# Leveraged Loans. Time to Start Buying. In Stages.

Leveraged loans have been one of the best investments in the last decade, on a risk adjusted basis.

Using the S&P LSTA Index as a gauge, the 10 year annualized return has been 8.9% with a volatility of less than 1%. The high yield bond market, proxied by the iBoxx HY index has returned 9.6% with less than 5% volatility while the iBoxx IG index has returned 5.5% on roughly 5% volatility as well. In contrast, the S&P 500 equity index has returned 14.3% but with about 15% volatility. A strategy of leveraging a portfolio of loans to bring the volatility in line with HY or IG or indeed equities would have generated far better returns.

Putting aside the technicalities and complexities of leveraging a portfolio of loans and considering loans on an unlevered basis, the attractions are still clear. Loans are floating rate securities and therefore have very low interest rate sensitivity, a useful property in a rising interest rate environment. Loans are senior secured claims and are therefore structurally senior to bonds which are senior unsecured claims.

The US economy is still growing and still robust. While growth may slow in 2019 to 2020, recession risk is low. Credit markets are not without risks and we will address those, but at the fundamental level, the labour market is tight, wages are rising, the housing market is robust, consumer debt is under control and leverage is lower than it was in 2007. The leverage of loan issuers has fallen from 2015 to 2018, from 6.2X to 5.3X, cash flow coverage has risen from 2.7X in 2016 to 3.2X in 2018. Overall corporate leverage has risen in the last 10 years but this surge has taken place mostly in the HY bond market and not the loan market. Company earnings may slow in 2019 and 2020 but growth is expected to be remain positive.

Loan prices are technically capped at 100 since an issuer can repay a loan early, at par. At times, loan prices have exceeded par, notably in in 2005/2006 when direct investors and CLOs were heavy buyers of loans. Prices breached par again in 2014 as taper tantrum stoked fears of rising interest rates making the floating coupon of loans valuable. In 2017 and 2018, loans traded above par again, most recently in October 2018 when some 65% of the market traded above par. Today less than 5% of the market trades above par. The average price of the S&P LSTA Index is down from 98.70 to 95.60 in the space of 2 months, a 3.11% decline. It’s a small number for equity and FX investors but in the loan world where volatility is often around 1%, this is a big deal. In 2015 when the HY market was under stress and China was dragging global growth down, loans traded to 89.3. In 2008, the depths of the global financial crisis saw loans trade to 61, default rates were in the mid teens while recoveries were in the 50s. That point was one of the best buying opportunities in loan market in history. An investor who bought loans in September 2008 would have made 9.8% by the end of 2009 for an annualized return of 7.05%.

Loans are not without their risks, even if fundamentals are sound. Much has been said about the predominance of covenant lite issues. This is true but a) the number of cov-lites is already receding, and b)the phenomenon is more a technical issue where the largest marginal buyers of loans, CLOs, would give up covenants for yield in an effort to improve their arbitrage between assets and liabilities. This is of course no excuse but explains the trend in cov lites. Another risk is liquidity risk. Loans are not exchange traded and while the market has grown, capital dedicated to market making has shrunk as a result of greater bank regulation. This presents liquidity risk which can exacerbate market volatility in a downturn. An increasing number of loan only capital structures which eschew the senior unsecured layer is another concern which can impact recoveries and increase leverage for the loan investor.

What we are fairly certain about for now and for 2019 is that the US economy is healthy and in expansion but that the rate of expansion could slow. We can see loan prices at 95.60, default rates of 1.6% possibly climbing to 3.2%, and we see current coupons at 6%. Should you buy now? In 2015, we saw a healthy US economy except for one spot which was the energy sector. Energy represents about 7% of the loan market (and 16% of the HY bond market.) Loans traded from 99 in late 2014 down to 89 in early 2016. In total returns, this was a -2% return (-1.3% p.a.) From June 2015 to Feb 2016, the total return was -4.16% (-6.6% p.a.). Time and collecting a coupon makes a big difference. The current move resembles the move in mid-2014, which could be a signal of further weakness down the line. However, for smaller investors there is the option to invest in closed ended loan ETFs which currently trade at a 13-14% discount to NAV. Here the attraction is buying an asset whose value is 95.5 and paying 87 for it and collecting a 6% coupon while waiting for the price to converge to the NAV. Even at a 5% default rate, which would indicate a recession, and zero recovery, the investment exhibits ample room for error.

For long term investors who do not like the complexity of buying closed ended ETFs and later switching to NAV products, the loan market is already good value. It may get cheaper over the coming months, and it might be dead money for a year, but the downside is reasonably limited and the coupon is attractive. It is difficult to time the market so a reasonable strategy is to begin buying in stages.