MassMutual Investments

The Potential Global Senior Loan Opportunity

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Summary

- In this uncertain and volatile environment, senior loans can provide a potentially compelling opportunity to capture risk in the form of credit.
- They are of relatively higher quality given their senior position in the capital structure.
- Senior loans offer attractive yields of nearly 10% and have little duration sensitivity given their floating-rate nature.

Investors are facing a challenging backdrop of elevated equity market valuations, concerns over the direction of U.S. Federal Reserve (Fed) monetary policy, and a subdued term premium. And, by term premium we are referring to the extra return that lenders demand to hold a longer-term bond instead of investing in a series of shorter-term securities. We believe that this difficult environment has propelled uncertainty, which has stoked market volatility. If we assume that risks across capital markets are what drive returns, then how can investors assess the current asset opportunity set in order to maximize return for the amount of risk they're taking?

Top of the debt chain

Before we get into the prospective opportunity in senior loans, it's important to level-set the discussion by explaining the asset and asset class. Senior loans are debt securities used by companies to finance operations, support business expansion, and refinance existing debt. They are known as "senior" loans due to their position at the top of a borrowing company's capital structure. They are typically structured as floating-rate loans, which means that the interest paid on these loans will move as interest rates fluctuate.

Another less appreciated benefit of senior loans is their higher quality, which is driven by seniority in the capital structure and covenant restrictions. Relative to other corporate debt, including high yield bonds, loans are typically more senior and first in line for repayment in case of default. Furthermore, loans tend to be secured by assets of the issuing company. These characteristics of senior loans have historically resulted in high recovery rates relative to other fixed income asset classes. Recovery rates are the estimated percent of a loan or an obligation that will be repaid to creditors in the event of a default or bankruptcy. The table below shows recovery rates within different segments of below-investment-grade credit.

Below-investment grade bond recovery rates

	Senior Loans	Senior Secured Bonds	Senior Unsecured Bonds	Subordinated Bonds	Emerging Market High Yield Bonds
Recovery Rate	72.6%	61.4%	46.9%	27.9%	38.0%

Source: Barings as of September 30, 2023.

Perhaps overlooked and underutilized

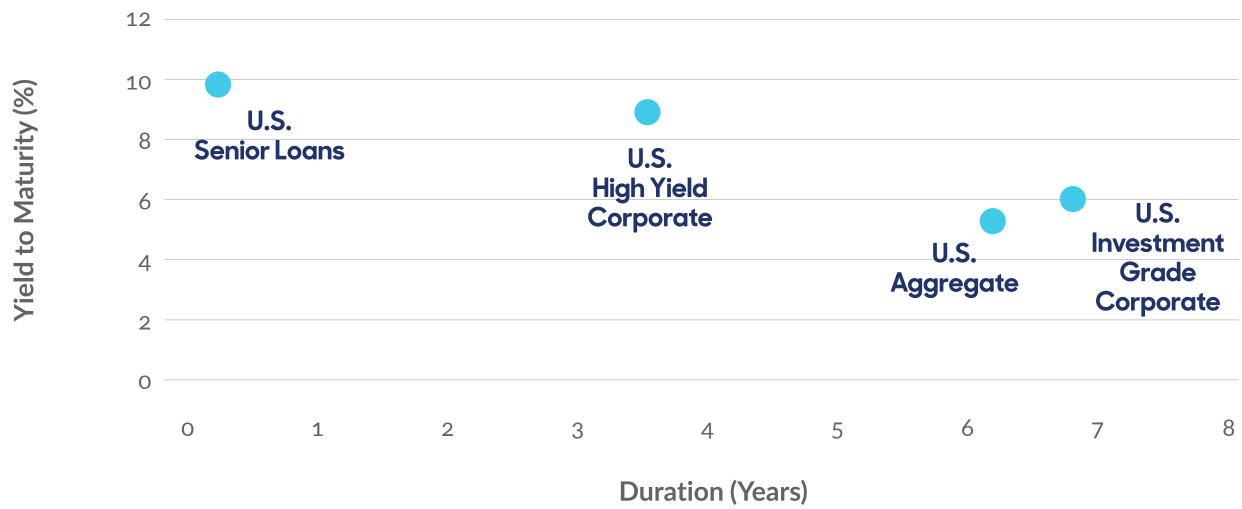
We believe that high yield credit is an underappreciated tool that can be utilized to participate in risk markets. Within the high yield opportunity set, senior loans — with their higher credit quality, lower duration profile, and low correlation to interest rate changes — can offer investors an attractive yield with minimal interest rate risk (as shown on the next page).

> "High yield credit has historically outperformed equities in low-growth environments and has never had consecutive negative calendar-year returns[1]."

Source: FactSet as of September 30, 2023.

[1] A low-growth environment is typically emblematic of flat or marginally positive economic (Gross Domestic Product) growth. In a low-growth environment, investors can generally look to income-generating assets to aid risk-adjusted returns.

Yield Driven by Credit, Not Duration/Years



Source: FactSet as of September 30, 2023. U.S. Senior Loans as represented by the Credit Suisse Leveraged Loan Index; U.S. High Yield Corporate as represented by the Bloomberg U.S High Yield Corporate Index; U.S. Aggregate as represented by the Bloomberg U.S. Aggregate Index; and U.S. Investment Grade Corporate as represented by the Bloomberg U.S. Investment Grade Corporate Index.

The higher quality nature of senior loans is also supported by the composition of issuers, which is less cyclical in nature relative to other areas of high yield. Investors can also add further diversification by expanding the typical U.S.-only focused loan universe to include European loans in its investible opportunity set. In the current investing environment, which is marked with a range of uncertainty regarding credit, interest rate, and geographic risks, a portfolio of higher-quality, lower-duration, and geographically-diverse loans can further help augment risk.

Why global?

- Broader opportunity set
- Additional relative value lever
- Lower potential volatility given senior loan market structure
- Lower correlations to other assets

Higher (income) for longer

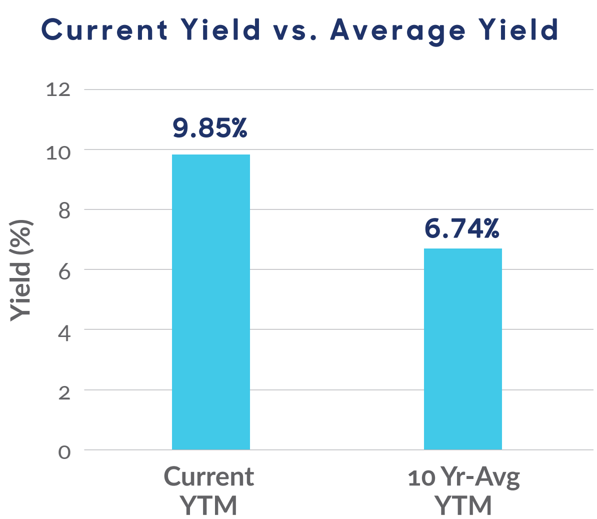
While many fixed income sectors have struggled in the current rising interest rate environment, senior loans have largely benefited. Compared to fixed-rate bonds, senior loans pay floating coupons that are based on a spread over a reference rate, which has historically been London Inter-Bank Offered Rate (LIBOR) but more recently Secured Overnight Financing Rate (SOFR). SOFR is a benchmark that financial institutions use to price loans for businesses and consumers.

As a result of their floating-rate nature, rising interest rates lead to rising yields for senior loans. The market appears to be beginning to accept the Fed's "higher for longer" interest rate narrative, and the loan category stands to continue offering compelling income to investors. This high level of income also offers a degree of performance protection should the asset class experience temporary price declines

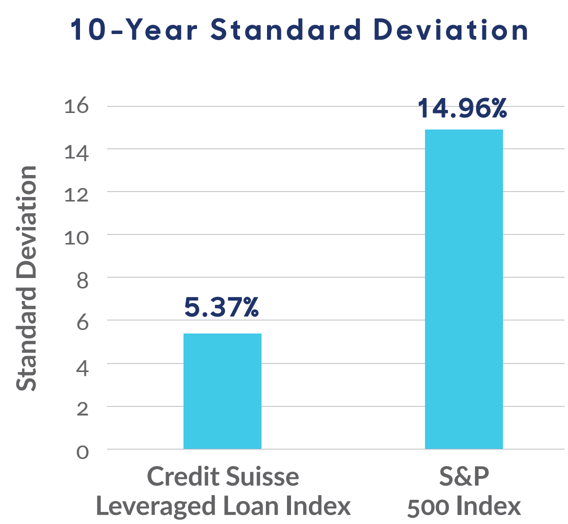
Risk and return potential

Loans in general were the strongest-performing asset class across fixed income in 2022 and have kept that going through the first three quarters of 2023[2]. Senior secured loans are yielding almost 10% (as shown in the left graphic below), which is well above the nearly 7% 10-year average yield-to-maturity (YTM). The senior loans are also trading at roughly a 4% discount to par[3], which is the face value of a bond.

Since the financial crisis of 2008, loan prices in general at these levels have always delivered a positive 12-month forward return[4]. Additionally, senior loans could potentially provide a return in line with the annual historical average total return of equities, but with roughly half of the realized volatility of stocks (as shown in the right graphic). As a result, investors who reallocate capital from equities toward senior loans to express market risk could theoretically maintain expected returns and reduce expected volatility.



Source: Morningstar Direct as of September 30, 2023.



Source: Morningstar Direct as of September 30, 2023.

[2] Source: FactSet as of September 30, 2023.

[3] Source: JPMorgan as of September 30, 2023.

[4] Source: FactSet as of September 30, 2023.

Bloomberg U.S. Aggregate Bond Index measures the performance of investment grade, U.S. dollar-denominated, fixed rate, taxable bond securities, including Treasuries, government-related and corporate securities, mortgage-backed securities (MBS) (agency fixed-rate and hybrid ARM pass-throughs), asset-backed securities (ABS), and commercial mortgage-backed securities (CMBS). The Index does not reflect any fees, expenses, or taxes and cannot be purchased directly by investors.

Bloomberg U.S. Corporate High-Yield Bond Index measures the performance of U.S. dollar-denominated, non-investment grade, fixed-rate, taxable corporate bonds, including corporate bonds, fixed-rate bullet, putable, and callable bonds, SEC Rule 144A securities, original issue zeros, pay-in-kind bonds, fixed-rate and fixed-to-floating capital securities. The Index does not reflect any fees, expenses, or taxes and cannot be purchased directly by investors.

Bloomberg U.S. Corporate Investment Grade Index measures the investment grade, fixed-rate, taxable, corporate bond market.

Credit Suisse Leveraged Loan Index tracks the investable market of the U.S. dollar-denominated leveraged loan market. It consists of issues rated "5B" or lower, meaning that the highest-rated issues included in this index are Moody's/S&P ratings of Baa1/BB+ or Ba1/BBB+. The Index does not reflect any fees, expenses, or taxes and cannot be purchased directly by investors.

S&P 500® Index measures the performance of 500 widely held stocks in the U.S. equity market. The Index is designed to broadly measure U.S. equity performance It is market capitalization-weighted. The Index does not reflect any fees, expenses, or taxes and cannot be purchased directly by investors.

Correlation measures how different investments react to the same market conditions.

Duration, expressed in years, measures the sensitivity of the price (the value of principal) of a fixed-income investment to a change in interest rates. The higher the duration number, the more sensitive a fixed-income investment will be to interest rate changes.

Gross Domestic Product (GDP) is a measure used to track the growth of a country's economy.

Risk-Adjusted Return informs investors not only what return was achieved, but what level of risk was taken to achieve the return.

Standard Deviation is a statistic that measures how widely a series of returns varies over a certain period of time. A high standard deviation implies greater volatility.

Yield to Maturity (YTM) refers to the total return anticipated on a bond if the bond is held until it matures.

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