Invesco Oppenheimer Senior Floating Rate Fund

2019 Loan market overview

Senior Loans returned 8.17% for FY2019 as a "risk on" tone underlined capital markets for much of the year.[1] From a fundamental standpoint, credit quality remained largely intact, with leverage at manageable levels for most borrowers and default rates finishing the year at 1.39%, well below their long-term average of 2.88%.[2] While fundamentally the loan market remained on solid footing, the most defining theme of the loan market in 2019 was the technical environment, which had the largest impact on returns.

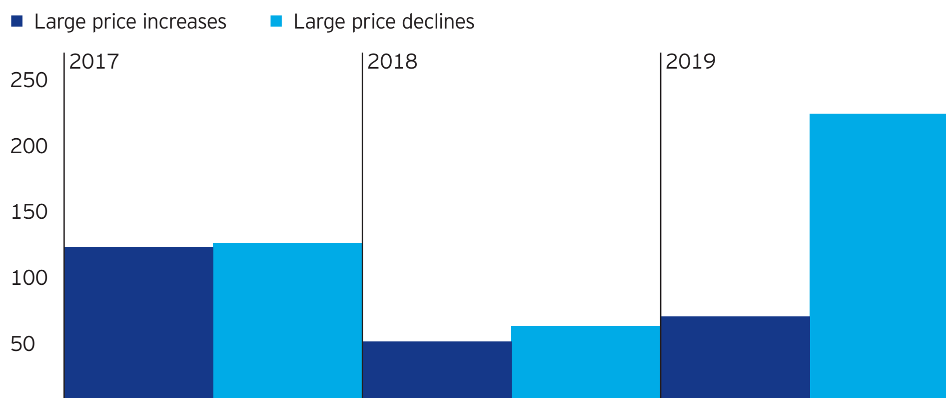
Technical dislocation – the "Haves versus Have-Nots"

While the performance of overall loan market in 2019 was strong, the sub-plot beneath the numbers revealed a technically driven bifurcation, resulting in significant return dispersion between higher rated loans and lower rated loans. For example, BB rated loans returned 9.09% on the year while CCC rated loans returned just 2.70%.[1] This was largely driven by strong demand for higher rated loans from Collateralized Loan Obligations (CLOs) and by diminished demand for lower rated loans from retail loan mutual funds.

2019 witnessed another year of strong new CLO volume of $118 billion.[3] CLOs represent the largest buyer of loans and typically gravitate towards higher rated loans, as they must continuously pass ratings tests and they have strict limitations on the total amount of CCC exposure they can hold (typically 7.5%). Additionally, CLOs will typically sell existing loan holdings if there are any concerns of a potential ratings downgrade.

Meanwhile, December 2019 marked the fifteenth consecutive month of retail mutual fund outflows from the loan market, totaling more than $58 billion.[3] Historically, retail mutual funds have been the marginal buyers of the lower-rated portion of the loan market, but due to the steady and persistent outflows they have been net sellers for much of 2019. This demand imbalance had a pronounced negative impact on many lower rated, out of favor loans. As shown in the chart below, the number of loans that experienced price drops of $5 or more increased significantly from the previous two years, despite a solid fundamental backdrop.

Lack of natural buyers resulted in large declines



Source: Barclays as of Sept. 30, 2019. Large increases/declines defined as price drops of $5 or more in a single trading session.

This document is for Professional Clients only and is not for consumer use.

FY 2019 Fund performance and discussion

2019 was certainly a challenging year for the Invesco Oppenheimer Senior Floating Rate Fund (the Fund), as it underperformed the benchmark by 533 basis points (bps). As described above, much of 2019 was characterized by technical dislocations and distortions as a result of a significant supply/demand imbalance in the lower-rated portion of the loan market. While this dynamic does not explain all of the Fund's underperformance, it does set the backdrop for last year and helps frame some of the challenges that caused certain portfolio holdings to underperform the market dramatically. This phenomenon coincided with some very specific and unrelated credit events that impacted the Fund's short-term performance as described below.

Approximately 40% of the negative performance can be traced to two high conviction holdings in the Fund: Murray Energy and Arch Coal. These positions were initiated in December 2015 and, in each case, our present valuations and expected ultimate recoveries were, and continue to remain, significantly higher than the current level of these two holdings.

Arch Coal

While detracting roughly 50bps from 2019 performance, it is worth noting that Arch Coal has been very accretive to the Fund's long-term performance. We built our position in Arch Coal expecting the company to file for Chapter 11 bankruptcy and purchased the first lien loans at a steep discount to par, which resulted in a cost basis of approximately $50. We believed that Arch Coal was an example of a good business, with a bad balance sheet and expected the Chapter 11 filing to eliminate nearly its entire debt load, while the first lien loan holders received the new equity. Our thesis stayed true to form and, at the end of the 2019, the recovery rate is well above $100 from a cost basis of approximately $50.[4] That said, we believe that there are a number of positive catalysts that are not reflected in the current price of the equity and will remain disciplined until it reached our valuation. We remain very close to and proactive with Arch Coal's management team to facilitate realization of recovery. As of Dec. 31, 2019, Arch Coal, Inc. comprised 2.89% of the Fund.

Murray Energy

As one of the Fund's largest positions and given the significant price volatility the loans experienced in 2019, Murray Energy was the single largest detractor from performance, at roughly 180bps. This is a high conviction position in the Fund, as we believe this is yet another example of a good company with a bad balance sheet.

Murray Energy is a low-cost thermal coal producer in the US and, despite commodity headwinds and negative sentiment towards the coal industry, generates significant EBITDA. True to our thesis, Murray Energy filed for Chapter 11 in October of this year, as the company could no longer support the debt it had accumulated, including $850 million in debt junior to the senior loans. We believe that this filing will allow the company to significantly reduce its overall debt burden and address other liabilities. With a meaningfully de-levered balance sheet going forward, we believe Murray Energy can return to being cash flow positive as the potential elimination of $850 million in subordinated debt frees up over $100 million of cash flow through interest expense savings alone.[4] The signed Restructuring Support Agreement (RSA) is a positive sign, as it will help expedite the bankruptcy process, and signifies to the bankruptcy judge that an agreement has been reached between the company and the first lien creditors.

Our investment thesis assigned a conservative valuation for Murray Energy's business as well as the first lien loans, and we are comfortable that there is sufficient junior cushion and compelling value that informed our decision to buy the loan at a discount to par. Based on our conservative valuation of the company, we strongly believe there is significant potential upside recovery on the loans and we will remain proactively engaged with the company's management team and our other first lien creditors during this workout process to seek to maximize our ultimate recovery. We take a patient approach and invest with a long-term view and will continue to hold these loans until they reach valuations in line with our estimates. As of Dec. 31, 2019, Murray Energy Corporation comprised 1.94% of the Fund.

Idiosyncratic events

The remaining significant detractors can be traced to a handful of issuers that experienced idiosyncratic challenges that can arise when investing in the arena of leveraged credit. Some specific examples included unforeseen events such as the unexpected loss of a key customer, and a company whose private equity sponsor inexplicably deciding to stop supporting their company and walked away. Events like these do happen from time to time and are a part of investing in the leveraged credit markets; however, we seek to run a diversified portfolio with more than 270 holdings to help mitigate this idiosyncratic risk.[4] In addition to a handful of fundamental credit events outlined above, we believe that the technical dislocations experienced in 2019 resulted in exaggerated price declines for a number of loans. Its important to recognize that many of these are mark to market declines, and not realized losses without the chance of recovery.

Conclusion

While 2019 posed a number of challenges, due in part to both the technical environment as well as our high conviction investment style, we continue to believe that many of the largest detractors during the calendar year 2019 have tremendous upside relative to their current trading levels. We will continue to maintain a patient approach to investing over the full cycle which, as evidenced in our long-term track record, has delivered strong performance to our clients.

1 Credit Suisse Leveraged Loan Index as of Dec. 31, 2019.
2. S&P LSTA Leveraged Laon Index as of Dec. 31, 2019, average ranges from Jan. 31, 1999 to Dec. 31, 2019.
3. JP Morgan as of Dec. 31, 2019.
4. Invesco as of Dec. 31, 2019.

About Risk

Senior loans are subject to credit, interest rate and prepayment risk, are typically lower-rated and may be illiquid investments (which may not have a ready market).

An issuer may be unable to meet interest and/or principal payments, thereby causing its instruments to decrease in value and lowering the issuer's credit rating.

Derivatives may be more volatile and less liquid than traditional investments and are subject to market, interest rate, credit, leverage, counterparty and management risks. An investment in a derivative could lose more than the cash amount invested.

There is a risk that the value of the collateral required on investments in senior secured floating rate loans and debt securities may not be sufficient to cover the amount owed, may be found invalid, may be used to pay other outstanding obligations of the borrower or may be difficult to liquidate.

The risks of investing in securities of foreign issuers can include fluctuations in foreign currencies, political and economic instability, and foreign taxation issues.

Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa.

Junk bonds involve a greater risk of default or price changes due to changes in the issuer's credit quality. The values of junk bonds fluctuate more than those of high quality bonds and can decline significantly over short time periods.

Leverage created from borrowing or certain types of transactions or instruments may impair the fund's liquidity, cause it to liquidate positions at an unfavorable time or lose more than it invested, increase volatility or otherwise not achieve its intended objective.

An issuer's ability to prepay principal prior to maturity can limit the fund's potential gains. Prepayments may require the fund to replace the loan or debt security with a lower yielding security, adversely affecting the fund's yield.

The fund is subject to certain other risks. Please see the prospectus for more information regarding the risks associated with an investment in the fund.

Important Information

Before investing, investors should carefully read the prospectus and/or summary prospectus and carefully consider the investment objectives, risks, charges and expenses. For this and more complete information about the fund(s), investors should ask their advisors for a prospectus/summary prospectus or visit invesco.com/fundprospectus.

This does not constitute a recommendation of any investment strategy or product for a particular investor. Investors should consult a financial professional before making any investment decisions.

Note: Not all products, materials or services available at all firms. Advisors, please contact your home office.

The opinions expressed are those of the fund's portfolio management, are based on current market conditions and are subject to change without notice. These opinions may differ from those of other Invesco investment professionals. Holdings are subject to change and are not buy/sell recommendations.

Past performance is not a guarantee of future results.

Diversification does not guarantee a profit or eliminate the risk of loss.

The investment techniques and risk analysis used by the Fund's portfolio managers may not produce the desired results.

All data provided by Invesco unless otherwise noted.

NOT FDIC INSURED   MAY LOSE VALUE   NO BANK GUARANTEE

invesco.com/us   O-SFLR-COM-1-E   02/20   Invesco Distributors, Inc.   NA1450