



# Redefining Core Fixed Income: The Case for Loans

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## Introduction

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As we enter 2026, we believe it is time to reframe how investors think about fixed income markets. Traditional “core” fixed income portfolios – comprised of Treasuries, Agencies, mortgage-backed securities, and investment grade corporate bonds – have historically served two primary purposes: providing contractual income and, more importantly, acting as a ballast within a broader portfolio.

In risk-off environments, a flight to quality typically meant that high-quality fixed income attracted capital flows and provided a natural hedge, particularly through government bonds. That dynamic is no longer reliably in place. While it may be premature to declare the hedging role of fixed income entirely defunct, it is certainly under strain.

This challenge is not just unique to the United States. Fiscal discipline has eroded across much of the developed world, including the United Kingdom, Canada, France, Italy, and Japan. Even Germany – long viewed as a model of fiscal restraint – is now forecast to run a budget deficit equal to 4% of GDP in 2026. More importantly, there appears to be little political will across developed markets to materially alter this trajectory.

This is not solely a question of fiat currency debasement; it is fundamentally about the outlook for intermediate- and long-term interest rates. As deficits expand, so too does the supply of government debt, requiring investors to demand increasingly higher risk premia to absorb that issuance. There is no quick fix. Despite the Federal Reserve cutting short-term interest rates by 175 basis points over the past 15 months, the 10-year Treasury yield remains meaningfully higher than where it stood when easing began.

Recent developments in Japan offer an early warning signal for the broader global system. Japan’s gross debt-to-GDP ratio exceeds 250%, a condition sustained for decades through aggressive quantitative easing by the Bank of Japan that kept interest rates near zero. As January 2026 draws to a close, that equilibrium has begun to fracture. Japanese government bonds – and the yen – have come under severe pressure.

Japan is not an isolated emerging economy; it is the world’s fourth-largest economy and the largest foreign holder of U.S. Treasuries, with holdings exceeding \$1 trillion. Liquidation of even a portion of these holdings to address domestic pressures has already contributed to higher U.S. yields. Equally important is Japan’s diminished appetite for future Treasury purchases. The outcome is clear: sustained upward pressure on rates. Duration risk will therefore need to be actively managed in fixed income portfolios going forward.

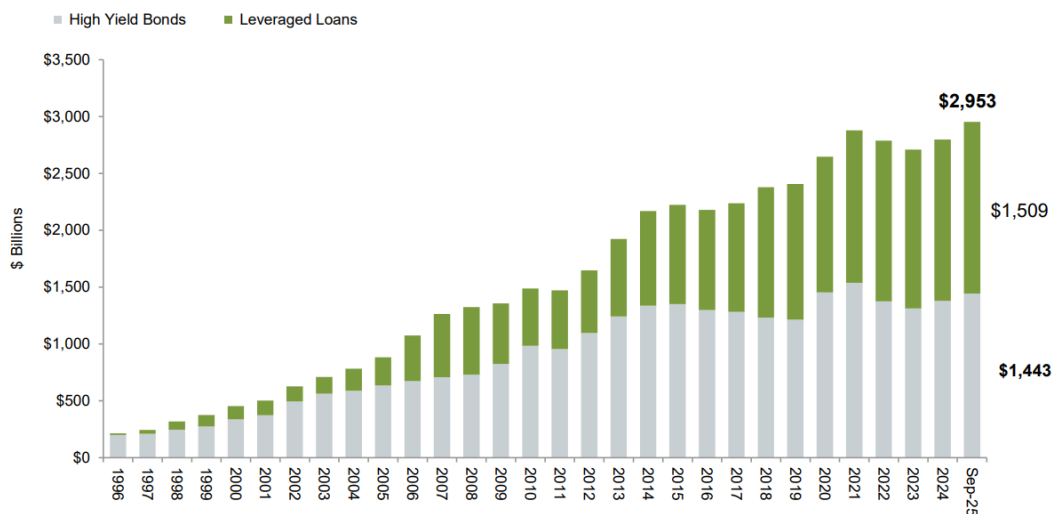
## The Syndicated Term Loan Market

We believe the broadly syndicated term loan market offers a compelling opportunity to generate offense while maintaining strong defensive characteristics in what is increasingly a challenging investment environment.

It is important to clarify what we mean by “loans.” We are not referring to private credit or direct lending, which has garnered significant attention in recent years. Our focus is on the broadly syndicated loan (“BSL”) market – also referred to as the syndicated institutional term loan market – which has grown into a major fixed income asset class exceeding US \$1.5 trillion in size. These loans are originated by banks and subsequently syndicated to institutional investors. They are rated, traded in public secondary markets, and have now surpassed the high-yield bond market in size.

I first became involved in this market back in 2002, when we maintained a small opportunistic allocation to loans within our collateralized bond and loan obligation (“CBLO”) structures. As corporate credit investors, we have historically found value in smaller issuances (sub-\$1 billion tranche sizes), as rating agency methodologies place considerable weight on issue size. We will explore this dynamic in greater detail later in this paper.

**Figure 1: Size of the Leveraged Finance Universe**



Over the past decade, this off-the-run segment has largely migrated from high-yield bonds to syndicated loans and club deals. The primary driver has been minimum issue-size requirements imposed by large high-yield bond ETFs and mutual funds, which effectively push smaller issuers (i.e., typically below \$600 million) into the loan market for term financing.

Two decades ago, the syndicated loan market was relatively insignificant. Its rapid expansion was driven in large part by regulatory changes stemming from the Basel Accords, which increased capital

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charges for banks lending to issuers rated below BB. As a result, banks increasingly originated and syndicated loans to institutional investors rather than holding them on their balance sheets. This shift coincided with the explosive growth of the collateralized loan obligation (“CLO”) market, which today holds over 70% of outstanding loans.

CLOs are a form of securitization that packages cash-flowing assets (in this case, corporate loans) and applies leverage to enhance returns. In structure, they are no different from asset-backed securities backed by credit card receivables, auto loans, or mortgage-backed securities using residential or commercial mortgages. A typical CLO manager purchases a diversified pool of approximately 200 loans and finances that portfolio using rated leverage.

CLOs function as synthetic banks, buying corporate loans with a leveraged balance sheet. Ironically, much of the rated financing is provided by banks and insurance companies seeking highly-rated assets. Standard BSL CLOs are typically levered at approximately 10:1, with roughly 65% of the capital structure rated AAA. These tranches receive priority in interest payments and benefit from favorable regulatory capital treatment.

It is worth noting that the United States has only two AAA rated corporate issuers – Microsoft and Johnson & Johnson – making CLOs and other securitized products critical providers of AAA rated assets within the financial system.

**Figure 2: CLO Capital Stack (Example)**

Class	S&P	Amount	% of Total	Coupon
A1	AAA	\$ 252,000,000	61%	S + 133 bps
A2	AAA	\$ 12,000,000	3%	S + 155 bps
B	AA	\$ 40,000,000	10%	S + 160 bps
C	A	\$ 24,000,000	6%	S + 185 bps
D1	BBB-	\$ 24,000,000	6%	S + 285 bps
D2	BBB-	\$ 4,000,000	1%	S + 395 bps
E	BB-	\$ 12,000,000	3%	S + 525 bps
SUB	NR	\$ 43,940,000	11%	

*Source: Bloomberg, December 19, 2024. % of Total rounded to nearest whole number.*

To achieve ratings, CLOs must adhere to parameters such as weighted average ratings factor (“WARF”), overcollateralization, and interest coverage tests. The underlying economics, however, are straightforward. A diversified loan portfolio yielding interest income (assume approximately 9.0% financed at a cost of 7.5% with 9x leverage), produces a gross equity return of roughly 13.5% (1.5% x 9) before fees. The CLO market is dominated by large asset managers, including Apollo, Carlyle, and GSO-Blackstone, as well as other prominent firms such as Ares, BlackRock, Prudential, Credit Suisse, and specialist managers such as Anchorage, Brigade, CIFIC, and Golub.

While CLOs dominate the primary issuance market and larger tranches, banks, insurance companies, and investment funds also actively participate in the secondary market, creating meaningful liquidity.

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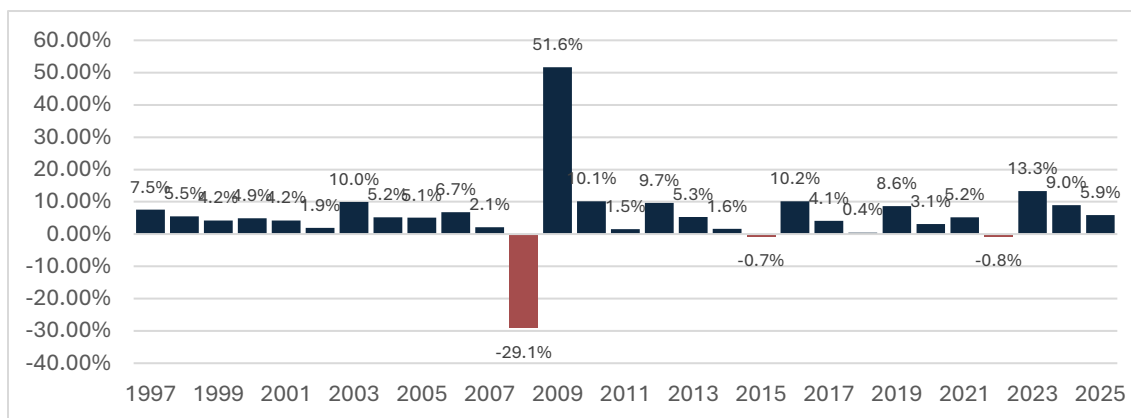
We have historically sourced loans from the secondary market, where our experience trading off-the-run credit has given us a sourcing and execution advantage.

### The Good, the Bad, & the Ugly

Leverage is a double-edged sword. When applied to quality assets, it can enhance returns; when applied indiscriminately, it can amplify losses, as evidenced by the 2008 financial crisis. Both corporate loans and CLO structures have now been tested through two major downturns: the global financial crisis and the COVID-19 pandemic in 2020. In both instances, performance was resilient. While CLOs represent a levered beta trade to the loan market, we believe that at this stage of the cycle, investors should prioritize alpha (risk-adjusted returns through security selection) over leveraged beta exposure.

Loans offer several attractive characteristics. They are senior secured, first lien obligations with historical recovery rates exceeding 70% since 2008. They are floating-rate instruments tied to SOFR (the Secured Overnight Financing Rate), resulting in minimal interest rate sensitivity. Given our long-term view on rates, this could be a meaningful advantage. Loans have also exhibited low volatility, with only one materially negative return year (>1%) over the past three decades – the financial crisis – followed by a strong recovery the subsequent year, as shown below in Figure 3.

**Figure 3: Annual Loan Returns**



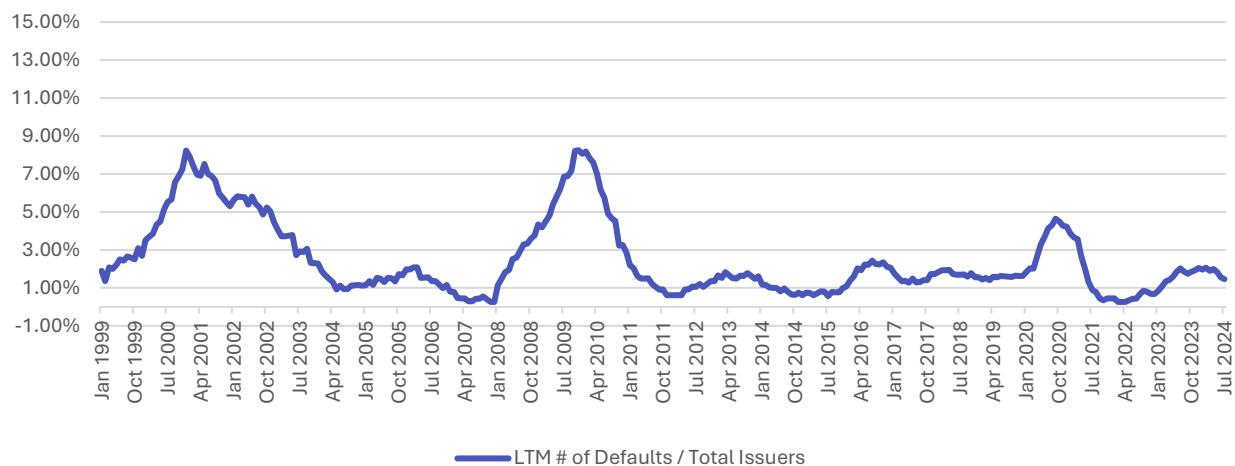
Source: Bloomberg as at December 31, 2024. Total annualized return of the Morningstar LSTA US Leveraged Loan Index.

Institutional loan investors also benefit from enhanced disclosure, including access to internal budgets and monthly reporting, effectively positioning loan investors as the banking system for a significant portion of the U.S. corporate sector.

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On the risk side, default rates have averaged approximately 2.5% over the past 25 years, skewed by 2008. Excluding that year, defaults closer to 2% are more representative. With expected recoveries of at least 65% on true first lien loans, expected annual losses are modest. At an 8% yield, this equates to an attractive risk-adjusted return of approximately 7.3%.

**Figure 4: Annual Loan Default Rates**



We expect default rates to increase for higher-levered capital structures over the next several years, including those involving liability management exercises. That said, for the asset class as a whole, we expect defaults to remain below broader market averages.

Defaults typically arise from declining cash flows, which can trigger maintenance covenant breaches as credit metrics deteriorate. Today, interest coverage ratios remain supported by strong underlying cash flows and proved surprisingly resilient in the face of significant interest rate increases from 2022 through 2024. In addition, spread compression has enabled another wave of refinancings at very tight spreads, helping to offset a portion of the rate increase.

The second key component of the systemic default narrative is liquidity – or more precisely, the lack of it. At present, this risk is largely absent. Through continued CLO formation and substantial private credit fundraising, capital continues to flow unabated into the leveraged finance market. While loan leverage is historically elevated, balance sheets and liquidity profiles remain strong, even if we are entering a recessionary environment, which is how we frame and price risk today.

This is the good.

Let us now turn to the bad, which, from an investor's perspective, is not bad but does present challenges for us as loan investors. While loans trade with global identifiers (i.e., similar to CUSIPs for bonds), they are not securities, which historically made settlement more complex. In the early days of loan trading, settlements could take months. Today, however, the Loan Syndications and Trading Association ("LSTA") has standardized documentation, and settlement is now typically measured in days rather than months.

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Another potential drawback is the lack of call protection. In high-yield bonds, investors typically benefit from two to three years of hard call protection, followed by meaningful call premiums beginning in years three or four. In contrast, call protection in loans is minimal and generally limited to six months to one year of “soft” call protection, meaning the loan cannot be repriced during that period.

That is the bad.

Now let’s turn to the ugly, because there is always an ugly. If it is not identified upfront, it tends to surface unexpectedly later on. In this case, the “ugly” is increasingly aggressive underwriting behavior as the credit cycle has moved into its later stages. Discipline often erodes when markets become popular, yet sound underwriting requires rigorous fundamental analysis.

Documentation represents the first challenge. Loan covenants (embedded in credit agreements between borrowers and lenders) establish the terms and conditions governing the loan. Over time, these documents have become increasingly borrower-friendly, which we view as a clear negative. Weak documentation is most exposed during downturns, when protections matter most.

Equally important, beginning around 2018, we observed a growing trend of companies receiving investor and rating agency approval for aggressive add-backs, often referred to as “pro-forma further adjusted EBITDA.” These adjustments frequently include projected synergies or cost savings that may or may not materialize. The result can be distorted – and in some cases, fictional – metrics that present a far more favorable picture than reality.

Figure 5 below illustrates a real-world example from a 2019 transaction.

**Figure 5: EBITDA Addback (Example)**

	Q3			Year to Date		
	'19 Actual	'19 Plan	vs. Plan	'19 Actual	'19 Plan	vs. Plan
<b>Net Sales</b>	\$494.0	\$515.1	(4.1%)	\$1,459.6	\$1,493.0	(2.2%)
<b>Gross Profit</b>	\$198.0	\$208.7	(5.1%)	\$581.9	\$590.7	(1.5%)
% Margin	40.1%	40.5%	(44)bps	39.9%	39.6%	31 bps
<b>Advertising</b>	\$50.2	\$56.0	(10.3%)	\$136.3	\$151.9	(10.3%)
% of Net Sales	10.2%	10.9%	(70)bps	9.3%	10.2%	(84)bps
<b>SG&amp;A</b>	\$76.0	\$80.6	(5.7%)	\$229.5	\$241.0	(4.8%)
% of Net Sales	15.4%	15.6%	(27)bps	15.7%	16.1%	(42)bps
<b>Adj. EBITDA (Before PF Cost Savings)</b>	\$71.8	\$72.2	(0.5%)	\$216.1	\$197.7	9.3%
% Margin	14.5%	14.0%	52 bps	14.8%	13.2%	156 bps
<b>Pro Forma Cost Savings (net of limitations)</b>	\$ 18.0	\$ 16.9	6.5%	\$ 53.9	\$ 50.6	6.5%
<b>Consolidated EBITDA</b>	\$89.8	\$89.0	0.8%	\$270.0	\$248.3	8.7%
% Margin	18.2%	17.3%	88 bps	18.5%	16.6%	187 bps

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Adjusted EBITDA of \$216 million was increased to \$270 million through \$54 million of assumed “future cost savings.” In our analysis, even the \$216 million figure incorporated adjustments we would need to reverse. Today’s loan market includes a meaningful amount of these types of adjustments, which can materially distort leverage profiles and obscure true risks. Leverage is the most important risk measure for us, and we believe an active, disciplined portfolio management process is essential for identifying and avoiding these distortions.

That was the ugly.

## Turning the Frog into a Prince

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Now that we have identified the risks, the natural question is, how do we mitigate them? In a word – work.

We are uniquely positioned to operate in this environment because our experience spans both the buy- and sell-side of the high-yield lending market over the past four decades. That perspective informs a disciplined, risk-first approach to credit investing. Historically, high-yield bonds have been unsecured obligations, sitting below bank debt and above equity in the capital structure. We have always viewed high-yield bonds as “equity with a coupon,” because if things go wrong and a bond defaults, recoveries can be minimal.

While loan documentation has undeniably deteriorated over time, we continue to view the secured nature of institutional term loans as a meaningful source of comfort. First lien security and collateral indicate materially higher recovery values in a default scenario. Having operated for years without a safety net sharpens discipline and improves outcomes. The lesson remains simple and enduring: do the work and don’t get it wrong.

The objective for all investors is to generate attractive returns while managing and limiting risk – what investors commonly refer to as “alpha.” For us, alpha begins with what we describe as size arbitrage.

Companies with revenues below \$1 billion are penalized by rating agency methodologies, often receiving meaningfully lower ratings (i.e., CCC) for a portion of their credit score regardless of underlying fundamentals. For example, a company with \$900 million in revenue can be rated significantly lower than a company with revenue exceeding \$1.0 billion, even if their credit profiles are otherwise comparable. As with many aspects of ratings methodologies, this outcome can feel arbitrary. However, these lower ratings often translate into higher yields despite below-average leverage, creating an attractive opportunity for disciplined investors. Figure 6 illustrates this size-related ratings skew using a Moody’s preliminary rating grid.

**Figure 6: Moody's Rating Score (Example)**

Surface Transportation and Logistics Industry Grid		Current LTM
Factor 1: Scale (15%)		Score
a) Revenue (USD Billion)		Ca
Factor 2: Business Profile (20%)		
a) Business Profile		B
Factor 3: Profitability & Efficiency (10%)		
a) Operating Margin %		Baa
b) EBITA / Average Assets		Ba
Factor 4: Leverage & Coverage (40%)		
a) Debt / EBITDA		A
b) FFO / Debt		A
c) EBIT / Interest Expense		Baa

Source: Moody's.

In this example, a company with \$500 million in sales receives a "Ca" rating for the revenue component of its score. The business profile category – also influenced by size – earns a "B." By contrast, the factors most relevant to fundamental credit analysis – profitability, efficiency, leverage, and coverage – receive strong ratings. The result is a combined score that materially understates the company's true credit quality, creating what we view as a clear size-driven inefficiency.

Because we are not fans of unnecessary jargon, we define alpha simply as yield per turn of leverage. The key question is: how much yield are we being compensated for the risk we are assuming?

In this context, we define leverage as first lien net debt to EBITDA, which we believe is the most important determinant of both default risk and recovery outcomes. Our objective is to fully underwrite a broadly diversified loan portfolio with overall company leverage of less than 4.0x on a first lien net debt/EBITDA basis.

This threshold is not arbitrary. It is informed by practical experience, including time spent in U.S. Federal bankruptcy courts dating back to the early 1990s. Historically, bankruptcy judges were reluctant to allow companies to emerge with high leverage, recognizing that excessive leverage increases the likelihood of a return to court. While a 4.0x leverage target is often viewed today as antiquated – or overly conservative – we believe it provides a meaningful margin of safety.

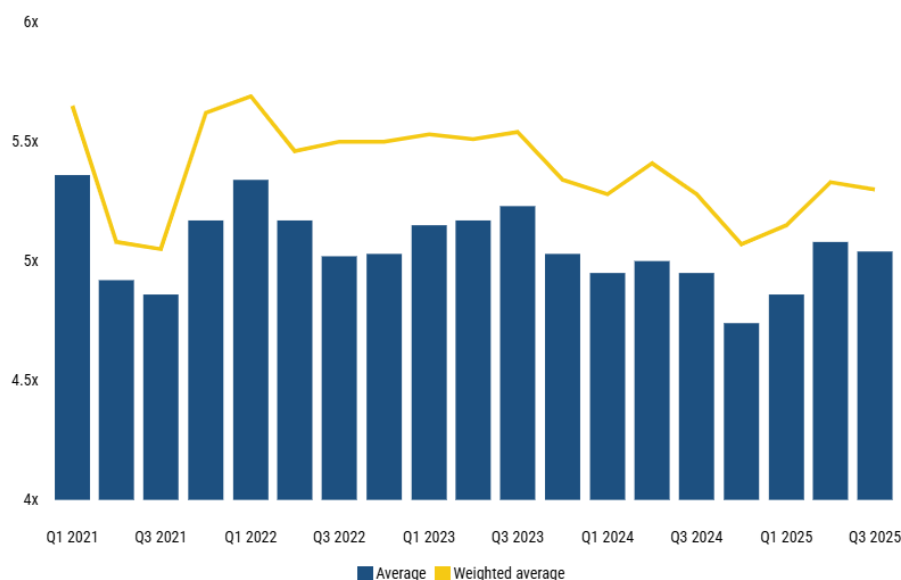
The typical exit for a term loan investment is refinancing. When leverage is manageable, access to the debt capital markets is far more likely, significantly reducing refinancing and default risk. Importantly, our EBITDA assumptions are based on stressed, "clean" EBITDA, well below credit agreement compliance EBITDA and consensus estimates for public issuers.

As shown in Figure 7, our sub-4.0x leverage target stands in stark contrast to the broader loan market's average leverage of approximately 5.5x. If unadjusted EBITDA were used, we believe

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reported leverage levels would be meaningfully higher. Regardless, we view loans with leverage at or below 4.0x as carrying materially lower refinancing and default risk.

**Figure 7: Average Leverage - Outstanding U.S. Loans**



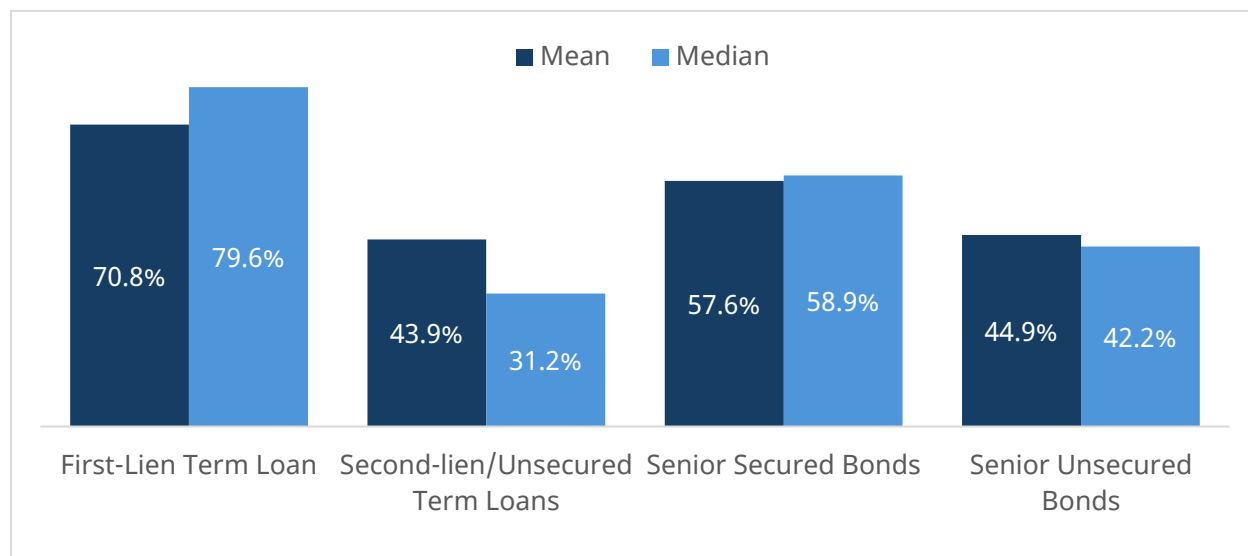
Source: PitchBook | LCD • Data through Sept. 30, 2025

Source: PitchBook, LCD. Data through September 30, 2025.

In addition to manageable leverage, we require our portfolio companies to demonstrate strong liquidity profiles, either in the form of excess cash and/or committed revolver availability. Most importantly, companies must be able to generate healthy free cash flow, defined as cash flow from operations less capital expenditures. While EBITDA is a convenient and widely used valuation metric, it is not cash flow. We also target net debt to total enterprise value of less than 50%, which provides meaningful subordinated capital beneath the loan and additional protection in downside scenarios.

To be clear, we are not originating loans. Rather, we vet opportunities across both the primary and secondary markets, fundamentally analyzing each name (what we refer to as underwriting), and selectively purchasing portions of loans that meet our criteria. Our objective is to generate attractive yields while minimizing defaults. Through this active management approach, we expect our portfolio to exhibit a lower default rate than broader loan indices. In a portfolio comprised of primarily first lien debt, even in an event of default, we would still expect strong recovery outcomes (see Figure 8).

**Figure 8: First Lien Recovery Rates (% of Face Value)**



Source: S&P Global Market Intelligence's CreditPro® and S&P Global Ratings Credit Research & Insights. Includes only debt instruments that defaulted from U.S. issuers. Data 1987 through September 30, 2025.

The final consideration is where the loan asset class fits within an investor's broader portfolio. Loans have a multi-decade history of positive returns with significantly lower volatility than many traditional asset classes. Given the interest rate headwinds discussed earlier, floating-rate loans with very short duration are particularly attractive in the current environment.

Today, syndicated term loans offer absolute yields above historical averages that compare favorably with long-term equity returns, while maintaining a senior secured position within the borrower's capital structure. We believe a carefully selected portfolio of low-levered, true first lien term loans, supported by a prudent amount of portfolio financing, should represent a core component of fixed income allocations today. Given strong absolute loan yields and current equity valuations, the asset class may also serve as a lower-volatility equity surrogate.

**Figure 9: Asset Class Returns & Risk (Since 1992)**

	Annualized Return	Standard Deviation	Return Per Unit of Risk
Leveraged Loans	5.62%	5.34%	1.05
High-Yield Bonds	7.33%	8.23%	0.89
Large Cap Equity	10.71%	14.69%	0.73
Small Cap Equity	9.31%	19.50%	0.48
BDCs	7.49%	22.92%	0.33

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*Source: Bloomberg. Returns and standard deviation as at January 31, 2026. The Leveraged Loans, High Yield, Large Cap Equity, Small Cap Equity and BDC Indices are represented by the total return of Credit Suisse Leveraged Loan Index, Bloomberg U.S. Corporate High Yield Index, S&P 500 Index, Russell 2000 Index and the Cliffwater BDC Index, respectively. Returns were calculated using monthly data and begin with the inception of the Credit Suisse Leveraged Loan Index on January 1, 1992. Returns for the BDC Index begin with the inception of the Cliffwater BDC Index on September 30, 2004.*

## About the Author

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Timothy J. Gramatovich serves as Principal of Invico Credit Partners, and brings more than 40 years of experience in the leveraged finance and high yield markets.

He is the Co-Founder and former Chief Investment Officer of Peritus Asset Management, where he spent 23 years developing investment strategies, leading portfolio construction, and making investment decisions across high yield bonds and leveraged loans. During his tenure at Peritus, Mr. Gramatovich launched and managed several cash flow CDOs and was instrumental in the creation of the first actively managed high yield bond ETF, which grew to more than \$1.2 billion in assets within its first three years. He also oversaw bespoke high yield credit portfolios for both individual and institutional clients.

Prior to founding Peritus, Mr. Gramatovich served as a Portfolio Manager at Travelers Asset Management in Los Angeles, managing high yield portfolios for high-net-worth and institutional investors. Earlier in his career, he was a Senior Vice President at Aegis Asset Management Inc., where he established the firm's buy-side high yield investment platform.

Throughout his career, Mr. Gramatovich has acted as a qualified expert on financing and valuation matters for the U.S. Trustee in the Federal Bankruptcy Courts of Los Angeles County. He began his career at Drexel Burnham Lambert in 1986, supporting the development and marketing of high yield corporate cash management products.

Mr. Gramatovich is a CFA Charterholder and a member of the CFA Institute. He is a graduate of the New York Institute of Finance.

## About Invico Credit Partners

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Invico Credit Partners ("ICP") is a U.S.-based credit research firm providing specialized market insight and underwriting support across the institutional leveraged loan market. Guided by a disciplined and active investment process, ICP focuses on identifying persistent inefficiencies in corporate credit markets while supporting family offices, multi-family offices, and other institutional investors through bespoke investment structures and portfolio solutions.