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Discipline Drives Performance ®

Floating rate assets have swiftly gained momentum amidst resurgent long-term U.S. Treasury yields and inflation concerns, as investors weigh the ramifications of unprecedented government stimulus and a gradually reopening economy. After $65 billion of withdrawals from retail bank loan funds and ETFs in 2019-2020, the loan market has been bolstered by $7 billion of fund inflows and heavy CLO issuance through February.[1]

Justin Slatky
CIO & Senior Portfolio Manager

David Lerner
Senior Portfolio Manager

Jeffrey Gallo
Portfolio Manager

Brian Goldberg
Portfolio Manager, Loan Capital Markets

Matthew Shepard, CFA
Portfolio Manager

Gregory Shenkman
Trader

Evan McGee
Analytics & Risk

Eileen Spiro
Structured Credit Analyst

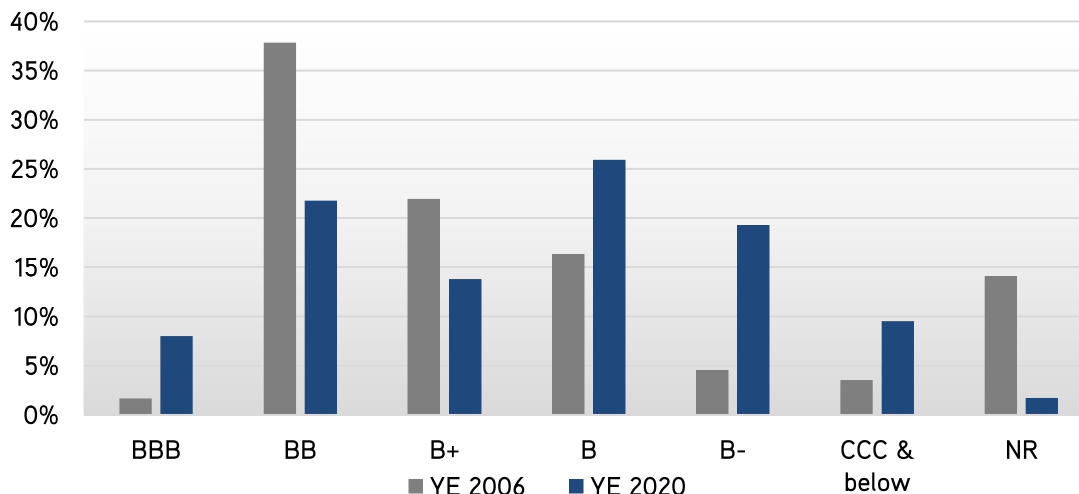
Nick Gray, CFA
Client Solutions

ClientSolutions@shenkmancapital.com

Bank loans are effective tools for isolating credit exposure without interest rate duration risk, and have become permanent fixtures in many portfolios (along with interrelated CLO tranches). We firmly believe investors are wise to maintain long-term allocations and may wish to consider tactically increasing their exposure given the trajectory of rates and the dearth of yield in other asset classes. In addition to floating rate protection against inflation, these assets offer excess spread and price appreciation potential relative to many other fixed income investments. However, significant changes in the loan market since the Global Financial Crisis have introduced not only benefits, but also risks that can be mitigated with prudent portfolio management.

The U.S. loan and CLO markets have nearly tripled in size since 2006, to approximately $1.2 trillion and $750 billion, respectively. With the loan market being a widely accepted source of funding for private equity sponsors and strategic acquirors alike, the number of issuers has increased by 50% to 1,200, and the average issuer size has doubled to over $1 billion. Meanwhile, loans' ratings profile has shifted to 29% B- and below (with less than 2% not rated), from 8% in 2006 (14% not rated) (see Exhibit 1). Whereas seniority and security may have once mattered most to some bank loan investors, we believe fundamental research and active credit selection are much more critical in today's single-B heavy market, in which issuers' net leverage is approximately 4.6 turns versus 3.0 turns in 2008.[2]

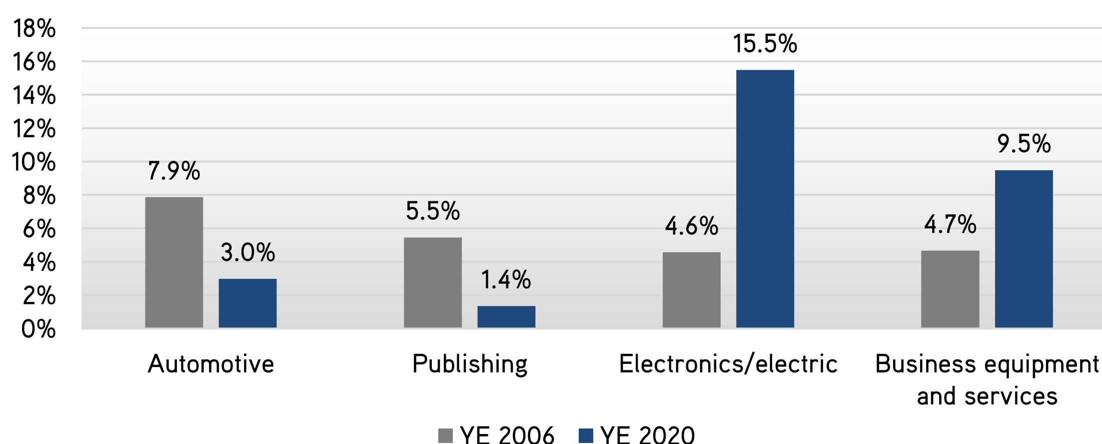
Exhibit 1: Loan Market Ratings Shift



As of 12/31/2020. Source: S&P|LSTA, Shenkman Capital

Although issuers are more highly levered today, the loan market has witnessed a sizable shift towards sectors with higher growth and stronger cash flows (See Exhibit 2). For example, Technology and Business Services have collectively grown to nearly 25% of the market, from less than 10% in 2006. Typically, companies in these industries have strong equity support, trade at higher enterprise value multiples, and provide solid loan-to-value for lenders, with more junior capital cushion than in past cycles. Industries that suffer from cyclical volatility and/or secular decline have contracted over the same period (e.g., Automotive and Publishing have shrunk to just 4%, from about 13%). While credit selection is still of the utmost importance, we believe this sector transition offers greater diversification across more attractive industries and supports a better fundamental outlook for the loan market.

Exhibit 2: Loan Industry Shifts (Select)



As of 12/31/2020. Source: S&P|LSTA

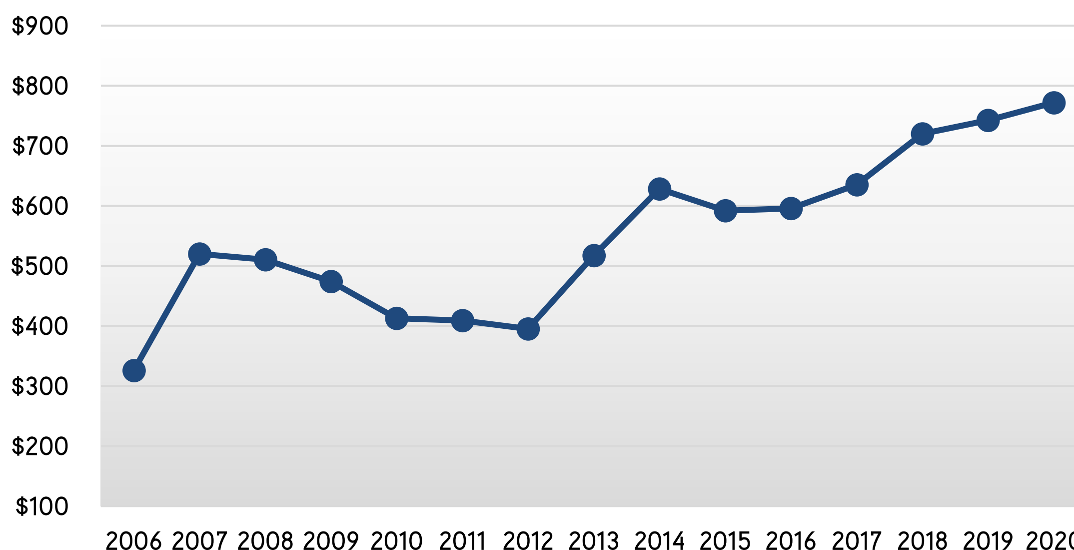
The loan market's expansion has been propelled by strong demand from a rapidly-growing CLO investor base, which owns over 60% of outstanding loans.[3] This is vitally important given CLOs are long-term vehicles that provide stable capital to support the loan market, which offsets the influence of retail flows. However, lower loan ratings have seeped into portfolios that underlay CLOs. As a result, holdings now average B/B-. Since most CLOs' CCC rated loan exposures are limited, the potential buyer universe dwindles dramatically when issues are downgraded below B-, as does liquidity. The negative consequences of owning these issuers are therefore more severe, as price drawdowns can be exacerbated when loans transition to the stressed/distressed investor base.

Corporate structures, collateral, guarantees, and deal documentation have become greater focal points in the loan market in recent years, as issuers and lenders have aggressively interpreted (and exploited) weaker protections in a few instances. Well-publicized examples include J. Crew ("trap door"), PetSmart/Chewy ("phantom guarantees"), and Serta Simmons ("lender-on-lender violence").[4] We believe this adversarial behavior will become increasingly prevalent in deeper default cycles, making credit mistakes more costly as loans' security and seniority to other debt will be questioned. However, downside protection can be significantly enhanced through diligent examination of documents' structures and covenants, during the initial underwriting and throughout the life of a deal. Investors must carefully consider issuers' management teams and equity sponsors and be ready and willing to proactively trade ahead of potential problems.

Trading volumes and dynamics in the loan market have dramatically improved in tandem with its growing size and number of participants, particularly under adverse market conditions (see Exhibit 3). This liquidity enables more relative value trading within the market and can allow investors to shift to a more defensive posture when needed. Evidence of this trend was seen at the onset of the COVID-19 pandemic in March of 2020, when extreme price volatility resulted in $119 billion of secondary market trading, a monthly record. Compared to a historical average

of $60 billion per month, this illustrates that investors can trade when necessary (albeit perhaps at wider bid-ask spreads). Furthermore, over 1,400 different loans trade in a typical month, and over 500 each day.[5] Therefore, even a highly diversified portfolio could likely be bought or sold in a short amount of time under most market conditions.

Exhibit 3: Annual Trading Volume ($ billion)



As of 12/31/2020. Source: LSTA

Notwithstanding the need for more diligent fundamental credit research, we believe bank loans offer compelling value. Loans and CLOs should perform well versus longer duration fixed rate assets if rates become unmoored, particularly low-yielding government and investment grade credits. Since 1993, loans have outpaced investment grade bonds all 13 times the 5-year U.S. Treasury yield spiked 70 bps or more over a 3-month period, by an average of 5.1%.[6] The UST 5-year note's yield has jumped more than 50 bps this year, as of March 22nd. Additionally, the Bloomberg/Barclays U.S. Aggregate Bond Index experienced 45 negative monthly returns over the past 10 years, in which loans outperformed in 39 of them, by an average of 0.69%. We believe these outperformance trends will persist despite a riskier loan market. However, relative returns are likely to be less impressive for investors who ignore the fundamentals!

In conclusion, we see the loan market's migration toward single-B as reminiscent of the high yield bond market heading into 2000, when fundamental credit analysis drove dispersion of returns among asset managers. We believe investors seeking to capitalize on loans' floating rate and defensive characteristics should understand that there is presently heightened credit risk. Preservation of capital via careful credit selection is paramount to achieve superior returns in income-producing assets, where coupons dominate performance. Case in point, the S&P/LSTA Loan Index has shown annualized income returns of 5.10% over the last decade, while mark-to-market price returns declined 0.75%.[5] With over 35 years of experience in the leveraged finance markets and a bank loan track record dating back to 1998, Shenkman Capital has the ability to deftly navigate the increasingly complex loan market to maximize risk-adjusted returns by avoiding credit missteps.

Sources: [1]Lipper FMI/J.P. Morgan Research, [2]Morgan Stanley Research, [3]S&P LCD, [4] For more information on these examples, please refer to the following articles from the law firms Skadden and Hogan Lovells:https://www.skadden.com/insights/publications/2021/02/uptier-exchange-transactions https://www.engage.hoganlovells.com/knowledgeservices/news/chewing-through-baskets-the-chewy-phantom-guarantee-and-a-cautionary-tale-of-the-release-of-a-valuable-guarantee-and-collateral-package_1, *[5]LSTA (Loan Syndications and Trading Association), [6]J.P. Morgan Research*

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