CEF Weekly Article

Where Do Bank-Loan CEFs Go From Here?

Funds that have performed the best in the recent past may also be the same funds taking on the most risk.

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We've written about the pros and cons of bank loans before, but the space is worth revisiting given the uncertainty facing floating-rate investors.

Bank loans (also known as floating-rate loans or senior loans) feature rates that regularly reset to a spread over Libor and are relatively immune to price changes driven by changes in broad-market interest rates. While interest-rate risk is minimal, borrowers (or issuers) in this market tend to have highly leveraged balance sheets. Even though bank loans are senior to high-yield bonds in the capital structure and thus typically offer better recovery rates, investors can lose money when loans default; this category is also subject to volatility in flights to quality.

The floating-rate or bank-loan asset class has approached interesting times. Over the past year, more than $70 billion has flown into open-end and exchange-traded bank-loan funds, but the category saw its first net outflows in April after 94 consecutive weeks of net inflows. The $766 million that came out of these funds in April is minimal relative to the overall size of the asset class, and so far in early May the outflows seem to have stabilized. Still, given how quickly the asset class has grown in the past year, investors are prudent to question the impact that a round of prolonged outflows would have on the space. To be sure, massive amounts flowing into and out of the space have less impact on bank-loan closed-end funds, but the knock-on effects can be significant, especially for the CEFs' share prices. In fact, during the last year, the average closed-end bank-loan fund returned 6.3% on an NAV basis, while open-end bank loans returned 3.5%. On a share price basis though, bank-loan CEFs lost an average of 4.6% over the past year as discounts widened to an average of 5.8% as of May 14.

Over the past couple years, a risk-led rally in the bank-loan space has rewarded those funds that were willing to invest in lower-quality loans. For example, over the past year through May 14, 2014, loans rated CCC have returned 7.7%, while higher-quality loans rated BB returned 2.7%.

As shown in the table below, the top-performing CEFs based on net asset value return over the past year tend to hold more lower-quality bonds which likely gave a boost to returns. The top performers carry an average below-B rated allocation of almost 8.2%, compared with just 4.4% for the bottom performers. It should be noted that the top-performing fund over the past year, Oxford Lane Capital Corp (OXLC), runs a concentrated portfolio of collateralized loan obligations, where data regarding credit quality is less transparent.

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Bank-Loan CEF 1-Yr Performance	1-Yr NAV Return (%)	1-Yr Share Price Return (%)	Discount	3-Yr Z-stat	Total Leverage Ratio	Dist Rate (Share Price)	Credit Qual Below B %
Top 10 1-YR NAV Performance							
Oxford Lane Capital Corp OXLC	12.75	14.64	5.44	1.33	23.24	14.13	N/A
Invesco Dynamic Cred Opps VTA	10.52	1.49	-6.62	-0.56	30.79	6.93	6.8
Nuveen Floating Rate Inc Opps JRO	8.19	-4.56	-3.69	-0.92	44.05	6.31	7.3
Nuveen Credit Strat. Income JQC	7.56	-3.15	-8.57	-0.63	29.23	6.71	11.6
BlackRock Debt Strategies DSU	7.45	-0.91	-6.55	-1.02	27.62	7.25	9.2
Nuveen Senior Income NSL	7.43	-8.41	-7.56	-1.76	44.05	6.2	7.3
Ares Dynamic Credit Alloc ARDC	7.31	-0.87	-6.39	-0.34	28.78	7.61	N/A
Nuveen Floating Rate Income JFR	7.08	-5.76	-7.19	-1.43	44.06	6.29	5.7
Nuveen Shrt Duration Cred Opps JSD	6.98	-4.34	-5.62	-1.13	30.07	7.4	9.7
Invesco Senior Income VVR	6.59	-7.33	-4.76	-0.8	22.75	6.72	7.8
Bottom 10 1-YR NAV Performance							
Blackstone/GSO LS Credit Inc BGX	5.37	-3.16	-7.43	-1.62	13.64	6.65	9.0
LMP Corporate Loan TLI	5.15	-9.15	-7.42	-1.05	33.83	7.26	7.4
BlackRock Defined Opps Credit BHL	4.91	-2.25	-5.88	-0.90	28.53	5.34	2.0
Blackstone/GSO Strategic Cred BGB	4.89	-4.24	-8.27	-1.15	31.33	7.14	6.6
Pioneer Floating Rate Trust PHD	4.58	-8.45	-6.07	-1.78	36.27	6.38	2.4
Blackstone/GSO Senior Floating BSL	4.57	-9.75	-4.38	-1.44	33.06	6.53	5.4
First Trust Senior FR Inc II FCT	4.42	-9.02	-6.98	-1.55	30.73	6.16	2.1
EV Senior Floating Rate EFR	4.36	-8.12	-6.29	-1.69	37.15	6.10	3.3
EV Floating Rate Income EFT	4.20	-8.60	-6.20	-1.38	37.25	5.71	3.1
EV Senior Income Trust EVF	3.56	-6.32	-7.51	-1.34	38.83	5.67	2.7

- source: Morningstar Analysts

Because of the differential in share price movements and underlying NAV returns, many of these funds, especially the recent underperformers, are starting to look inexpensive based on their three-year Z-statistic scores. But, investors should understand the risks associated with bank loans before jumping in. Yes, defaults remain low, excluding the recent but highly expected bankruptcy filing of Energy Future Holdings, and the benign economic environment has given investors more confidence in lower-quality loans. But, should fundamentals deteriorate or defaults rise, investor sentiment could turn against these loans (and the funds that hold them) quickly.

Also, many investors plowed money into this category to protect their income against rising rates because bank-loan interest payments are tied to short-term Libor rates. However, a steepening of the yield curve could actually hurt these loans. Should longer-

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term interest rates rise faster than short-term rates, it's possible that the income paid to lenders would not rise as expected. Should this happen, income-seekers could possibly sell their bank-loan investments for higher-yielding options. It's also important to note that many bank-loan funds hold securities with Libor floors, meaning that short-term rates must rise beyond those interest floors before payouts increase. Depending on how quickly short-term rates rise, impatient investors might flee.

These risks are exacerbated by liquidity concerns, which can cause discrepancies between market prices and underlying value. For open-end funds, managers might be forced to sell holdings at below market prices if outflows occur en masse. CEFs have more flexibility to navigate this uncertain environment as managers are not forced to sell due to outflows from investors. However, given mark-to-market accounting for loan valuations, bank-loan CEF investors may still see short-term declines in their portfolios in this scenario. But, CEF managers can take advantage of any short-term price discrepancies and snap up cheap assets as open-end fund managers indiscriminately sell assets to meet flows.

CEFs may experience sudden share price declines if investors flee those funds, but investors can take advantage of short-term disruptions in CEF market prices, purchasing cheap shares from investors unwilling to wait out the storm. The floating-rate market can provide investors with protection against rising rates but are not without significant risks. As billions have flown into the asset class, bank loans appear priced for perfection. Anything less might trigger a sell-off. The funds with the riskiest holdings may be the most susceptible, so investors should have a strong understanding of what types of loans their funds own. Funds that have performed the best in the recent past may also be the same funds that are taking on the most risk.

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