

Floating-Rate Bonds Revisited: The New “Old Maid?”

A Coming Liquidity Event?

If CLOs stop buying FRBs, it could trigger downward pricing pressure and problems for investors seeking redemptions.

Settlement Challenges

Selling a FRB can take up to 25 days—putting pressure on FRB funds if shareholders sell.

Another Peak?

CLO issuance in 2014 eclipsed the prior record set in 2006—prior to the subprime crisis.

The Lesson?

Understand your investments and the risks attached to potential rewards.

In “Old Maid,” the kids’ card game, the loser was left holding the lone “Old Maid” card. Today, investors holding floating rate bonds (FRBs) or FRB funds may end up in a similar situation – unable to “discard” potentially illiquid bonds as they lose value.

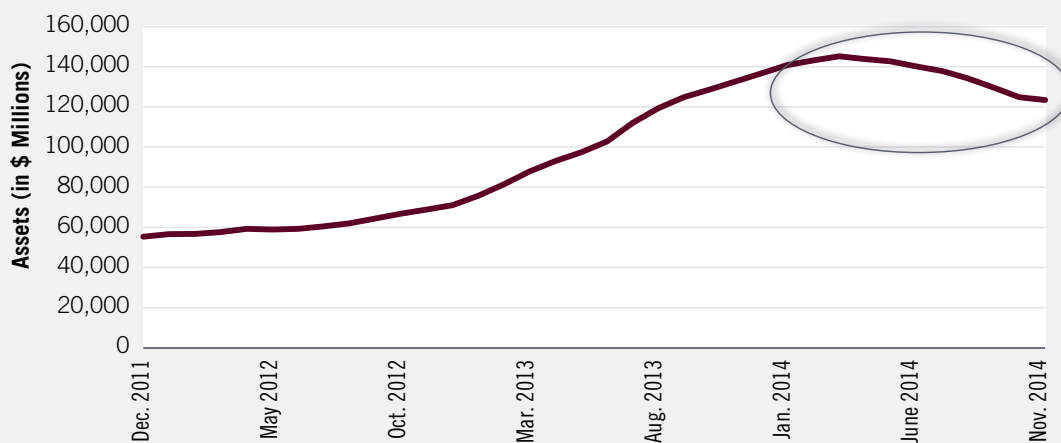
Last year, an article from the Brandes Institute, “Floating Rate Bonds: Switching One Risk for Others,” showed these instruments carry risks that could potentially outweigh their rewards. This follow-up piece, featuring insights from Brandes Fixed Income Portfolio Manager/Analyst Timothy Doyle, CFA and other sources, seeks to expand on the FRB risk discussion, focusing on liquidity and credit risks.

Demand for Yield Masking Risks? CLO Purchases Help Offset Retail Outflows From FRB Funds

In 2014, FRB fund assets fell during the latter part of the year, dropping almost 15.0% between their March peak and November. Exhibit 1 shows the decline in bank loan fund assets, a proxy for floating rate bonds. “While retail investors were pulling money out of these funds since March 2014, I believe the lower demand for FRBs was partially offset by increased demand for FRB-backed collateralized loan obligations (CLOs) from institutional investors,”¹ said Mr. Doyle.

Exhibit 1: Retail Demand for Bank Loan Funds Cooled in 2014

Bank Loan Fund Assets Fell by More Than \$20 Billion Between March and November 2014



Source: Morningstar; Based on assets in U.S. open-ended bank loan funds, ex-money market funds, from 12/01/2011–11/30/2014, as of 11/30/2014

“There was \$100+ billion in CLOs issued in 2014,” said Mr. Doyle.² “A good chunk of them were FRBs and I think that’s why we haven’t seen a pullback among floating rate bonds—the institutional demand largely offset the FRB fund sales in the second half of 2014.”³

¹ “2014 Leveraged Loan Investor Market: CLOs dominate as retail bid, banks fade.” Leveragedloan.com, 12/19/2014

² Haunss, Kristen. “Leveraged Loan Funds Seen Plunging 40% After Record Year.” Bloomberg.com, 12/15/2014 <http://www.bloomberg.com/news/2014-12-16/leveraged-loan-funds-seen-plunging-40-after-record-year.html>

³ From Morgan Stanley US Credit Strategy: 2014 Performance Recap, 1/5/2015, page 5.

Why would institutional investors pick up the FRBs that retail investors were discarding?

1. Yields on traditional bonds remained stubbornly low, so institutional investors were attracted to higher-yielding alternatives, including CLOs. And with the painful memories of exposure to subprime CLOs fading, investors were more focused on yield than potential risks.
2. Companies took advantage of strong investor demand for higher-risk, higher-yielding debt by issuing record amounts of bonds (including FRBs) in 2014.⁴
3. CLO issuers, aware of stricter regulations on the horizon, pushed to create new CLOs, brought them to market and set a record for yearly issuance (more than \$119 billion through mid December 2014 vs. the previous high of \$94 billion in 2006—just before the subprime market burst).

Will CLO issuance remain robust in 2015, helping prop up FRBs?

“Wall Street dealers are bracing for a steep drop in issuance of collateralized loan obligations after a record amount of the debt was raised” in 2014, according to Bloomberg.² Stricter regulation stemming from Dodd-Frank legislation “would require CLOs to hold onto 5 percent of the debt they package or sell.”⁵ This new rule, released October 21, 2014, won’t take effect for two years—but it’s already altering the landscape.² A spokesman for the Loan Syndications and Trading Association said, “People are scrambling to figure out” how or if they can comply with the new regulation.²

Liquidity Risk Lurking?

Looking ahead, the potential lack of CLOs buying FRBs could trigger a significant liquidity event for these securities, creating downward pricing pressure and problems for investors seeking redemptions.

“Bank loan mutual funds, and ETFs in particular, have a structural mismatch between the cash settlement of the assets they hold and their liabilities to fund investors,” according to Moody’s. “In stressed market conditions, redemptions typically increase, potentially leading to scenarios where funds would be unable to return cash from the proceeds of fund investments to their investors within the typical cash settlement period....” The report adds that settlement times for bank loans “typically range from 15 to 25 days.”⁶

Industry research firms like Moody’s are not the only organizations calling attention to possible liquidity dangers with FRBs. The Securities and Exchange Commission (SEC) launched a review of mutual fund liquidity, seeking in part to gauge the potential risk of FRB funds. SEC Chairwoman Mary Jo White said, “A fund that does not manage liquidity risk in its portfolio could have difficulty meeting redemptions if it came under stress.”⁷

Mr. Doyle warned, “Many investors have piled into floating rate bonds; it seems some are starting to bail out. The other big issue for FRBs is banks can’t be the liquidity providers they were in the past. They don’t have the capacity—not even on corporate and high-yield bonds. Some eyes may be opened when we see some volatility, which we expect to return at some point.”

⁵ Source: Bloomberg article, “CLOs’ \$94 Billion Sales Record Poised to Crumble in U.S.”; same source for stricter regulation for CLOs: Bloomberg.com, 9/24/2014 – <http://www.bloomberg.com/news/2014-09-24/clos-94-billion-sales-record-poised-to-crumble-in-u-s-.html>; Kristen Haunss writes, “Just because the rules don’t kick in for a while, doesn’t mean investor reception to certain managers won’t be affected in the interim,” according to Rishad Ahluwalia, the head of global CLO research at JPMorgan.” Source for this quote: Haunss, Kristen, “Leveraged Loan Funds Seen Plunging 40% After Record Year.” Bloomberg.com, 12/15/2014 – <http://www.bloomberg.com/news/2014-12-16/leveraged-loan-funds-seen-plunging-40-after-record-year.html>

⁶ Moody’s, “Mind the Gap: Retail Bank Loan Funds Pose Liquidity, Reputational Risks for Managers,” July 6, 2014 http://www.alacrastore.com/moodys-credit-research/Mind-the-Gap-Retail-Bank-Loan-Funds-Pose-Liquidity-Reputational-Risks-for-Managers-PBC_172343

⁷ From NY Times article “Mutual Fund Industry May Face New Rules” by Peter Eavis, Dec. 11, 2014. http://dealbook.nytimes.com/2014/12/11/mutual-fund-industry-may-face-new-rules/?_r=1

Wall Street dealers are bracing for a steep drop in issuance of collateralized loan obligations.

Lingering Credit Risk, Too

Since FRBs and FRB funds seek to limit interest-rate risk, they typically have to take on more credit risk to generate a return for investors.⁸ The underlying debt in FRBs is made up of loans to companies that typically carry a below-investment-grade credit rating. Consequently, FRBs tend to behave more like high-yield bonds than other short-term investments. “This means that although these are floating rate instruments and should trade to zero duration, the credit risk can have a greater impact on prices than the movement of rates,” Mr. Doyle explained. Default rates for FRBs are significantly higher than investment grade bonds—3.4% vs. 01%.⁹

Credit risk has an impact on FRB funds’ performance. For example, when credit spreads widened during 2008, the Credit Suisse Leveraged Loan Index (the widely used floating-rate funds benchmark) returned –28.8%, underperforming the Barclays U.S. Aggregate Bond Index by 34 percentage points.¹⁰ “Investor memories are short,” Moody’s reported, “largely ignoring that bank loans traded at less than 50 cents on the dollar as recently as 2008.”⁶

Buyers Beware: Understand the Risks

Investors may be best served by weighing the risks versus the potential rewards when investing in floating rate bonds. After all, it wasn’t too long ago when investors—both retail and institutional—overlooked the risks involved with more complex and illiquid vehicles that contributed to the global financial crisis. Moody’s reported, “The current structure of bank loan funds is a prime example of what often happens in mature bull markets—the selling of less-liquid yield-generating assets in marketable liquid products.”⁶

“While the currently low interest-rate environment may have encouraged investors to reach for extra yield, it is important to gain a better understanding of the risks attached to these investments,” said Mr. Doyle.

Recalling the card game from our youth, some investors may be left holding “Old Maid” FRBs if credit and liquidity risks arise.

Duration: The weighted maturity of a fixed-income investment’s cash flows, used in the estimation of the price sensitivity of fixed-income securities for a given change in interest rates.

Yield: annual income from an investment (dividend, interest, etc.) divided by the current market price of the investment.

The Barclays U.S. Aggregate Bond Index is a broad-based benchmark that measures the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market. This index is a total return index which reflects the price changes and interest of each bond in the index.

The Credit Suisse Leveraged Loan Index is an index designed to mirror the investable universe of the \$U.S.-denominated leveraged loan market. Source: <https://www.credit-suisse.com/us/en/private-banking/glossary-indices.html>

The London Interbank Offered Rate (LIBOR) is a benchmark rate that some of the world’s leading banks charge each other for short-term loans. Source: Investopedia.com

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⁸ Credit risk: The risk of loss of principal or loss of a financial reward stemming from a borrower’s failure to repay a loan or otherwise meet a contractual obligation. Source: Investopedia.com

⁹ Bennyhoff and Zilbering, “A Primer on Floating-rate Bond Funds,” Vanguard, September 2013. Figure 2. Average annual default rates between 1996 and 2012.

¹⁰ Vanguard, “Don’t forget credit risk—Views on floating-rate bond funds,” Feb. 28, 2014-
https://advisors.vanguard.com/VGApp/iip/site/advisor/researchcommentary/article/IWE_InvComFloatingRate

Default rates for FRBs are significantly higher than investment grade bonds.