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PUBLIC FIXED INCOME

The Investment Case for Senior Secured Bonds

INSIGHTS

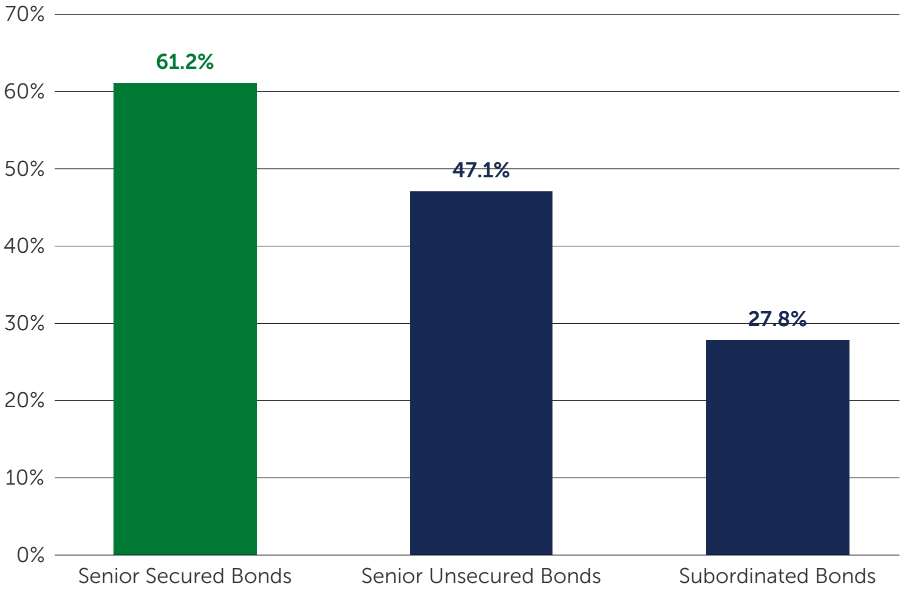
In an environment of higher rates and uncertainty, the combination of seniority and security, relatively lower interest rate sensitivity, and high current yields presents a compelling case for senior secured bonds.

The Case for Senior Secured Bonds

Senior secured bonds are high yield bonds that are both senior and secured in the capital structure. This means that if a company defaults on its debt obligations, these bonds are the first in line to be repaid, ahead of junior, or subordinated, debt. They are also secured by collateral, which can comprise a range of assets including real estate, equipment and vehicles, as well as intangible items such as software or trademarks.

As a result of these characteristics, in the case of bankruptcy or default, senior secured bonds have historically offered a **higher recovery rate than unsecured bonds**. For example, from 1987–2022, the average recovery rate for defaulted senior secured bonds was 61.2%, compared to 47.1% for senior unsecured bonds and 27.8% for subordinated debt **(Figure 1)**.

Figure 1: Senior Secured Bonds Have Historically Offered Higher Recovery Rates



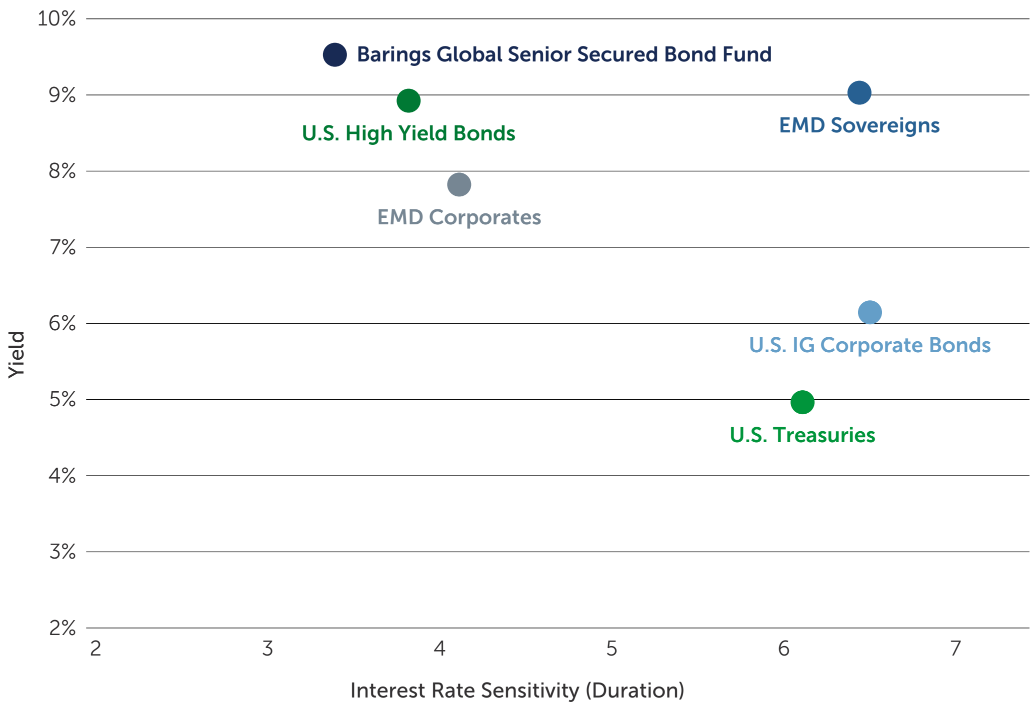
Source: Moody's Investors Services Annual Default Study. As of March 13, 2023.

It is worth noting that restructuring an issuer's debt in order to achieve the best possible recovery rate requires deep resources and experienced investment teams. To that end, we believe it is important for investors to partner with managers that have a long track record of handling such situations through the ups and downs of economic cycles. The average annual recovery rate for the Barings Global Senior Secured Bond Fund since inception in 2011 has been 67%.[1]

1. Source: Barings. As of August 30, 2023.

In addition, senior secured bonds exhibit relatively **low sensitivity to interest rate moves** as evident by the low duration profile of the asset class—senior secured bonds currently have an effective duration of 3.2 years, compared to 3.5 years for the broader high yield market and 5.9 years for investment grade credit.[2] In particular, the global senior secured bond market has a relatively short maturity profile, with only 1% of the market having a maturity greater than 10 years.[3] This should make the senior secured bond market less sensitive to any selling pressures across the longer maturity segment of the bond markets (i.e. to a steepening of the yield curve).

Figure 2: High Yield Prospects With Limited Interest Rate Sensitivity



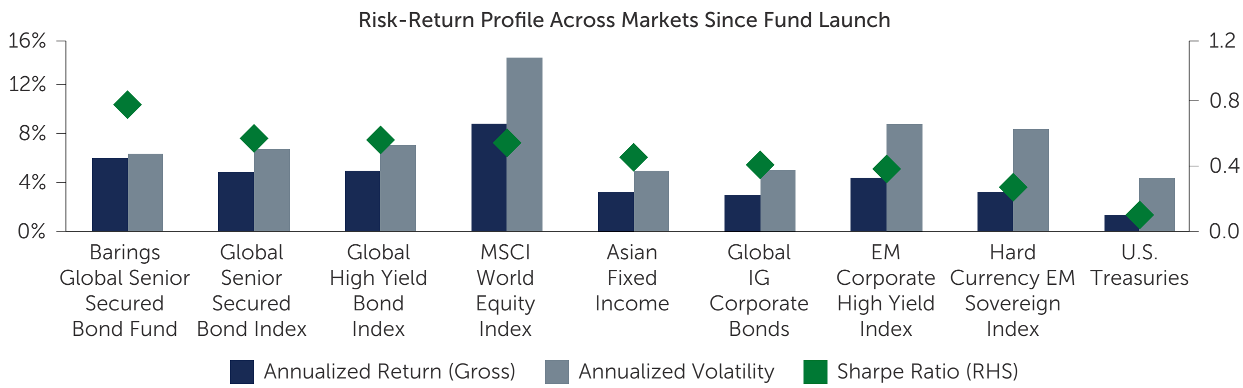
Source: JPM CEMBDI BD Index, JPM EMBI GD Index, ICE BofA U.S. Corporate index, ICE BofA U.S. Treasury Index, ICE BofA U.S. High Yield Index, Barings Global Senior Secured Bond Fund. As of September 29, 2023. Yield figures for the Barings Fund are in USD Hedged terms.

Further, in a recessionary environment, given that they are higher in the capital structure than unsecured bonds, senior secured bonds can offer investors **greater protection from principal loss** in the event that market default rates spike. That said, the asset class is not recession-proof. Similar to traditional high yield bonds, senior secured bonds are sensitive to the credit fundamentals of the issuer, and economic slowdowns can put pressure on corporate cash flows and/ or profitability. An actively managed investment approach focused on rigorous bottom-up credit analysis, and careful security selection, can help mitigate some of the downside risks.

2. Source: ICE BofA BB-B Global High Yield Secured Bond Index, ICE BofA Non-Financial Developed Markets High Yield Constrained Index, ICE BofA Global Corporate Index. As of September 29, 2023.
3. Source: ICE BofA. As of September 29, 2023.

The characteristics of this asset class have resulted in a **compelling performance profile** on a historical basis. In particular, the Barings Global Senior Secured Bond Fund has delivered superior risk-adjusted returns since its inception over 12 years ago **(Figure 3)**. To provide some context, the Fund has achieved almost double the returns generated by the global investment grade corporate bond market with only modestly higher volatility. Even relative to global equities, the Fund has achieved around two thirds of the total returns with less than half the volatility. In addition, the yields on offer in the senior secured bond market today are akin to what equity markets have delivered over the long term, with the added benefit of regular coupon income and capital structure seniority.

Figure 3: Global Senior Secured Bonds Have Delivered Attractive Risk-Adjusted Returns (February 2011–September 2023)



Source: ICE BofA BB-B Global High Yield Secured Bond Index (USD Hedged), ICE BofA Non-Financial Developed Markets High Yield Constrained Index (USD Hedged), JPM EMBI Global Diversified Index, JPM CEMBI Broad Diversified Non-Investment Grade Index, MSCI World Equity Index, JPM JACI Index (USD Hedged), JPM U.S. Treasury Index and ICE BofA Global Corporate Index (USD Hedged). As of September 29, 2023. Notes: All returns in USD. Risk-adjusted returns are calculated as (annualized returns-risk free rate)/standard deviation. Risk free rate for sharpe ratio and risk-adjusted return calculation is the Bloomberg Barclays U.S. Treasury Bellwethers 3-Month Total Return Index. Barings Fund returns provided on a gross of fee basis.

A Deep and Well-diversified Opportunity Set

The senior secured bond market has experienced substantial growth over the last decade, reaching around $573 billion in face value today, equivalent to about one third of the global high yield bond market.[4] The growth of the asset class is largely due to its emergence as a viable source of funding for companies as other capital-raising avenues—including loans and unsecured bonds—faced limitations.

Comprising this broad and deep market are bonds from recognizable global brands and leaders within their respective industries—such as American Airlines, Royal Caribbean and Virgin Media—as well as smaller and lesser-known companies, across a range of sectors from telecommunications to services to health care. Companies choose to issue senior secured bonds for a number of reasons including refinancing existing debt, lowering their cost of capital, or as part of a finance package to complete a merger or acquisition. In particular, companies will aim to match their balance sheet with what is specifically required for their needs and what is available in the market. And if a company has assets it can pledge as security, a secured bond—as opposed to a traditional high yield bond—may better suit its needs, and could be a cheaper method of financing.

4. Source: ICE BofA. As of September 29, 2023.

Why Now?

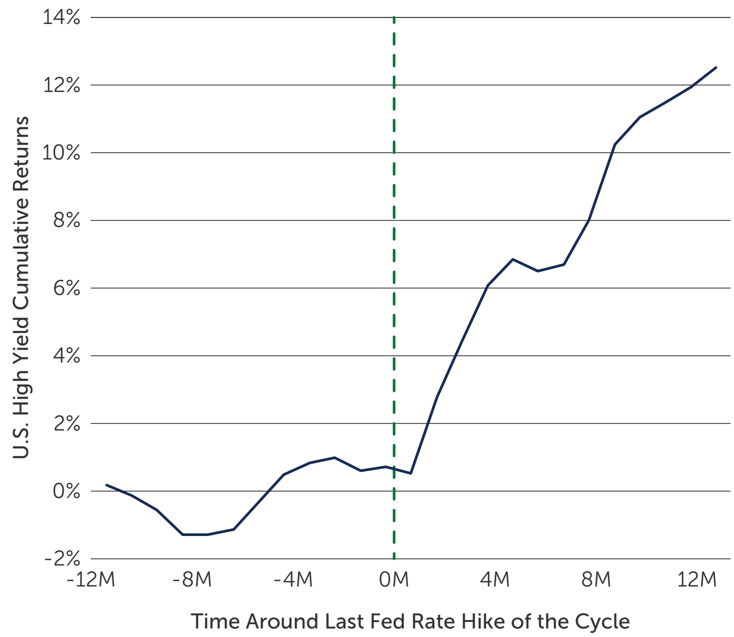
Since early 2022, fixed income markets have undergone significant re-pricing, driven by the fastest pace of U.S. interest rate hikes since 1980. Inflationary pressures have eased in recent periods, with U.S. headline CPI inflation falling from 9.1% year-over-year in June 2022 to 3.7% year-over-year in September 2023. While near-term prospects for interest rate moves remain uncertain and data driven, moderating inflation should slow the eventual need for future hikes, which should provide a more constructive backdrop for fixed-rate assets. To provide some historical context, looking at the past four U.S. rate hiking cycles since 1994-1995, the last rate hike of the cycle has on average been followed by high yield returns of 11.8% over the subsequent 12-month period **(Figure 4)**.

In addition, most high yield issuers are generally starting from a position of relative strength, and have been able to protect their balance sheet credit quality despite higher marginal funding costs. Companies took advantage of record low interest rate levels in 2020 and 2021 to issue new debt and lock in low borrowing costs. Debt proceeds were predominantly used for creditor-friendly refinancing purposes, which pushed out the debt maturity profile and gave companies ample headroom to navigate the current market environment **(Figure 5)**.

In contrast, if you compare corporate behavior in the period leading up to the Global Financial Crisis, a lot of the new debt proceeds were instead being used for shareholder-friendly activities such as mergers and acquisitions and leveraged buyouts, which added more strain on company balance sheets.

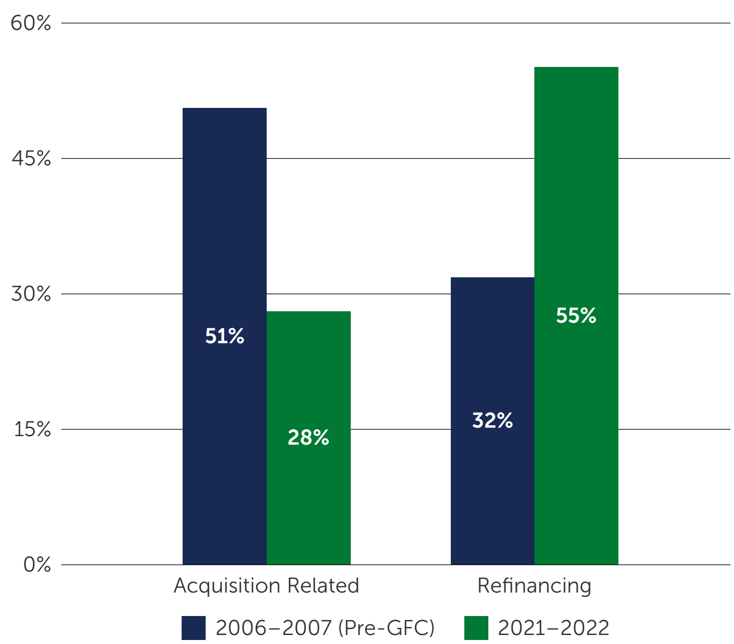
As we look ahead, we expect new issuance activity to remain modest, especially given the higher rate environment and lower need for most companies to refinance debt in the near term. In contrast, on the demand side, we have started to see interest pick up for fixed-rate investments given the elevated yields on offer. This should provide a supportive technical market backdrop.

Figure 4: U.S. High Yield Returns During Past Rate Hike Cycles



Source: Bloomberg, ICE BofA US High Yield Index. As of December 31, 2019. The four previous U.S. rate hiking cycles referenced here cover the periods 1994–1995 (last hike in Feb 1995), 1999–2001 (last hike in May 2000), 2004–2007 (last hike in June 2006) and 2015–2019 (last hike in Dec 2018).

Figure 5: Use of New Bond Issuance Proceeds



Source: Pitchbook, LCD. As of December 31, 2022.

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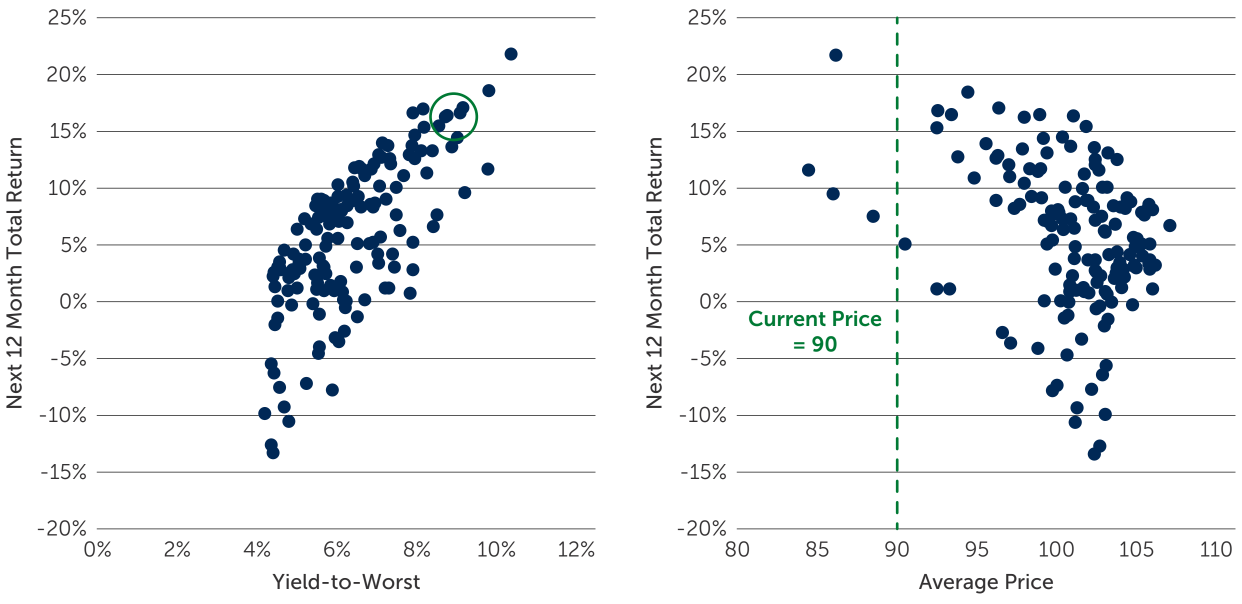
"Manageable default rates combined with higher starting yield levels and a regular stream of coupon income should provide greater cushion for credit investments in a downside scenario."

Even if a recession arrives in 2024, a sharp increase in defaults looks less likely, especially given the ample cash cushions and financial discipline evident at these issuers. In our opinion, at current and anticipated default rates, likely credit losses can be readily absorbed by the senior secured bond market given the current yields on offer. Any degradation in company profit margin levels, or a generally more challenged growth environment, should also have a greater impact on economically sensitive equity markets, while manageable default rates combined with higher starting yield levels and a regular stream of coupon income should provide greater cushion for credit investments in a downside scenario. In particular, yields across most fixed income asset classes are in the 80th-90th percentile versus the last 20 years, with yields on the global senior secured bond market reaching 8.9% with a discounted price level of 90 **(Figure 6)**. From a historical perspective, yields/prices near current levels are rare and have historically led to strong double-digit 12-month forward returns.

Figure 6: Current Prices and Yields Have Historically Led to Strong Double-Digit 12-Month Forward Returns



Source: Barings and ICE BofA. As of September 29, 2023. Global Senior Secured Bond market represented by the ICE BofA BB-B Global High Yield Secured Bond Index (HW4S). Total return next 12 months represents the return for the index for the 12 months following the price as of each date. Time period shown is the start of 2010 to the end of 2022 using month-end values. For illustrative purposes only. This analysis is intended to demonstrate only the specific elements discussed. This analysis does not represent all of the elements and variables that could be factored into the potential outcome. PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS.

Specific to senior secured bonds, the high current yields on offer combined with a relatively short duration profile create a compelling backdrop and provide resiliency from an expected return standpoint. Figure 7 looks at how market outcomes might be impacted in different scenarios. Taking a 12-month forward view, and given the current profile of the market, yields or credit spreads would need to widen by over 300 basis points (bps) in order to produce a breakeven or zero return outcome. A scenario of no price change would likely produce a return outcome more in line with the income profile, while price increases as bonds move closer to par value from highly discounted levels would add additional capital appreciation potential to the total return profile.

Figure 7: 12-Month Forward High Yield Returns Across Various Scenarios

		12-Month Look Forward		
Global Senior Secured Bond Index		Breakeven	No Price Change	No Spread Change
Price	90.0	84.0	90.0	92.1
Coupon	6.0%			
Yield-to-worst	8.9%	12%	9.6%	8.8%
Spread-to-worst	446	770	525	446
Mod Dur to Worst (yrs)	3.4			
Next 12-Month Return		0%	7%	9%

Source: Barings, Bloomberg. As of September 29, 2023. Global Senior Secured bond market represented by the ICE BofA BB-B Global High Yield Secured Bond Index (HW4S). For illustrative purposes only. This analysis is intended to demonstrate only the specific elements discussed. This analysis does not represent all of the elements and variables that could be factored into the potential outcome.

It's important to note that periods of volatility can—and often do—result in opportunities for active, bottom-up managers to generate alpha. A credit-intensive approach, however, is crucial to both avoiding additional downside, and identifying issuers that can withstand the current challenges with the potential to thrive beyond today's events.

Our Approach

Barings has been an early investor in the global senior secured bond market, with a more than 12-year dedicated track record, making us one of the most established asset managers operating in this space. More broadly, Barings' history across high yield investing goes back over two decades, with a successful track record operating high yield bond and senior secured loan strategies across multiple market cycles.

Figure 8: Compelling Risk-Reward Profile Relative to the Index

Since Inception	Annualized Returns	Annualized Volatility	Sharpe Ratio	Upside Capture	Downside Capture	Beta
Fund—Gross of Fees	6.10%	6.46%	0.8	101.66%	84.31%	0.92
Index	4.96%	6.85%	0.59	—	—	—
Difference—Gross of Fees	+114 bps	—	0.21	—	—	—

Source: Barings. As of September 29, 2023.

Our historical performance track record has been compelling, from a total return, benchmark relative return (alpha), as well as from a risk-adjusted return perspective **(Figure 8)**. The Fund has also delivered consistent outperformance in differing market environments, highlighting the benefits of an active and bottom-up oriented investment approach.

A key contributor to our success is our large global team. Barings has one of the industry's largest dedicated global teams, with over 60 dedicated U.S. and European high yield investment professionals. Another benefit of our high yield platform is our ability to collaborate with our Capital Solutions group, which helps us maximize recovery values in the event of a credit impairment. Our scale allows us to conduct detailed, bottom-up analysis of company financials, integrate ESG factors into our credit assessment, and to actively engage with company management to identify attractive opportunities. Given the market uncertainties at play, we continue to manage the Barings Global Senior Secured Bond Fund in a highly active manner, with a strong emphasis on bottom-up security selection.

Barings Global High Yield Bonds & Loans

$50.7 B AUM

20+ YEARS INVESTING IN HIGH YIELD

16 PORTFOLIO MANAGERS WITH

22 YEARS ON AVERAGE INDUSTRY EXPERIENCE

31 RESEARCH ANALYSTS

6 DEDICATED TRADERS

Source: Barings. As of June 30, 2023.

Barings is a $351+ billion global investment manager sourcing differentiated opportunities and building long-term portfolios across public and private fixed income, real estate and specialist equity markets. With investment professionals based in North America, Europe and Asia Pacific, the firm, a subsidiary of MassMutual, aims to serve its clients, communities and employees, and is committed to sustainable practices and responsible investment.*

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**As of June 30, 2023*

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