Invesco US Senior Loan Fund

A Sub-Fund of Invesco Zodiac Funds

Invesco Senior Secured Management, Inc.

"You know more of a road by having travelled it than by all the conjectures and descriptions in the world."
- William Hazlitt

Kevin Egan

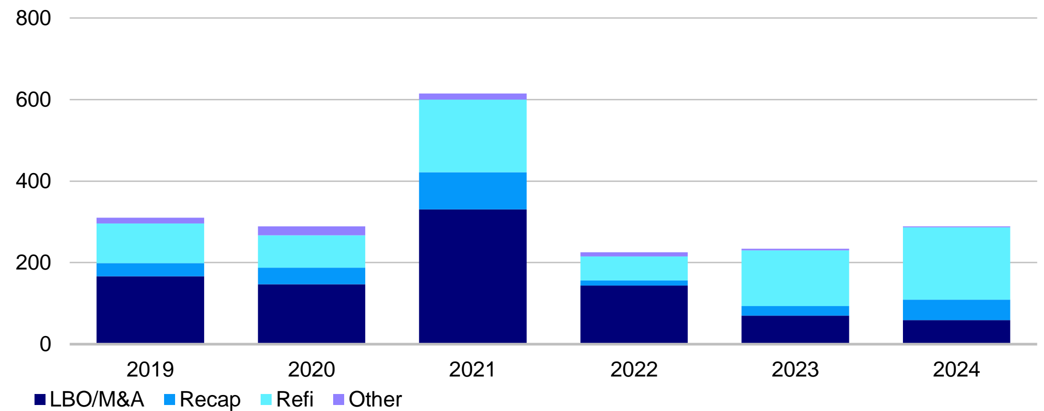
Senior Portfolio Manager, Co-Head of Credit Research

2024 Second quarter market review

Loans delivered a gain of 1.86% during the second quarter driven by monthly returns of 0.67%, 0.91%, and 0.27% in April, May, and June, respectively.[1,2] The quarterly return was comprised of 2.41% in coupon income, offset by 0.54% decline in principal return.[1]

Q2 witnessed a continued surge of repricing activity, with nearly 30% of the asset class having repriced in the first half of the year.[3] Gross issuance in May of $159.7bn was an all-time monthly record, and June's gross issuance of $149.6bn represented the second highest month. M&A and LBO activity remained muted which, combined with continued retail and institutional demand and CLO origination translated to strong net demand for loans. As exhibited below in Figure 1, the majority of primary activity was refinancing/reprice driven, as there was only $32.4bn of net new issuance in the quarter. Despite the active repricing calendar, the nominal spread of the loan market has only compressed by 12 basis points since the start of the year.[1]

Figure 1: YTD loan supply exceeds 2023 full-year supply



Source: Bank of America as of July 12, 2024. Supply in USD billions

As in prior quarters, credit fundamentals continued to hold up as well with the default rate remaining well below the historical average while issuer leverage, interest coverage, and cash balances remained healthy. Moreover, persistent lack of new loan supply, returning retail inflows, and consistent CLO formation supported the market technical.

Sector dispersion was more pronounced in Q2 as shown in Figure 2 than in Q1. Shipping was the strongest performing sector while Broadcasting, Cable/Wireless Video and Telecommunications were the laggards and posted negative returns. The delta between the best and worst performing sectors was 790 basis points ("bps"), or 634bps excluding the three sectors with negative return.[1]

Invesco Management S.A. (the Management Company) has appointed and delegated discretionary investment decisions with respect to the Fund to Invesco Senior Secured Management, Inc. ("The Investment Manager"). See prospectus for more information. All information as of June 30, 2024, unless otherwise noted. Fund launch date is August 11, 2006. Base currency is US dollar.

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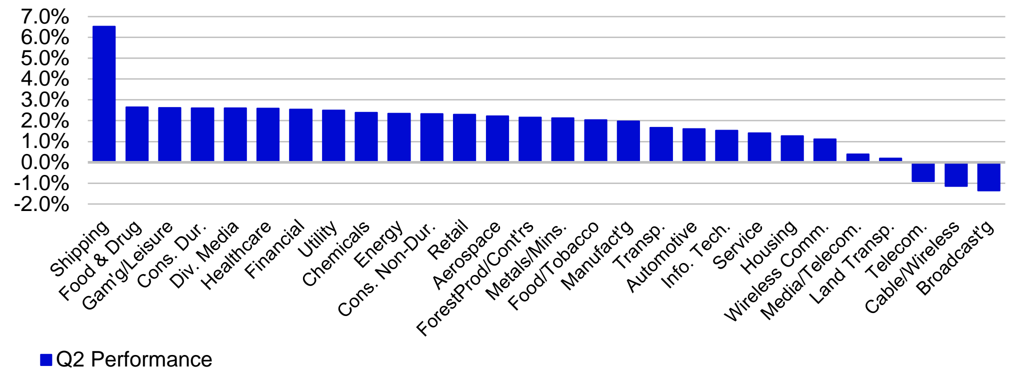
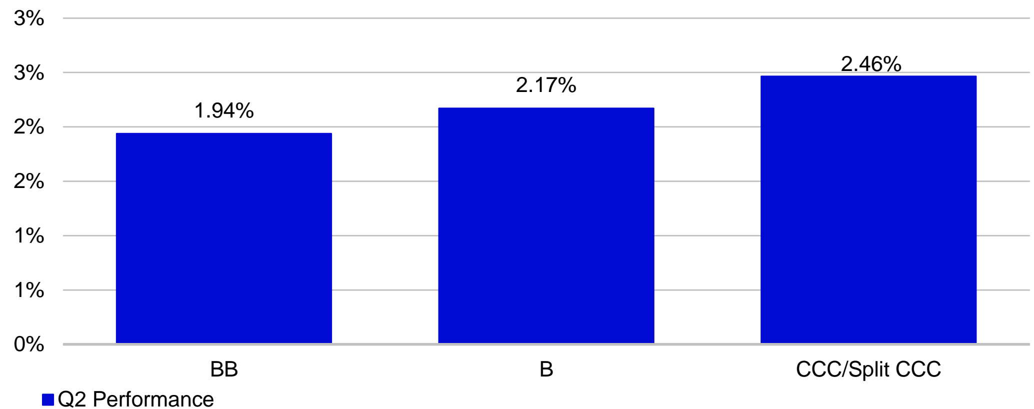
Figure 2: Performance dispersion across sectors was more pronounced in Q2



Source: Credit Suisse Leveraged Loan Index, total returns in USD, as of June 30, 2024. **Past performance is not a guide to future returns**.

Across the quality spectrum, returns were led by lower quality in Q2 with "CCCs" (2.46%) outpacing "Bs" (2.17%) and "BBs" (1.94%), although the delta between ratings' categories was much tighter than in Q1.[1]

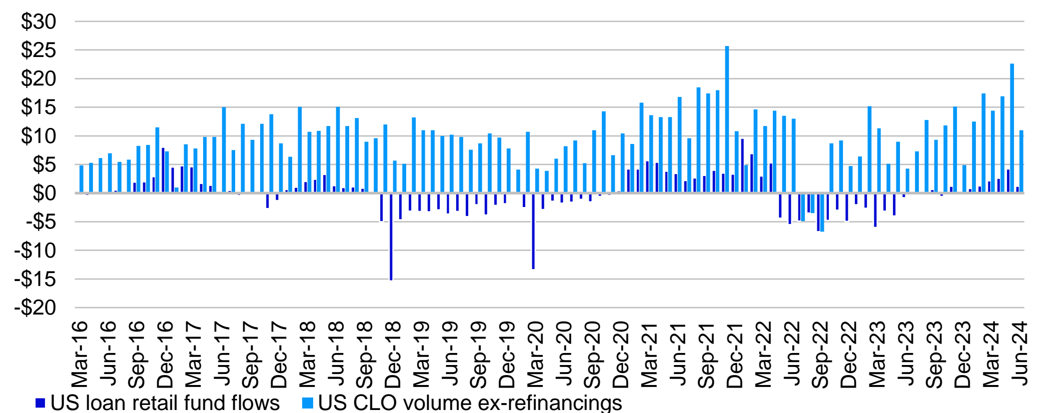
Figure 3: Lower quality outperformed to start 2024



Source: Credit Suisse Leveraged Loan Index as of June 30, 2024. Returns are total returns in USD. **Past performance is not a guide to future returns**.

Retail funds attracted $8.0 billion (bn) of new capital in Q2, nearly doubling the Q1 pace.[4] More impactfully, CLO issuance in Q2 broke the previous record held in Q1 with $117.7bn of gross issuance, and $50.5bn excluding refis/resets.[4] Tightening liability spreads throughout the CLO capital stack, in particular AAAs, supported both new CLO origination and refinancing of existing structures.[4]

Figure 4: CLOs remained a robust source of demand while retail flows accelerated in Q2



Source: J.P. Morgan as of June 30, 2024. Flows in USD billions.

Meanwhile, gross loan issuance in Q2 exceeded a very strong Q1 as refinancing activity continued to accelerate with net issuance remaining muted. Gross issuance of $381.7bn eclipsed the $390.1bn of issuance in all of 2023 and continued to be dominated by repricing and refinancing activity as issuers took advantage of strong market conditions to extend maturities and lower borrowing costs. The $32.4bn of net new issuance in the quarter took a step-back from the $37.8bn of net new issuance in Q1 but still was up from $21.8bn in Q4.[4]

The average loan price slightly declined from $95.98 to $95.68 in Q2.[1] The percentage of loans trading below $80 stayed low at 4.4%, reflecting a manageable docket of medium-term expected restructurings.[4] Nominal loan spreads decreased from 3.93% to 3.86% in Q2, while the market's spread-to-3 year average life (i.e., the yield expressed as a spread over SOFR) compressed slightly to SOFR + 5.07%.[1] Meanwhile, three-month SOFR ended the quarter at 5.32% (essentially flat to Q1), translating to a loan market coupon of 9.19% at quarter-end.[1]

During Q2, the par-weighted loan default rate edged lower from 1.14% to 0.92% (excluding distressed exchanges) amid limited new default activity.[4] Reasonably healthy balance sheets across the market and limited near-term maturities continued to limit restructuring activity in the syndicated loan market.

Risk warnings

For important information on risks associated with this product, see the "Risk Factors" in Section 31 on pages 53-59 of the Prospectus.

Senior loans may be illiquid and more difficult to sell quickly at a fair price. Because of the risk of illiquidity of the instruments in which the product will invest, the processing of the redemption requests may be deferred in certain circumstances. Interest rates on senior loans depend on the level of an underlying rate; as such, they may change and cause fluctuations in the net asset value of the product. Senior loans are exposed to credit risk which is the ability of the borrower to repay the interest and capital on the scheduled dates. The product will hold debt instruments which are of lower credit quality and may result in larger fluctuations in the value of the product. The product may also use derivatives for investment purposes. The use of derivatives may result in the product being significantly leveraged and may result in large fluctuations in the value of the product. The product may invest in developing markets, this may cause large fluctuations in the net asset value of the product.

Invesco US Senior Loan Fund objective and strategy

The Fund seeks to provide a high level of current income, consistent with the preservation of capital, by investing primarily in adjustable rate senior loans organized or located in the United States or Canada. The Fund invests primarily in senior, secured loans to non-investment grade corporations with interest rates that float at a spread above a base rate and reset about every 60 days. Invesco seeks to invest in loans to companies which in its judgment exhibit mature and stable operating profiles, with dependable cash flow generation and strong asset coverage. To manage risk, the team keeps the portfolio broadly diversified and generally avoids industries they believe to be fundamentally flawed or speculative. The investment concerns the acquisition of units in an actively managed fund and not in a given underlying asset.

Past performance does not predict future returns. Please see the following returns for the Invesco US Senior Loan Fund's H share class.

Performance

Time frame	Invesco US Senior Loan Fund H share class gross (%)	Invesco US Senior Loan Fund H share class net (%)	Credit Suisse Leveraged Loan Index (CS LLI) (%)
Q2 2024	1.64	1.41	1.86
Six months	4.22	3.76	4.44
1 year	10.59	9.61	11.04
3 years	5.68	4.72	5.96
5 years	5.60	4.65	5.36
10 years	4.87	3.92	4.61
Since inception (August 11, 2006)	5.41	4.40	4.68

Time frame	Invesco US Senior Loan Fund H share class gross (%)	Invesco US Senior Loan Fund H share class net (%)	CS LLI (%)
6/30/19 – 6/30/20	-4.12	-4.97	-2.27
6/30/20 – 6/30/21	16.03	14.98	11.67
6/30/21 – 6/30/22	-2.86	-3.73	-2.68
6/30/22 – 6/30/23	9.88	8.84	10.10
6/30/23 – 6/30/24	10.59	9.61	11.04

Source: Invesco, as of June 30, 2024. Fund and benchmark returns are total returns in USD. Returns may increase or decrease as a result of currency fluctuations. The benchmark index is shown for performance comparisons purposes only. The fund is actively managed and does not track the index.

For the period ended June 30, 2024, the Fund was overweight the Chemical sector by 529 basis points (bps), the Gaming/Leisure sector by 277bps, and the Telecommunication sector by 256bps. During the quarter, the Telecommunication sector replaced the Manufacturing sector as the third largest overweight.

The Chemicals sector at large weathered the severe inflationary environment of 2021 and 2022 remarkably well despite exposure to commodity prices, proving that it had the ability to pass through price increases to maintain margins. 2023 proved to be a more challenging year due to inventory destocking in the channels, end market softness across many verticals/geographies, and margin compression as higher cost inventory was sold into a deflationary environment. Many issuers have seen sequential improvements in 2H23 and into 2024 as customer destocking has faded, and we expect earnings trends to broadly stabilize going forward as destocking ends and prices/cost of inventory better align. Though our earnings growth outlook is somewhat cautious, our portfolio exposure is weighted towards companies with ample balance sheet cushion to withstand such an environment. During the quarter, the sector was among the better performing in the Credit Suisse Leveraged Loan Index (Index) (2.50% average return), which resulted in positive contribution to Fund performance.[5]

The Fund's overweight position in the Gaming/Leisure sector continues to reflect our conviction in a number of issuers that benefited meaningfully from the resumption of normal operations and pent-up demand from consumers over the past two years. These continued to include positions in hotel, cruise line, and gaming operators. We have reduced the Fund's overweight exposure over time as the sector has performed well and the relative value has become less compelling for certain issuers; however, we remained overweight the sector as we believe that many issuers in the sector may continue to be significant beneficiaries of consumer demand for experiences and can provide attractive risk adjusted returns. During the quarter, the sector continued to outperform the Index and was accretive to relative performance.[5]

The Fund's exposure to the Telecommunication sector is focused on issuers with defensible business models and strong asset coverage given the significant change that technology has ushered into the industry. These secular changes have created uncertainty (and opportunity), which has led the sector to underperform the Index (-7bps total return in the quarter);[1] however, our credit selection within the sectors generated slightly positive returns in the quarter.[5] That said, the overweight exposure to the sector was a headwind to relative performance given the overall sector performance.

Conversely, the largest underweight sectors in the portfolio remain the Healthcare sector by 846bps, the Information technology sector by 427bps, and the Financials sector by 215bps. During the quarter, there were no changes to the composition of the Fund's top three underweight industries.

The Fund's persistent underweight position in the Healthcare sector continued to reflect our belief that investors are not being adequately compensated for the risks facing healthcare providers in the current operating environment. The sector has been persistently under pressure by the shift toward healthcare consumerism and pressure on reimbursement rates from Medicare and other payors. Over the past two years, many sub-sectors within Healthcare have been negatively impacted by proposed "surprise billing" legislation, which garnered significant legislative focus and is expected to continue to do so under the Biden administration. At the same time, the operators have been negatively impacted by rising wages and labor shortages, thus compressing margins. In our view, the highly politicized nature of the Healthcare sector adds meaningful risk to the downside, and we have been highly selective in our investing in the sector. That said, we have been identifying issuers within the sector with compelling business models that offer solid relative value, and added 80bps of exposure to the Fund during the quarter. The Healthcare sector did outperform the Index by 69bps during the quarter, which was a headwind to relative performance.[5]

The Fund has been underweight the Information Technology sector for several years, which reflects our concerns that valuations were excessive, which led to elevated leverage levels and constrained free cash flow. The latter issue became particularly acute with the sharp rise in interest rates over the past two years. Furthermore, many of these businesses have struggled making the transition from on-premises to cloud-based solutions and from perpetual license to subscription-based revenue models. As such, we closely monitor and manage our positions in the sector to ensure that the risk-adjusted return profiles remain acceptable. During the quarter, the sector underperformed the Index by approximately 40bps, which added to relative performance.[5]

Lastly, the Fund's underweight position in the Financials sector continues to stem from a lack of attractive relative value opportunities in the sector. Additionally, the sector's credit quality skews toward the lower end of the credit quality spectrum, and we have not found the risk-adjusted returns to be appealing. Finally, there are a large number of relatively small loans to borrowers in the Investment Management industry, which we feel may exhibit above-average volatility in stressed markets. As such, we have actively underweighted the sector. The sector outperformed the Index during the quarter by 48bps, creating a slight detraction from relative performance.[5]

Risk positioning

Risk positioning within the Fund subtracted 15bps from relative performance during the quarter vis-à-vis the Index. Over the past two years, we undertook multiple extensive reviews of each position in the portfolio to remove/reduce exposures that we felt were more sensitive to the downside from inflationary/supply chain issues as well as rising interest rates. The former has abated, and the latter has been offset to a large degree by continued growth in earnings and free cash flow across the universe of borrowers. That being said, it appears that rates will remain higher for longer, and we continue to keep a close eye on credit metrics (e.g., interest coverage ratios) and manage the Fund's positions accordingly. As we have become increasingly comfortable that the macro environment will remain resilient, over the last two quarters we began reducing the underweight to the "B" rated risk cohort by nearly 550bps. On average, during 2Q24, the Fund was approximately Index weight "BB" issuers, while approximately 634bps underweight "B" rated issuers. This compares with approximately 1,243bps underweight "B" rated issuers at year-end 2023. The Fund's holdings of CCC and lower-rated facilities remained overweight the Index (by 346bps), down from a peak overweight of 521bps in 3Q22. The "CCC" cohort is comprised of idiosyncratic credit situations and is not a general risk allocation for the Fund. We continue to actively manage the CCC cohort and exit positions that we believe are fairly valued.

Throughout 2023 and continuing into 2024, sentiment shifted meaningfully with investors becoming increasingly confident that the US would avoid a "hard landing" despite the Federal Reserve maintaining high rates. As such, appetite for lower rated credits improved appreciably, and after a very tough year for CCC loans in 2022 (-13.26% return), CCCs produced positive returns of 16.13% during 2023, besting the returns of BB (10.05%) and B (14.41%) rated loans.[1] This continued into 2024, and during the first half of 2024 CCCs again outperformed with a return of 8.80%, compared to 4.67% for Bs and 3.95% for BBs.[1]

Q2 2024 performance commentary

The gross return for the H shares of the Fund for the second quarter of 2024 was 1.64% versus 1.86% for the Credit Suisse Leveraged Loan Index, resulting in underperformance of 22bps. The net return for the H shares of the Fund over the same time period was 1.48%. Performance attribution descriptions are provided in the appendix.[6] The following commentary is applicable to all share classes of the Invesco US Senior Loan Fund.

Underperformance during the quarter was driven primarily by asset selection (-30bps) and to a lesser extent, by risk positioning (-15bps) and sector positioning (-7bps). These were offset in part by strong performance in credit selection (+30bps). With respect to asset selection, underperformance was primarily due to withholding taxes on the gain from the Fund's sale of energy exploration and production company QuarterNorth Energy to Talos Energy in March. As the Fund's interest in QuarterNorth is considered an interest in US real property by a foreign entity, FIRPTA ("Foreign Investment in Real Property Tax Act") withholding taxes apply. The Fund will recover any over-withheld taxes when it files its 2024 tax returns. This also had a negative impact on the monthly distribution for the Fund, as the Fund distributes all income earned during the month net of expenses and the withholding tax represented a one-time Fund expense. To a lesser extent, the Fund's interest in the reorganization equity of Commercial Barge Line also weighed on asset selection.

Risk positioning also detracted (-15bps) from performance. Despite the ongoing reset of interest rate expectations, buoyant risk appetite enabled lower quality credit to rally during the quarter. As a result, "CCCs" (2.46%) led the way in total return during the quarter, followed by "Bs" (2.17%) and "BBs" (1.94%).[1] The Fund's overweight position in outperforming CCC and lower rated issues was not enough to offset the Fund's underweight in the larger outperforming B cohort.

Finally, sector positioning was a nominal detractor, subtracting 7bps from relative performance. This was primarily driven by the Fund's overweight exposure to two underperforming sectors during the quarter, Cable (-0.27% average return) and Telecommunication (-0.07% average return), as well as the Fund's underweight to the well-performing Healthcare sector (2.55% average return).[5] This was offset in part by the Fund's overweight (529bps) to the well-performing Chemicals sector (2.50% average return).[5] This was the Fund's largest overweight.

Offsetting these in part was credit selection (+30bps of relative outperformance). This was driven by strong performance in several high conviction credits. Largest among these was outdoor shed and furniture manufacturer Keter, which completed a restructuring transaction at end of April that allowed lenders to take control of the company, in turn causing the debt to trade up in May. Additionally, hard beverage packer City Brewing announced an exchange transaction with the majority of its secured lenders in April (in which the Fund participated) as well as modestly better-than-expected 1Q results in May, which caused the credit to trade up as well. Also contributing to relative outperformance was engineering and construction company McDermott International, which continued to benefit from strong 1Q earnings and the completion of an amend-to-extend transaction in May, as well as chemical manufacturer Trinseo Materials, which the Fund had been purchasing at a discount in 2023 when the credit sold off on destocking concerns and which traded up on strong 1Q earnings and 2Q guidance.

Year-to-date 2024 performance commentary

The gross return for the H shares of the Fund for the year-to-date (YTD) period ending June 30, 2024 was 4.22% versus 4.44% for the Credit Suisse Leveraged Loan Index, resulting in underperformance of 22bps. The net return for the H shares of the Fund over the same time period was 3.76%. Performance attribution descriptions are provided in the appendix.[6] The following commentary is applicable to all share classes of the Invesco US Senior Loan Fund.

Relative underperformance was driven primarily by asset selection (-71bps) and to a lesser extent by risk positioning (-9bps) and sector positioning (-8bps). These were offset in part by credit selection (+66bps).

With respect to asset selection, as noted above, underperformance was primarily due to withholding taxes on the gain from the Fund's sale of energy exploration and production company QuarterNorth Energy to Talos Energy in March. To a lesser extent, as also noted above, the reorganization equity received in inland barge operator Commercial Barge also softened YTD due to the market technicals associated with this illiquid equity. Financial performance for the company remains solid, but nonetheless the downdraft in the equity price weighed on Fund performance. Finally, fixed and floating rate notes in the Altice family of borrowers fell in March when Altice France management laid out a new plan to delever the company from 6.0x to 4.0x during an earnings call. This plan called for a combination of asset disposals (which the market had anticipated) and "creditors' participation" in the form of par discounts captured via exchanges, tenders, or debt repurchases. This latter component came as a surprise to the market and contradicted the company's narrative shared with investors in 3Q/23 which was centered around inorganic asset sales and deleveraging by approximately 1x from asset sales. While these notes have rallied off their lows, they have still weighed on performance YTD.

Risk positioning also detracted (-9bps) from performance. As noted above, buoyant risk appetite enabled lower quality credit to rally, particularly during the first quarter. As a result, "CCCs" (8.80%) have led the way in total return YTD, followed by "Bs" (4.67%) and "BBs" (3.95%).[1] The Fund's overweight position in outperforming CCC and lower rated issues was not enough to offset the Fund's declining but still underweight position in the larger, marginally outperforming B cohort.

Sector positioning was also a modest detractor, subtracting 8bps from relative performance. This was primarily driven by the Fund's overweight exposure to two underperforming sectors Telecommunications (-0.23% return) and Cable (1.32% return), as well as the Fund's underweight to the well-performing Healthcare sector (5.72% return).[5] This was offset in part by the Fund's overweight (538bps) to the best-performing sector: Chemicals (5.91%).[5] This was the Fund's largest overweight.

Offsetting these in part was credit selection (+66bps in relative contribution). This was driven by strong performance from a broad range of high conviction credits. In addition to City Brewing, Keter, and McDermott International as noted above, other significant contributors included margarine manufacturer Sigma/Flora Foods, which reported better-than-expected earnings, and telecom software provider Mitel, which reported in-line earnings and movement towards a restructuring agreement between its sponsor and lenders. Additionally, the Fund saw improved levels from luxury river cruise operator Scenic, commercial laundry services provider Spin Holdco and airport guidance systems provider Safegate, all of which reported strong Q4 results.

1 Credit Suisse Leveraged Loan Index, total returns in USD, as of June 30, 2024.

2 Credit Suisse Leveraged Loan Index, total returns in USD, as of April 30, 2023, May 31, 2023, and June 30, 2024, respectively.

3 Bank of America as of July 12, 2024

4 JP Morgan as of June 30, 2024.

5 Source: Invesco Performance Attribution. Sector performance represents loan only average returns from sectors within the Credit Suisse Leveraged Loan Index based on average weight over the period ending June 30, 2024.

6 Performance Attribution descriptions:
- **Credit Selection: contribution to performance** from over/underweights in individual credits to the CS LLI.
- **Risk Positioning**: contribution to performance from ratings over/underweights relative to the CS LLI.
- **Sector Positioning**: contribution to performance from sector over/underweights relative to the CS LLI.
- **Asset Selection**: contribution to performance from non-benchmark CS LLI assets (Floating Rate Notes, High Yield Bonds, non-US loans, CLOs, Equity, Cash, etc.)
- **Trade Execution**: contribution to performance from ability to execute inside the bid/ask spread of the US senior loan market.

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