

# Private Market Insights

A NEWSLETTER BY FAST

## As Rates Rise, Traditional Fixed Income Investments Sink. Instead, Consider Ones that Float.

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### How floating rate direct loans have thrived in past periods of rising interest rates and market volatility



Led by the Federal Reserve's campaign of increasingly large hikes, interest rates have risen meaningfully year-to-date. Conventional wisdom would guide investors to sell fixed income—a reflection of one of the most fundamental relationships in the investment world: as rates go up, investments go down. Add on top of this the potential risk of higher corporate default rates in a subsequent possible recession, and it's easy to come to the conclusion of selling.

However, such sweeping generalizations can cause investors to miss opportunities with certain types of debt investments that, perhaps surprisingly, can provide compelling risk-adjusted returns through periods of rising rates, economic volatility and even subsequent recessionary periods.

Through our in-depth research on the topic, Ares has found that Floating Rate Direct Loans can help drive returns that are resilient and relatively protective of downside risk, resulting in a potentially attractive investment in a rising rate environment, both during and after potential market dislocations. We summarize what you need to know in our latest Private Markets Insights newsletter.

## Floating Rate Direct Loans defined

The type of debt discussed here will be termed “Floating Rate Direct Loans,” meaning loans that have the following characteristics:



Issued directly by a non-bank lender, not a traditional financial institution, and not part of the liquid credit market (this makes it “direct” as opposed to “publicly traded” or “syndicated” by a bank).



Makes coupon payments based on a rate that fluctuates with short-term interest rates (this makes it “floating rate” as opposed to “fixed rate”).



Lent to midsize companies, not large companies or an individual or government entity.

Let’s look at how each of these characteristics contributes to returns that have historically been both resilient and relatively protective of downside risk, resulting in a potentially attractive investment in a rising rate environment or even dislocated markets.

## Resilient returns

### Floating > fixed

The floating rate feature is the most critical in a rising rate environment because it mitigates the two largest reasons investors traditionally don’t like fixed income investments when rates are low and rising: 1) low, fixed coupon payments and 2) loss of principal.

### Rate resets

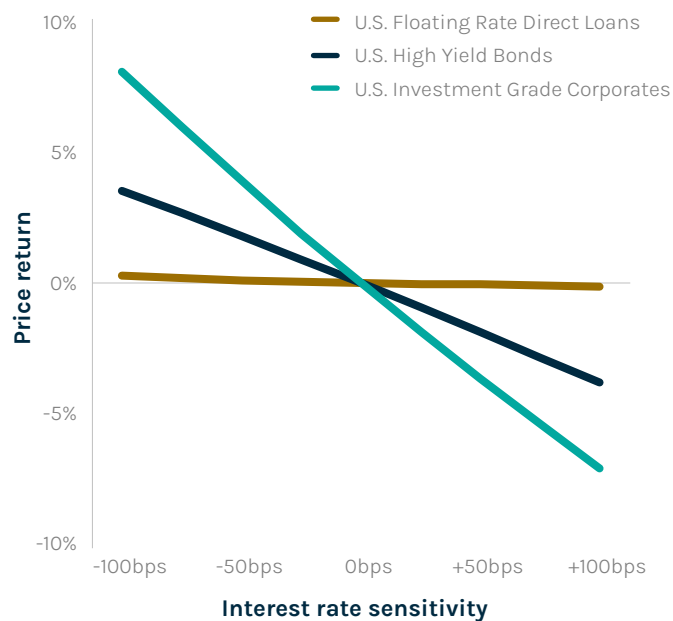
By definition, floating coupon rates are reset to a reference interest rate every 30 to 90 days. So as rates increase, incrementally more income—the core component of return—is generated for the investor.

### Diminishing duration

By pegging the coupon rate to the market, sensitivity of the price to changes in interest rates is nullified, holding all else equal. In addition, Floating Rate Direct Loans often have shorter contractual maturities of 5-7 years with a weighted average life of ~3-4 years compared to long-dated corporate bonds. Another way to say this is that the effective duration is low. This means these assets can deliver incrementally higher investment returns and current income as base rates increase without a corresponding reduction in the value of the debt (assuming credit spreads remain constant). An illustration of this can be seen in the figure to the right.

### Price Sensitivity: Direct Lending vs. High Yield and Investment Grade Corporates

Holding other variables constant<sup>1</sup>, a 100bps increase in rates has a much greater impact on high yield and investment grade bond prices compared to U.S. Floating Rate Direct Loans.<sup>2</sup>



Past performance is not a guarantee of future results.

1. Other variables may impact loan and bond pricing, including changes in credit spreads to base interest rates.

2. US High Yield Bond per the HUC0 index. US Investment Grade Corporate per the COA0 index. US Floating Rate Direct Loans assume an asset with a 90bps LIBOR floor, L+450 with a 5-year contractual maturity. Please refer to the end of the document for index definitions.

## Volume and velocity

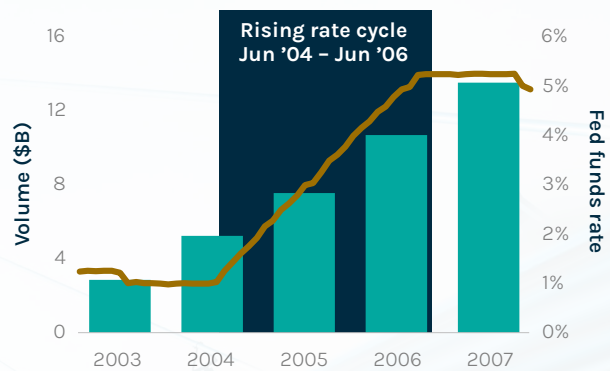
When it comes to loans of this kind, another core component of return is the “upfront economics” of the transaction. This is the structuring fee that the lender receives up front for structuring and completing the transaction. Therefore, higher transaction volume leads to more upfront fees passed on to the investor.

One might intuit that in a period of rising rates, fewer loans are issued because it costs more for

companies to borrow. Lower volume would mean lower upfront fees and, therefore, lower expected return. However, research shows that Floating Rate Direct Loan volumes during past periods of rising interest rates have actually increased due to the combination of strong economic tailwinds and investment capital flowing to floating rate opportunities. This is illustrated in the figures below.



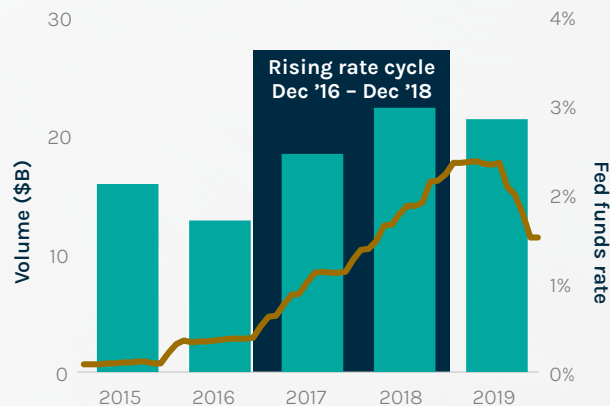
### Annual volume 2003 – 2007



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Source: Company reports. Business Development Companies included: ACAS, ALD, ARCC, AINV, MCGC. AINV and ARCC IPO'ed in 2004. Data in 2003 is estimated using the average growth rate in originations from 2003-2004 for ACAS, ALD and MCGC to adjust for the addition of AINV and ARCC to the dataset in 2004.

### Annual volume 2015 – 2019



#### Past performance is not a guarantee of future results.

Source: Company reports. Business Development Companies included: ARCC, AINV, BBDC, BKCC, FSK, GBDC, GSBD, HTGC, MAIN, NMFC, OCSL, PNNT, PSEC, SLRC, TCPC, SLX.

# Private protection

Because Floating Rate Direct Loans require borrowers to pay higher interest as rates increase, credit risk is the most prevalent and important risk to manage. In our analysis of the last two of the Fed's rate-tightening cycles, we observed very limited impact to direct loan default rates during these periods.

## Fundamentals matter

These low default rate trends are due largely to relatively strong underlying economic and corporate fundamentals. Typically, the Fed tightens monetary policy when the economy is exhibiting stronger fundamental trends. During these two periods of rising interest rates, the average default rates of middle market companies have been lower than the long-term average annual default rate. This is largely attributable to improving economic fundamentals, which muted the impact of a gradual rise in interest expense on interest coverage ratios.

## Careful covenants

In addition to strong fundamentals, private credit investors are protected by lending practices and documentation, which are arguably more stringent than those found in the syndicated loan or high yield markets. In the past, it has been difficult for the Fed to engineer a soft landing (i.e., no recession) after a rate-tightening cycle. While a recession is a possible scenario during the current tightening cycle, we believe middle market direct lending assets remain well positioned relative to other public market assets such as stocks and bonds. This is due to their seniority in the capital structure, covenant protections and long-term, flexible capital, which often enable the lender to mitigate defaults during periods of credit deterioration. We break this down even further below:

**Position in capital structure.** Last year, over 90% of private credit loans were structurally senior secured loans, meaning a company's value would have to significantly deteriorate before resulting in compromised loan repayment.

**Tighter terms.** Private loans often have covenants, including a financial maintenance covenant that typically concerns leverage. These are considered important as they permit lenders to "get to the table" early and proactively address problems with the company before they become a crisis, ultimately protecting the investor.

## More robust underwriting and monitoring.

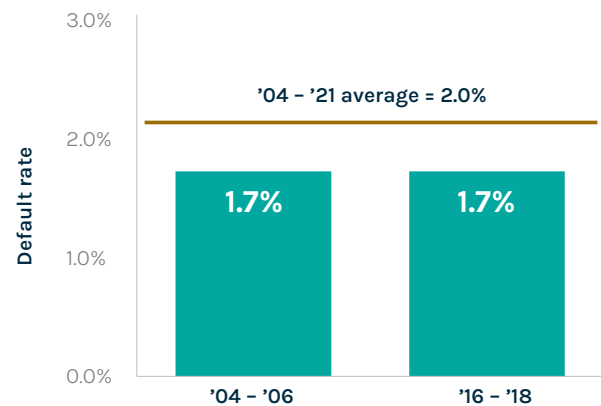
Private credit lenders invest in loans with the intention of holding them to maturity, not repackaging and selling them to others. Therefore, the lenders are more likely to conduct extensive business and legal diligence before investing in the company. Additionally, they may actively monitor the performance of the company.

**Aligned motivations.** Most private credit loans are made to nonpublic companies that are backed by private equity sponsors and have deep relationships with their lenders, which is important in a troubled loan situation. As private lenders likely represent a borrower's most senior creditors, they are motivated to ensure the borrower's business survives and the loan is repaid.<sup>3</sup>

While never fully mitigating credit risk, the combination of greater control over terms and access to non-public creditor information provides a sourcing and pricing advantage. This can add a measure of investor protection from default.<sup>4</sup>

## Middle market default rates during rising interest rate periods

Average default rates during rising rate periods were below the long-term 2004-2021 average



## Past performance is not a guarantee of future results.

Sources: Fitch US Leveraged Loan Default Index, Refinitiv LPC, Bloomberg. Middle market default rates prior to 2008 include year-end non-accruing loan rates for three of the largest Business Development Companies: American Capital, Ltd, Apollo Investment Corp and Ares Capital Corp.

3. Source: Proskauer Insights Report 2021.

4. References to "downside protection" or similar language are not guarantees against loss of investment capital or value.

# NOT paying the price

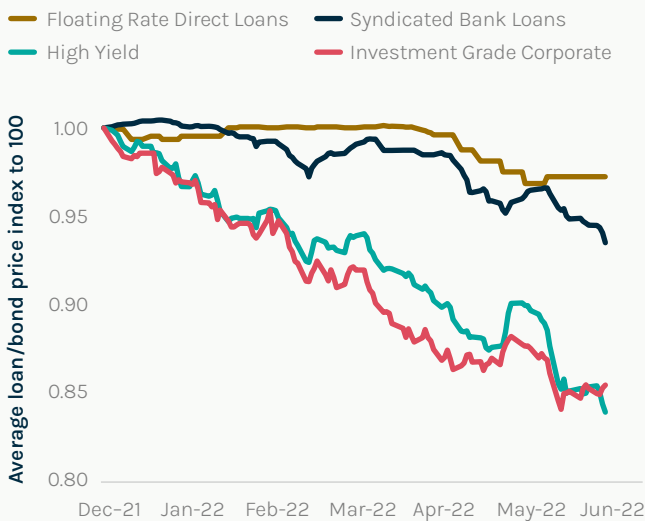
## More price stability

Once the loans are made and the debt issued, the debt is largely owned by institutional investors. This type of investor base generally buys the debt as a longer-term investment and will hold it until maturity, not trading frequently. As a result, private credit typically exhibits greater price stability than public market equivalents, as demonstrated by the chart below (gold line vs. others). Due to the sharp rise in treasury rates, fixed rate, long-term assets such as high yield bonds and investment grade corporate bonds have experienced more significant price volatility, with year-to-date returns of -14.0% and -14.4%, respectively.<sup>5</sup>

## Price point

In addition to greater price stability, Floating Rate Direct Loans have consistently generated higher coupon yields compared to high yield bonds, bank syndicated loans and investment grade corporate bonds, largely due to the illiquid nature and proprietary sourcing and structuring of the assets. By combining higher coupons, larger structuring and prepayment fees, low credit loss rates and relatively stable asset prices, Floating Rate Direct Loans have generated superior total returns over the past decade, as shown in the chart below.

### U.S. Floating Rate Direct Loans exhibited greater stability vs. public market credits during recent market volatility

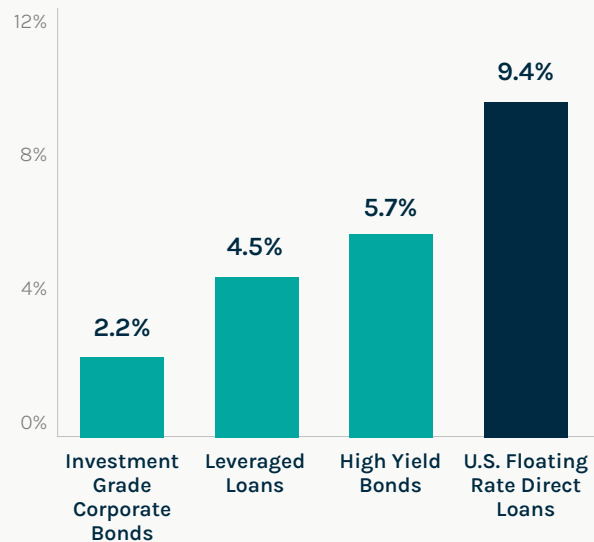


#### Past performance is not a guarantee of future results.

Sources: Bloomberg, ICE BofA HY Master II Index, LCD. Data December 31, 2021 through June 30, 2022. Middle Market Loans as represented by Middle Market Index Data provided by S&P Leveraged Commentary and Data (LCD), Syndicated Bank Loans as represented by S&P/LSTA Leveraged Loan Price Index, High Yield as represented by ICE BofA HY Index, and Investment Grade Corporate as represented by the S&P US Investment Grade Corporate Bond Index. Please refer to the end of the document for index definitions.

5. Source: As of June 30, 2022.

### Ten-year total annualized returns on select credit assets



#### Past performance is not a guarantee of future results.

As of March 31, 2022. Sources: Ares, Bloomberg, Bloomberg US Investment Grade Aggregate Bond Index, Credit Suisse Leveraged Loan Index, ICE BofA HY Index, Cliffwater Direct Lending Index. Please refer to the end of the document for index definitions.



# Conclusion

Putting this together, an analysis of Cliffwater's Direct Lending Index returns highlights that Floating Rate Direct Loans outperformed other credit market alternatives such as syndicated bank loans, high yield bonds and investment grade corporate bonds during the last two of the Fed's rate-tightening cycles (2005-06 and 2017-18). Direct lending returns also held up relatively well when the economy subsequently slipped into a recession following these cycles. When reviewing the full business cycle, including the period of rising rates and the subsequent recession

and declining rate period followed by the recovery, the Floating Rate Direct Loans outperformed by a significant margin in both the 2005-2009 cycle and again in the 2017-2021 cycle.

Based on their attractive characteristics—floating rate coupons, strong structural protections and price stability—we believe Floating Rate Direct Loans have the ability to outperform in the current interest rate hiking cycle and related market volatility.

## Total returns of selected credit investments during rate hiking cycles and subsequent recessions

Period	Year	Direct Loans	Syndicated Bank Loans	High Yield	Investment Grade Corporates
Rising rates	2005	10.1%	5.1%	2.7%	1.7%
Rising rates	2006	13.7%	6.7%	11.9%	4.3%
Stability	2007	10.2%	2.1%	1.9%	4.6%
Recession	2008	-6.5%	-29.1%	-26.2%	-5.0%
Recovery	2009	13.2%	51.6%	58.2%	18.7%
Rising rates through market bottom	2005-2008	29.0%	-18.8%	-13.5%	5.4%
Rising rates through market recovery	2005-2009	46.0%	23.1%	36.8%	25.1%
Rising rates	2017	8.6%	4.1%	7.5%	6.4%
Rising rates	2018	8.1%	0.5%	-2.1%	-2.5%
Stability	2019	9.0%	3.1%	7.1%	14.5%
Recession	2020	5.5%	3.1%	7.1%	9.9%
Recovery	2021	12.8%	5.2%	5.3%	-1.0%
Rising rates through market bottom	2017-2020	34.9%	11.3%	20.8%	30.6%
Rising rates through market recovery	2017-2021	52.2%	17.0%	27.1%	29.2%

Past performance is not a guarantee of future results.

Sources: Cliffwater Direct Lending Index, Credit Suisse Leveraged Loan Index & ICE BofA High Yield Index, Bloomberg US Corporate Bond Index. Please refer to the end of the document for index definitions.

Private securities investments carry many risks, including the risk of substantial loss of part or all of an investment. This material does not take into account any specific objectives or circumstances of any particular investor, or suggest any specific course of action. Individual investors should consult with their financial advisor when considering any investment.

# About the Financial Advisor Solutions Team (FAST)

FAST offers resources and one-on-one support to help navigate the complexities of private markets investing. The team's goal is to empower investors to confidently incorporate private markets investments into portfolios. The educational content, research and analytics that FAST delivers are designed to enhance the understanding of the benefits of private markets investments. FAST is a skilled and knowledgeable team of professionals who can answer questions and foster more informed decisions.

## AWMS Financial Advisor Solutions Team



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### INDEX DEFINITIONS

- 1. The ICE BofA U.S. High Yield Master II Index ("HOAO")** tracks the performance of U.S. dollar denominated below investment grade corporate debt publicly issued in the U.S. domestic market. Qualifying securities must have a below investment grade rating (based on an average of Moody's, S&P and Fitch), at least 18 months to final maturity at the time of issuance, at least one year remaining term to final maturity as of the rebalancing date, a fixed coupon schedule and a minimum amount outstanding of \$100 million. Index constituents are capitalization-weighted based on their current amount outstanding times the market price plus accrued interest. Accrued interest is calculated assuming next-day settlement. Cash flows from bond payments that are received during the month are retained in the index until the end of the month and then are removed as part of the rebalancing. Cash does not earn any reinvestment income while it is held in the index. The index is rebalanced on the last calendar day of the month, based on information available up to and including the third business day before the last business day of the month. No changes are made to constituent holdings other than on month end rebalancing dates. Inception date: August 31, 1986.
- 2. The Credit Suisse Leveraged Loan Index ("CSLLI")** is designed to mirror the investable universe of the \$ U.S.-denominated leveraged loan market. The index inception is January 1992. The index frequency is daily, weekly and monthly. New loans are added to the index on their effective date if they qualify according to the following criteria: 1) Loan facilities must be rated "5B" or lower. That is, the highest Moody's/S&P ratings are Baa1/BB+ or Ba1/BBB+. If unrated, the initial spread level must be Libor plus 125 basis points or higher. 2) Only fully-funded term loan facilities are included. 3) The tenure must be at least one year. 4) Issuers must be domiciled in developed countries; issuers from developing countries are excluded.
- 3. The S&P/LSTA Leveraged Loan Index ("S&P LSTA LLI")** reflects the market-weighted performance of institutional leveraged loans in the U.S. loan market based upon real-time market weightings, spreads and interest payments. Facilities are eligible for inclusion in the index if they are senior secured institutional term loans with a minimum initial spread of 125 and term of one year. They are retired from the index when there is no bid posted on the facility for at least 12 successive weeks or when the loan is repaid.
- 4. The S&P U.S. Investment Grade Corporate Bond Index**, a subindex of the S&P 500 Bond Index, seeks to measure the performance of U.S. corporate debt issued by constituents in the S&P 500 with an investment-grade rating. The S&P 500 Bond Index is designed to be a corporate-bond counterpart to the S&P 500, which is widely regarded as the best single gauge of large-cap U.S. equities.
- 5. The S&P Leveraged Commentary & Data ("S&P LCD") Middle Market Index** reflects data and analysis on U.S. loans for issuers typically generating \$50 million of EBITDA or less collected by S&P Global Market Intelligence.
- 6. The Cliffwater Direct Lending Index (CDLI)** seeks to measure the unlevered, gross of fee performance of U.S. middle market corporate loans, as represented by the asset-weighted performance of the underlying assets of Business Development Companies (BDCs), including both exchange-traded and unlisted BDCs, subject to certain eligibility requirements.

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