The Case for Non-Traditional Fixed Income in Every Rate Environment

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INTRODUCTION

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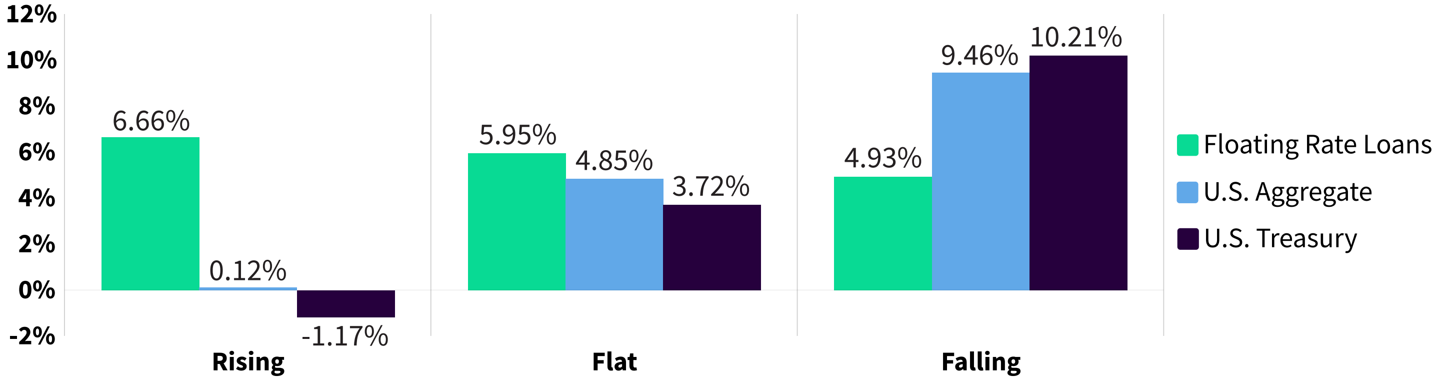
Mr. Sokolowski has 29 years of credit, portfolio management and trading experience. He is the lead portfolio manager for CIFC's corporate credit funds and a member of the firm's Investment Committee.

In this case study we will take a close look at the large, liquid and mature $1.2 trillion U.S. senior secured corporate loan market. In this study, we present our case for loans in every rate environment. A decade of headlines have been written offering unknowledgeable opinions, selective facts and ultimately, an incomplete picture of the loan asset class. This is at a time when investors are rightfully seeking more information and solutions on how to navigate an unprecedented landscape of historically low interest rates and yields. The mismatch between retirement assets and income is only getting worse as the headwinds of secular challenges grow. One of the key messages that has been inaccurately communicated to retail investors time and time again is that senior secured loans, given their floating rate nature, only perform when interest rates are increasing. Fake news! As is often the case, opinion and emotion are ubiquitous while facts and analysis can be difficult to find.

Floating-Rate Loans in Rising, Flat, and Falling Rate Environments



Source: Credit Suisse and Bloomberg Barclays Indices. "Rising" indicated by an increase of more than 50 bps. "Falling" indicated by a decrease of more than 50 bps. Data reflects rolling 12-month periods from January 1993 through December 2018.

To illustrate our case, consider the chart above which demonstrates the performance of senior secured corporate loans, as well as traditional, rate sensitive fixed income products such as U.S. Treasurys and the Barclay's U.S. Agg Index in periods of rising, falling and flat interest rate environments over the last 27 years. The data and analysis, those necessary counterweights to opinion, show historically strong positive returns for loans in every rate environment. In fact, loans have demonstrated their ability to deliver positive returns not only in different rate environments but also in the varying macroeconomic and market backdrops that tend to accompany those periods, including low growth and slightly recessionary conditions. You do not see that in the headlines.

HOW DO INTEREST RATES IMPACT LOAN & BOND RETURNS?

An observation from our study is that loans do enjoy a tailwind from rising interest rates, generally outperforming traditional fixed income because as interest rates rise, so do floating rate coupons. However, that is only part of the story. What drives this performance? As a reminder, the coupon rate or yield on loans is derived from a current, short term reference rate, usually 1-month or 3-month LIBOR (the rate banks charge to lend money to each other) plus a spread or risk premium for lending money. As rates rise, the reference rate adjusts periodically to reflect the changing conditions and generates a higher coupon payment to an investor. Traditional corporate bonds have a reference rate too, usually the "risk-free", longer term, 5-year or 10-year U.S. Treasury. Bonds likewise possess a risk premium spread. As the name implies, these instruments fix their coupon rate for a longer term. This coupon does not adjust no matter what happens to interest rates. This is the rate sensitive part of traditional fixed income and one that exposes investors to duration. Duration is defined as the risk that the value of a bond will decline or rise as a result of a change in interest rates. Clearly, rising interest rates create a headwind for traditional fixed income investors, who would now be able to obtain a theoretical higher rate of return elsewhere, than the one they locked in at purchase. On the other hand, a front-end asset class such as senior secured loans practically eliminate the risk of duration, given their short-term nature. Additionally, loans possess base rate floors. This means loans cannot generate a negative yield like bonds can at times.

> "Our case study data suggests historically strong returns for loans in every rate environment."

So, what happens when interest rates are falling? Or are flat? Loans keep paying coupon income just like bonds. In fact, we do not have to go far back in history for a case study on loan performance in a decreasing rate environment. Throughout 2019, the Federal Reserve carried out three interest rate cuts, reducing its policy rate by a cumulative 0.75% from 2.50% to 1.75%. Against this backdrop, and much as the above chart would suggest, loans generated a positive return of over 8%.

THE "NEW NORMAL" & THE PROBLEM WITH "TRADITIONAL"

We are in an unprecedented economic environment and the traditional fixed income landscape presents unique challenges for investors. We believe this will continue for years to come. In response to a global pandemic and in the span of a fiscal quarter the Federal Reserve has slashed interest rates in the U.S. to effectively zero, expanded its balance sheet by a head-spinning $3.02 trillion, committed unlimited ammo to its quantitative easing program and became an active risk taker in the credit markets. These historic actions have pulled forward a key secular trend; low rates. Pronounced investor concerns about future economic prospects have also contributed to plummeting yields.

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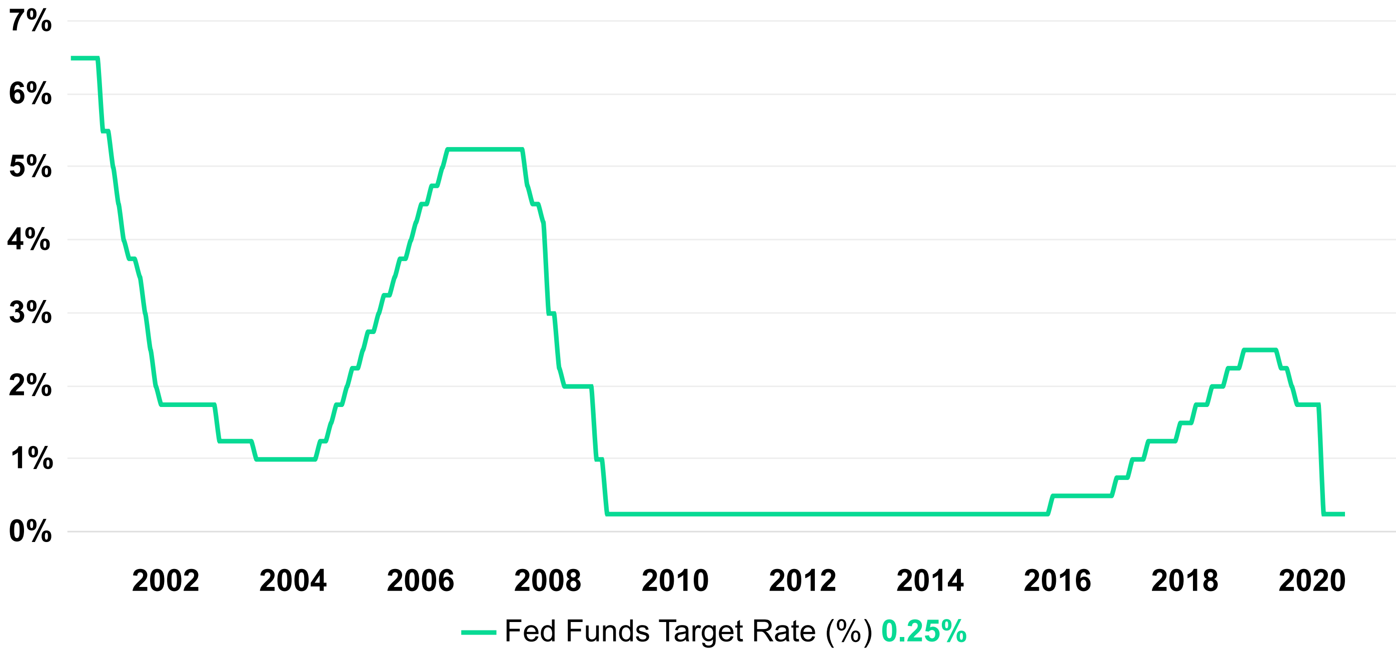
The zero-yield world was ushered in much faster than many anticipated. Investors now must weigh novel risks and conundrums, not the least of which is significantly adjusting investment return expectations and ultimately meeting retirement goals. The other is discarding the perceived sense of peace of mind and feeling of stability that has not been provided by traditional fixed income asset classes. It is all a bitter pill to swallow after rates have already been falling for the past three decades.

Historically Low Fed Funds Rate



THE CASE FOR NON-TRADITIONAL FIXED INCOME

Today, the yield curve is lower and flatter than it has ever been. Indeed, the "Japanization" of developed market bond markets is upon us and appears to be here to stay. What does this mean? Investors are simply not being paid to take on the duration risk associated with traditional fixed income. Consider that 10-year U.S. rates sit at around 0.60% and 5-year rates are in line with 3-month LIBOR at 0.27%. There is little to no room left for rates to move down to produce the necessary tailwinds needed for traditional fixed income outperformance.

We believe that the U.S. Aggregate Bond Index will probably only earn ~1% in the coming years and therefore investors will have to transition more to newer generation income producing alternatives, such as senior secured corporate loans and other parts of the credit markets to compliment and diversify their fixed income portfolios. The days and role of traditional fixed income in an investment portfolio have changed immensely. Investors must assess how they need to respond to this new world.

Important Risk Factors:

Investing in a mutual fund that contains senior secured loans involves risk. Senior secured loans have the potential for credit risk as these loans are typically made to companies with ratings below investment grade. As with all secured loans, there is potential for default which could affect the amount of funds recovered for the investor. Volatility risk exists for senior secured loans as the rates will fluctuate with the valuations of the loans. Senior bank loans are subject to the risk that a court could subordinate a senior loan, which typically holds the most senior position in the issuer's capital structure, to presently existing or future indebtedness or take other action detrimental to the holders of senior loans. These risk factors may affect the value of the investment.

Investors should carefully consider the investment objectives, risks, charges and expenses of the Catalyst Funds. This and other important information about the Fund is contained in the prospectus, which can be obtained by calling 866-447-4228 or at www.CatalystMF.com. The prospectus should be read carefully before investing. The Catalyst Funds are distributed by Northern Lights Distributors, LLC, member FINRA/SIPC. Catalyst Capital Advisors, LLC is not affiliated with Northern Lights Distributors, LLC.