Income and Performance in Rising-Rate Environments

For investors seeking higher yield from a fixed-income solution and protection from the impact of rising interest rates, floating-rate loans can be a beneficial addition to a traditional fixed-income portfolio.

What are floating-rate loans?

Floating-rate loans are loans made to corporate borrowers. The loan is first arranged by a financial intermediary and then sold to institutional investors, including mutual funds. Companies borrowing through the loan market vary in size and scale and include familiar household names such as: Air Canada, Dell, Heinz, Four Seasons and Neiman Marcus. A company may require funds for several reasons, including financing of acquisitions, capital expenditures and general operating purposes. The debt of these companies is typically rated below investment grade.

How are floating-rate loans different from traditional bonds (investment-grade government and corporate bonds)?

Floating-rate loans are similar to bonds in that they represent the debt of the issuing company. However, they differ from traditional bonds in two key ways:

1. Unlike traditional bonds, the interest rate on floating-rate loans is reset frequently based on market rates. When interest rates rise, the interest paid by a floating-rate loan will also rise. In contrast, traditional bonds pay fixed interest rates, which stay the same for the term of the bond no matter what happens to market rates.
2. Floating-rate loans represent a senior/secured claim against the company. This means that in the event of default, holders of the floating-rate loans have first claim on the company's assets. This senior claim on assets isn't available to stock holders or traditional bond holders.

I haven't heard about floating-rate loans until recently. Is this a new asset class?

There has been an active market in floating-rate loans for over 20 years. Today, the market holds $1.312 trillion in assets (as at December 31, 2013), roughly the same size as the more well-known high-yield bond market.

Concerns that interest rates will rise in the near future continue to draw attention to floating-rate loans from both institutional and retail investors.

How will floating-rate loans help me when interest rates rise?

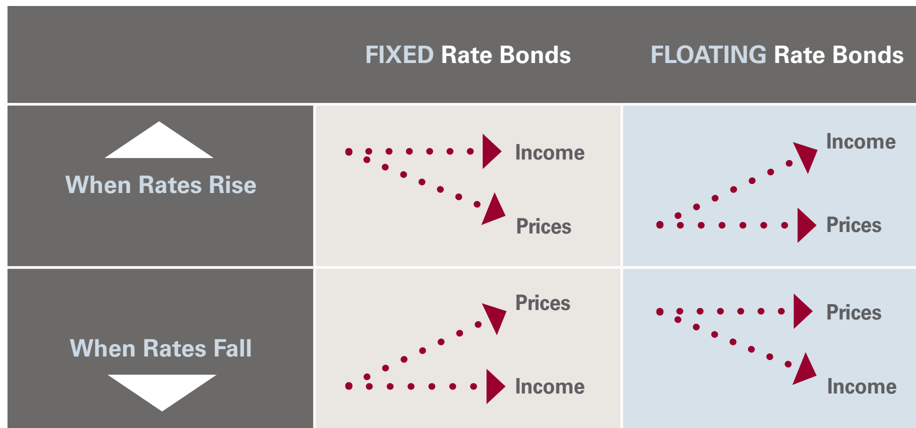
When you hold traditional bonds, they pay a fixed interest rate for the term of the bond. When market rates rise, the price of these bonds tends to fall because of this fixed income stream (which cannot increase to keep up with market rates). For these 'fixed-pay' bonds the only way to respond to interest rate movements is for prices to go up or down. In contrast, the interest paid on a floating-rate loan is based on prevailing market rates, and will rise (or fall) with the market (see Figure 1).

Let's assume the current market rate is one percent and the loan floats at the market rate plus four percent (called the spread or premium). The interest rate on the loan for the next three months will be five percent. Every three months, it will reset to the current market rate plus four percent. So if market rates rise to two percent, the new rate of interest on the loan will be six percent. Since the interest rate floats to keep up with market rates, the price of the floating-rate loan will not fall (see Figure 1). It's this flexible interest rate policy which leads to more stability in the price of floating-rate loans.

Interest rates are near historic lows and they have no place to go but up. The important question isn't when, but how much will they increase and how will that affect fixed-income portfolios.

Just as with equities, it's important to diversify the fixed-income portion of your portfolio to prevent a loss of value. Combining floating-rate loans with traditional bonds can be a good strategy to defend against interest-rate risk and prepare portfolios for this eventuality.

Figure 1: The impact of interest rate movements on bond pricing



Why should I use floating-rate loans as a source of income?

This asset class isn't about interest-rate timing – it's about getting ahead of the cycle. Increasing diversification among fixed-income holdings (to floating-rate loans) today can potentially help you prevent a future loss of value in your fixed-income portfolio when rates do rise.

Since floating-rate loans are made to below-investment-grade corporations, they typically offer greater yield potential than traditional bonds to compensate investors for the extra risk (known as credit risk). So even if rates don't rise immediately, you can still earn a competitive yield (higher than traditional investment-grade government and corporate bonds).

How do floating-rate loans impact risk in my portfolio?

1. Unlike many other types of bonds, floating-rate loans are secured by a company's assets. In the event of bankruptcy, floating-rate loans typically take priority over the other debts of a company. Repayment of floating-rate loans will come before other bonds, preferred shares, or common stock, adding a degree of security to investors holding these loans.
2. Investing in assets that tend to perform differently than existing holdings is an effective way to reduce portfolio volatility. Floating-rate loans have a low-to-negative correlation to traditional investment-grade fixed income and equity asset classes (in other words, they move in opposite directions).

It is important to note that floating-rate loans do carry extra risk because these are lower-quality debt and their prices can fluctuate at times. Investors are paid higher yields to compensate for this additional risk.

How can I access this asset class?

Since the loan market is limited to institutional investors, mutual-fund products like the Renaissance Floating Rate Income Fund offer individual investors access to this asset class.

While each investor's unique objectives must be considered, the Renaissance Floating Rate Income Fund can be used to potentially boost income in today's low-rate environment and safeguard your core fixed-income holdings in anticipation of rising interest rates.

Speak to your Advisor about how the Renaissance Floating Rate Income Fund can potentially:

- **Boost income** as floating-rate loans typically offer higher yields than traditional fixed-income assets.
- **Protect against rising interest rates** as the prices of loans are less sensitive to changes in market rates.
- **Manage portfolio risk** by increasing diversification in a fixed-income portfolio.

Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments. To obtain a copy, call CIBC Securities Inc. at 1-800-465-3863 or ask your advisor. Please read the Renaissance Investments family of funds simplified prospectus before investing. Mutual funds are not guaranteed, their values may change frequently and past performance may not be repeated. ®Renaissance Investments is offered by, and is a registered trademark of CIBC Asset Management Inc.