An Update on the IA Clarington Floating Rate Income Fund

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Have you made portfolio adjustments given recent volatility in fixed-income markets?

Tracy Zhao: We plan to maintain status quo as floating rate loans, given its lack of interest rate sensitivity, will continue to stand out amongst credit. First quarter was certainly a shock to fixed-income investors who for the most part saw losses in the mid- to high-single digits, which were on par with losses seen in the equity markets. Meanwhile, the Credit Suisse Leveraged Loan index was down only -0.1% in the first quarter.

On the topic of rising inflation, we're always mindful of our portfolio companies' margins and ability to service their debt. While increasing inflation is top of mind for all, we've also seen our companies be able to offset inflation through means such as cost pass-throughs. For example, airline ticket prices are 20% higher or more in some cases than 2019, yet demand is soaring as travel rebounds.

So far, we've not seen a significant deterioration in margins our portfolio companies.

Why are floating rate loans a good option in an environment where inflation and interest rates are rising?

Tracy Zhao: For credit investors to generate a positive real return, an important piece of the pie is for yield generated to be sufficient to offset inflation. This is a challenge for most fixed-income assets currently. Meanwhile, floating rate loans will see their coupons reset and increase as rates rise. This is especially the case now with LIBOR and SOFR at 1%+ and they are exceeding the coupon floors on virtually all floating rate loans. At the end of the first quarter, the Credit Suisse Leveraged Loan index had yields of 7.1% based on a three-year LIBOR curve. A number that continues to rise.

Are you putting cash to work in this environment?

Tracy Zhao: Well, we've been fortunate to add yet another credit analyst to the team in 2021, so with six investment professionals we've added over 15 new names into the portfolio since last year. And as a result, we've also reduced individual weights and position sizes and increased diversity to the portfolio. More recently, we took advantage of the volatility in the market that began in late January from the uncertainty on rates and inflation, followed by February's geopolitical tensions to add a handful of names at attractive levels.

The average price of the Credit Suisse Leveraged Loan index slid in late January and hit a one-year low in mid-March of 95.8, which quickly rebounded to 97.4 by the end of the month. We also reduced several positions in higher duration, high yield credits, mostly at prices above par.

Is your data showing strong flows into senior loans from investors?

Tracy Zhao: We're certainly seeing a continuation of the strong flows that began last year. The reflationary conditions set in 2021 have now led to 16 consecutive months of retail inflows. Retail inflows in the first quarter of 2022 were the second largest quarterly inflows on record. Similarly, inflows from institutional have also been strong and this has created a very strong technical for our loans.

The hawkish tone from the Fed as well as other central banks through the first quarter of 2022 resulted in market expectation by end of March for eight rate hikes in 2022 in the US. That's up from an expectation of three hikes at year-end 2021. Fed fund futures are now pricing in an additional nine-plus 25 basis point hikes for the balance of 2022. The expectation currently is for two 50 basis point hikes in May and June, so the traditional 25 basis point hiking cadence should change as well as the Fed is so far behind the curve.

Are you concerned about defaults?

Tracy Zhao: By the end of last year the loan default rate had fallen to 0.7%. That's the fourth lowest level in history and we expect that it will remain comfortably below historical averages this year as well. Given the strong investor demand for loans in 2021, it was an advantageous year for borrowers to refinance their near-term maturities with new loans and push out their maturity profiles and generally also price their debt at very attractive rates.

Without imminent debt maturities to address we think the risk of defaults remains low in 2022. What we are mindful of this year is that while lower quality CCC credit had a tremendous year in 2021, returning 15% versus 5.4% for the overall index, against a backdrop of higher inflation, pressuring margins and higher rates resulting in increased interest expenses, it will be more precarious for some of these lower quality credits that have higher leverage and lower interest coverage to withstand these pressures.

Our floating rate funds have an average rating of single B flat, and we generally focus on staying in higher credit quality names. We continue also to believe that slowing growth is inevitable as the central banks tighten liquidity, and as such we're increasing diversification and liquidity in the portfolio by reducing maximum hold levels, adding new positions and tilting the portfolio to higher quality borrowers.