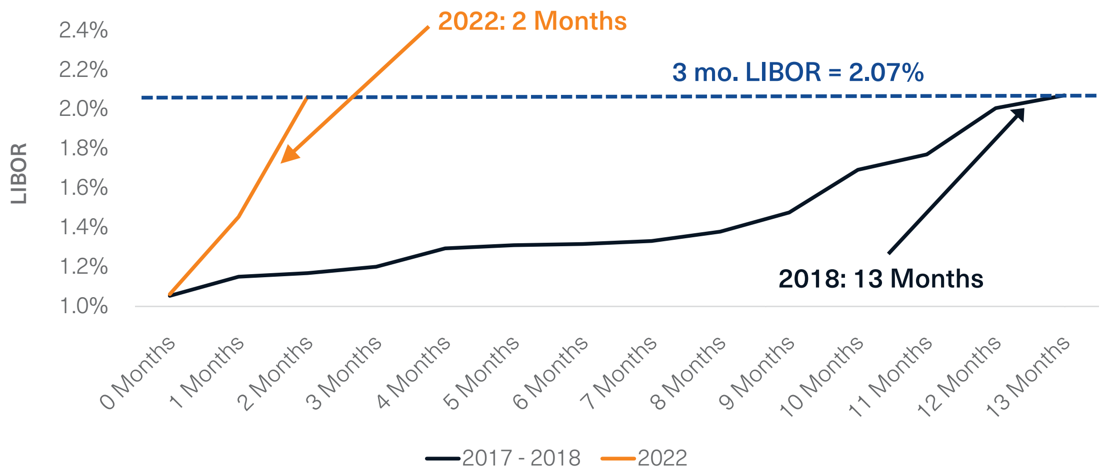
Senior Loans: Rising Rates, Rising Coupons

Fund in focus: Symphony Floating Rate Senior Loan Fund (SSF.UN)

On June 16, 2022, the U.S. Federal Reserve announced a 75-bps interest rate hike – the largest rate hike since 1994, bringing the Federal Funds target rate to 1.5-1.75%. Meeting participants (Federal Reserve Board members & Federal Reserve bank presidents) projected a median Fed Funds rate of 3.4% by year-end 2022, suggesting that interest rate hikes are likely to continue through the balance of 2022 and beyond in an attempt to control rising inflation.

The rapid increase in the Fed Funds rate is driving short-term interest rates higher. Of particular interest, LIBOR (a common reference rate for floating-rate Senior Loan coupons) has risen more rapidly than in past interest rate cycles. On June 16, 3-month LIBOR reached 2.07%, after increasing 100 bps (1%) in only 2 months. In the previous interest rate cycle, it took 13 months for 3-month LIBOR to increase by 100 bps to reach the same 2.07% level – see Chart 1 below. In addition to the rapid increase in 3-month LIBOR, the LIBOR curve in 2022 is steeper than it was in 2018, implying that the market expects continued upward pressure on LIBOR rates.

Chart 1: Time taken to increase the last 100 bps to reach 3-month LIBOR = 2.07% , 2022 vs 2018



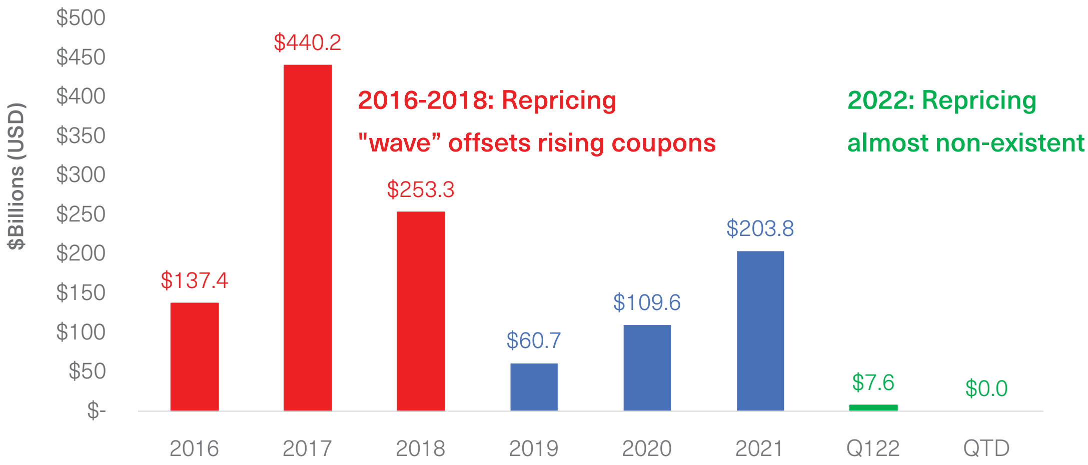
Source: Refinitiv DataStream, Brompton Funds, as of June 17, 2022

For most fixed income categories, rising interest rates have been a negative factor in 2022 and have resulted in a drop in market price for bonds. Senior Loans are different than fixed-rate bonds in this respect: the floating rate coupon payments made by the borrower generally reset monthly or quarterly, with reference to short-term market interest rates such as 3-month LIBOR. When short term interest rates rise, this usually indicates potential coupon payment increases, enhancing portfolio income. This appears to be the case in 2022, and we expect floating-rate Senior Loan coupon payments to increase in the coming months.

In 2018, rising LIBOR didn't result in rising loan coupon payments to the degree anticipated by investors. This was due to market conditions that favored the borrower on a couple of fronts. One factor that prevented Senior Loan coupons from floating higher in 2018 was re-pricing risk. When a loan trades in the market at a premium to par value, issuers have the ability to call the loan at par, and re-issue with a lower coupon rate. Repricing at a lower coupon rates effectively prevents the loan's coupons from floating higher. In 2018, when 3-month LIBOR was at the same level it is today, 70% of the Senior Loan market was trading at a premium to par; the situation was similar in the preceding two years. This led to a wave of repricing, in total approximately US$830B of premium-trading Senior Loans were called at par and repriced with lower coupon rates in the 2016-2018 time frame. Repricing in 2016-2018 put downward pressure on Senior Loan coupons at the same time as rates were rising, giving investors a disappointing experience when loan coupons didn't float higher as freely as expected.

2022 is a completely different story. Currently, almost 100% of the Senior Loan market is trading below par, making it uneconomic for issuers to call loans at par (a higher price than the current market price), which effectively eliminates re-pricing risk for Senior Loans. This is borne out by very low repricing activity in 2022 YTD. This fact should give Senior Loan investors confidence that there is strong potential for higher income in the near term due to rapidly rising LIBOR and other short-term rates.

Chart 2: Loan Repricing Volumes ($US Billions)

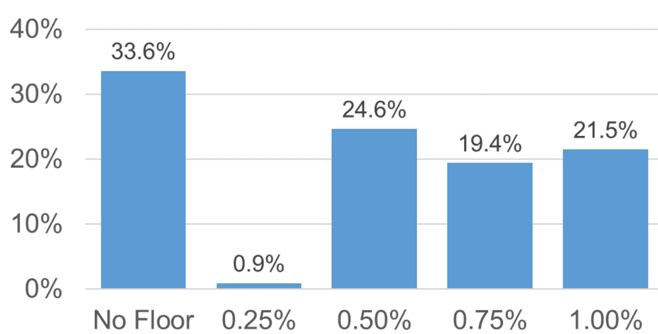


Source: J.P. Morgan, June 1, 2022

Another factor for Senior Loans can be LIBOR floors, which were designed to be a minimum-base-rate protection mechanism for investors. Floors set a minimum LIBOR rate for coupon payment calculations, guaranteeing a sufficient minimum coupon rate when reference LIBOR rates are low or declining. Conversely, when LIBOR rates are rising but below the floor value, the LIBOR floor feature will prevent coupon payments from adjusting upwards.

Due to the significant interest rate hikes in the past few months, LIBOR is now well above floors for most Senior Loans. SSF.UN's LIBOR floor profile is shown in the graph below as an example. With 3-month LIBOR above 2%, higher than the highest LIBOR floor in SSF.UN's portfolio, the coupon rate in our Symphony Floating Rate Senior Loan Fund can adjust higher with rising short term interest rates without being hindered by LIBOR floors. Again, this indicates strong potential for rising income for Senior Loan investors.

Chart 3: LIBOR Floors, %SSF Portfolio



Source: Refinitiv DataStream, Nuveen Leveraged Finance, Brompton Funds, as of June 6, 2022

Senior Loan coupons are already responding to rising short-term interest rates, and Senior Loans are trading at a level that provides very attractive all-in returns, with strong potential for rising income. SSF.UN provides an attractive 6.8% distribution yield based on June 24, 2022 closing market price, with potential for the portfolio to earn increased income in coming quarters, if interest rates continue in their current direction.

Fund in Focus:

Symphony Floating Rate Senior Loan Fund (SSF.UN) invests in an actively managed, diversified portfolio consisting primarily of short-duration floating rate senior corporate instruments, including Senior Loans and other senior debt obligations of North American non-investment grade corporate borrowers. Nuveen Asset Management LLC, sub-advisor to the fund, has a team of 50+ dedicated investment professionals with more than 20 years of experience in managing senior loan portfolios for both private and institutional clients.

Annual Performance as at May 31, 2022	1-YR	3-YR	5-YR	10-YR
Symphony Floating Rate Senior Loan Fund – Class A[1]	1.9%	2.2%	2.5%	4.5%
Morningstar Category Average: Canada Fund Floating Rate Loans[2]	(1.0%)	0.4%	1.3%	3.2%

[1] The table above shows the Fund's compound returns for each period indicated. Returns are for the period ended May 31, 2022 and are unaudited. Past performance does not necessarily indicate how the Fund will perform in the future. The information shown is based on Net Asset Value per unit and assumes that distributions made by the Fund on its units in the periods shown were reinvested (at Net Asset Value unit) in additional units of the Fund.

[2] Source: Morningstar, as at May 31, 2022. Funds in the Floating Rate Loan category must have a stated mandate to invest in floating rate loans such that at least 25% of the portfolio is invested in non-investment grade floating rate loans. The average credit quality of the portfolio must be below investment grade (lower than BBB or equivalent). As of May 31, 2022, the Canada Fund Floating Rate Loan Category included 134 investments. © 2022 Morningstar. All Rights Reserved. The information contained herein: (i) is proprietary to Morningstar and/or its content providers; (ii) may not be copied or distributed; and (iii) is not warranted to be accurate, complete or timely. Neither Morningstar nor its content providers are responsible for any damages or losses arising from any use of this information. Past performance is no guarantee of future results.

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INTEGRITY
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Investor Relations
PHONE 416.642.6000
TOLL FREE 1.866.642.6001
FAX 416.642.6001
EMAIL info@bromptongroup.com

Website
www.bromptongroup.com

Address
Bay Wellington Tower,
Brookfield Place
181 Bay Street
Suite 2930, Box 793
Toronto, Ontario M5J 2T3