BUYER BEWARE: BANK LOANS ARE NOT WHAT THEY SEEM

Are high-yield bank loans the fix for rising rates? Wall Street sure thinks so, and plenty of bond investors seem to agree. But a closer look reveals that these floating-rate instruments aren't the cure-all they're often made out to be.

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In 2017, investors poured $11.5 billion into US mutual funds and exchange-traded funds (ETFs) that invest in high-yield bank loans, with the hope that the adjustable coupons will provide protection by rising along with rates. A rise in US Treasury yields this year has boosted demand for these instruments, which many investment managers promote as a reliable way to generate high income while reducing interest-rate exposure.

Bank loans have delivered attractive returns so far this year, and there are times when it may make sense to include them in a diversified fixed-income portfolio. But we don't think now is one of those times. The way we see it, many investors have rushed into loans without understanding the risks.

When it comes to rising interest rates, floating-rate bank loans have overpromised and underdelivered. As a long-term income generator, they've been a poor substitute for other types of credit exposure. Perhaps most importantly, the loans being extended to companies today are riskier than ever.

To make better portfolio decisions, it's critical that investors get to know the whole story.

THE BANK LOAN MARKET: NOT WHAT IT SEEMS

Let's start with a rundown of what makes high-yield bank loans similar to high-yield bonds—and what makes them different. As it turns out, those differences matter.

High-yield bank loans are variable-rate loans to companies with low credit quality. They're commonly referred to as leveraged loans because they involve high leverage multiples and are often used to fund leveraged buyouts or refinance debt. Mutual funds, hedge funds and other investors that buy these loans in the primary or secondary markets are compensated for the added credit risk with higher yields.

In this way, loans are like high-yield bonds, which also offer higher income potential in exchange for the risk of lending to firms with low credit ratings. And like high-yield bonds, bank loans have had a low correlation to traditional fixed-income assets over the years, particularly to the investment-grade government and corporate bonds that dominate most core bond portfolios.

But loans have two key features that high-yield bonds typically don't have.

Floating Rates: Loan coupons adjust periodically based on changes in short-term interest rates. So when the Federal Reserve is raising rates, the income that loans produce should go up as well. This helps to make their duration, or sensitivity to interest-rate changes, lower than that of high-yield and investment-grade bonds.

Seniority in Capital Structure: Bank loans are secured by the borrower's collateral, which gives them seniority over unsecured bonds in a company's capital structure. If a company defaults, bank loan recovery rates should be higher than those on high-yield bonds, giving investors an extra layer of credit protection.

Together, these two features appear to shield bank loans from both interest-rate risk and credit risk. But the reality is quite different.

FLOATING RATES: READ THE FINE PRINT

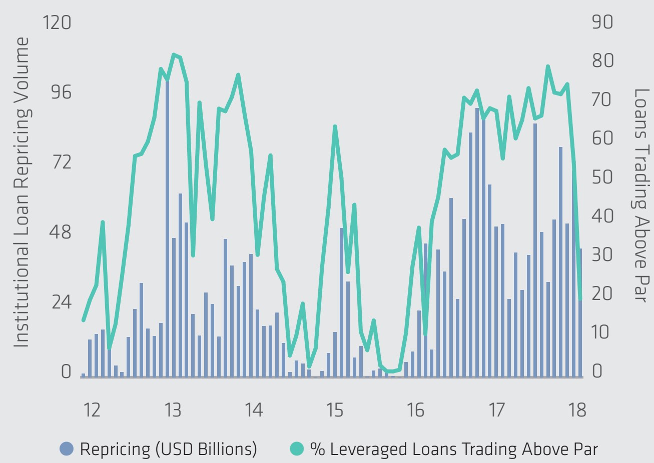
In name, high-yield bank loans are floating-rate instruments. Their coupons adjust based on changes in LIBOR or other widely accepted reference rates, plus a spread over the reference rate—determined in advance—to compensate for credit risk.

But bank loans don't always behave like floating-rate instruments should.

The reason is that bank loans are callable—and lately they've been called in massive numbers: 73% of outstanding bank loans were refinanced or repriced in 2017. Ironically, this is the result of high investor demand: inflows drive credit spreads and yields down, allowing borrowers to refinance at lower rates. Some 67% of outstanding loans were trading above par at the end of 2017, making them ripe for refinancing. The percentage rose to more than 70% in early June 2018 before dropping as supply finally started to outstrip demand (*Display 1*).

DISPLAY 1: WHAT YOU DON'T KNOW ABOUT BANK LOANS CAN HURT YOU

Repricing Volume and Loans Above Par



Through June 30, 2018

Historical and current analyses do not guarantee future results.

Source: J.P. Morgan

All that refinancing has taken its toll. Through June, the trailing one-year dividend income from one of the largest bank loan ETFs declined by 7.5% despite seven Fed interest-rate hikes since 2015 and higher short- and long-term Treasury yields.

This translates to lower returns, too. The Credit Suisse Leveraged Loan Index delivered a 4.25% total return last year, well below the 7.50% return on the Bloomberg Barclays US High Yield Corporate Bond Index. In fact, bank loan returns have trailed those of high-yield bonds in nine of the last 10 years.

Bank loan performance has rebounded this year, outpacing high-yield bonds through June. This isn't much of a surprise, though. Bank loans tend to do best in the late stages of the credit cycle, when interest rates are rising and growth is still strong. But they tend to do poorly when the cycle turns, growth slows and defaults start to rise.

For example, the Fed raised rates 17 times between June 2004 and June 2006, and high-yield bonds outperformed bank loans during that period (17.9% versus 12.6%). But from March 2005 to June 2006—the late stages of the cycle when higher rates hadn't slowed growth yet—bank loans beat high-yield bonds by 3.5%. High-yield bonds then retook the lead, outpacing bank loans in 10 of the next 12 months as the economy slowed and the Fed stopped raising rates. Over the next five years, high-yield bonds beat bank loans by more than 32% on a cumulative basis.

Why did bank loans underperform high-yield bonds when the cycle turned? Both assets involve high levels of credit risk, but high-yield bonds also have duration that provides a cushion in down markets.

The Fed's latest round of tightening began in 2015, and we think we're getting closer to the turning point in the credit cycle. When it comes, we fear it's going to be a bigger problem for bank loans than it has been in the past.

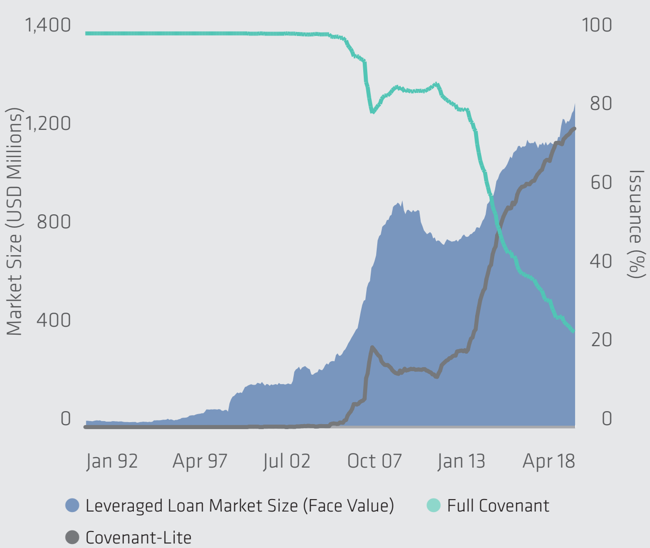
BAD BORROWING: WILL IT BITE BACK?

There's a big reason for that: the quality of today's bank loans has declined. This is partly because strong demand has been promoting lax lending and sketchy supply. If you bought a bank loan lately, chances are it doesn't have strong creditor protections. These protections, called covenants, have historically provided bank loans with better downside protection than bonds.

These days, companies know that high demand means they can borrow at favorable rates and refinance at will. Put another way: they can afford to be aggressive. It's no surprise that many firms decide they can offer less covenant protection and still borrow on good terms. Before the global financial crisis, less than 20% of the high-yield bank loan market was what's known as covenant-lite. Today? It's 75% and growing (*Display 2*).

DISPLAY 2: AS THE BANK LOAN MARKET HAS GROWN, SO HAVE THE RISKS

Credit Suisse Leveraged Loan Index: Market Size vs. Covenant Protection



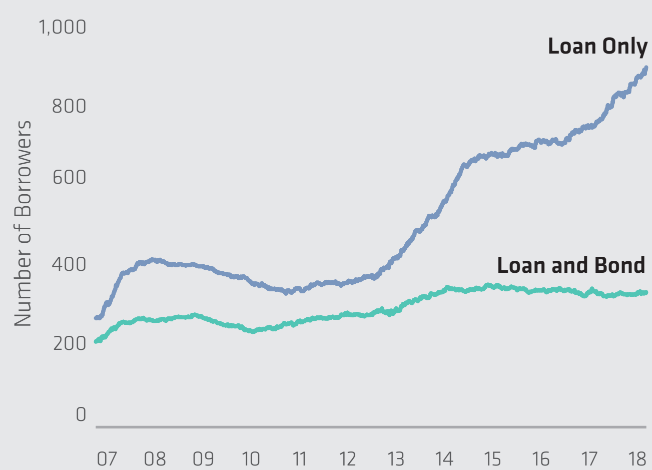
Through June 30, 2018
Historical and current analyses do not guarantee future results.
Source: Credit Suisse, S&P and AB

In the past, covenant-lite didn't always mean a loan was inferior from a credit investor's perspective. Investors often accepted covenant-lite arrangements from higher-quality borrowers that seemed less likely to default. But buyers would demand full covenant protection from the weakest borrowers. This is one reason why covenant-lite loans held up better than full-covenant loans during the financial crisis.

We wouldn't bet on covenant-lite loans to stage a repeat performance. Remember that covenant-lite loans account for a larger share of the overall bank loan market today. What's more, the credit quality of the companies issuing them has deteriorated—and so has their earnings quality. Seniority probably won't offer much protection, either. That's because more than half of loan issuers today don't have any unsecured debt to cushion their balance sheets (*Display 3*).

DISPLAY 3: GROWTH IN LOAN INDEX DRIVEN BY FIRST-TIME, LOWER-RATED ISSUERS

These Dynamics Provide Fuel for the Next Default Cycle

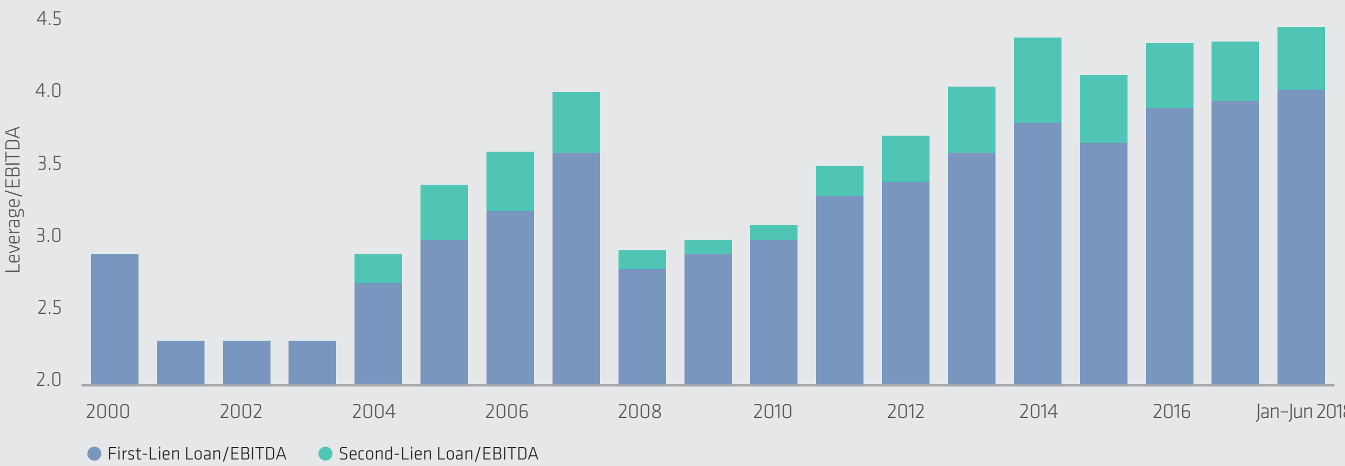


Through June 30, 2018
Historical and current analyses do not guarantee future results.
Source: J.P. Morgan, Morgan Stanley and S&P

For many companies, it's simply become cheaper and easier to tap the high-yield loan market than the high-yield bond market for financing. In January 2000, the face value of all outstanding US high-yield bonds was nearly four times that of outstanding bank loans. By June 2018, the two were almost equal.

DISPLAY 4: BANK LOANS PLAYING LARGER ROLE IN LEVERAGED BUYOUTS

Leveraged Buyouts



As of June 30, 2018

Historical and current analyses do not guarantee future results.

Source: Morgan Stanley, S&P and AB

What's more, bank loans have surpassed high-yield bonds as the most popular way to finance leveraged buyouts—the riskiest type of corporate takeover (*Display 4*).

This trend suggests that default risk is a lot higher than many investors realize. And when those defaults happen, we think recovery rates are likely to be a lot lower than they've been in the past.

CROWDED TRADE, ILLIQUID ASSET

Higher loan issuance and lower quality are also connected to changes in the way banks view and value the loans they make to companies. In the past, banks viewed the loans as investments that would stay on their balance sheets. But in the 1990s, they began selling many of these loans to institutional investors, including mutual funds, to maximize profits (*Display 5, page 5*).

As a result, the number of open-ended bank loan mutual funds and ETFs has more than tripled since 2008 (*Display 6, page 5*).

This explosion in bank loan vehicles creates another risk: most investors today own high-yield bank loans through mutual funds or ETFs, highly liquid instruments that investors can enter and exit at will. But the underlying bank loan market is less liquid than the high-yield bond market. Trades can take weeks to settle, and loans don't change hands often. This creates a liquidity mismatch—vehicles that promise "daily liquidity" but invest in assets that can't be bought or sold on a daily basis.

As long as prices rise, this isn't a problem. But when the tide turns, strategies like these are bound to run into trouble. In a downturn, loan liquidity would likely become even more scarce as investors rush to sell their fund shares at the same time. Mutual funds would be forced to sell at marked-down prices, and investors who want out would likely have to take big losses.

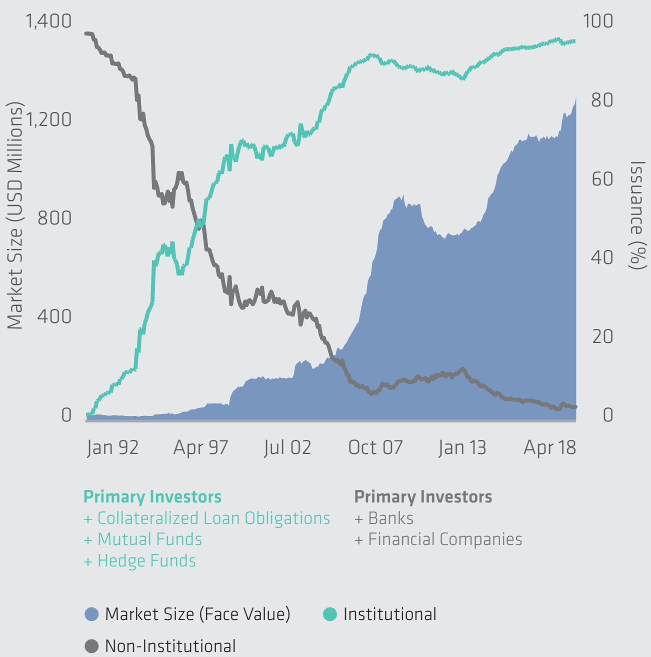
BANK LOANS' PRICES MATTER MORE THAN INTEREST RATES

Bank loans have failed to protect investors from rising rates while exposing them to credit and liquidity risk. Should fixed-income investors simply buy high-yield bonds instead? Not necessarily. Both segments are expensive today and have a thinner cushion against future losses.

As *Display 7, page 6* illustrates, bank loans' price discount to par is similar to high-yield bonds' average option-adjusted spread (OAS).

DISPLAY 5: BANKS BARELY INVEST IN TODAY'S LOAN MARKET

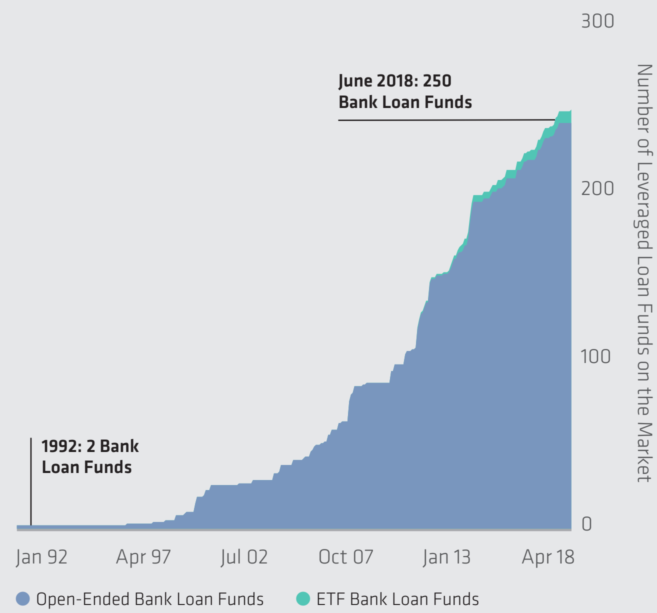
Credit Suisse Leveraged Loan Index: Market Size vs. Facility Type



Through June 30, 2018
Historical and current analyses do not guarantee future results.
Source: Credit Suisse, S&P and AB

DISPLAY 6: THE LOAN MARKET HAS EXPANDED DRAMATICALLY SINCE THE 1990s

Number of Bank Loan Funds in Morningstar Universe: Open-Ended Funds and ETFs



Through June 30, 2018
Historical and current analyses do not guarantee future results.
Source: Morningstar Direct and AB

Both measures reflect the market's assessment of credit risk and liquidity conditions.

The US today is in the late stages of one of the longest credit expansions on record. When the cycle turns, both bank loans and high-yield bonds are likely to underperform.

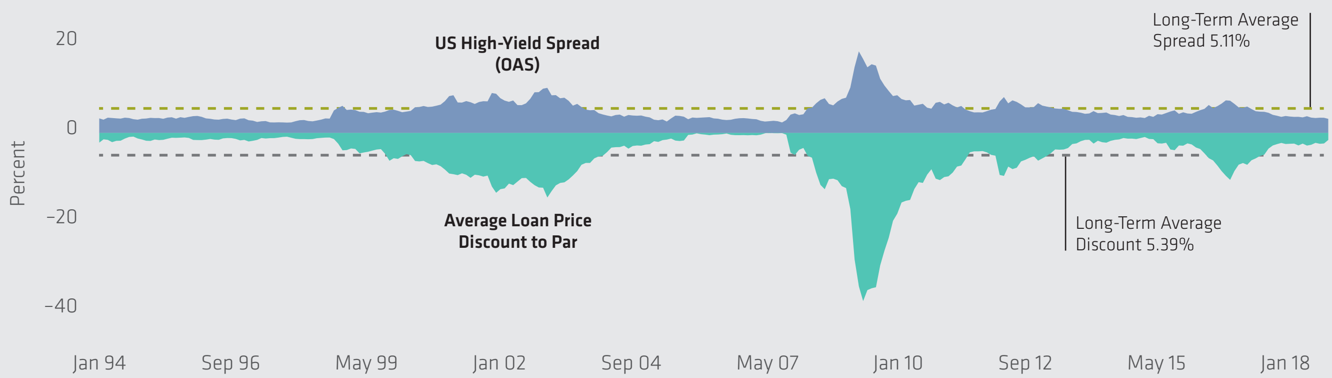
But we think bank loans' underperformance will be more severe. As we've seen, high demand has driven up the average bank loan price. And our research shows that average price has historically been a better predictor of performance than the level of interest rates.

We looked at the month-end average price of bank loans in the Credit Suisse Leveraged Loan Index between January 1992 and June 2018, then calculated the return over the next two years. When loans were trading at $98.50 or above at a given month-end, they delivered an average of 2.8% over the subsequent two years.

High-yield bonds fared a little better, generating a subsequent return of 3.7% during the same periods. But here's the part that may surprise some people: the five-year US Treasury beat both high-yield bonds and bank loans handily, with an average return of 6.2%. The reason? Credit valuations usually become stretched in the later stages of a credit cycle. When the cycle turns, prices correct, rates begin to fall and interest rate–sensitive assets such as Treasuries outperform.

DISPLAY 7: LOAN PRICES, HIGH-YIELD SPREADS REFLECT CREDIT CONDITIONS

US High-Yield Average Spread (OAS) vs. Average Loan Price Discount to Par: January 1994–June 2018



Through June 30, 2018

Past performance does not guarantee future results.

Based on the AB Income Fund—Advisor Shares (ACGYX)

Source: Bloomberg Barclays, Credit Suisse, Federal Reserve Bank of St. Louis, Morningstar Direct, S&P and AB

Do bank loans ever deserve a place in a well-diversified portfolio? Sure—but only at the right price and in the right conditions. These are usually when rates are already falling, growth has already slowed and the average bank loan price is well below par. In these environments, investors can rebalance their portfolios by selling outperforming US Treasuries and other rate-sensitive assets and by buying underperforming credit assets at a discount.

But even in these situations, we believe investors would be better off taking their credit risk in high-yield bonds, not in bank loans. To see why, let's look at bank loans' historical performance when prices decline. During months when the average price was $88 or lower, bank loans produced an average return of 12.1% over the next two years—more than double the five-year Treasury's return of 5.5%. But high-yield bonds did even better, returning 20.5%.

A MORE BALANCED APPROACH

We think investors are too focused on rising interest rates and not focused enough on credit risk. As rates continue to rise, investors should be gradually tilting their portfolios away from bank loans—and even high-yield bonds—and toward interest rate–sensitive assets such as US Treasuries and other high-quality government debt. Once higher rates have slowed the economy and provoked declines in credit assets, investors should start shifting back toward credit.

The way we see it, the best way to do this is to pair the two types of assets in a single "barbell" strategy, with high-yield bonds anchoring the credit side of the portfolio and intermediate-duration Treasuries anchoring the interest-rate side.

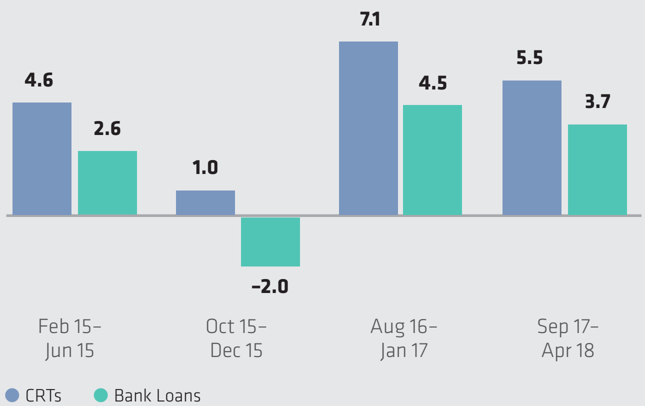
A HIGHER-INCOME ALTERNATIVE

Some investors may need more income than this barbell approach can offer. For them, we think a global, multi-sector high-income strategy can offer more sustainable returns over time than high-yield bank loans. This strategy can blend selective exposure to attractively valued high-yield bond sectors with positions in select emerging-market debt and securitized assets.

What about investors who do want floating-rate exposure? They could access it by investing in credit risk–sharing transactions (CRTs), a new type of mortgage-backed security issued by US federal housing agencies. Like bank loans, these securities' coupons increase as interest rates rise. But CRTs are a different animal: unlike bank loans, they're not continuously callable, and CRT returns have outpaced those of bank loans when rates have risen (*Display 8, page 7*).

DISPLAY 8: CRTs: A BETTER WAY TO GET FLOATING-RATE EXPOSURE

CRTs Beat Loans in Rising Rates:†
Returns in Rising-Rate Periods (Percent)‡



As of June 30, 2018

Historical analysis does not guarantee future results.

* Bank loans are represented by the Credit Suisse Leveraged Loan Index.

† Rising-rate periods are defined as time periods when the 10-Year US Treasury rate increased by 20 or more basis points.

‡ There is no CRT index. Therefore, CRT returns in this display are represented by the CRT holding in the AB Mortgage Income Portfolio.

Source: Bloomberg, Credit Suisse, Fannie Mae, Freddie Mac and AB

High-yield bonds, emerging-market debt and CRTs all occupy a riskier part of the global bond market and would be vulnerable to drawdowns during an economic downturn and market correction. But spreading exposure across multiple sectors and regions reduces the potential damage that a large drawdown or spike in default rates in any single sector can do.

SUMMING IT UP

It's not hard to see why some bond investors view high-yield bank loans as a cure-all in today's increasingly volatile and less predictable capital markets. But a closer look reveals that these assets simply don't live up to their promise.

Will there be times when bank loans deliver strong returns? Absolutely. But over the long run, we think they're likely to bring investors more risk than they bargained for while generating lower-than-expected returns. With credit assets looking expensive—and with the US credit cycle in its twilight stage—we think now is an especially ill-advised time to bet big on bank loans.

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