Bank Loan Market Discussion
with Frank Ossino, Bank Loan Sector Head, Newfleet Asset Management
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Transcript edited for clarity

Christine McQuillian: *I'm Christine McQuillian, product specialist responsible for fixed income portfolios at Virtus Investment Partners. Joining me is Frank Ossino from our affiliated manager Newfleet Asset Management. Over the last several months, the industry has seen a significant increase in both interest and allocations to the bank loan category driven by rising rates and investors' search for yield. Frank is the bank loan sector head at Newfleet for the Virtus Multi-Sector Fixed Income Funds and serves as portfolio manager of the Virtus Senior Floating Rate Fund.*

We have a quick update for those of you who have not read the latest prospectus. The management fee for the Virtus Senior Floating Rate Fund was recently reduced to 45 basis points. The total annual fund operating expenses are currently 1.02% for the A shares and 0.77% for the I shares.

We'll now begin our discussion on the bank loan market. Frank, can you start us off with an overview of Newfleet's investment process and how it's different from other fixed income managers?

Frank Ossino: Sure. That's an important question to set the table as to how we view the loan space. As you mentioned, I manage the loan business at Newfleet. It's roughly $2.5 billion of the $12 billion we manage. There are 40 investment professionals in Hartford. Every sector of the bond market has a sector head—my partners and my peers—including emerging market debt, municipal bonds, structured product, investment grade, high yield, and so on.

While the team meets every day, we do formally for the last 20 years conduct three formal meetings a month. The first is where every sector head reviews their sector with the other sector heads. Why that's important is because now I'm not looking at the loan market in a vacuum; I get to listen to specialists in other sectors and take that information, synthesize it, and that may or may not influence a decision within my space.

Then we present the loan space to everyone else. What we're predominantly known for at Newfleet is our Multi-Sector suite of products. We take all that information having listened to everyone and literally allocate across all those sectors and create portfolios based on the particular mandate or requirements of those individual portfolios.

Finally, our last meeting is how we did – we call it "portfolio review." So, if I was looking for an allocation for the loan market and took it from another sector head and that happened to be the wrong call, I would have to go ahead and explain myself to the team. What did we get wrong? What did we learn? And what do we do going forward? So that is a process that is repeatable, 20 years old, and I think frankly unique for a firm of our size.

On the loan market side, I cut my teeth as a banker. Loss avoidance and credit selection are major tenets when we think about the loan space in particular. We'll talk about that later.

Christine McQuillian: *Can you give us a quick overview of the capital markets and where bank loans fit in an overall asset allocation strategy?*

Frank Ossino: Sure. I think this question really hits on the challenge that the end user has today, the ultimate investor. The challenge being, we've had a generation that has seen rates really go down in the last 30 years – and as we all know, when rates go down, bond prices go up. We are now in a period with the fed funds rate, for example, bumping along near zero, and we no longer have the benefit of declining rates, increasing bond prices, and the duration working in our favor if you will.

Today we are in a period where we may be entering a rising rate environment. Durations across fixed income asset classes have been extended. The world is in a low yield environment. And certainly we are in the later stages, in our view at least, of a credit cycle today than we were as we exited the crisis period of 2008.To put that in context, we have $8 to $9 trillion of zero or negative yielding assets on one bookend, and we have the Pakistani 2025 bond yielding 6.2%.

So that's the pond we're swimming in. There are some outliers on either side, but certainly that's the pond. Investment grade in Europe and Asia is yielding 1%. The Bloomberg Barclays U.S. Aggregate Bond Index is yielding 2.5% roughly with a duration of over six years. The investment grade market is yielding roughly 3.25% with a seven-year duration.

As it relates to the loan market, the loan market today is yielding roughly 4.5%. The high yield market is just south of 6%. The challenge here again is the client marrying the amount of duration risk with the amount of credit risk but also looking for the appropriate amount of yield for the amount of rate and credit risk that they're taking. It's our view that non-investment grade credit in the U.S. is an attractive place to be when we think about relative yields around the world.

Christine McQuillian: *We've heard a lot about the impact from the Trump administration on markets. What are your views on how the Trump administration may impact markets going forward?*

Frank Ossino: I'll start by saying that here at Newfleet we're not doing anything to the portfolios broadly speaking because of a change of administration. We like to think of ourselves as longer term investors. We're value investors. And so we are not going to holistically change portfolio construction because of something that an administration may or may not do.

What we do know is at least from the 50,000 foot view, the policies are stimulative, whether that's deregulation, reducing taxes, infrastructure spending, or defense spending. On balance those appear to be positive. We don't know the order of magnitude. We don't know what they're actually going to be able to get done. And frankly we don't know multipliers either – building a highway in the 1950s had a much greater multiplier for the economy than changing the guardrails in 2017. So we'll have to see what those policies look like and what they can get done.

What we do know and have a better handle on is that while we don't know if Donald Trump's administration will get 4% GDP or 2.5%, what we do know is that 2% GDP today is good for fixed income, and his policies when we layer in on top of the stimulus things like trade wars, protectionism, and maybe even some geopolitical risks, they're all inflationary. And so you can point to a path over the next few years of inflation increasing because of these policies. And so we'll take 2.5% GDP growth if that's all he gets us, but we do know that if we do have inflation, the cleanest way to combat inflation is to increase rates.

Christine McQuillian: *Now that we've set the stage on capital markets in general, let's get a little bit more into bank loans. What makes bank loans different than other fixed income securities?*

Frank Ossino: This is a subject near and dear to my heart. By way of background, I started in the loan market in the mid-1990s as a large corporate banker, moved into the credit analyst role, and then finally as a portfolio manager, so 20 years in the making.

The loan market has some characteristics that are really unique and make it different from other fixed income products. The first is that loans float. These are loans to large corporate borrowers, companies like Dole Foods, American Airlines, Charter Communications, Univision, large corporate borrowers that happen to be non-investment grade. They have a lot of leverage or they may be an LBO through a private equity sponsor.

And while fixed income generally is based off of a fixed rate—Treasuries plus a spread, the spread being what we charge for the risk we're taking—the loan market is based off of typically 3-month LIBOR—so LIBOR plus a spread. In doing that, we've effectively eliminated the interest rate risk, at least on a 90-day basis. Think about the duration of the loan market being a quarter of a year, if we set our risk free on 3-month LIBOR. So when LIBOR goes up or down, the borrower owes us more or less coupon. We're effectively insulated from the interest rate risk.

The second major characteristic is that loans are senior in right of payment and secured by all assets of the borrower. If Dole Foods were to file for bankruptcy, we have a first lien on the shipping assets, the land in Hawaii, and most importantly, the brand. As a first lien lender, we would hire a bank to find us a buyer of the Dole Foods brand. We have a lien on that brand.

Now for those two major characteristics, there's no free lunch. We float and we're secured. What we give up is that loans are pre-payable at par any time – just like your mortgage might be. And so in my example of Dole Foods, if they were to sell a business for $1 billion, we may wake up one day and see that Dole Foods is repaying debt at par with no penalty. Loans don't go to 105 or 110 or 120 like bonds do. Bonds, because they're fixed and they're unsecured, need that benefit or that convexity, if you will, that upside. And so the loan market is incredibly asymmetric—the best we're going to do is par, while if our credit selection is wrong, you can see real portfolio losses. And our style is really borne out of that. At Newfleet, in non-investment grade credit, we are spending less time swinging for fences and spending more time on credit selection and trying to avoid losers. It's our view that alpha is created if we don't lose money.

Christine McQuillian: *You mentioned bank loans and refinancing. What exactly is refinancing and how does that work?*

Frank Ossino: This is something that the market is really wrestling with today. Again, when a loan reaches par, par is our best. Today the loan market is in an environment where technically speaking, there's a lot of demand for the space. So much so that when a borrower sees all this demand for their loan, they look to refinance into a lower rate—much like you would your mortgage. If your mortgage is at 4% but you think that you can get 3%, and with no penalty, naturally you're going to refinance into a lower rate.

And so the market right now is going through this. We've seen upwards of $100 billion refinanced just in January. Roughly a third of the market has refinanced since last summer. Two-thirds of the loan issuance last year were for refinancings. And by the way, that number was near 60% in the high yield market as well. So the market is struggling with a tightening of spread as borrowers refinance into lower spread product.

What I advise my clients is while LIBOR is starting to increase, and maybe we see two rate hikes this year, some of that might be partially offset by the spread side of the equation--remember LIBOR plus a spread—starting to reduce as refinancings start to happen.

Now having said that, despite spreads tightening today, they still look attractive to us when we look at other periods of rising rate environments. Spreads today are attractive relative to 1994 and relative to 2004-2006, some periods where the market was near par, defaults were as low as they are today, but spreads were a lot tighter then than they are now. And so it's our view that despite a tightening spread environment, the loan market is still attractive.

Christine McQuillian: *What are you doing in the Multi-Sector portfolios as well as the Senior Floating Rate Fund, what is your outlook for the rest of the year, and how are you positioning the portfolio?*

Frank Ossino: We'll take the Multi-Sector side first. These are, as I said earlier, vehicles that have upwards to 14, 15 sectors, and so we spend a lot of time seeking relative value across all of those

sectors. There's always a richer or cheaper sector than the sector that I might be looking at. And so we spend a lot of time on that.

Now sector specific, we've spent the last eight or nine months, since the springtime of last year, methodically adding to credit spread product, whether that's the emerging market sectors or specifically high yield, at the expense of loans. And so we spent time reducing the loan side of the equation to add where we thought there was more value. Valuations in high yield were more attractive than they were in loans, and so we spent the last eight or nine months doing that trade. Today we're taking a little bit of a pause from that add. We've had a fantastic rally since February, March of last year, to the point where today we're studying the loan market more than just at the margin looking more attractive than the high yield market. And so we're spending some time on that, but generally speaking taking a pause from a sector shift perspective.

Within sectors, we've also been spending time reallocating within sectors, whether that's adding risk at the margin within a sector. That may be going from BB risk to single-B risk. That may be adding traditionally or recently out-of-favor sectors like adding metals & mining, adding energy. We've done some of that within sectors.

As it relates to the loan market, not dissimilar. We entered last year with a bias towards being under risk. Valuations got very cheap, valuations that we hadn't seen in the loan market since the U.S. being downgraded. We're talking about the high 80s. So since February, March of last year, we've been slowly adding credit risk. We've gone from an underweight energy position to a slight overweight energy position. We've added 8% or 9% roughly to single-B risk versus BB. We are fully invested today when we were actually carrying cash the early part of last year, not dissimilar to what we've been doing in the Multi-Sector portfolios.

Today we're taking a little bit of pause on that because the loan market is now near par. And so we're now taking a step back and making sure that we fully understand the positions we've put on. And again, credit selection today, if we think we're in the seventh inning versus the second inning, is something that we're spending a lot of time on.

Christine McQuillian: *What are your three top takeaways from today's discussion?*

Frank Ossino: We start with the generational challenge that the client has. At the end of the day, clients will grow poor slowly in this environment if they don't have some level of spread product within their portfolios. Rates are generationally low and feel like directionally they may be increasing. Given that duration has extended, a rising rate environment and the sensitivity to a rising rate environment is something that we ought to be thinking about. While it's our view that credit today is benign and we don't forecast a recession this year, it's certainly not 2009 in those levels, and that's something to think about. And then again, yields globally are low, so we need to think about what that appropriate mix of yield, duration, and credit risk is for the client.

Second, the loan market can help with that challenge; the thesis worked in '94. It worked in '04 to '06. It worked during the Federal Reserve "taper tantrum." And you only have to go back to the fourth quarter of last year to see the 10-year Treasury move roughly 80 basis points and see the Treasury market negative, the investment grade market negative, the Barclays Bloomberg U.S. Aggregate Bond Index negative, and loans and high yield being up a couple of percent.

Loans float. They are secured. They effectively have no duration. And in a yield starved environment, I like getting 4.5% relative to what the rest of the world is giving me.

And then finally, our style and philosophy at Newfleet fits very well with what the market gives us. The loan market is an asymmetric asset class. And so it's our view that a loss

avoidance, defensive type of style married with a repeatable credit selection process in a portfolio that provides broad diversification to an investor that can't get exposure to the space otherwise is a very thoughtful way to add a strategic allocation to this space rather than looking for managers that are either habitually of high risk or habitually of low risk. It's our view that credit selection will create alpha if we can create a portfolio that gives our investors broad exposure. So those are really the three things.

Christine McQuillian: *What are the things that keep you up at night that could potentially be a worry coming up this year for the market?*

Frank Ossino: In my space when I think about loans and even high yield, I think less about the rate side of the equation. Even the high yield market, even sub-6% has sufficient carry given the intermediate type duration in high yield. So with Jon Stanley, my partner on the high yield side, Kyle Jennings, our head of credit research, we spend a lot of time on the credit side of the equation. And while defaults are low today and even with 1.5%, 2% GDP, borrowers pay interest and principal, it's our view that the vintage alone today is starting to keep us up at night. We're seeing a lot of first-time borrowers, borrowers that have never managed with leverage, borrowers that may have a single product, they're a single customer. We're seeing borrowers with a lot of adjustments in their financial statements.

A lot of the data points are pointing to, generally speaking, a pre-crisis type of environment where the worst deals are done in the best of times. That's the cliché, and so we are spending a lot of time doing the credit work with our analyst team, the dozen or so analysts that we have, making sure that we're following earnings, we're seeking to understand is the thesis still intact? To the extent that we see degradation or a thesis change within credit, that might be a flag to reduce or even exit a position. So we're spending a lot of time on the credit side despite, as I mentioned earlier, an environment that feels benign today. That's where you get hurt in loans and high yield to the extent that we have a loss rather than get par back. Over time, if we have a lot of losses that eats into total return.

Christine McQuillian: *Thank you, Frank, and everyone who's joined us for today's discussion. At Virtus we are committed to driving better client outcomes and believe that insightful market perspective is key to helping investors meet their objectives. To learn more about our investment solutions, please call us at 1-800-243-4361 or visit at virtus.com. Thank you.*

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Funds referenced:

Virtus Senior Floating Rate Fund[1,2,3,4,5,6,8] (A: PSFRX, C: PFSRX, I: PSFIX, R: VRSFX)
Virtus Multi-Sector Intermediate Bond Fund[1,2,3,4,5,7,8] (A: NAMFX, C: NCMFX, I: VMFIX, R: VMFRX)
Virtus Multi-Sector Short Term Bond Fund[1,2,3,4,5,7,8] (A: NARAX, C: PSTCX, I: PIMSX, R: VMSSX)

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[3]**Bank Loans:** Loans may be unsecured or not fully collateralized, may be subject to restrictions on resale and/or trade infrequently on the secondary market. Loans can carry significant credit and call risk, can be difficult to value and have longer settlement times than other investments, which can make loans relatively illiquid at times.

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Bloomberg Barclays U.S. Aggregate Bond Index: Measures the U.S. investment grade fixed rate bond market. The index is calculated on a total return basis. The index is unmanaged, its returns do not reflect any fees, expenses, or sales charges, and is not available for direct investment.

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LIBOR (London Interbank Offered Rate): A benchmark rate that some of the world's leading banks charge each other for short-term loans; serves as the first step to calculating interest rates on various loans throughout the world.

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