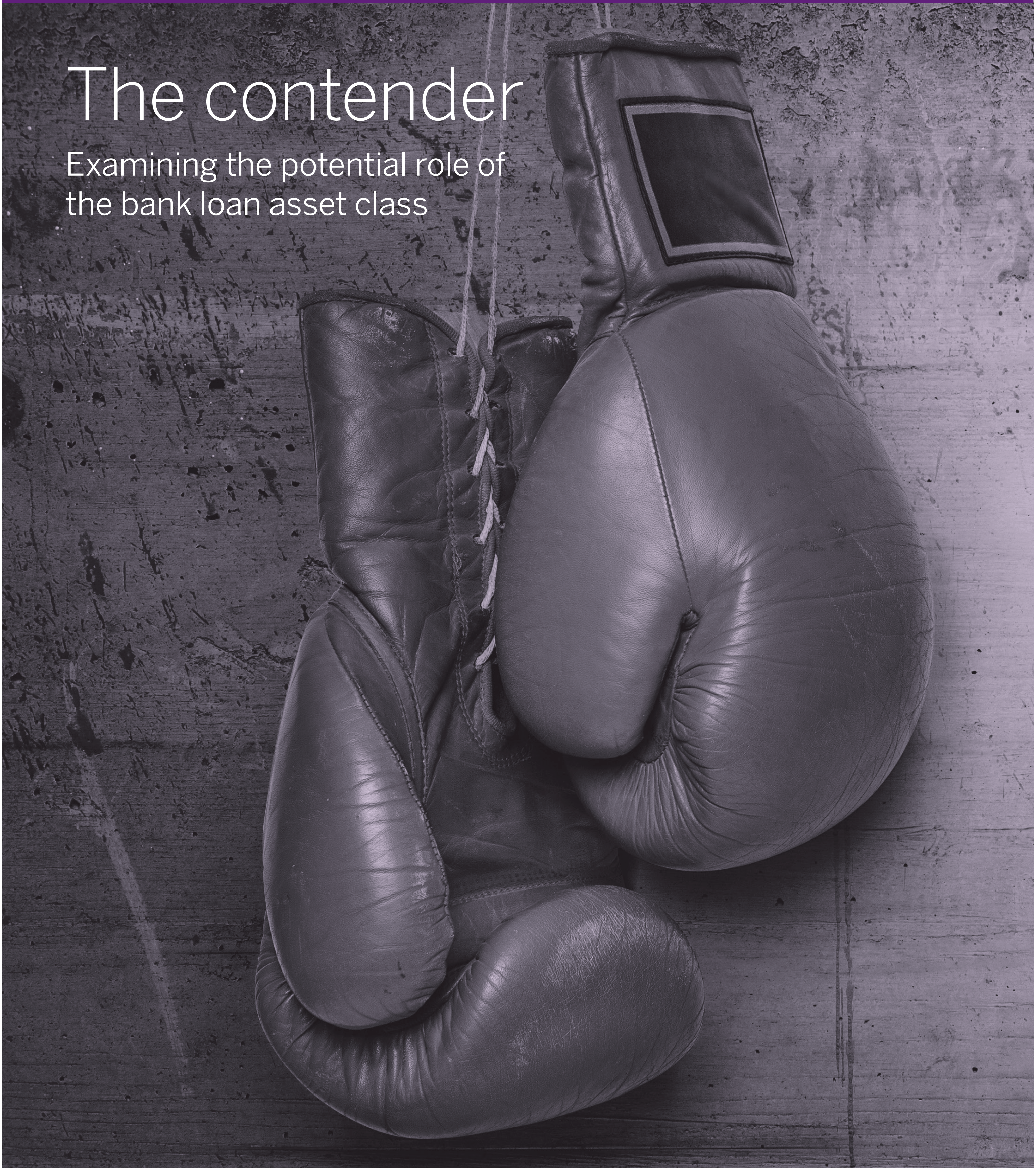
SPECIAL REPORT

The contender

Examining the potential role of the bank loan asset class



Victory Capital®

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Table of contents

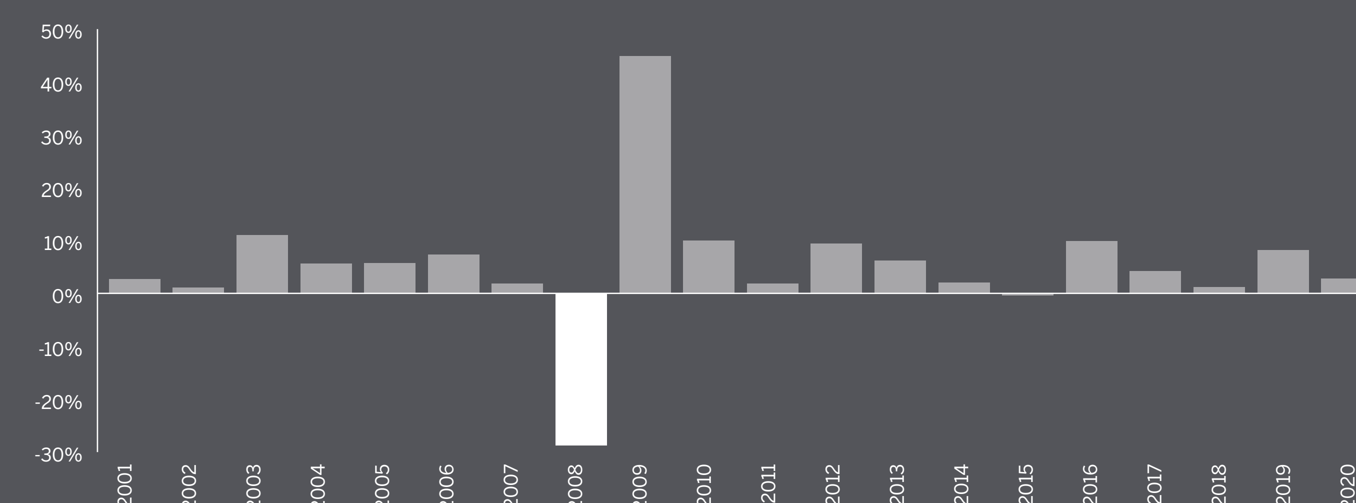
Quick hits

> Floating-rate bank loans exhibit characteristics that make them a potentially useful component of a diversified fixed income portfolio. Specifically, floating-rate bank loans may be an effective hedge against rising interest rates and inflation because their rates reset as market interest rates rise.

> The Credit Suisse Leveraged Loan Index,[1] a widely used benchmark for the asset class, has had only two negative years since 1992: once during the height of the global financial crisis in 2008, and a marginal negative return in 2015. On average this index has returned 5.5% annually. Of course, past performance does not guarantee future results.

EXHIBIT 1. Returns of the bank loan market

Credit Suisse Leveraged Loan Index annual returns, 2001–2020



Past performance does not guarantee future results. Index returns are for illustrative purposes only and do not reflect management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index.

Source: Zephyr StyleAdvisor.

> Bank loans may provide diversification benefits due to their low duration[2] and low historical correlation[3] with other fixed income and income-earning equity investments.

> The bank loan asset class is well established, and long-term institutional investors tend to dominate the market, which generally has a stabilizing effect.

1 The Credit Suisse Leveraged Loan Index is a monthly rebalanced index with an inception date of December 31, 1991. It is designed to mirror the investable universe of the USD-denominated leveraged loan market.

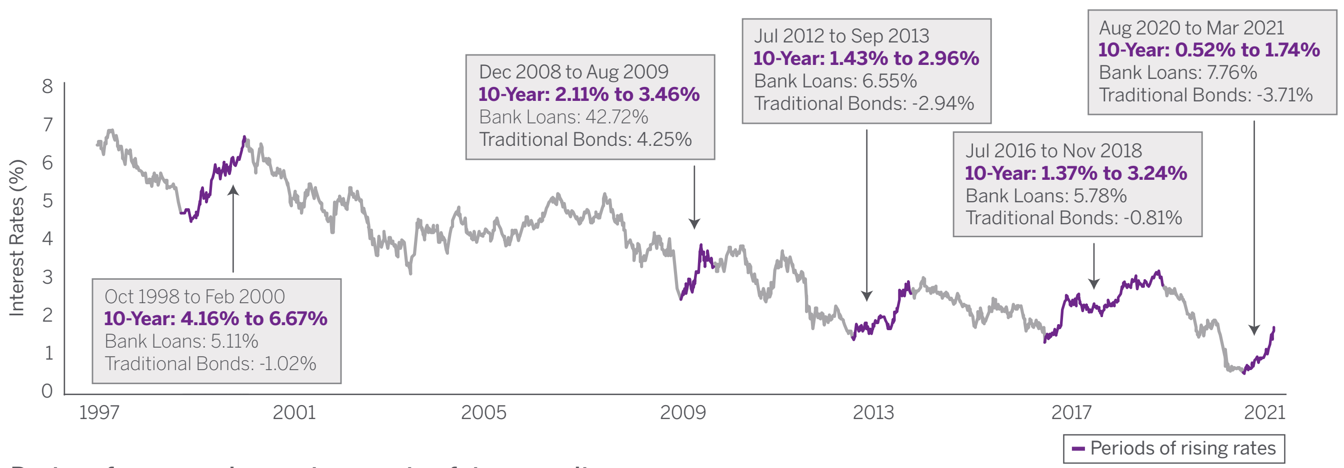
2 Duration is a measure of a bond price's sensitivity to a given change in interest rates. Generally, the longer a bond's duration, the greater the price sensitivity to a change in interest rates.

3 Correlation is a statistical measure of how two securities move in relation to each other ranging between -1.00 and +1.00. Securities with a correlation of +1 move together in the same direction. Conversely, those with a low correlation of a -1.00 move in opposite direction.

EXHIBIT 2. Bank loans in a rising rate environment

10-Year Treasury Rate, January 1997–March 2021

As investors position portfolios with the expectation of rising interest rates, consider the historical returns of floating-rate bank loans during three different periods of federal funds rate increases. Yield on bank loans adjusts periodically based on a short-maturity interest rate benchmark, often the three-month London Interbank Offered Rate (LIBOR).



Past performance does not guarantee future results.

Sources: The 10-year U.S. Treasury yield: Bloomberg.
The Bloomberg Barclays U.S. Aggregate Bond Index returns: Bloomberg.
S&P/LSTA Leveraged Loan Index return data: S&P Leveraged Commentary & Data.
Index returns are for illustrative purposes only. Index performance does not reflect management fees, transaction costs or expenses.
Indexes are unmanaged and one cannot invest directly in an index.

A ringside view of the bank loan asset class

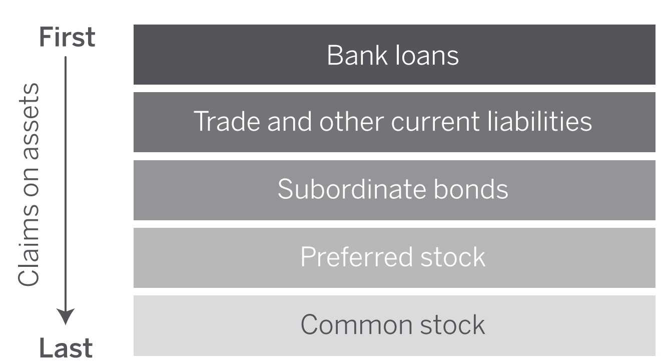
As their name suggests, floating-rate bank loans are loans with variable interest rates that banks provide to companies. Rates normally reset every 90 days and are based on a short-term interest rate benchmark, the three-month London Interbank Offered Rate (LIBOR).[4] Although these loans are usually rated below investment grade,[5] they are typically senior-ranked debt secured by company assets (Exhibit 3).

Over the past 30 years, the bank loan market (also known as leveraged bank loan or structured bank loan) has gone from a small secondary market to an established asset class.

Unlike most fixed income instruments, bank loan yields adjust. In theory, this regular interest rate adjustment provides a high degree of price stability, which is especially appealing at a time when rates are moving higher, since bond prices fall when interest rates rise. Some investments are more sensitive to rate changes than others, and duration is a measure of that sensitivity. The greater the duration, the greater the negative impact of rising rates.

Investors considering corporate debt face two key risks: credit (or default) risk and interest rate (or duration) risk. Those seeking higher yield in government or investment-grade debt are taking on relatively little default risk, so higher yields come from taking more duration risk by buying longer-term securities. Some investors seeking greater interest income have been gravitating toward high-yield bond funds, which seek higher yields through greater duration risk, greater credit risk, or both.

EXHIBIT 3. Senior in the capital structure



Source: Victory Capital.

4 The London Interbank Offered Rate is a benchmark rate that some of the world's leading banks charge each other for short-term loans.

5 A below-investment-grade bond is a corporate or municipal bond that has a credit rating below BBB from the major credit rating agencies. These are also called junk bonds.

Blow by blow: Basic features of leveraged loans

Historically, bank loans were customized, private agreements between banks and their customers. Loans were strictly buy-and-hold instruments held on banks' books until the loan was repaid or otherwise extinguished.

But it was difficult for large companies to manage relationships with dozens of banks, each with its own credit agreement, and the proliferation of foreign banks lending in the 1970s and early 1980s only exacerbated this problem. In response, standardized credit agreements emerged in which a borrower would designate an "agent bank" to administer the loan. This standardization of credit agreements laid the groundwork for trading in bank loans.

Subsequently, a secondary market for leveraged bank loans emerged in the 1980s as investors began to understand the potential benefits of this asset class:

> Low duration may limit exposure to rising rates:
One of the unique characteristics of leveraged bank loans is that, unlike most fixed income instruments, they can limit exposure to rising interest rates, providing greater price stability when compared with longer-term fixed interest rate bonds. Bank loans typically reset every 90 days and are priced at a spread based on LIBOR, which is the rate at which banks borrow unsecured funds from each other.

The vast majority of loans have "floors," which keep their yields steady until LIBOR has risen by a set amount. While this may suppress yields at the beginning of a sustained rise in rates, it also provides stability and generally does not outweigh the benefit over the longer term.

As illustrated in Exhibit 2, bank loans have offered competitive returns in rising rate environments. This feature appears to be increasingly important as investors adjust to a reversal in the long-running trend of falling U.S. interest rates. While floating-rate loans may not offer the highest absolute yields, they have the potential to offer compelling value, especially when duration risk is considered.

> Governed by credit agreements with covenant packages:
Bank loans are governed by credit agreements that contain both affirmative ("you shall do this") and negative covenants ("you may not do this"). Sometimes there are also financial covenants that limit, for example, the amount of debt a company can take on. Loans without financial covenants are known as "covenant lite."

> Low historical correlation with other asset classes:
Correlation is the tendency of different types of investments to move in tandem, and it can be a vexing issue for investors seeking to diversify their portfolios, particularly if they have little tolerance for significant swings in valuation. Bank loans have had a low correlation to traditional fixed-income investments and to equities (Exhibit 4). This low correlation can be helpful in building more resilient portfolios.

EXHIBIT 4. Correlations

June 2011–May 2021

	Credit Suisse Leveraged Loan	Bloomberg Barclays U.S. Corporate High Yield	S&P 500	Bloomberg Barclays U.S. Corporate Investment Grade	Bloomberg Barclays U.S. Treasury
Credit Suisse Leveraged Loan	1.00	–	–	–	–
Bloomberg Barclays U.S. Corporate High Yield	0.85	1.00	–	–	–
S&P 500	0.65	0.77	1.00	–	–
Bloomberg Barclays U.S. Corporate Investment Grade	0.54	0.66	0.35	1.00	–
Bloomberg Barclays U.S. Treasury	-0.37	-0.23	-0.40	0.47	1.00

Past performance does not guarantee future results.

Source: Zephyr StyleADVISOR.

- Seniority in the capital structure: Default rates for bank loans generally are low, and in the event of a default, bank loans are typically senior in the capital structure and secured by a lien on assets (Exhibit 3). In other words, these loans have priority for repayment and access to collateral. Over the past 20 years, which of course includes the 2008 financial crisis, the long-term average default rate for leveraged loans was 3.0%.When a borrower did default, the 23-year average recovery rate was 65%, compared with 36% for high-yield bonds (Exhibits 6 and 7).
- Institutional participation provides stability: Collateralized loan obligations (CLOs), which package loans together and offer them to investors in tranches, make up approximately 70% of the leveraged loan market, according to JP Morgan. CLOs are often favored by institutions with longer investment horizons. CLO money is typically committed for a period of eight to 10 years and thus can have a stabilizing influence on the loan market, since CLOs do not engage in the kind of rapid-fire trading that often fuels volatility. Investment in CLOs remains robust (Exhibit 5). CLOs continue to offer vital support to the loan market.

ROUND 1 ONE

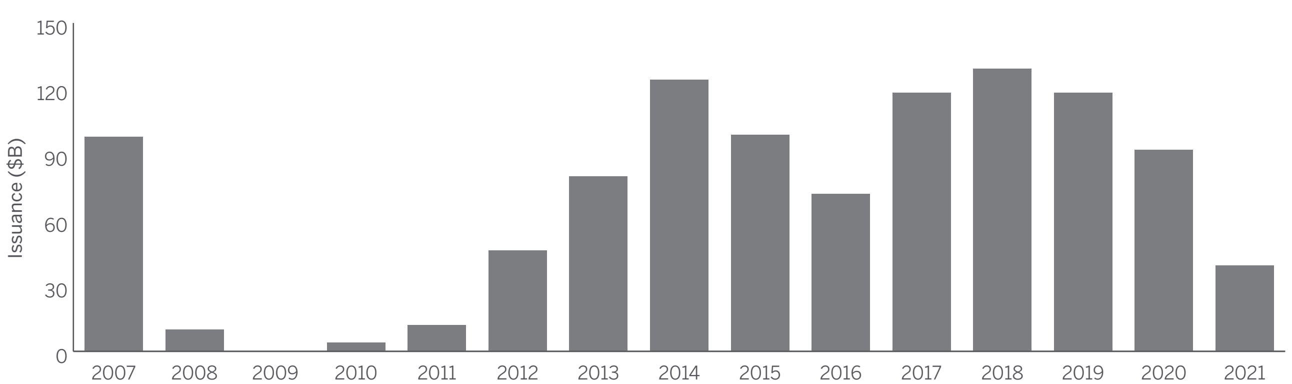
Bank loans versus chasing yield

For several decades until recently, Treasury yields have been trending lower. While low interest rates are generally considered constructive for economic growth and for asset classes such as equities and real estate, they make it more challenging to generate current income. As a result, many fixed income investors have turned to high-yield debt investments[6] as a means to boost the income potential of their fixed income portfolios.

Falling Treasury yields and heavy demand for high-yield bonds has tended to inflate prices for the lowest-rated bonds. That calls into question whether high-yield corporate bonds still offer a favorable balance of risk and reward when compared to other strategies.

From a credit risk perspective, there is an important distinction between floating-rate bank loans and high-yield bonds. Since floating-rate bank loans are generally below investment grade, credit risk is greater than it is with investment-grade debt. However, credit risk in bank loans is generally lower than that of comparably-rated high-yield bonds (Exhibits 6 and 7). Although bank loan and high-yield bond default rates spiked in 2009, over the long term the default loss rate for bank loans has been significantly lower than that of high-yield bonds.

EXHIBIT 5. Collateralized loan obligations (CLOs)
January 2007–March 2021

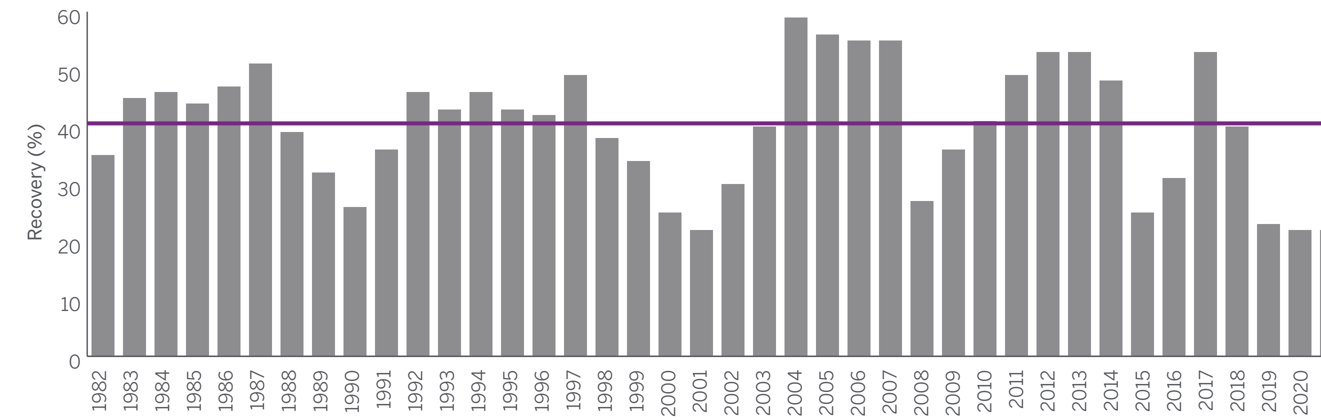


Source: Leveraged Commentary and Data (LCD), which is an offering of S&P Global Markets Intelligence.

6 High-yield debt funds (often referred to as junk bond funds) are rated below investment grade and considered at higher risk for default. However, these funds typically pay higher yields than investment-grade funds.

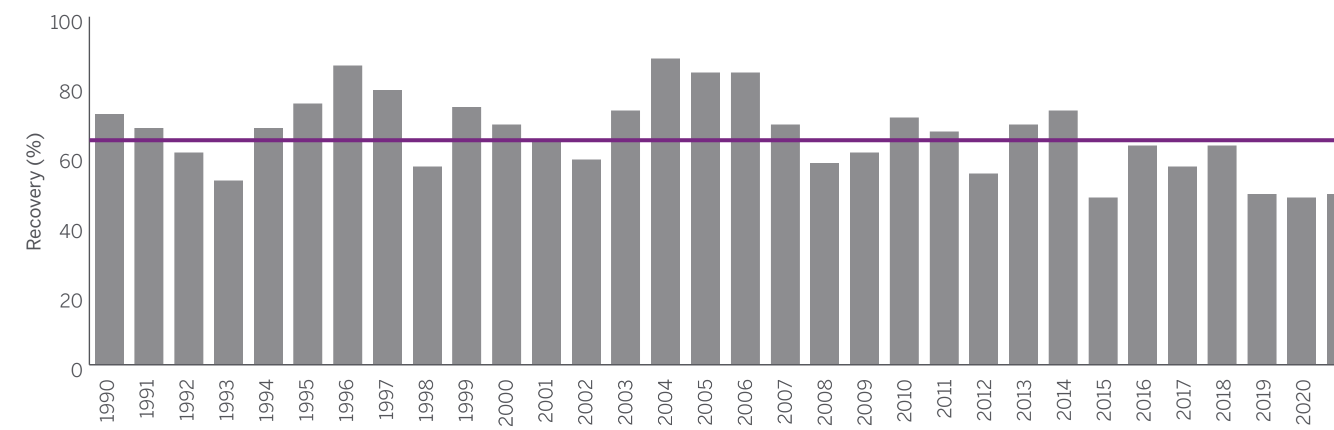
7 Drawdown is the peak-to-trough decline in the price of an investment during a specific time period.

EXHIBIT 6. Bond issuer-weighted recovery rates (As of 2021)



Note: Recoveries in 2009 were 22.4% and 48.3% for all bonds and loans, respectively, based on prices 30 days post default and were 35.7% and 61.4% based on year-end prices.
Sources: Moody's Investors Services, J.P. Morgan, Markit, S&P LCD.

EXHIBIT 7. First-lien leveraged loan issuer-weighted recovery rates (As of 2021)



Note: Recoveries in 2009 were 22.4% and 48.3% for all bonds and loans, respectively, based on prices 30 days post default and were 35.7% and 61.4% based on year-end prices.
Sources: Moody's Investors Services, J.P. Morgan, Markit, S&P LCD.

ROUND 2 TWO

Bank loans versus income alternatives

Investors continue looking beyond high-yield bonds to nontraditional income strategies as a means to boost yields. Among other approaches, they have sought out dividend-paying and preferred equities, as well as tax-advantaged real estate investment trusts (REITs) and energy infrastructure limited partnerships. Of course, every income-bearing strategy carries its own risk and reward trade-offs. The risk profile of higher-yielding assets is dynamic, and asset classes fall in and out of favor with investors. Rising demand can impact pricing, so investors should consider not only default and interest rate risk, but also volatility and potential drawdown.[7]

Given the current low interest rate environment, a closer look at the risk profile of floating-rate loans versus alternative income-generating strategies reveals that they may be a suitable addition to investor portfolios. However, it is important for investors to understand that if there is a sustained trend of bank loan refinancings, yields on floating-rate mutual funds could come under pressure.

From a volatility and drawdown perspective, floating-rate bank loans historically have performed admirably in a variety of rising rate environments that are typically challenging for fixed income investors. While floating-rate loans may not offer the highest absolute yields, they have the potential to offer compelling value when risk is considered. However, investors should always take a holistic view and understand that trying to capture a few extra basis points of yield can lead them to assume a great deal of added risk.

Another key attribute of floating-rate bank loans is their lower historical correlation to other fixed income asset classes. Correlation has been a vexing issue in portfolio construction, particularly for investors intolerant of significant swings in valuations. Floating-rate bank loans have the potential for fulfilling an important diversification role, as these fixed income investments do not move in lockstep with many other assets. Bank loans may prove helpful in building more resilient portfolios (Exhibit 8).

EXHIBIT 8. A well-diversified fixed income allocation may provide benefits*

Annual returns represented by indices, December 2001–December 2020

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
BEST	8.78	19.49	28.97	11.73	10.73	11.85	10.95	12.39	58.21	15.12	10.70	18.54	7.44	9.05	3.30	17.13	9.32	1.87	14.42	10.11
	8.44	13.11	25.66	11.13	5.69	9.88	8.66	10.89	44.87	12.04	9.02	15.81	6.15	5.97	1.23	10.19	7.50	1.60	14.32	7.94
	7.23	11.50	14.91	10.35	3.51	7.33	6.97	5.24	28.18	9.98	8.46	9.43	0.64	5.53	0.86	9.88	7.49	1.28	8.72	7.51
	5.28	10.26	11.01	5.60	3.07	6.12	6.83	4.97	12.91	6.54	7.84	6.78	0.07	4.92	0.65	2.65	5.45	1.14	8.17	7.11
	5.13	9.60	5.31	4.48	2.74	4.85	6.28	2.06	5.93	5.52	4.98	4.21	–2.02	2.45	0.55	1.60	4.25	0.88	7.54	5.88
	4.42	6.28	4.10	4.34	2.65	4.84	5.00	–2.47	3.82	5.17	1.82	2.02	–2.55	2.06	0.05	1.28	3.54	0.01	6.83	5.21
	2.65	1.78	2.81	3.48	2.43	4.33	3.36	–10.91	2.55	2.80	1.59	1.65	–2.60	0.77	–0.38	1.05	2.30	-0.84	5.90	3.33
	1.36	1.12	2.36	1.33	1.77	4.25	1.88	–26.16	0.21	2.38	6.35	1.26	–4.00	0.03	–3.57	0.33	0.86	-2.08	4.03	2.78
WORST	-0.99	–1.41	1.15	1.30	–6.88	3.48	1.87	–28.75	–2.20	0.13	0.10	0.11	–6.58	–0.48	–4.47	0.25	0.84	-4.61	2.28	0.67

- Credit Suisse Leveraged Loan Index
- JPMorgan EMBI Global Index
- Bloomberg Barclays U.S. 1–3 Year Govt/Credit Bond Index
- Bloomberg Barclays Municipal Bond Index
- Bloomberg Barclays U.S. Corporate High-Yield Index
- Bloomberg Barclays U.S. Aggregate Bond Index
- Bloomberg Barclays U.S. Government Bond Index
- Citi World Government Bond Index
- BofA Merrill Lynch 3-Month U.S. Treasury Bill Index

Past performance does not guarantee future results. Diversification does not guarantee profit or protect against loss in declining markets.

Indices are unmanaged and not available for direct investment, and do not represent the performance of any specific security.

* *See back page for index descriptions.*

ROUND 3 THREE

Active versus passive in the bank loan market

As investors began realizing the potential benefits of the floating-rate bank loan asset class, exchange-traded funds (ETFs) emerged to offer passive approaches to this sector. Convenience and transparency are factors that investors must consider in determining if passive investing is suitable for bank loans.

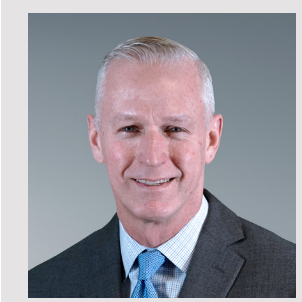
The potential benefits of ETFs are well advertised. They typically include: lower costs; risk mitigation; and the ability to buy and sell anytime during the day on a public exchange. However, there are still drawbacks to the indexed approach, and investors should understand exactly what their ETF owns and the rules under which it operates. For example, buying a leading ETF that owns the 100 largest bank loans may provide quick tactical access to this asset class, but if one of the largest bank loans within this portfolio is of poor quality, investors in the ETF will be exposed to that low-quality investment. And if one of the largest loans goes into default, a passive manager may be required to immediately liquidate that investment, which might not be the most strategic response.

Although the bank loan market has matured, it is still inherently inefficient. This is a potential advantage to active investment teams with deep credit research capabilities and the ability to identify and exploit inefficiencies. An ETF may also be at a disadvantage by not having access to primary issuances (new bank loans that come to market).

Andrew Liggio, portfolio manager of the Victory Floating Rate Fund, believes that active management can mitigate some of the risks, such as those embedded in credit agreements. "Fundamental research is vital in evaluating loan issuers in terms of financial soundness, management credibility, loan underwriting and terms, and the quality and liquidity of collateral, to name just a few key elements," says Liggio. "Discrimination and judgment are particularly important in today's market, and we believe that knowing when not to invest is also an important component of success."

He goes on to explain that the Victory Floating Rate Fund invests selectively and in a small number of loans that analysts know in depth and monitor closely. "There are no passengers in the portfolio," he says. "And the fund typically holds under 150 issuers, which we believe gives it an advantage over peers that may hold hundreds of loans that would be difficult to monitor vigilantly." This high-conviction strategy is a key distinguishing trait (Exhibit 9).

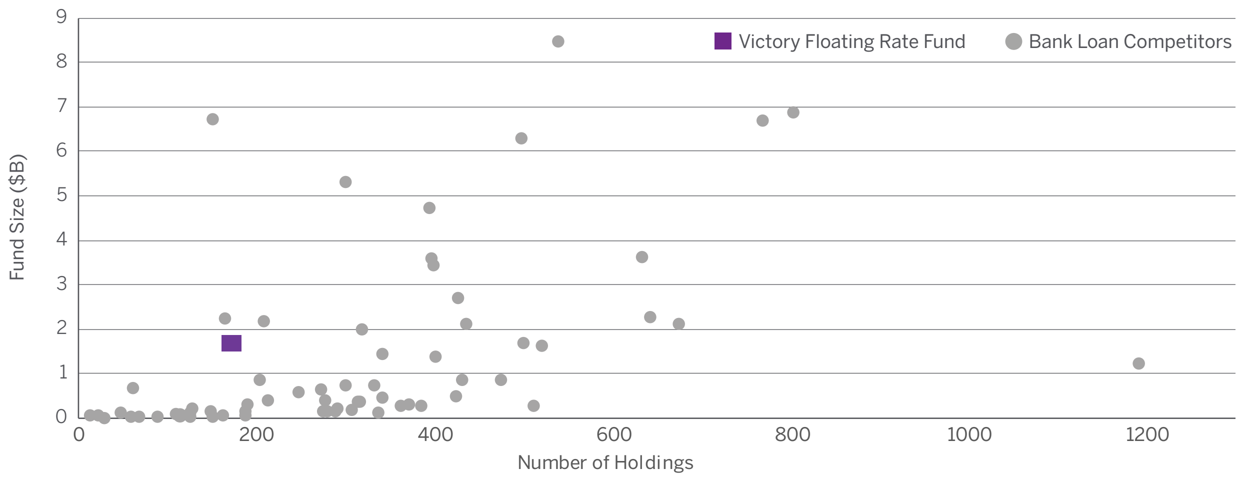
"Discrimination and judgment are particularly important in today's market, and we believe that knowing when not to invest is also an important component of success."



Andrew Liggio, portfolio manager of the Victory Floating Rate Fund, suggests that floating-rate bank loans can potentially deliver competitive yields with a favorable risk profile in the current environment. He sees bank loans as an important component of portfolio construction. Because their rates reset regularly, leveraged loans have minimal duration risk. In effect, investors trade increased credit risk for lower duration risk. At the same time, however, seniority within the capital structure helps mitigate the credit risk.

EXHIBIT 9. **A focused, high-conviction approach**

The Victory Floating Rate Fund had 140 investments as of May 31, 2021, which is a higher-conviction approach than most of its competitors.



Source: Lipper.
Bank Loan Competitors: All bank loans in the Lipper category

As always, an investor who prefers active management for the bank loan sector should choose carefully. Among other aspects, investors should evaluate expense ratios and determine if the manager has credit research capabilities and bank loan experience. In addition, the investor may wish to understand if the investment manager holds restricted securities or invests in securities priced internally.[8] All these features could impact the true risk profile of a bank loan strategy.

The decision: A potentially valuable portfolio tool

Certainly, investors seeking higher yield potential have an array of choices at their disposal. However, there are always trade-offs. Rather than taking a simplistic approach of chasing the highest yielding securities, investors should take a more holistic approach and consider factors including credit risk, duration risk, return volatility, and potential drawdown when evaluating each investment type.

In addition, floating-rate loans are among the few fixed income assets that have the potential to maintain or increase in value in a rising rate environment. This feature should not be overlooked, particularly given the unusual macroeconomic backdrop that has many investors seeking both higher yields and protection against the possibility of rising interest rates and inflation. From this perspective, bank loans may prove invaluable in structuring a fixed income portfolio.

8 Restricted securities or those priced internally are typically less liquid and of lower credit quality. These types of investments can increase the potential yield of a portfolio of bank loans, but they may also raise the risks significantly.

GO THE DISTANCE: STURDY FUNDAMENTALS FOR BANK LOANS

Although some investors worry about the fact that most floating-rate funds invest in below-investment-grade debt, the Victory Floating Rate Fund investment team believes that a spike in the default rate is unlikely. The team suggests that loan fundamentals have remained healthy into early 2021 and are substantially better than before defaults spiked in the aftermath of the global pandemic in 2020.*

While current leverage is comparable to that of the pre-spike period in 2019, companies are in a similar position to cover principal and interest payments out of cash flow as they were then. At the end of the first quarter of 2021, companies' ratio of interest payments to earnings before interest, taxes, depreciation and amortization (EBITDA) is the same as it was pre-pandemic (Exhibits 10 and 11).

EXHIBIT 10. **Debt/EBITDA ratio***

2002–2021

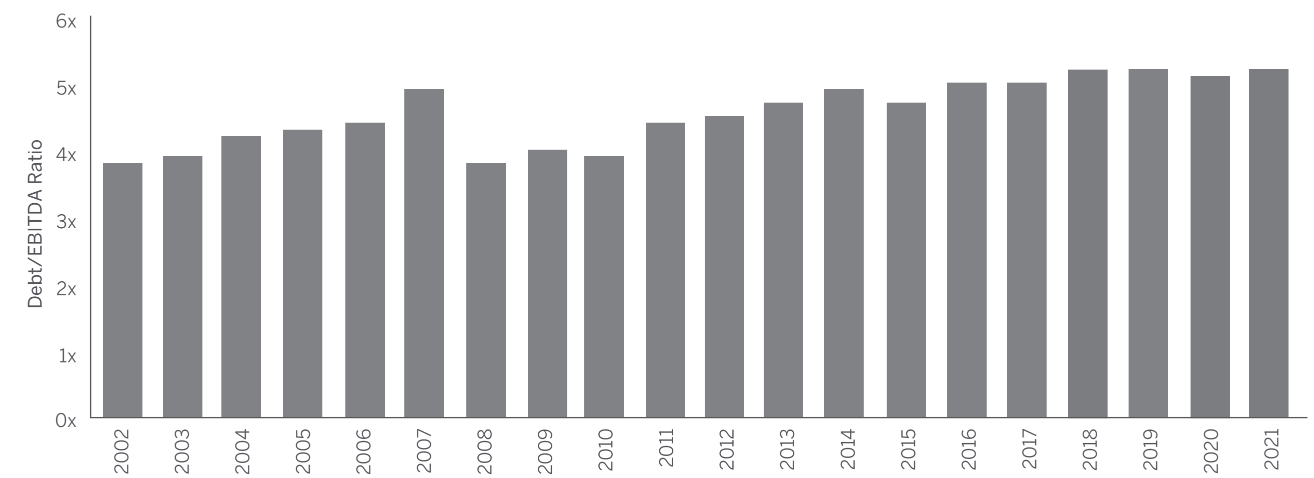
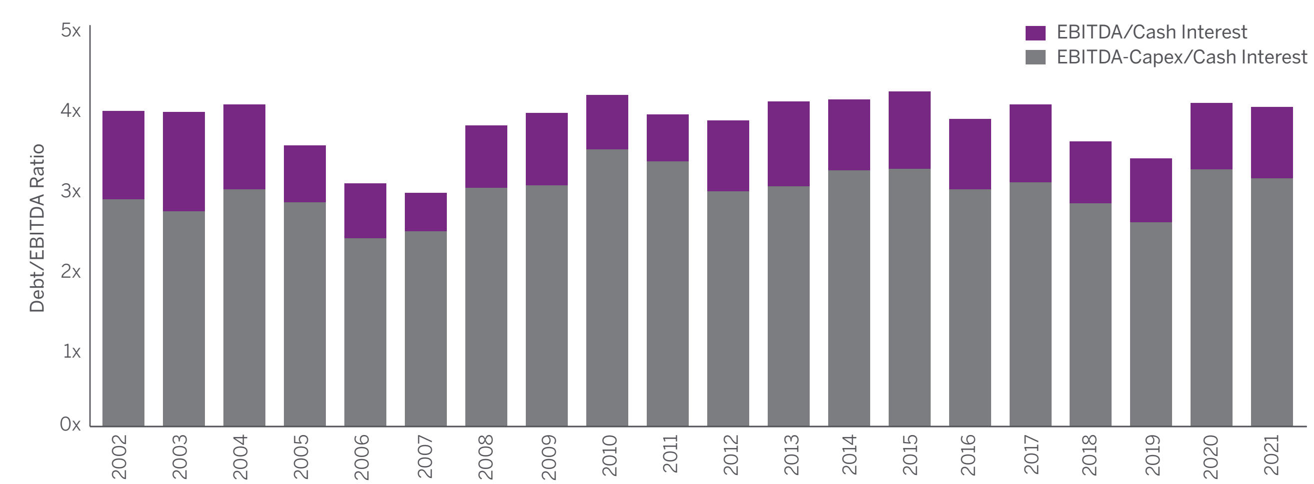


EXHIBIT 11. **Cash flow coverage of outstanding loans***

The cash flow coverage of interest and principal (i.e., debt service) is more robust than before the 2008 crisis.
2002–2021



* Source: Leveraged Commentary and Data (LCD), which is an offering of S&P Global Markets Intelligence.

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Index definitions

Credit Suisse Leveraged Loan Index: This index tracks the investable market of the U.S. dollar-denominated leveraged loan market. It consists of issues rated "5B" or lower, meaning that the highest rated issues included in this index are Moody's/S&P ratings of Baa1/BB+ or Ba1/BBB+. All loans are funded term loans with a tenor of at least one year and are made by issuers domiciled in developed countries.

JPMorgan Emerging Markets Bond Index (EMBI) Global Index: This index tracks total returns for traded external debt instruments in the emerging markets. It is an expanded version of the JPMorgan EMBI+. The EMBI Global includes U.S. dollar-denominated Brady bonds, loans, and Eurobonds with an outstanding face value of at least $500 million.

Bloomberg Barclays U.S. 1–3 Year Government/Credit Bond Index: This index includes all medium and larger issues of U.S. government, investment-grade corporate, and investment-grade international dollar-denominated bonds that have maturities of between 1 and 3 years and are publicly issued.

Bloomberg Barclays Municipal Bond Index: This index is a rules-based, market-value-weighted index engineered for the tax-exempt bond market. All bonds in the index must have a minimum rating of Baa3/BBB–/BBB–, using the middle rating of Moody's, S&P, and Fitch, respectively.

Bloomberg Barclays U.S. Corporate High-Yield Bond Index: This index is a market-value-weighted index that covers the U.S. non-investment-grade fixed-rate debt market. The index is composed of U.S. dollar-denominated corporate debt in industrial, utility, and finance sectors with a minimum $150 million par amount outstanding and a maturity greater than 1 year. The index includes reinvestment of income.

Bloomberg Barclays U.S. Aggregate Bond Index: This is an unmanaged index of publicly issued investment-grade corporate, U.S. Treasury and government agency securities with remaining maturities of 1 to 3 years.

Bloomberg Barclays U.S. Government Bond Index: This is an unmanaged index of public obligations of the U.S. Treasury with remaining maturities of one year or more.

Citi World Government Bond Index (WGBI): This index measures the performance of fixed-rate, local currency, investment-grade sovereign bonds. It is a widely used benchmark that currently comprises sovereign debt from over 20 countries, denominated in a variety of currencies.

BofA Merrill Lynch 3-Month U.S. Treasury Bill Index: This index is an unmanaged market index of U.S. Treasury securities maturing in 90 days that assumes reinvestment of all income.

Carefully consider the Victory Floating Rate Fund's investment objectives, risks, charges and expenses before investing. To obtain a prospectus or summary prospectus containing this and other important information, visit www.vcm.com/prospectus. Read it carefully before investing.

Investing involves risk, including the potential loss of principal. Fixed income securities are subject to interest rate, inflation, credit and default risk. The bond market is volatile. Bonds and bond funds will decrease in value as interest rates rise and vice versa. Credit risk refers to the possibility that debt issuers may not be able to make principal and interest payments or may have their debt downgraded by ratings agencies. Securities with floating interest rates are less sensitive to interest rate changes but may decline in value if their interest rates do not rise as much as interest rates in general. Floating rate investments issued in connection with leveraged transactions are subject to greater credit risk than many other investments. In certain circumstances, a lack of a ready market may make it difficult for the Fund to purchase or sell particular investments within a reasonable time and/or at a fair price. High yield securities may be more volatile, be subject to greater levels of credit or default risk, and may be less liquid and more difficult to sell at an advantageous time or price than higher-rated securities of similar maturity. International investments may involve risk of capital loss from unfavorable fluctuation in currency values, from differences in generally accepted accounting principles or from economic or political instability in other nations. Derivatives may not work as intended and may result in losses. The value of your investment is also subject to geopolitical risks such as wars, terrorism, environmental disasters, and public health crises; the risk of technology malfunctions or disruptions; and the responses to such events by governments and/or individual companies.

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