MANAGER INSIGHT

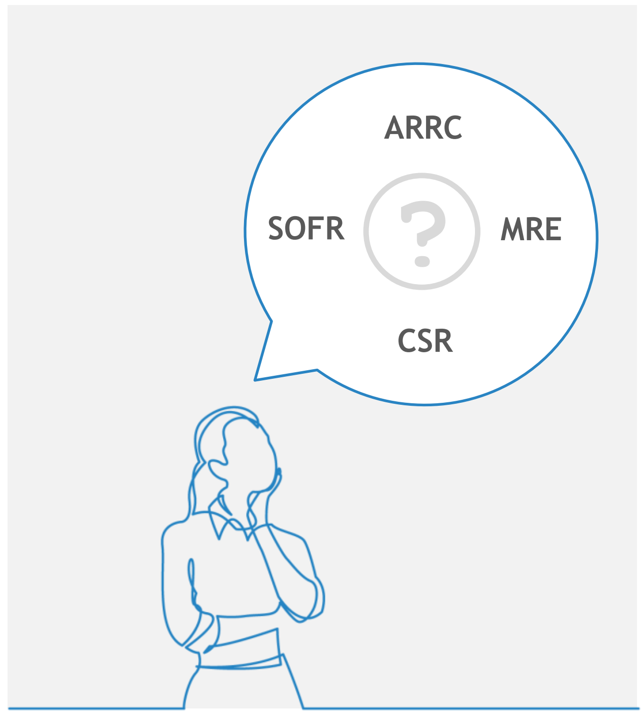
SEPTEMBER 30 2021

Loomis on Loans

A quarterly look at data and topics in the syndicated loan market

THE RATES THEY ARE A-CHANGIN':
THE TRANSITION AWAY FROM LIBOR

In the immortal words of Bob Dylan, "Come gather 'round people, wherever you roam," for it's time to admit that the reference rate we most often use in the bank loan market, LIBOR, is going away, and the market needs to embrace a change. It's been a multi-year effort to determine how best to manage this transition, and there is still much to be deliberated before LIBOR officially ceases in all of its forms in 2023. However, there will be no new LIBOR-based instruments issued after the end of 2021, so the next few months will be spent analyzing the options that work best for each individual issuer. In this edition of Loomis on Loans, we'll dive into some of those choices and the repercussions for the markets that rely on this rate.



WHEN IS LIBOR GOING AWAY?

The popular 1- and 3-Month Term LIBOR interest rates are going to be phased out over the next few years, and will stop being published completely on June 30, 2023. This should allow ample time for the multiple trillions of dollars of financial instruments that rely on this rate to transition to whichever rate best suits their needs going-forward. As a step forward in the transition process, no new instruments that use LIBOR as a reference rate can be issued after December 31, 2021. Therefore all new bank loans syndicated or refinanced after that date must choose a new rate.

(Continued on the next page)

LOAN MARKET QUICK TAKE

S&P/LSTA Index	YTD Return (%)	Price	3-Mo. Price Change	Nominal Spread
"All" Leveraged Loan Index	4.42	98.62	0.24	371.67
BB Index	2.43	99.37	0.13	285.96
B Index	4.33	99.34	0.04	402.86

Source : LCD, an offering of S&P Global Market Intelligence; S&P/LSTA Leveraged Loan Index, as of 09/30/21.

Past market performance is no guarantee of future results.

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WHAT RATES WILL BE USED INSTEAD? DO THEY REQUIRE ANY ADJUSTMENTS?

The Alternative Reference Rates Committee, ARRC, as established by the Federal Reserve Board, has formally recommended the use of the Secured Overnight Financing Rate, SOFR, as a new virtually risk-free rate. Per Bank of America, SOFR is based on nearly $1 trillion of daily trading volume, and thus is unlikely to be manipulated like LIBOR had been in the past. Term structures similar to the 1- and 3-Month formats used by LIBOR have been created to help issuers forecast their debt costs. The ARRC also recommends a small conversion spread between LIBOR and SOFR.

Another still-emerging option is a Credit Sensitive Rate, CSR, which contains an element of credit risk, and is thought to behave more like LIBOR over time, particularly in periods of economic disruption. CSRs are typically higher than SOFR, but may provide protection for certain types of loans during a downturn, and may be a better fit for some institutions.

ARRC - Alternative Reference Rates Committee
SOFR - Secured Overnight Financing Rate
CSR - Credit Sensitive Rate
MRE - Multi-Rate Environment
CLO - Collateralized Loan Obligations

WHAT IF THERE ARE MANY DIFFERENT REFERENCE RATES?

Given that no new loans can use LIBOR after the end of this year, it is highly likely that we'll be living in a "multi-rate environment." The easiest way to move to a new rate will be for existing loans to refinance, and we expect to see activity to do that both before the year ends and after as patterns in rate selection emerge. New loans that are being syndicated today typically include what's referred to as "fallback language" in their credit agreements that states which rates will likely be used as the transition occurs. Some issuers might choose to wait until 2023 and use their existing fallback language to transition. With over 1400 different loans in the bank loan market, even if one rate is recommended over another, there will likely be dispersion in what issuers choose.

HOW WILL THIS AFFECT CLOS?

Collateralized loan obligations (CLOs) buy the majority of newly issued loans in the leveraged loan market. What makes a CLO work is the arbitrage between the interest income it earns on the loans it holds and the interest expense it must pay on the debt that finances the structure. Typically, that debt is based on a spread over LIBOR, and that is unlikely to change as we move into 2022. Over time though, the loans held in a CLO will refer to rates other than LIBOR, and there could be some basis risk between those rates. In newer CLOs that have an "Asset Replacement Trigger," once a majority of the loans held use a new reference rate, the debt can then start using that rate too. But in the meantime, this transition could mean slightly lower returns for CLO equity investors.

DO YOU EXPECT ANY DISRUPTIONS TO THE MARKET?

While there is a lot to be still decided and digested, we do not expect this transition to cause a disruption to the loan market. There may be operational challenges and credit agreement amendments to be handled, but loan market participants generally have these processes well understood. The loan market has seen many changes before: the rise of CLOs, covenant-lite loans, LIBOR floors. We've adapted before and we will adapt again. The fact that the average price of the loan market, as determined by the S&P/LSTA Leveraged Loan Index, is very close to par is a good indicator that the market itself is not stressed by the pending transition.

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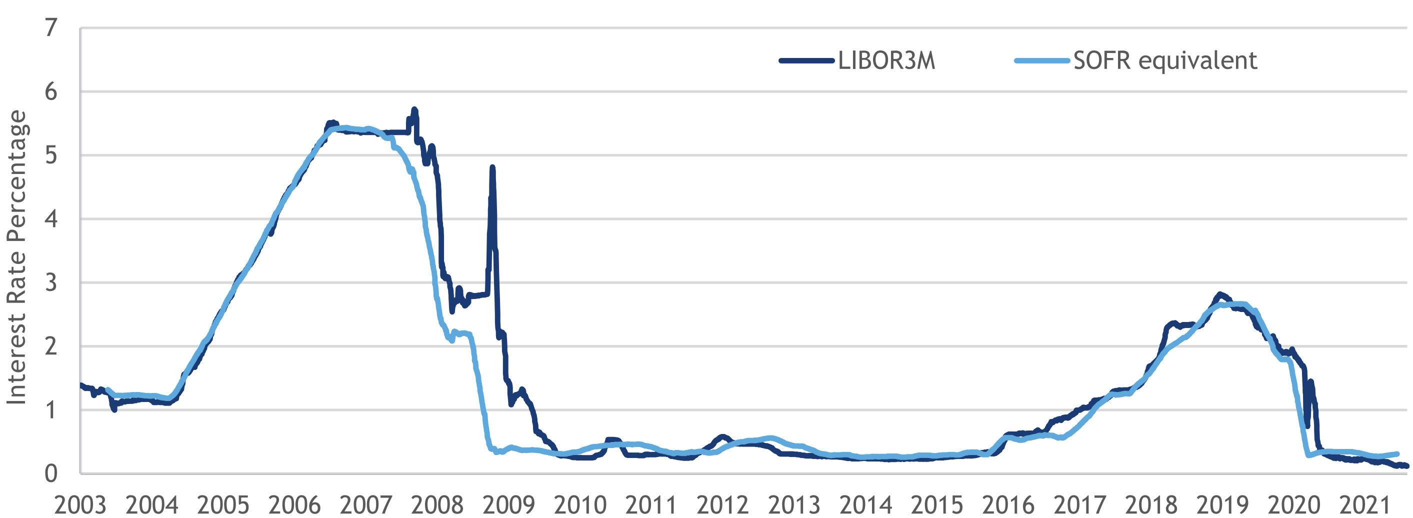
MOST IMPORTANTLY, DOES THIS CHANGE THE INVESTMENT PROCESS AT LOOMIS?

No, this new environment will not change our investment process. We have always calculated a horizon return on each loan to see if it beats our internal bogeys for where we forecast the market is going, and these new rates will be part of that ongoing conversation. With apologies to Mr. Dylan, come investors and traders throughout the land, no need to "criticize what you can't understand." While there are still minor questions ahead, the shift to a new rate environment is in process. As the loan market has adapted before, it will again now. At Loomis, fundamental research remains our focus even as market dynamics are, as ever, "a-changin'."

3-MONTH LIBOR AND ITS SOFR EQUIVALENT OVER TIME



Source: Bloomberg. Data as of 8/4/2021.

Past market experience is no guarantee of future results.

THE TEAM

John Bell, VP
Portfolio Manager

Heather Young, VP, CFA
Portfolio Manager

Emily Sweet, VP, CFA
Associate Investment Director

Michael Klawitter, VP, CFA
Portfolio Manager

Christos Maniatis, VP
Portfolio Manager (CLO)

Cheryl Stober, VP
Investment Director

LET'S CHAT

QUESTIONS OR CONCERNS ABOUT THE BANK LOAN MARKET?

Email Cheryl Stober to learn more.
cstober@loomissayles.com

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Diversification does not ensure a profit or guarantee against a loss.

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