potentially climbing interest rates.

Floating-rates are responsive to changes in LIBOR. When short-term market interest rates go up, the LIBOR component of a borrower's interest rate — and therefore the overall interest rate paid by the borrower, as well as the income to a portfolio invested in senior loans — also goes up. Conversely, when short-term market interest rates go down, the income from senior loans also goes down. There is a lag — known as the "interest rate reset period" — between the change in the market interest rate and the corresponding adjustment to the interest rate paid by a senior loan. The interest rate reset period varies from loan to loan; a large, diversified portfolio of senior loans is typically constructed to have a weighted average interest rate reset period of 60 days or less. This means the income earned from a senior loan portfolio is generally very responsive to changes in short-term interest rates.

Interest rate changes have limited impact on loan prices. While the amount of interest paid by a senior loan typically fluctuates with changes in market interest rates, absent other factors such as changes in the creditworthiness of the borrower, the price of a senior loan is generally unaffected by changes in market interest rates. There can be some price fluctuation because of the lag between a change in market interest rates and the interest rate reset period of a portfolio of senior loans, but because these periods are generally short, such price fluctuations are relatively moderate.

Prices of senior loans hold steady despite interest rate fluctuations



Conclusion

Senior loans represent a unique asset category with the potential to provide investors with protection against rising interest rates and ramped-up inflation while at the same time offering the security of assets that are backed by collateral. While senior loans will not provide an entire investment program, investors have the opportunity to benefit from the unique characteristics of this asset class by including a senior loan allocation in their portfolios. ■

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