Clark Capital MANAGEMENT GROUP

NavigatorInsights

Will Floating Rates Rise to the Occasion?

The Good, the Bad and the Ugly of Floating Rate Debt

Historically low interest rates, accompanied by an unprecedented investor desire for income generation, have evidently led floating rate debt instruments to take center stage in the search for yield. The Morningstar Bank Loan (floating rate) category has had net flows of $38.6B year to date through July 31st, making it the #1 category in 2013. Clients are looking toward alternative income sources, and bank loans have captured their attention.

With interest rates poised to rise, this class of fixed income may help protect investors from the risks associated with a rising rate environment. But when considering investing in floating rates, it is critical to understand the unique characteristics of this asset class, and the impact the current market and economic environment will have on their potential for return.

In this issue of Navigator Insights, we will examine the benefits and risks associated with floating rates and how the current climate has led to structural changes in many of the current issues.

The Good

Floating rates have a variable interest rate that is typically tied to a money market rate index such as LIBOR. They carry little interest rate risk since the interest rate of the issue periodically adjusts as interest rates change and is designed to keep pace with the overall market's rate of interest.

During periods of economic growth and rising interest rates, floating rates can help investors diversify fixed income allocations and protect against interest rate risk. Unlike fixed rate bonds whose prices decline when rates rise, floating rate prices have been seen to remain relatively constant.

In today's extremely low rate environment, most high grade bonds are returning a zero real return when interest is adjusted for inflation. Floating rates offer a higher yield and may help investors maintain a sufficient income stream that is protected against inflation.

The Bad

The primary risk associated with this asset class is credit risk. Issues are typically below investment grade, and firms issuing the debt are highly leveraged. They cannot be considered a conser-

Correlation of Returns with Floating Rate Bonds

Source: Morningstar Direct

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As Clark Capital's Chief Investment Officer, Sean oversees all of the Firm's investment activities and heads the Firm's portfolio team. Sean joined the Firm in 1993 and is responsible for asset allocation and investment selection for Navigator Investment Solutions as well as directing ongoing market research and contributing to the development of proprietary products. Sean is a member of the Clark Capital Management Committee and the Board of Directors. He graduated from the University of Delaware, earning a B.S. and an M.A. in Economics. Sean is a Chartered Financial Analyst and a member of the CFA Institute (formerly AIMR) and the Financial Analysts of Philadelphia, Inc. Sean is considered an industry expert and is often asked to appear on CNBC and Bloomberg television to share his views on the market. In addition, Sean has been quoted in a number of articles in nationally distributed business journals and newspapers.

vative investment, and the majority of floating rates posted losses during the credit crisis.

Floating rates are not correlated to treasuries, which can make them a beneficial component to a diversified portfolio. However, they are highly correlated to high yield (junk) bonds.

The bank loan marketplace is typically a private one, unlike the traditional public corporate bond market. Because the market is private, pricing is often opaque, and liquidity constraints may negatively impact returns. With the amount of inflows into the category year to date, there are concerns that investors may be checking into Hotel California – You can checkout any time you like, but you can never leave! At least not without paying a steep price if everyone heads for the door at the same time. On the other hand, high yields have greater liquidity and better price transparency.

The Ugly

Today's floating rates carry some additional risks that must be considered. The current high demand for floating rates has led to an increased frequency of new issues, many of which have more aggressive risk profiles than usual. Most bank loans are now structured in a way that may seek to cap interest rates unless short term rates rise to a predetermined point. As a result, investors may not see an increase in coupon payouts until money markets rise higher than is typically required for the issuer to make a change to the coupon rate.

Furthermore, many of the bonds are callable. If an issuer redeems a bond before maturity, the investor could miss a significant portion of the rate increase. In such a scenario, the investor may never see the benefits of holding onto floating rates in a rising rate environment.

Investment Considerations

Floating rate funds are included in the investment universe for Clark Capital's Navigator® Fixed Income Total Return strategy. Our portfolio managers consistently weigh the benefits and the risks associated with investing in this asset class. Up until this point, we have used high yield bonds as the primary low quality debt investment vehicle in the strategy. If we identify benefits that floating rates will provide above and beyond high yields, such as providing a cushion against rising rates or enhancing the risk profile of the overall portfolio, we would consider an investment in the floating rate space.

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