Senior Secured Loans

Why Global Loans?

For investors wary of interest-rate volatility, the variations that exist throughout the global loan market may provide relative stability and more, explains Jonathan Butler of Prudential Fixed Income.

Q. Leveraged loans have drawn investors seeking attractive income opportunities and a hedge against rising interest rates. What other benefits might investors obtain from a global loan allocation in comparison to a pure U.S. or European loan strategy?

A. While investors have been drawn by the aforementioned attributes of leveraged loans, gaining exposure to these characteristics should not come at the cost of a comprehensive investment strategy. By expanding to a global loan strategy, investors might combine the benefits of an interest-rate hedge and attractive income potential with relative value and diversification opportunities. Investors focused on the U.S. loan market might increase their opportunity set by about 25% by taking a global perspective. Similarly, investors focused on European loans could more than triple the size of their investment universe by including the U.S. market.1

This breadth may be demonstrated in a global sector, such as packaging, where a company may issue loans and bonds in both euros and U.S. dollars. By evaluating an issuer's capital structure across regions and currencies, an asset manager can be more selective in seeking the best relative value opportunities and improving diversification compared to a strategy that relies on allocations to a specific currency or region.

When viewing the leveraged finance markets from a global perspective, it is apparent how the relative value opportunities shift over time, as the following chart demonstrates. With the caveat that fundamentals also change, U.S. leveraged loans appeared attractive in early 2011 before their spreads tightened significantly relative to the other leveraged asset classes. Similarly, euro loans presented an attractive value compared to other leveraged markets as of December 31, 2013, again, with the caveat that there were fundamental differences between these markets as well.

1 All data points are from Credit Suisse unless otherwise indicated.
Spread of U.S. bank loans, U.S. high yield, and European high yield relative to European bank loans

January 1, 2008 – December 31, 2013

Source: Credit Suisse. Bond spreads represent spread to worst. Loan spreads represent 4-year discount margin 5-year swap adjusted.

The different regions within a global loan strategy have their own characteristics, such as varying market sizes, economic growth rates, and regulatory environments. An integrated, global leveraged finance team with the familiarity of these varying characteristics underscores how these nuances may present the opportunities that support the comprehensive investment approach of a global loan strategy.

Q. What might investors expect from loans considering the general lack of inflation and central banks’ commitment to maintain accommodative policies for the foreseeable future?

A. Although inflation is generally low in the developed world, the interest-rate floors on some loans may help ensure attractive yields given the prospects for only limited short-term rate increases in the near future.

The prevalence of the rate floors can vary by region. For example, 83% of the U.S. leveraged loan market carried LIBOR floors with an average rate of 1.15% as of the end of 2013. Although rate floors among European leveraged loans were limited to 25% of the market, with an average rate of 1.08%, the prevalence of LIBOR floors was up from only 9% of the market in 2012.

While rate floors are an important consideration in terms of short-term rate increases, the markets have experienced repeated bouts of volatility in long-term interest rates over the past year. Should this turbulence re-emerge, the minimal durations on loans may offset some of the consequent volatility within investors’ fixed-income portfolios.
Q. With investors’ prolonged interest in loans, how have covenants changed in the asset class, and do these changes have any investment implications?

A. As investor demand for loans has risen in recent years, particularly in the U.S., the pendulum has swung toward issuers in terms of loosening covenant packages. While “covenant-lite” issuance in 2013 climbed to more than half of the new supply in the U.S. and more than a quarter of the total issuance in Europe, this uptick implies little about the overall credit quality of the respective issuers.

The default rate on covenant-lite issuers in the U.S. is generally below the level of similarly rated companies, according to Moody’s Investors Service. In addition, first-lien, covenant-lite loans issued in the U.S. between 2005 and 2007 have experienced above average recovery rates in comparison to all defaulted first-lien loans.

Although the leveraged loan markets have seen an increasing trend of covenant-lite issuance, which bears watching going forward, the increase tends to have a limited effect on issuers’ credit quality in general.

Q. Where might an allocation to global senior loans fit within an institution’s high yield/credit spread basket?

A. An exposure to global leveraged loans provides the potential for yield enhancement and attractive loss-adjusted spreads across a more diverse portfolio. From the perspective of matching portfolios, an allocation to global senior loans may provide a hedge against a potential increase in short-term interest rates and accelerating inflation.

The opportunities that various institutional investors may find from global loans reflect the relative value, diversification, and income potential that may be achieved by expanding beyond strategies restricted to a single region or currency to an investment universe that is over $900 billion in size and consists of approximately 1,650 issues.
Notice

Source(s) of data: Credit Suisse unless otherwise indicated, as of 12/31/13 unless otherwise noted.

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