MARKET INSIGHT

The HUB

NEWS AND VIEWS FOR INSTITUTIONAL INVESTORS

Are senior loans set to shine?

It's a rare fixed income asset class that has the potential to both increase yield and lower volatility

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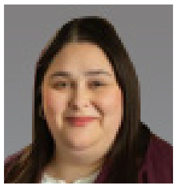

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An allocation to senior loans in a fixed income portfolio can be valuable – in both the short and long term – for two main reasons. First, because they are backed by collateral and have a senior, secured position in the capital structure, bank loans can substantially reduce risk to investors' capital in a default scenario. Second, they temper interest rate risk because they have floating coupons. The floating rate of interest protects the prices of senior bonds from declining when rates are rising. These dual advantages are not available with the majority of traditional fixed income securities.

So how can institutions invest in senior loans and is now a good time to be making an allocation?

How to invest in senior loans

The senior loan market consists of loans made by major commercial and investment banks to companies seeking to raise capital. The sizes tend to be large: most syndicated senior loans in the US market are between $100 million and $5 billion.

Senior loans are actively traded in the secondary market like high yield and investment grade bonds. The senior loan market is similar in size to the high-yield market ($1.3 trillion versus $1.5 trillion) and, like the high-yield market, senior loans are generally rated by Moody's and Standard & Poor's.

Senior loan-issuing companies are usually sub-investment grade, or high yield, so senior loans tend to offer higher income than investment grade bonds, but lower than high-yield bonds. "The yield in excess of investment grade reflects a greater perceived credit risk," says Cheryl Stober, an investment director in the bank loan team at Loomis Sayles, an affiliate of Natixis Investment Managers. "The slightly lower yield versus high yield is because bank loans are more senior in the capital structure, so there is less risk to investors' capital."

What is the case for allocating?

The long-term strategic case for bank loans is driven by the asset class's behavior over a full credit cycle. While most other asset categories generally are hurt by rising rates, declining corporate credit, or both, senior loans directly benefit from rising rates and are somewhat insulated from declining credit by their senior, secured position in the capital structure.

The case for banks loans – and particularly – dollar-denominated bank loans, is particularly strong right now. Given the level of economic uncertainty in Europe amid the war in Ukraine, dollar-denominated loans, mainly issued by north American companies, could be a rewarding segment in the coming months and years.

In an environment of global economic uncertainty and, probably, rising interest rates, senior loans' dual protection of principal and interest is prized by investors.

Since senior loans are both senior and secured, they are more protected from a decline in enterprise value of the borrowing company, unlike bonds that are lower in the capital structure. Since bond prices fall when interest rates rise,

Key takeaways:

- Most assets are hurt by rising rates and declining corporate credit, but senior loans directly benefit from rising rates and can be more insulated from declining credit by their senior, secured position in the capital structure.
- The case for dollar-denominated bank loans is particularly strong right now. In an environment of high economic uncertainty in Europe and rising interest rates, senior loans provide dual protection of principal and interest.
- Security-specific fundamental credit research is critical given that successful bank loan investing is mostly about winning by not losing.

this could have significant implications for more traditional bond portfolios as rates normalise.

"Companies in the loan market are well positioned to survive any likely increases in interest rates," says Stober. "With few maturities scheduled in the coming years, defaults are projected to be quite low."

Floating-rate coupons allow bank loan prices to remain fairly steady during periods of rising rates. At a time when bank loans offer current yields close to other near-rated bonds this up-rate optionality is, by implication, cheap.

"We have seen Australian investors allocate to bank loans ahead of, and during, periods of rising rates," says Louise Watson, Country Head of Australia & New Zealand at Natixis Investment Managers.

"Investors gravitate to the asset class as bank loans are designed to be somewhat resistant to both principal risk (because of collateral) and interest rate risk (because of floating coupons).

Watson adds "Australian Institutions view an allocation to bank loans as a strong addition to their fixed income portfolio for both the short-term and long-term."

Allocations are rising

Even though senior loans are relatively standard fixed income investments and are more defensive than high yield, they often are considered as alternative investments. The Mercer European Asset Allocation Insights 2021, for example, views senior loans as "growth-oriented fixed income" instruments, which is a sub-category within alternative investments. The same survey shows that only 5% of European pension funds have an allocation to senior loans. But those that invest in senior loans have a relatively strong conviction in the asset class, allocating 4% of their total assets to it. In Switzerland, pension fund regulation also considers senior loans as alternative investments. The Credit Suisse Swiss Pension Fund Index 2021 survey indicates that Swiss pension funds had an average allocation of 0.62% to senior loans at the end of 2021. The average allocation of schemes that invest is generally in the 2%-4% range.

In an enduring negative yield (after the costs of hedging) environment for both domestic and foreign investment grade bonds, most Swiss pension funds have low expectations for their fixed income allocations – which average around 30% – to generate return, and view fixed income more as risk- mitigators.

"Naturally, allocations to higher-yielding fixed income segments have increased, through increased corporate credit risk, such as high yield, or through credit country risk such as emerging debt," says Olivier Bluche, head of institutional sales for French-speaking Switzerland, at Natixis Investment Managers. "More recently, we have seen increased appetite for private debt, which is a very effective way to increase the yield further and lower volatility of returns, since investments are not as readily marked to market."

In addition, a number of Swiss local and international consultants recommend senior loans, as a way to get exposure to an asset class which offers a combination of high yield, no duration risk and high liquidity. "With interest rises a reality, investors will have to find strategic or tactical alternatives to reduce duration risk and potential capital loss on fixed income investments, while keeping volatility under control," adds Bluche.

What risks do investors need to know?

The principal risks are credit quality, market liquidity, default risk and price volatility. While bank loans are secured by collateral, the issuing companies are often rated below investment grade and so may have a higher risk of default. At the end of 2021, the 12-month default rate by amount outstanding was 0.29%. "Assuming a 60% recovery rate, this implies a portfolio loss of just 0.12%," says Stober. "But broad and deep research support is essential to keep default rates low and recovery rates high.

In addition, the loan market, at times of pressure, may experience reduced liquidity that adversely impacts loan prices. Inefficiencies in pricing and liquidity are constants in the market due to investors' tendency to overreact to events. An example is the 2008-2009 financial crisis, when forced selling from bank balance sheets resulted in steep price declines, resulting in the first ever year of negative senior loan returns since the benchmark index's inception in 1992. "In early 2009, selling pressure eased and investors raised new money to buy substantially undervalued credits," adds Stober.

Winning by not losing

Loomis Sayles is the Natixis Investment Managers affiliate with the longest investment history. Founded in Boston in 1926, it now manages $363 billion of client assets, about 70% of which are fixed income. Loomis Sayles has long been known for its credit research expertise and has used a proprietary credit rating system since the 1930s.

The Loomis Sayles senior loan team has managed discretionary accounts and mutual funds since 2004, with assets of $3.3 billion invested (as of 12/31/21) in a defensive, transparent, benchmark-aware and long-only way.

Security-specific fundamental credit research is critical given that successful bank loan investing is mostly about winning by not losing. Portfolios of 200-300 names are diversified by industry and security, favouring higher-quality, par loans that offer multiple credit cushions.

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