



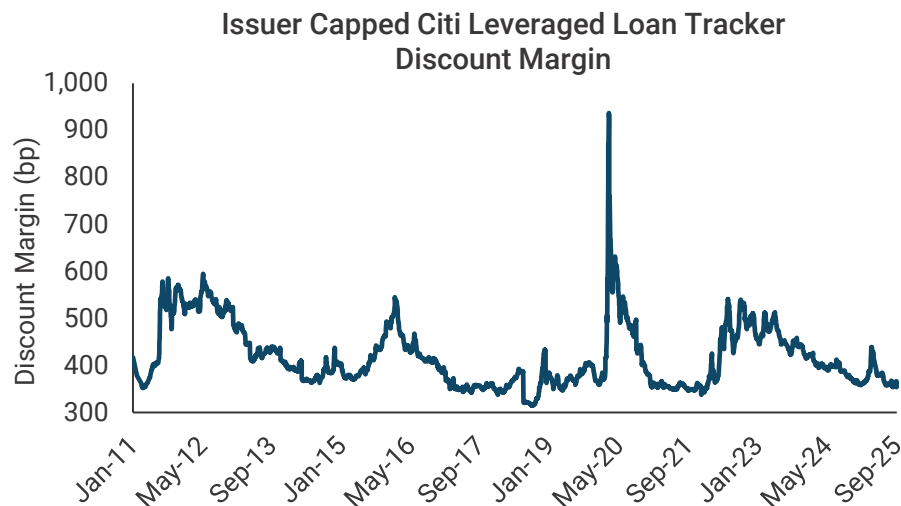
## The Role of Bank Loans in High Yield Portfolios

A recent study showed that most High Yield Funds had an average exposure to bank loans of 6%. That is about the average of our high yield portfolio, but some managers can allocate as high as 20% - 30% to bank loans even when *their underlying benchmarks do not incorporate any loans*. Why do managers use bank loans?

### History

Bank loans are issued by public and private companies, many of which are issuers of high yield bonds. The structure of bank loans are fairly consistent:

1. Secured on a 1st or 2nd lien basis against most of the company's assets.
2. Callable generally within one year at a modest premium (101 price) or no premium.
3. Maturities range from 3 years to 8 years.
4. They have a floating coupon rate tied to SOFR, offered at or near par, with a spread that can range from 200 to 600 bps for a newly issued bank loan. Today, the average spread is around 350 bps.

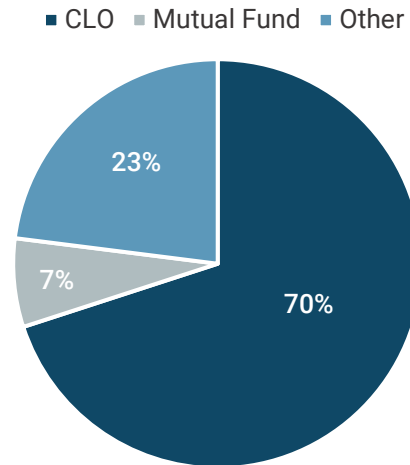


Source: Citibank

The buyer base for loans is dominated by Collateralized Loan Obligation (CLO) investors that leverage a pool of these loans (which can total 100 loans) at 7X -10X in an investment vehicle. Some say this represents double leverage since most of the companies that issue loans are leveraged 3X - 6X EBITDA. The other investors include floating rate funds, high yield funds and other fixed income products. You can even find bank loans in equity products.

The chart below does not incorporate the private debt market. Most of that debt is in bank loan form and is estimated to total about \$500 Billion versus a \$1.6 Trillion bank loan market.

#### Investor Base (as of Sept. 2025)



Source: Citibank

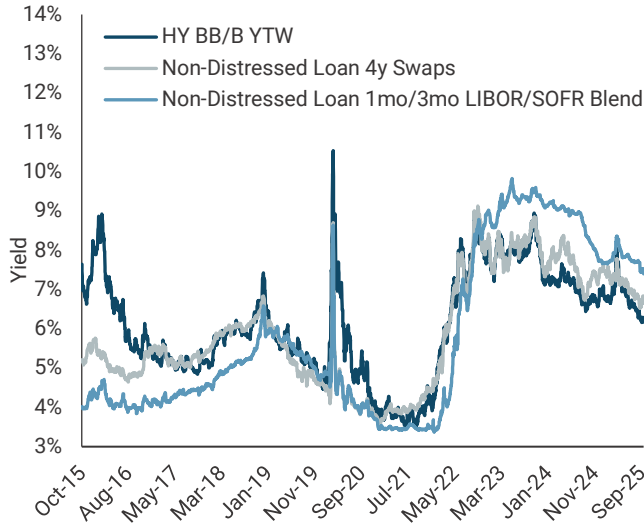
### Relative Attractiveness - Bank Loans Versus Bonds

There are several ways investors look at relative attractiveness over time between.

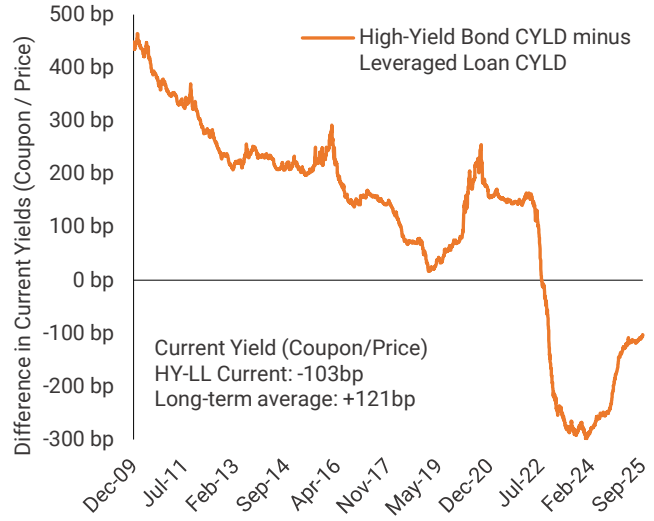
The first way is to look at loan Yield To Worst (YTW) versus High Yield bond YTW. This is helpful to some extent, but there are two weaknesses:

1. Loan yields can fall over time with changes in the SOFR rate, which is very sensitive to the Federal Funds Discount Rate.
2. Bank loans are often callable within six months to two years, depending upon the situation. High yield bonds are callable no earlier than  $\frac{1}{2}$  of the bond maturity and often have a significant prepayment premium. For example, an 8-year high yield bond with a 9% coupon would be callable in year 5 at 104.5 price. A similar 8-year loan would be callable in year 2 at 101. *That is why high yield bonds have more total return potential as most high yield bonds are redeemed before maturity at a premium.*

If you look at the history of yields for both high yield and bank loans over time, you will note that high yield tends to have higher yields over bank loans, except during the most low-rate period. Since 2009, high yield bonds have yielded about 120bps more than loans. Today, bank loans yield about 100bps higher than high yield bonds.



Source: Citibank



Source: JPMorgan

The second way is the approach Hotchkis and Wiley considers in looking at the relative attractiveness. Our approach is to use a forward curve of SOFR and to imply a return on the bank loan. Since most non-distressed bank loans trade at or around par, the price of the bank loan is not critical, but it is incorporated in the yield. We then compare that bank loan “return” to our universe of options in the high yield market on a YTW basis. If the loan stands cheap relative to high yield bonds, then we consider adding it to the portfolio. See the example below.

**Simple Example of Calculating Current Yield Using Forward SOFR Curve<sup>A</sup>**

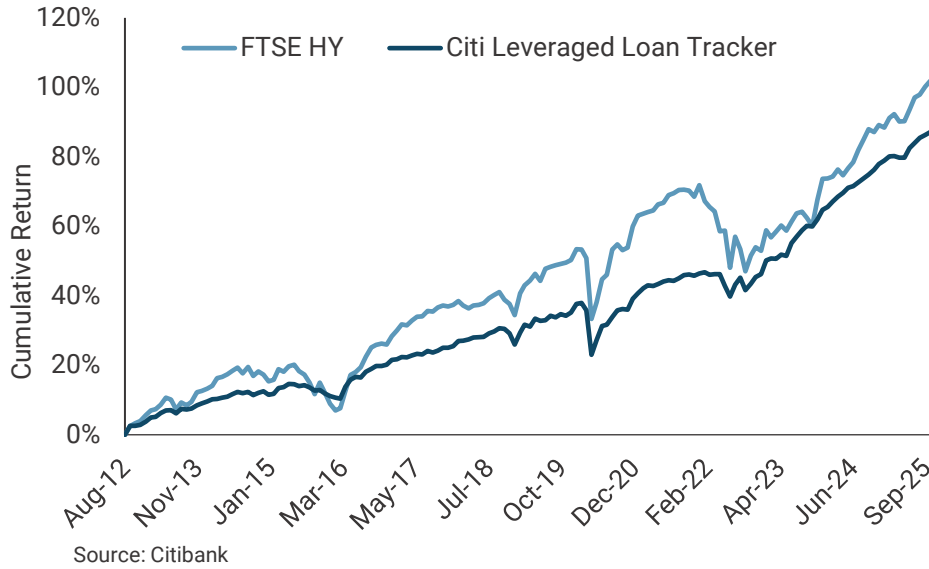
	Using Today’s SOFR	Using Forward SOFR Curve
Price	99.7	99.7
Spread	375	375
SOFR	4.00% Today	4.00%/3.60%/3.30%
Yield	7.9%	7.5%

<sup>A</sup>Assumes 3-year maturity. Standard approach is to amortize the discount equally to maturity.

*If your High Yield YTW target is 7.75%, at first glance, using a simple yield, the bank loan looks attractive, but when you adjust for the forward SOFR curve, the bank loan can actually look unattractive!*

**Performance Over Time - Loans Versus Bonds**

The analytical approach above is nice, but at the end of the day, did the bank loan beat the high yield bond in the portfolio? The answer is at times, it clearly does, especially when the SOFR rate is materially higher than treasury rates and high yield spreads. In this case, the “carry” of the loan yield simply beats the bond performance, especially when treasury rates are backing up. Thus, loans are a great way to insulate against rising rates, but the opposite is true, in a falling rate environment, loans can underperform. **Since the 1960s, the yield curve has been upward sloping 70-85% of the time, meaning that rates like SOFR are lower than term treasury rates during most of the time. Thus, most of the time, high yield bonds have a return advantage on rates alone.**



	HY	Loan
Annualized Return	5.55%	4.94%
Standard Deviation	2.02%	1.22%

### Other Factors to Consider When Owning Loans

Besides yield and return, there are other factors to consider when adding loans to a portfolio.

- Benefit of Security** - Having a secured position in a debt instrument is beneficial when problems occur. Simply stated, the recovery rates are higher for secured instruments. Today only about 40% of high yield bonds in the high yield market are secured versus almost 100% of bank loans. The amount of secured high-yield bonds has almost doubled over the past 10 years. One of the interesting trends between bank loans and high yield bonds is that recovery rates have been rising in high yield bonds and falling in bank loans, reflecting the improving quality of the high yield market and the deteriorating quality of the bank loan market.

#### Issuer-Weighted TTM Recoveries

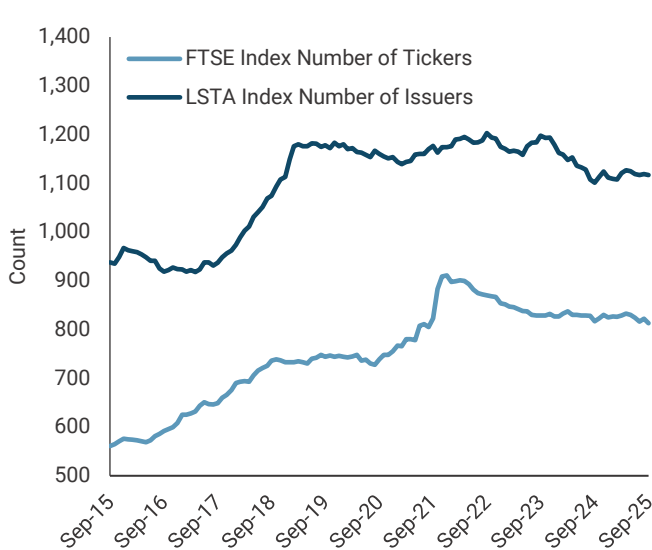
	8/31/2025	2024	2023	1983-2024
1st Lien Bank Loan	58.7%	60.4%	58.8%	64.4%
Sr. Unsecured Bond	45.1%	48.4%	32.6%	37.9%

Source: Citibank

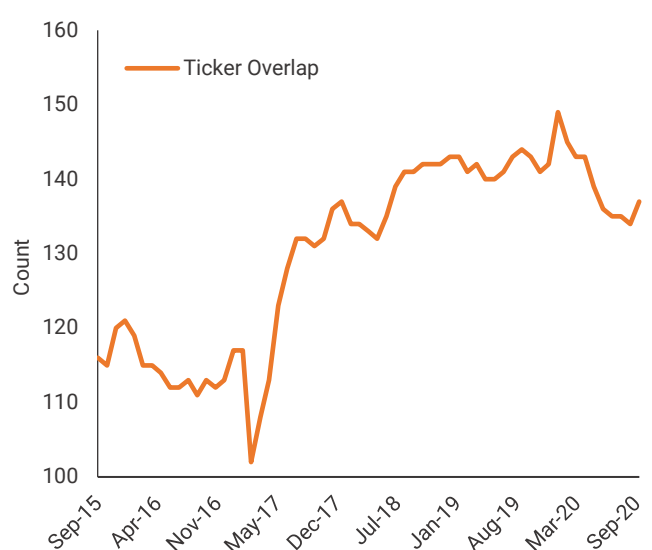
*One interesting trend noted by JP Morgan is that recovery rates for 1<sup>st</sup>-lien debt is 38% compared to a 25-year average of 62%, again reflecting the lower quality trends of bank loans.*

- Exposure to Different Names/Sectors** - Diversification is one of the largest benefits of adding bank loans to high yield portfolios. Today the number of issuers in the bank loan markets is about 1,200 versus 800 in the high yield market. The overlap is only about 140 names between the two markets. This has been falling steadily over the past 10 years showing the bank loan market and high

yield market are becoming distinct markets. Thus, an investor that uses a high yield bond benchmark for a portfolio that is heavily invested in bank loans should recognize that they are taking on significant tracking error.

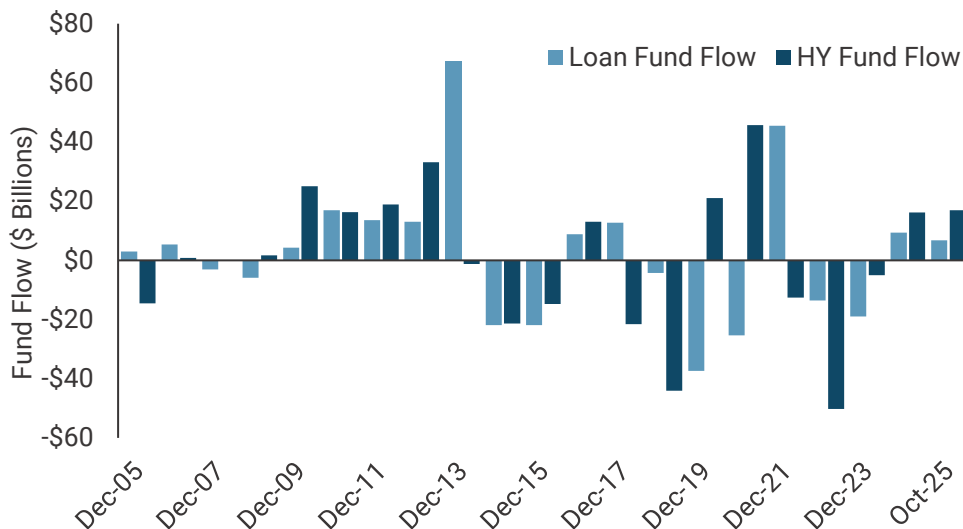


Source: Citibank



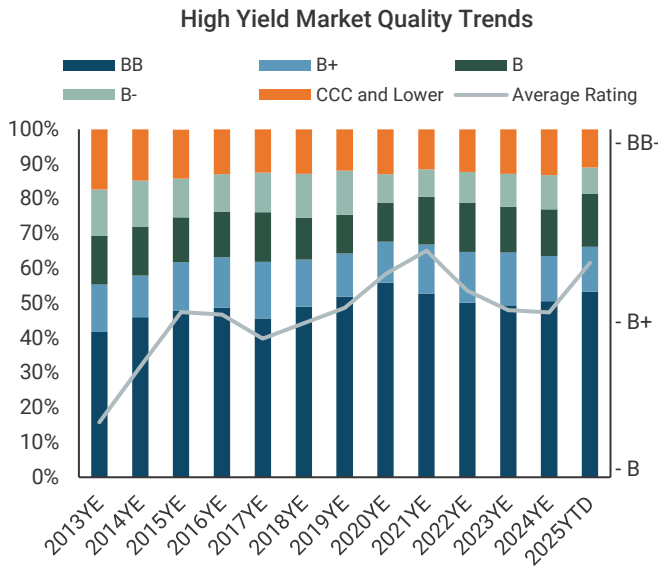
Source: Citibank

- Taking Advantage of Technical Flows** - Trading in the bank loan and high yield bond markets is fairly efficient. There are settlement differences in the two asset classes that can cause liquidity squeezes (bank loans tend to take much longer for a portfolio manager to convert to cash when liquidity needs arise). Fund flows can also be variable in the two asset classes that provide trading opportunities in both asset classes.

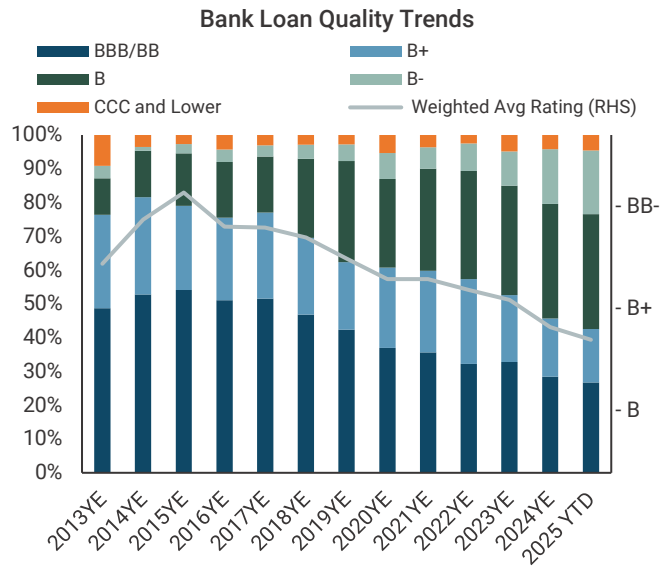


Source: Citibank

4. **Exposure To More Risk Assets** - The bank loan market is lower in quality than the high yield market. This is a remarkable difference from the bank loan market of the mid 2000s where the high yield market was clearly lower in quality. When we talk about the high yield market today and compare the current tight spread level to historic tights (May 2007), investors need to consider that bank loans are where risks are concentrated and not the high yield market. Moreover, investors will point out that the yields are higher in the bank loan market today, but some of that reflects the higher risks in the bank loan market.



Source: Citibank



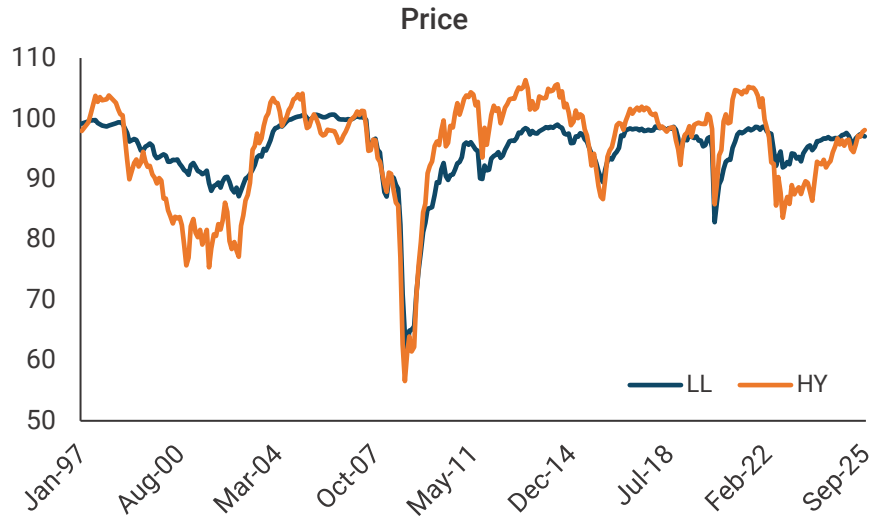
Source: Citibank

### Risks of Exposure to Loans

As investors weigh the benefits and yields in the bank loan market, there are risks that should be incorporated over time:

1. Most bank loan owners as an asset class are not natural credit owners. The ownership of the asset class is dominated by CLOs that act differently than most credit managers:
  - a. They cannot hold many bank loans upon a CCC downgrade and generally must sell them, even at prices well below their recovery value.
  - b. Substitution restrictions in CLOs limit their ability to work out distressed bank loans.
  - c. Decisions to own or sell bank loans are dominated by quantitative models.
2. Yield curves are generally upward sloping over time, so the bias favors high yield bonds. During the 2022-2024 period, the yield curve was inverted for long periods of time.
3. The growth of the private debt is cannibalizing the bank loan market. This will put downward pressure on spreads for the bank loan and private debt markets since they are floating rate based and tend to chase the same names. We are still in the infancy of the modern private debt market and there is little data about the relative performance of private debt, but the massive fund flows into the private debt market will only put downward pressure on bank loan spreads.

- Call risk limits the upside for loans relative to high yield especially when high yield bond trading price is lower than loans. The opportunity for total return price appreciation is simply higher in high yield bonds.



Source: Bloomberg, ICE BofA, H&W

### Conclusion

The use of loans can be beneficial to the overall return of a high yield portfolio, especially in a rising rate environment. At Hotchkis and Wiley, we maintain a modest exposure to bank loans within our portfolio. Considering the forward curve when comparing loans to bonds is an important tool when looking at the relative attractiveness of loans. There are benefits to having loans in a portfolio, such as dampening interest rate risk and diversifying names and sectors. However, there are also risks such that portfolio managers should manage the exposure accordingly. As we look at the current rate environment, we should be reminded that as the Federal Reserve cuts rates, high yield bonds will likely outperform. Below are the relative performance histories of bank loans and high yield bonds by rating category 12 months after a rate cut.

#### Performance By Rating 12 Months Post Fed Rate Cuts

	BB Forward	B Forward	CCC Forward	BB Forward Range	B Forward Range	CCC Forward Range
Bank Loans	3.8%	0.8%	-14.3%	-1.3% to 7.3%	-2.1% to 7.7%	-27.2% to 1.7%
HY Bonds	6.2%	4.6%	2.5%	2.8% to 10.6%	-1.1% to 10.8%	-12.3% to 20.7%

Happy Hunting!

The Hotchkis and Wiley High Yield Team

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