

Loomis on Loans

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

DEFAULTS: TURBULENCE ALONG THE WAY

The word “default” is sometimes uttered as if it were a tragic event for credit investors. We think it’s time to demystify defaults and put them in their proper light: as a sign that some investors may be taking appropriate risks to achieve their return goals.

Allow us this analogy: There are (at least) two ways to get from Boston to Los Angeles. You can drive, or you can fly. If you drive, you will get there over a number of days. If you fly, you will get there in a few hours. But if you fly, you may well get turbulence along the way. A lot of passengers hate turbulence, while pilots seem quite calm about it. Passengers suffer the bumps to save time.

Credit investing is choosing to fly, and accept turbulence, rather than drive, and lose time. Driving is like buying short Treasuries. Little turbulence, but it takes a long time to earn a lot. Turbulence is the price of the time advantage. Default risk is the price of the yield advantage of credit investing.

How Can A Portfolio Manager Allow Defaults?

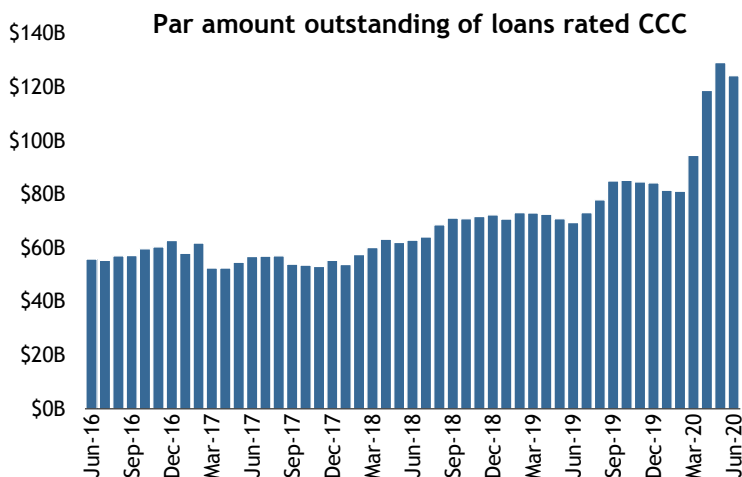
How can they not? Life happens, circumstances change, management teams make bets that don’t always pay off. From credit cards to auto loans to home mortgages to high yield bonds to syndicated loans, defaults happen on a regular basis. The only way to avoid defaults is to sell out just before they happen, and that’s a good way to throw away investor money because buyers will try to pay a price that gets them a strong return from that point forward. That is a point often missed by those who are deathly afraid of defaults: a default is rarely the end of the story.

Continued on the next page.

LOAN MARKET QUICK TAKE

S&P/LSTA Index	Q2 2020	YTD 2020	Price	3-Mo. Price Change	Spread
“All” Leveraged Loan Index	9.70%	-4.61%	91.30	9.43%	L+345
BB Index	7.16%	-4.50%	94.95	7.18%	L+250
B Index	11.12%	-4.12%	92.44	11.45%	L+371

Source : LCD, an offering of S&P Global Market Intelligence; S&P/LSTA Leveraged Loan Index as of 06/30/2020



The second quarter of 2020 saw the loan market bounce back from the COVID-related performance lows of March. While retail outflows were muted, CLO issuance gained steam throughout the quarter.

Ratings agencies have been busy downgrading loans so far in 2020, with CCCs now adding up to more than 10% of the market. However, that means almost 90% of loans are rated above CCC despite a massive pandemic and economic slowdown.

Data through June 30, 2020; ratings reflect S&P Global Ratings facility rating.
Source : LCD, an offering of S&P Global Market Intelligence; S&P/LSTA Leveraged Loan Index



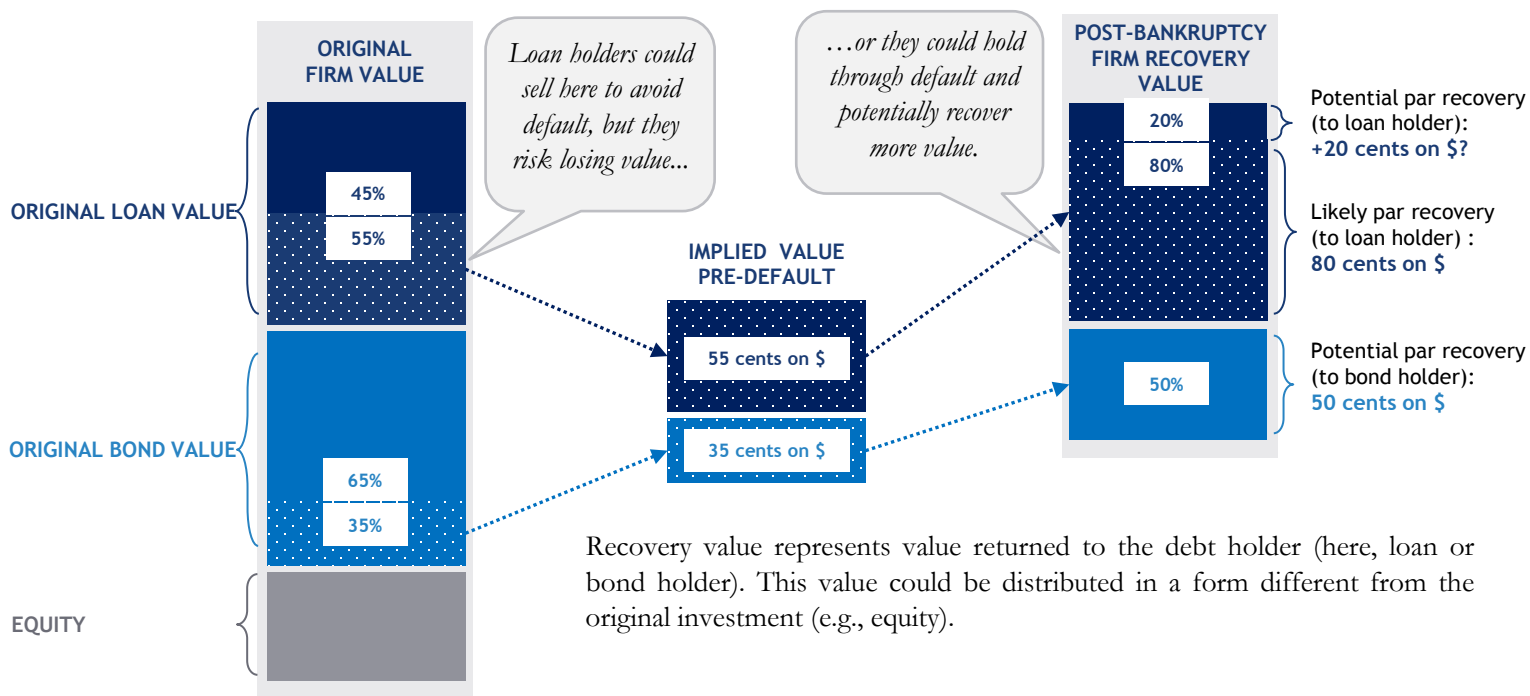
DEFAULTS: TURBULENCE ALONG THE WAY(CONTINUED)

Why Does A Portfolio Manager Hold Rather Than Sell a Loan that Will Default?

First, what is a default? It is the inability to pay an obligation when it is due. For example, if a bond or loan reaches maturity and the market will not refinance it (and the borrowing company cannot repay principal), the company will be in default. What happens then? Most large companies in the United States proceed to Chapter 11 bankruptcy, which means they reorganize, reduce their debts to a manageable level, and re-emerge to live on as viable businesses. This scenario is in stark contrast to Chapter 7 bankruptcy proceedings, in which a company is dissolved and its assets distributed to debt holders in order of seniority.

In Chapter 11, the value of a company’s assets is paid out to lenders in order of their collateral, first, and seniority, second. Syndicated loans are senior, secured claims on the value of a company’s assets. Just because those assets could not support all their debt does not necessarily mean that they do not have a lot of value. Part of our job is comparing that asset value versus the loan market value and deciding if the asset value is more than the loan value. If the answer is clearly yes, it makes sense to hold that defaulted loan and wait to get paid what we view it's worth.

EXAMPLE



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Investing involves risk including possible loss of principal.

Please see Key Risks on the last page.



How Should Investors Think About Loans When Defaults Are Rising?

In our view, defaults do not overturn the loan story. Loans tend to pay a fairly high yield compared to most fixed income. Most of their return comes from that yield most of the time. Sometimes their prices are low (not coincidentally when default fears are higher) and capital gains are possible too. Sometimes rates rise and they can benefit from that. But mostly, loans can be a way to earn a good yield without the extra volatility built into high yield bonds.

Default fears are like turbulence bumps that make the journey less fun. Actual default losses are not as simple as default rate times price at default versus average price in the portfolio because the market may have already priced in a lot of the defaults that could happen; and, average price at time of default is not a great estimate of ultimate recovery. We model possible default losses in a couple of non-typical ways, but we think it is more useful to predict defaults one by one than paint broad strokes on credits we do not follow. Like the pilots on that Los Angeles flight, we can tell you if we are expecting it to be bumpy, but we do not know how many bumps there will be. However, good pilots will try to keep the bumpiness down, making good decisions along the way. We try to be in the good decisions business, too, and that means both keeping and selling defaults, as well as using turbulent markets to buy loans that we think are cheap.

So, how do we think about defaults? We believe that defaults are necessary turbulence on the way to earning returns in credit markets. We try to reduce their effect but understand they are part of seeking attractive returns over time. We fasten our seatbelts when turbulence picks up, we don't reach for a parachute, because that's the way we reach our goal.

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