



Market Conditions Should Drive Bond Investors To Floating-Rate Loans

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed Larry Holzenthaler, an investment strategist and analyst at Nuveen who specializes in floating rate and high yield investments. Read the Q & A below as Larry says that income-oriented investors who have allocations to junk bonds are likely under-allocated to loan funds, which offer equal returns with less risk. Holzenthaler says the floating-rate opportunities are particularly attractive in closed-end funds, thanks to persistent discounts – despite more interest in loans – that let investors buy the



Larry Holzenthaler

economic earning power of a dollar in loans, plus leverage, for about 95 cents.

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CHUCK JAFFE: Larry Holzenthaler, investment strategist for Nuveen is here, and we're talking about the floating-rate securities and broad corporate credit markets, welcome to The NAVigator. This is The NAVigator, where we talk about all-weather active investing and plotting a course to financial success with the help of closed-end funds. The NAVigator's brought to you by the Active Investment Company Alliance, a unique industry organization that represents all facets of the closed-end fund industry. From users and investors to fund sponsors and creators, if you're looking for excellence beyond indexing, The NAVigator's

going to point you in the right direction. And today it's pointing me in the direction of Larry Holzenthaler, he's investment strategist and analyst for Nuveen, where we works on their floating rate and high-yield funds. And if you want to learn more about the firm, it's Nuveen.com. Larry Holzenthaler, thanks for coming back to The NAVigator.

LARRY HOLZENTHALER: Thanks for having me back, Chuck.

CHUCK JAFFE: Now you were last with us in August of 2020, and the picture for credit risk at that time was really interesting because equities by then had already recovered from the pandemic starting, equities went in the tank, the credit market went right with them. By the time we got to the summer, equities had totally recovered, they retraced everything, but the credit market was still pricing in a high level of risk and was lagging. So let's start with where we go to now more than a year later, have we closed that disconnect? We had an equity market that was much more optimistic than the broad corporate credit market, where is that equilibrium now?

LARRY HOLZENTHALER: So the relationship has persisted I would argue. If you go back to August, it was interesting in the sense that as you mentioned, equities had largely done a complete recovery at that point or close enough, and credit was still pricing in an elevated level of risk versus what it had prior to Covid. And it's interesting if you fast-forward through today, credit is clearly not as optimistically priced as equities. And what I mean by that is, equities have continued to move beyond pre-Covid levels to new all-time highs. On a spread basis, loans, high yield, corporate credit, other parts of the credit markets are kind of back to pre-Covid levels, but they're certainly not generically tighter. Parts of the Covid-facing sectors, more levered names are actually even priced a little bit wide to where they were prior to Covid. So I would argue it continues to be a scenario where the corporate credit markets broadly are fairly priced but they're not quite pricing in the level of optimism that you have within equities, at least broadly.

CHUCK JAFFE: There also seems to be optimism when it comes to floating rates because floating rate mutual funds have seen really strong inflow trends. And yet when it comes to the closed-end funds, floating rate closed-end funds have been trading at discounts. So where's the disconnect there, and how good is the environment right now for floating rate? Is the environment as good as the demand?

LARRY HOLZENTHALER: That's a great observation in the sense that you're right, the loan market had basically two years of outflows between December of 2018 and December 2020. The loan mutual funds and ETF peer groups saw about \$86 billion of outflows. It virtually cut the peer group in half from an AUM perspective. Year-to-date we've seen a complete reversal of that. Year-to-date we've seen a little less than \$40 billion of inflows, so about half the money, a little bit less that left the asset class over the prior two years has come back in. And so we've seen pretty consistent weekly inflows. In fact, there's only been one weekly read this year that didn't show an inflow into the loan peer group, and what's causing that feast-famine is rates. Interest rates, duration risk, volatility in the treasury market, all of those things typically drive almost entirely the demand component within retail markets. So retail investors kind of flood into the asset class when they are worried about rates or their bond portfolios are getting hit, and they tend to run for the exits when rate risk is kind of on the backburner. And institutions actually take a little bit more of a holistic view, they look at how do credit fundamentals look, what's my IRR likely going to be, what's my risk? And you're right, closed-end funds today still trade at a discount to net asset value, floating rate funds do. And arguably that discount has tightened over the last year, relative to historical averages were kind of an average discount roughly. But what's interesting, your observation is correct, in the mutual fund space effectively what you have is too much demand and not enough supply. That's the reason loans have done very well, that's the reason since late September when the treasury market got volatile that loans had been fairly resilient, is you have more buyers than sellers. But in the closed-end fund context, obviously a discount to net asset value would mean that you don't necessarily have more demand than you have supply. And so what I would say is if you're looking to buy exposure to the loan asset class, you think about a closed-end fund trading at a 5% discount, I'm effectively able to buy a dollar of cashflows for 95 cents. So will the fund appreciate above NAV? Hard to say, but I'm in essence buying the economic earning power of a dollar of loans for 95 cents. And I'm also getting by the way obviously leverage attached to that, which is coming at fairly cheap funding costs. So there are different risk-return thresholds for different clients, but the closed-end fund wrapper for a loan product, especially as folks are cognizant of the fact that the vast majority of your returns going forward are going to be driven by yield than by carry. So having a little bit of leverage attached should in theory if you're kind of optimistic on the

asset class, should improve your IRR over time, yet the closed-end fund complex arguably trades at a bit of a discount to the mutual fund space.

CHUCK JAFFE: What's your broad outlook with where we're going with interest rates and what's happening on the corporate credit side? Because with inflation, if you've got a situation as we've seen right about now with junk bonds, high-yield debt, lower-grade corporate debt, however you want to call it, where junk bonds are not necessarily able to out-earn inflation. And this inflation which they're saying is transitory, looks like it may be transitory for a little longer, if that's a thing. What's the outlook for you when it comes to the corporate space going forward?

LARRY HOLZENTHALER: You're right. Historically high-yield bonds, junk bonds, whatever you choose to call them, are credit sensitive assets. If I buy a junk bond, a high-yield bond, the primary risk I have is that the company, the issuer of the bond for whatever reason will not be able to service their debt. And yet high-yield junk bonds also are fixed rate in nature, so there is a treasury component, and we've seen that. During periods like in, again the most recent period that began on September 22nd through October, where you had a little bit of volatility in the fixed-income market, high yield will feel that. Now it will outperform longer duration assets, you have a little bit of a higher coupon to help offset some of those losses that you don't have within, as an example, investment grade corporates. But with spreads and yields as low and tight as they are, a little bit of inflation, a little bit of volatility in a rate market can materially impact your IRR. And we as an investment team, we invest opportunistically and fluidly between high yields and senior bank loans. In fact, we kind of consider them almost one asset class. And as a firm, our view has been that loans offer arguably very similar compensation if not the same compensation from an IRR basis as you would have in high yield. Yet loans, number one, first and foremost are floating rate, so I don't have the treasury component that I have with high-yield bonds, and I'm also senior secured, so I sit at the top of the capital structure versus high-yield bonds generally speaking are unsecured and they're longer dated. So a lot of the focus right now has been on interest rate duration, which is sensitivity to rising rates, but loans also have about half the spread duration of high-yield. They're shorter dated, so if spreads widen, the math would tell you they have to widen less, or the price of the loan has to go down less than in high yield. So the end of it is you have an asset that provides kind of a similar IRR, a similar return profile, but

has a lower volatility, has a better part in the cap structure, lower duration. So it's basically equal returns with less risk. So we've actually been recommending to clients that they at the very least familiarize themselves with the loan asset class. Because the interesting statistic is the mutual fund peer group for the loan market is about \$100 billion asset class, the high-yield peer group is about a \$300 to \$400 billion, so three to four times the size. Yet the loan market and the high-yield market are roughly equal in size from an investable universe. So if you're a financial advisor and you're allocated broadly for clients, there is a high likelihood that you have more exposure to high yield within your clients' portfolios than you do loans. And so we're not recommending that everyone shift all their money out of high yield, but certainly familiarizing yourself with the market, understanding some of the different ways to play the non-investment grade credit market can make sense, especially if you're worried about rates.

CHUCK JAFFE: Larry, really interesting, thanks so much for joining us. I look forward to the next conversation already.

LARRY HOLZENTHALER: Thanks Chuck, we'll talk to you soon.

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