



Moving on Up (In the Capital Structure)

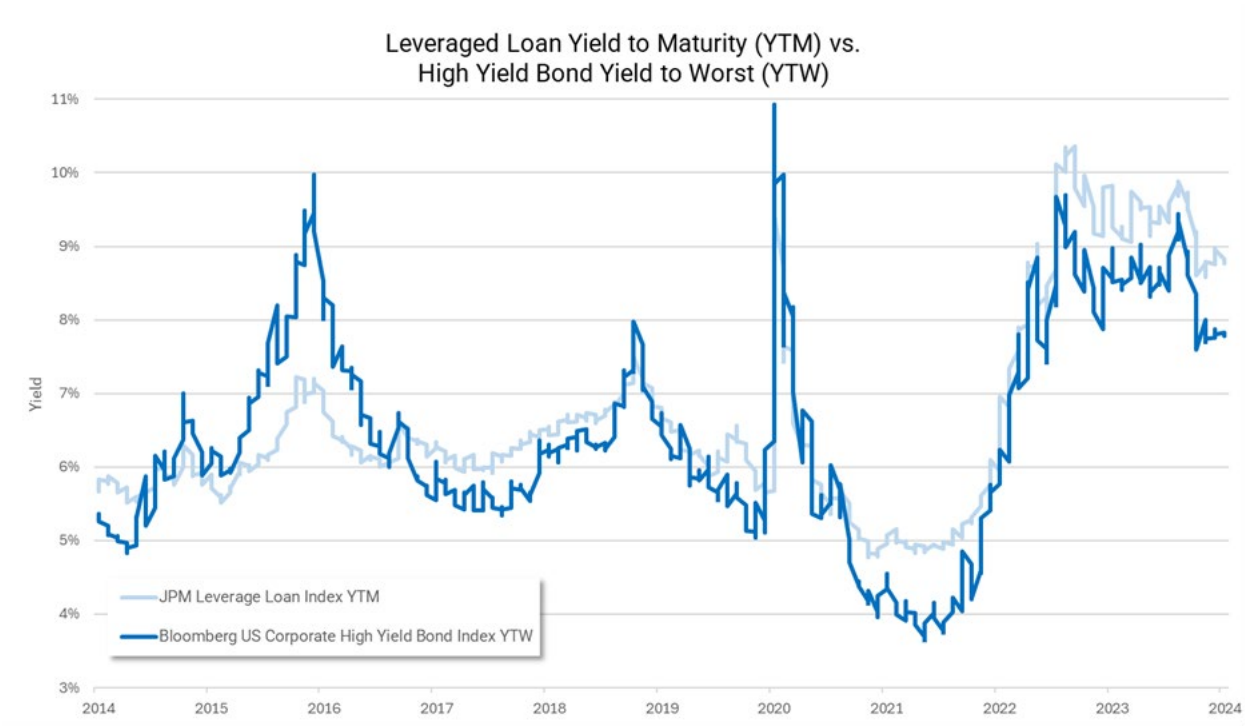
At Smith Capital Investors, we have a keen focus on relative value, not just on a security and sector-specific basis, but also at the asset class level. One interesting trend we have been tracking at the asset class level is the divergence in relative value between high yield bonds and leveraged loans versus historical relationships.

For most of the 2000s, leveraged loans as an asset class have yielded less than high yield bonds. This seemed to make sense given the fact that leveraged loans are generally secured with a first-priority lien on the assets of the issuer, whereas high yield bonds are generally unsecured. This lien creates seniority within the capital structure and typically leads to better recoveries in bankruptcy scenarios and therefore less risk.



Beginning in late 2022 and accelerating into 2023, the historical yield relationship between loans and bonds broke down, with leveraged loan yield-to-maturity (YTM) exceeding high yield bond yield-to-worst (YTW) by hundreds of basis points (bps). Multiple factors have been cited as drivers for this divergence, with the most likely being the deterioration in underlying credit quality in loan issuers relative to bond issuers. Following years of rapid expansion in leveraged loans and a credit rating-upgrade cycle in high yield bonds, the average loan issuer is smaller and higher levered than the average high yield bond issuer with corresponding lower interest coverage and lower average credit rating. Lower fundamental quality on a relative basis would argue for higher risk and therefore higher yields.

Another factor that likely contributes to elevated yields in loans is the fact that loans generally have floating rate coupons, meaning that interest payments are determined based on a fixed spread over a reference rate, typically the Secured Overnight Financing Rate (SOFR). If interest rates decline in the future (due to central bank easing or other factors), SOFR rates could also move lower, which would lower leveraged loan coupons and likely result in lower yields. This outcome is currently the consensus expectation, with the SOFR forward curve showing expectations for lower rates in the future. High yield bonds generally have fixed coupons and as such would not face the risk that coupons reset lower. In fact, high yield bonds would likely see further outperformance in a lower interest rate environment given longer duration than loans (all else being equal).



Source: Smith Capital Investors, Bloomberg, J.P Morgan 3/6/2024

While at the asset class level this divergence may make sense given the factors discussed above, on an individual security basis we are finding interesting opportunities in loans that we believe offer superior risk-adjusted return profiles relative to secured or unsecured bonds in the same capital structure. We like this trade not just for yield pickup but also for fundamental downside protection.

On a yield basis we are finding opportunities in high quality loans where the loan YTM is 150bps or more in excess of the YTW of not just pari-passu bonds, but unsecured bonds in the same structure. Even adjusting for the current SOFR forward curve, which implies lower rates in the future, the yield on these loans is often above the yield on the issuer's subordinated bonds. In the event that rates stay flat or move lower by less than consensus expectations, the significant carry advantage in the loan will create relative outperformance. From a capital preservation perspective, moving higher in the capital structure in primarily large, liquid, public issuers should result in less downside price volatility in a risk-off scenario relative to owning subordinated bonds in the same structure.

There may not be broad mispricing of leveraged loans relative to high yield bonds, but we believe that within the overall opportunity set bottom-up, fundamentally focused investors emphasizing security selection and active management can find superior risk-adjusted return opportunities.

Let's keep talking!

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Past performance is no guarantee of future results. Investing in a bond market is subject to risks, including market, interest rate, issuer, credit, inflation, default, and liquidity risk. The bond market is volatile. The value of most bonds and bond strategies are impacted by changes in interest rates. The return of principal is not guaranteed, and prices may decline if an issuer fails to make timely payments or its credit strength weakens. High yield or "junk" bonds involve a greater risk of default and price volatility and can experience sudden and sharp price swings.

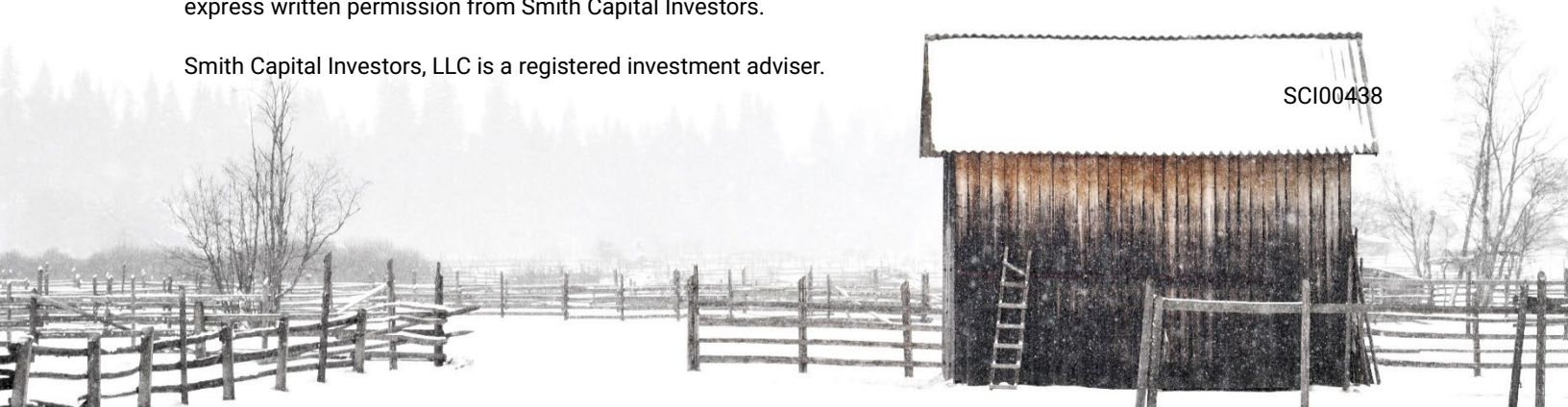
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