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Loans: Your questions, our answers

Loans – Delivering across cycles

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Q&A with Portfolio Manager Movin Mokbel

Movin Mokbel, Fixed Income Portfolio Manager and expert on leveraged loans, offers his thoughts on the current loan market. With 21 years of experience in fixed income markets and deal structuring, Movin is the Lead Portfolio Manager for Mackenzie Floating Rate Income Fund and ETF. Here he discusses how he is positioning the portfolio in the late stages of the COVID-19 pandemic.

The Mackenzie Fixed Income Team has been investing in the floating rate loan space since 2012 and, as a testament to the liquidity of this segment, we launched Mackenzie Floating Rate Income ETF (MFT) in April 2016.

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Q | As an asset class, how have loans behaved during the COVID induced market correction in March 2020 and since then?

The pandemic came as a global shock. It triggered an increase in volatility as investors sold risk assets in favour of government-backed safe havens. In March 2020, the loans index* returned -12.5%, with spreads widening to more than 1,000 basis points on market outflows during that period. But relatively speaking, that was lower than 1,600 bps witnessed in the 2008 Great Financial Crisis (GFC).

Roughly US$19 billion left the asset class in 2020, in addition to the US$28 billion in outflows in 2019.** Our fund was no exception to this sentiment, but we had adequate liquidity to meet the rush of redemptions.

In the second quarter, however, the high-yield market gained traction, in part because investors recognized there were many "fallen angels" in the space which had been oversold, and also due to the Federal Reserve extending its bond buying program to include high yield bonds. As a result, the high yield benchmark now has a 54% exposure to BB-rated bonds* and that's facing a new headwind: the potential for rising rates. Of course, loans are not affected by this concern due to their floating-rate nature.

As markets normalized, the loan asset class* displayed their benefits of diversification and low correlation and have posted a 12-month return of 20.7%, as of March 2021.

In terms of issuance, we saw a record of US$181 billion in Q1 2021, with refinancing contributing US$80 billion of that total – and this involved a surge of loan repayments.

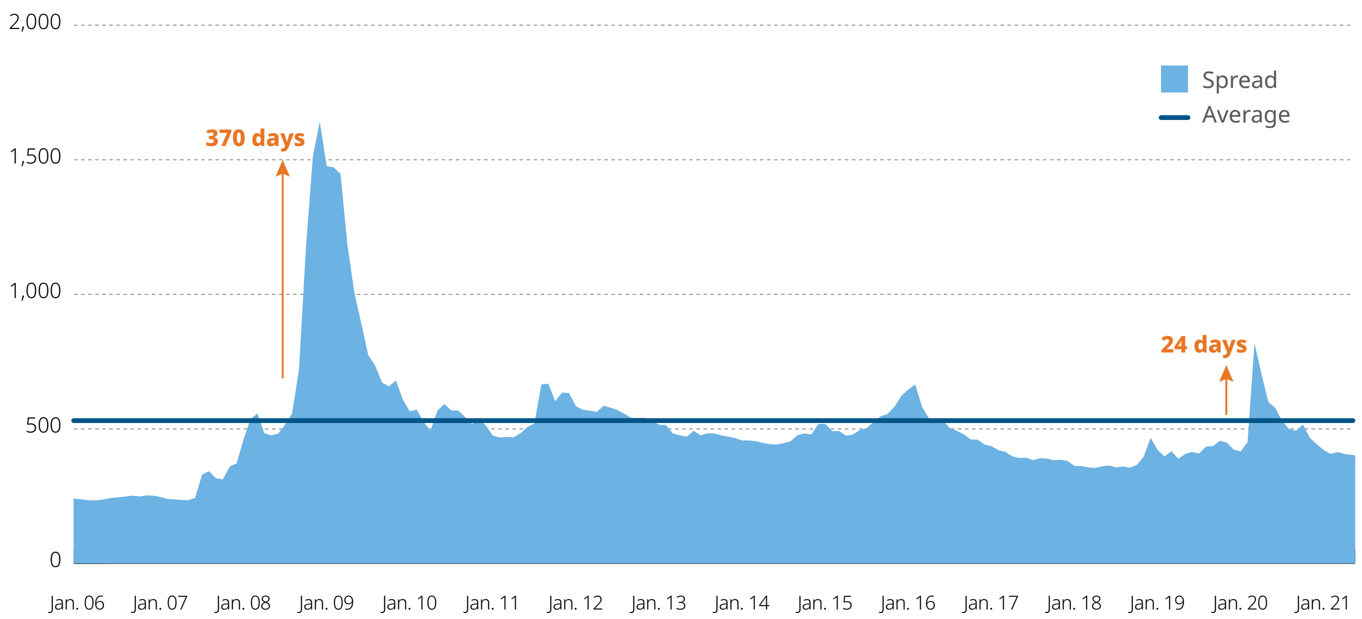
As a result, the loan market grew to a record US$1.2 trillion in assets the end of March 2021, compared to US$1.5 trillion for the high-yield market.*

Q | How was the 2020 experience different from that of the Great Financial Crisis?

We saw much more volatility in 2020 than in 2008-09 crisis, but that included some positive volatility. In the Financial Crisis we saw spreads above 600 bps for sixteen months. In 2020, spreads were that high for just three months.

Twelve years ago, the loans market was only about US$500 billion, compared to the US$1.2 trillion it hit in March 2021.

Chart 1 – Average secondary spread to maturity



Source: LCD, an offering of S&P Global Market Intelligence, S&P/LSTA Leveraged Loan Index

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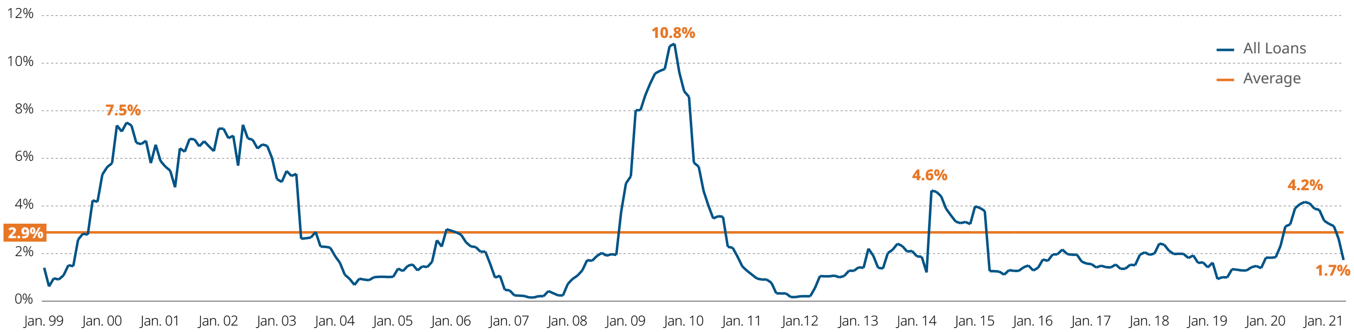
Chart 2 – Default Rates – below historical average and down 244 bps from the Sep. '20 cycle peak



Source: LCD, an offering of S&P Global Market Intelligence, S&P/LSTA Leveraged Loan Index

As seen in chart 2, default rates were much higher in the 12 months from March 2009 to February 2010, averaging 9% per month. This time around it peaked at 4.2% in September 2020, largely due to the more favourable monetary and fiscal policies used to address the pandemic.

We avoided most of the bankruptcies in 2018 and did so again in 2020. We did have about 5-6% exposure to the energy and travel sectors in Q1 2020 – the two most COVID-vulnerable sectors – and that is now about 4-5%.

Q | How would you describe your management style and key differentiations?

In our investment philosophy, fundamental credit analysis underpins every investment followed by analysis of covenants and deal structure. Our strategy steers us clear of distressed credits which can often be bought at a discount. We focus on quality credits, and it shows in the weighted average price: $98.24 (per $100 face value) in the fund and $98.83 in the ETF, versus $97.55 as the market average as of March 2021.

Our management style is very active. We participate in primary market issuance as much as possible to try to capture the original issue discount and we are selectively opportunistic on secondary markets.

We have always tended to focus on new issues that are under-the-radar and off-benchmark, that we believe have attractive valuations and tight structures. These make up more than 70% of the portfolio. We prefer senior secured first lien loans, while we underweight second lien loans and don't buy as many B-rated loans.

The loans we invest in come with some level of price discovery, are generally smaller in size, have less leverage, higher asset coverage and are usually better structured than the benchmark deals. They also pay a higher coupon and we generally hold them to maturity.

Many of these borrowers are actually seasoned issuers. Some are "storied" credits where the market requires favourable concessions on structures and higher coupons. We have found these storied deals tend to do well in the secondary market and over the cycle.

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Q | How is the mandate positioned as of June 2021?

The mandate is a near pure play in loans, with a small amount – currently about 6% – in high yield bonds. We hold these bonds for their higher potential for price appreciation compared to loans. Traditionally Mackenzie has settled loans faster than the industry with almost 75% of loans executed in less than 10 days, compared to industry turnover of 50%.

I would say the portfolio is defensive at the moment. From March 2020 to December 2020, our exposure to CCC rated loans was higher, averaging more than 10% compared to the benchmark weight of 7.7%. We are now around 4% and are also underweight second lien loans. At the same time, the portfolio's yield to maturity is around 60 bps higher than the index, compared to 120 bps in December 2020.

The fund is 90% exposed to the US, which is not surprising given the size of the market, and we have 7% exposure to Canada and 3% to Europe. Foreign currency exposure is predominantly hedged back to CAD. At a granular level, the portfolio provides exposure across 30 sectors, spread across 200 borrowers. The average position is not more than 1.7% per borrower.

Q | How do you manage default scenarios?

Our preference for first lien loans, at the top of the capital structure, helps us stay nimble and avoid concentration risks.

Every situation is different, we watch for early signs by having constant communication with the analysts and reviewing the company releases and news flow. We reflect on what the loan is trading at compared to our recovery estimates to arrive at an informed credit decision. If we are convinced of a recovery higher than the market price, then we hold. Otherwise we try to sell before they default if we can find a buyer. If not, we try to capture most of the recovery.

In certain cases when a company defaults, we see debtor-in-position financing, where the lender becomes the owner, and this allows the business to continue operating.

Q | What's your view on covenant-lite loans and where do you stand today?

Covenant-lite loans have less restrictive covenants, rather than the traditional maintenance covenants. But this doesn't mean that a borrower's underlying credit is weak, nor do strong covenants make a weak credit better.

We believe that the loss of maintenance covenants is moot if the underlying credit is healthy, and the business model supports the issuer's ability to manage debt.

Covenant-lite loans have grown to almost 85% of the index compared to 20% just 10 years ago.* This reflects an increased presence in the space by seasoned high-quality issuers with higher market acceptance. Covenant-lite loans make up nearly 80% of both our fund and ETF as of Mar'21, which is in line with our focus on non-benchmark deals.

Q | Do Loans need rising rates to perform?

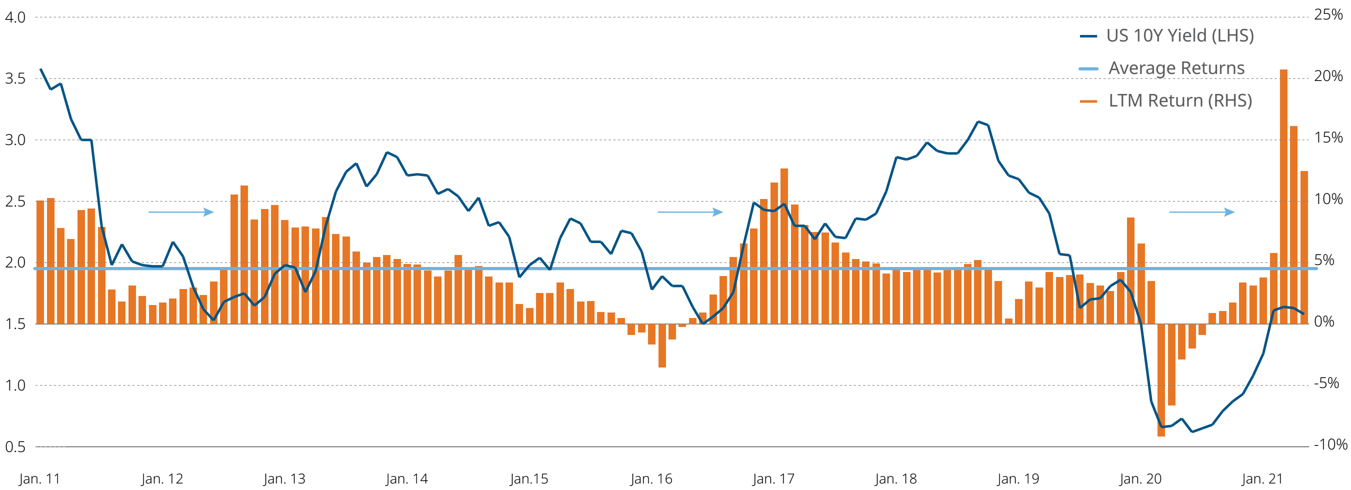
Contrary to what may be popular belief, loans do not need a rising rates environment to perform well. The asset class has historically delivered across rate cycles (please refer to Chart 3). For a core-plus fixed income sleeve, there is a strong case for a strategic allocation to loans as part of the "plus" component, which consists of higher yielding fixed income assets.

Bear in mind that these are secured loans at the top of the capital structure, so they offer more protection than unsecured bonds, convertible bonds, preferred shares and equity.

The risk of default or bankruptcy reinforces how vital active management is in this space. It allows us to create value by avoiding risky names, manage lower defaults and potentially provide a favourable risk-adjusted reward.

The Mackenzie loans team is a seasoned participant in the loan space and have demonstrated our capability consistently since 2012.

Chart 3 – Periods of falling Treasury yields, followed by above average returns



Source: LCD, an offering of S&P Global Market Intelligence, S&P/LSTA Leveraged Loan Index and Bloomberg for US 10Y Treasury Yields

Q | What are your views on the transition from the London Interbank rate (LIBOR) to secured overnight financing rate (SOFR)?

In our view the transition is much like the “Y2K” event: by the time it happens it will be a non-event, because all stakeholders are well aware of the proposed change. The Intercontinental Exchange (ICE) will continue publishing LIBOR through June 30, 2023, by which time a considerable number of US-dollar loans tied to LIBOR will have matured.

However, the extension does not alter the regulatory perspective on new loan issuances: that market participants should already be using language that provides for an automatic switch from LIBOR to a replacement in new loan agreements and that June 30, 2023 should be the target for the cessation of new loans based on LIBOR.

Q | What is your outlook for floating rate loans in the second half of 2021?

We continue to generally be constructive on credit and floating rate loans in the second half of 2021. With economies opening and vaccinations rolling out in full force globally, we expect H2 2021 to provide above average returns in the loan market. With loans’ total return at +3.1% in 2020 which is a below-carry year, and at +3.3% in H1 2021, we expect a little more recovery in loan prices throughout the second half of 2021 and for total returns to be above carry in 2021 overall.

There’s also the risk of significant spread repricing with rally in price above par, which could have a potential impact to the return expectations, similar to what we saw in the first quarter, when almost 20% of loans were repriced/repaid.

Credit selection will only become more important through the rest of 2021, as investors shift from buying market beta to an increased focus on corporate earnings and fundamentals, considering the record low spreads and certain cyclical sectors.

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We firmly believe that ESG leaders will outperform laggards over the long term and that ESG factors play an important role in portfolio construction. We now have a growing list of loans that have ESG key performance indicators that are linked to the loan pricing. Many of these have originated in Europe and are slowly coming to the US market.

Technicals and fundamentals are supportive of the continued rally in loans. We note, among other things:

The average price of loans is still below par, at 98.4, with 4.2% YTM and 400 spread over LIBOR (as of June 30, 2021). These are still attractive given the current low rate environment

New CLO formation for 2021 is running at a record pace with $82 bn priced YTD (to June 30th) and a revised forecast of $130 bn.

Increased allocations from institutional investors, hedge funds, high yield managers and SMAs.

Retail outflows were a drag on performance in 2020, however flows have consistently been positive throughout 2021. $20 bn has now come back into loans in H1 2021. Even if we see some weekly outflows from loans in 2021, they may not be as large or consistent as we witnessed in 2020 (and 2019).

Credit fundamentals have been improving and will get even better as we compare year over year going forward.

LTM default rates in loans have been trending down as credit fundamentals improve amid an economic recovery and now stand at a low 1.3% (as of June 30, 2021).

Additionally, and importantly, the ONE big risk that has been taking hold in 2021 is rising rates. While rising Treasury yields will not derail the economic recovery, they would have an impact on bond returns and hence we favour allocating to floating rate loans at this juncture of the markets.

Contact your Mackenzie Sales Representative to learn more about Mackenzie Floating Rate Income Fund / MFT ETF.

As of June 30, 2021	3M	YTD	1Y	3Y	5Y	SI	Inception Date
Mackenzie Floating Rate Income Fund - F	1.30%	3.20%	10.70%	2.10%	4.80%	4.20%	9-May-13
Mackenzie Floating Rate Income ETF	1.50%	3.30%	10.20%	2.40%	4.90%	4.90%	19-Apr-16
S&P/LSTA Leveraged Loan Index (Hedged to CAD)	1.50%	3.20%	11.40%	3.50%	4.20%	4.80%	

* LCD, an offering of S&P Global Market Intelligence, S&P/LSTA Leveraged Loan Index
** Lipper; JP Morgan

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