Nuveen's Holzenthaler: Surprise, It's 'A Buyer's Market' On Senior Loans

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed Larry Holzenthaler, investment strategist and analyst for Nuveen. Read the Q & A below as Larry says that "floating rate loans actually look arguably cheap to us today," acknowledging that it's surprising that the asset class is trading at a discount "in the middle of one of the most brutal rate-hike campaigns we have ever seen." Holzenthaler – who also covers the high-yield space – says that senior loans have been one of the few places where investors have avoided much of the pain in the fixed-income markets, making them feel like a safer haven and a relatively good value.

Larry Holzenthaler

The podcast can be found on AICA's website by clicking here: https://aicalliance.org/alliance-content/pod-cast/

CHUCK JAFFE: Larry Holzenthaler, investment strategist and analyst at Nuveen is here, and we're talking high yield, senior loans and more, now on The NAVigator. Welcome to The NAVigator, where we talk about all-weather active investing and plotting a course to financial success with the help of closed-end funds. The NAVigator is brought to you by the Active Investment Company Alliance, a unique industry organization that represents all facets of the closed-end fund industry from users and investors to fund sponsors and creators. If you're looking for excellence beyond indexing, The NAVigator's going to point you in the right direction. And today we're looking in the direction of Larry Holzenthaler, investment strategist and analyst at Nuveen, one of the leading providers of closed-end funds, which you can learn about at Nuveen.com. He works on their high yield, their corporate junk debt, also on their floating-rate high-yield funds, etcetera. If you want to learn more, it's Nuveen.com. And while you're learning, if you want to expand and get a little bit more knowledge about business-development companies, interval funds, and closed-end funds generally, check out AICAlliance.org too, that's the website for the Active Investment Company Alliance. Larry Holzenthaler, thanks for joining me again on The NAVigator.

LARRY HOLZENTHALER: Thanks for having me back, Chuck.

CHUCK JAFFE: Right now with the market being as crazy as it is, people want to be looking for high yield, improving their returns, doing anything that's going to be a safe haven. But in a rising-rate environment, I'm not sure that anything is a safe haven. So let's start by getting a look at where the high yield and senior loan markets are. I mean, where do the fundamentals stand right now? Is this a good time or is this a troubling time?

LARRY HOLZENTHALER: It's interesting in the sense that fundamentals, vis a vis high yield and loans, tend to be kind of one story. In the sense that loans are a form of corporate credit, high yield is also a form of corporate credit. In fact, a lot of the same issuers that issue high-yield bonds also issue loans as well. So they're very similar asset classes, they're both basically forms of below investment-grade rated corporate debt. But on the other hand they have a very big difference as well, which is there's a coupon structure of loans is floating rate, so it typically consists of a LIBOR or a SOFR, kind of a base rate component plus a spread. And that gives the loan asset class de minimis amounts of interest rate sensitivity or duration. High yield on the other hand, even though it is a credit-sensitive asset, I would say the number one risk you have if you buy junk bonds is if for whatever reason the companies that issue them are not able to service their debt. But the other risk they have is that they're fixed rate, so that does give them a bit of a treasury component. And this year, just like you've seen in traditional fixed income, it's been basically the worst year ever, high yield is feeling that pain. So if you look at year-to-date returns for high yield, most high-yield funds and indices are down double digits. Contrast that with loans, loans are down, it's a moving target but less than 5%. So loans have dramatically improved and that's been nearly entirely a function of duration. If you look at spreads, spreads have only begun to widen in high yields really since the beginning of April. Before that, really all throughout Q1, all of the mark-to-market volatility you saw in high yields was rate driven. And so that's an important distinction for investors, you have on the one hand two very similar asset classes from a fundamental perspective. If things are good in loan land from a credit perspective, they should be good in high yield as well and vice versa. But the duration can give them markedly different experiences during a period of rising rates.

CHUCK JAFFE: The experience this year has been tough for all bond investors. I mean, there are folks talking about how bad this year's going to be for bonds generally, the start of the year, terrible. However, on a relative basis, senior loans were kind of a sweet spot. They've been a volatile spot, especially of late, but they've been okay. So how is the outlook there?

LARRY HOLZENTHALER: Even though loans have outperformed just about everything year to date, actually as a firm we continue to like them on a relative value basis. As an example, if you look at the spreads attached to loans versus the spreads attached to high yields, so just kind of throwing out the duration piece and just looking at the risk premium attached to loans. Loans actually arguably today, even if I don't assume the forward curve, the yield on loans and a yield to maturity type concept. Not only the coupon but the accretion of these discounts of loans back to par, that number looks attractive in our mind versus high yield. And we run high yield and loans off of an integrated desk, so we don't necessarily have a preference, we just kind of call it like we see it. And as a firm, our team, we continue to think that senior loans, despite the fact that they've outperformed, if you were to put money to work today, we actually on the margin see more value in loans currently. Now obviously there are situations in high yields and thematically things that we are looking at in high yield, but if you had to own an index today, our belief is the risk-return of loans looks a bit better than the risk-return of high yields. Even if I throw rates out. And so if you assume a little bit of rate volatility going forward, the idea that you can somewhat insulate yourself from at least the duration piece within loans. As people are looking for safe havens, again loans are not impervious to a bit of volatility, but certainly versus other asset classes they've tended to behave a little bit more resiliently.

CHUCK JAFFE: In terms of what we're seeing broadly with the market, yep, things were beaten up at the beginning of the year, now we've got a rising-rate environment. How worried are you that along with some of these opportunities we're also going to see more defaults. I mean, we call it high yield, but if we wanted to put the other term on it, it's junk.

Junk hasn't been junky. But when the credit environment and the rate environment change, will it get more junky?

LARRY HOLZENTHALER: If you look at current estimates, so taking into account everything that we know, again, they tend to be one in the same. They're slightly different but default rates for both loans and high yields through the end of next year, most firms expect default rates even through 2023 to be below average, which averages are around 3% for both asset classes. And so you're looking at sub 3% default rates through the end of next year. And those are pretty fresh numbers, they include the latest information that the major firms have. It's interesting, incrementally higher rates, margin pressure, if you look at the loan issuer base as an example, let's take loans. Obviously loans have floating rate coupons, so the cost of funding, the cost of liabilities for these companies is moving higher. And obviously you have inflation, you have higher input costs, you have margin pressure. So at the margin, yes, things do not look as positive as they might have four, six weeks ago, or even a couple of months ago. But if you look at prices, they in many cases reflect that. And one of the things I've been highlighting for clients is, as an example, the loan issuers who are most at risk, so B-, B3 rated, CCC rated. So the lower quality, more levered issuers out there obviously have more risk of deteriorating backdrop, higher funding costs, all those things. So if you just look at the better quality companies, one of the statistics I've been citing with clients is let's just look at BB rated loans. So you're still junk but you're kind of the higher quality loans in the market. And let's not look at just BB loans, but let's look at BB loans that are billion dollar facilities or more. So these are going to be public companies, in many cases with New York Stock Exchange listed equity, these are large, multi-billion dollar companies. They're companies that have a lot of access to capital, have a lot of leverage they can pull if they get into trouble. And if you just isolate that bucket, billion dollar BB loans, the yield on that cohort of names today, and again it's a moving target, but it's somewhere between 7 and 8%. So you ask yourself, "Okay, what can go wrong?" Yet the default risk potential you have within that cohort of names is even lower than the overall market. So if the market default rate is two, and that's concentrated in weaker issuers, the BB segment should be a fairly clean number of issuers. So if you have a good manager to go in there and cherry pick some names, one would think that the IRR attached to loans today offers some value. You always default risk with loans, but a lot of that is already priced in. And so we actually think, somewhat ironically given all of the focus on the Fed, that floating-rate loans actually look arguably cheap to us today. Which is quite unusual. It's unusual that this asset class would be trading at what you could argue is a discount or a dislocated asset class in the middle of one of the most brutal rate hike campaigns we've ever seen. One would have expected loans to be trading at par, and it be kind of a seller's market. And in fact, it's arguably almost a buyer's market today, even though the asset class has a lot of things that people arguably want to buy.

CHUCK JAFFE: And what that also means is that you're going to have to sort of accept the warts, but you think that ultimately it rides it out. This is one of those asset classes where it might feel a little bit ugly but it plays out the right way in these kinds of conditions. That's the wager that somebody's making here, right?

LARRY HOLZENTHALER: That's exactly it. And credit selection matters. Credit selection matters in a good market, credit selection matters in a bad market. So we think the market is interesting today, and so if you have a firm with a deep team of analysts who can go in and cherry pick the names, you really do have a bit of a baby with the bathwater situation. You have a risk-off mentality, people want liquidity, so you're going to find situations where the prices and yields attached to some of these individual assets, to a smart analyst it's going to be very obvious that these prices and yields don't make sense versus the risk you're taking. So for clients, this is one of the windows that we see open from time to time that if you're good and active and you can make some swap trades, you can put together a pretty interesting mix of assets in this market.

CHUCK JAFFE: Larry, really interesting stuff, thanks so much for joining me to talk about it.

LARRY HOLZENTHALER: Thanks for having me again, Chuck.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. And yes, that's me, you can check out my hour-long weekday podcast on your favorite podcast app or by going to MoneyLifeShow.com. To learn more about closed-end funds, interval funds, and business-development companies go to AICAlliance.org, the website for the Active Investment Company Alliance. They're on Facebook and LinkedIn @AICAlliance. Thanks to my guest Larry Holzenthaler, investment strategist and analyst at Nuveen, which you can learn about at Nuveen.com. The NAVigator podcast is new every Friday, ensure you don't miss anything by following along on your favorite podcast app. And if you like us, please leave a review because they really do help.

Until we're together to do this again, happy investing everybody.

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