

High yield bank loans: The case for a strategic allocation



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High yield bank loans can be used successfully to complement a high yield bond strategy or as a standalone asset class. Bank loans can provide superior risk-adjusted returns over several alternative investment classes. They also provide portfolio diversification benefits, a senior claim position with higher recovery potential in bankruptcy, and the potential for strong returns in a rising interest rate environment. To increase the likelihood of capturing these benefits, it is important to actively manage a diversified portfolio of loans.

KEY POINTS:

- The bank loan investor base has expanded aggressively over the past two decades, as bank loans have become a more investable asset class.
- Among the benefits of loans are portfolio diversification due to their low correlation with other assets, a senior position in the capital structure, and higher expected recovery rates than bonds.
- The recent credit crisis masks a very favourable long-term Sharpe Ratio for loans that reflects superior risk-adjusted returns over several asset classes.
- Despite the rally in 2009, valuations remain attractive and are still priced at a 10% discount from par.
- With the significant amount of refinancing commencing in a few years, it is crucial to have the expertise required to navigate through the volatility and opportunities that lie ahead.

Growth of bank loan investing

Over the past two decades, the bank loan investor base has expanded aggressively. Loans were initially the territory of traditional banks. However, through syndication, participants now include money managers, hedge funds, insurance companies and collateralised loan obligations (CLOs)¹. Liquidity has greatly improved, and bank loans have attracted more interest following the standardisation of loan trade settlement procedures, reductions in minimum investment trading block sizes, the waiving of trade-related administrative fees by most dealers and better pricing transparency. These developments occurred largely out of tighter US Federal Reserve guidelines, which required banks to have greater capital ratios, and the significant growth in the leveraged buyout (LBO) market in 2005 to 2007, which was heavily financed with bank debt.

Additionally, banks wanted to diversify their books of business as well as reduce the relatively high capital costs associated with holding loans.

New investors were attracted to bank loans for a variety of reasons, including seniority in the capital structure, better recovery rates², downside protection in rising interest rate environments, since most loans pay on a

floating rate spread over 3-month LIBOR, new investment opportunities with loan-only issuers (companies that do not use corporate bonds in their capital structure), historically low volatility of returns and low correlation with other assets classes.

Analysis of the bank loan market

High yield bank loans – which are also referred to as leveraged loans, floating rate loans, or par loans – are those with credit ratings below investment grade, as indicated by a rating lower than BBB- by Standard & Poor's and Fitch, or Baa3 by Moody's³. The loan market can be broadly divided into two camps: pro rata and institutional. Institutional loans – the focus of this article – offer longer duration, have negligible amortisation, are traded more frequently and are held more widely across traditional institutional investors. Institutional loans sit at the top of the capital structure. They are typically secured by all company assets and provide the added protection of covenants requiring mandatory loan pay-downs as well as first priority of pay-down under various scenarios.

The institutional loan market has grown from a par amount outstanding of about \$100 billion early in the last decade to almost \$600 billion at the end of 2008. The

greatest growth was in 2006 to 2007, when approximately 80% of loans outstanding today were issued, fueling the LBO market⁴. The borrower base represents virtually all industries and, therefore, enlarges the universe of investment opportunities. Similarly, credit ratings span the entire quality continuum of high yield but are most heavily represented in the single-B category. Whilst some capital structures are limited to bank-loan-only models, the majority have both loan and bond structures, providing the investor with the opportunity to invest throughout the capital structure with various risk/return options.

The credit crisis that began in 2007 had a significant impact on all asset classes, and bank loans were not immune. The effects are still being felt strongly today and are likely to continue in the foreseeable future. In particular, the largest buyer of loans had become CLOs, which, as noted earlier, are structured investment vehicles that purchase loans and then use them as collateral to issue new securities of different seniority levels. Loans held by CLOs deteriorated along with the credit markets, which resulted in CLOs becoming forced sellers due to strict quality and price requirements as dictated by their indentures. This selling drove prices down even more. Many CLOs also employed leverage, further worsening the market technicals. This resulted in a 2008 return for the bank loan market of -29.5%. Today, the new issue market for loans is extremely light, albeit improving, and CLO participation has largely evaporated.

Potential for strong risk-adjusted returns

Until 2008, loans traditionally had fairly stable and moderate returns with limited volatility. Despite an outstanding 2009 performance, the fundamentals, technicals and valuations of the loan market still present a significant opportunity for robust risk-adjusted returns.

When analysing past returns and risk metrics, it is important to factor in the meaningful impact of the credit crisis. In particular, there is a stark contrast between the average Sharpe Ratios⁵ for pre-credit crisis time periods and those running through to December 2009. The impact on loans was extraordinary. The Sharpe Ratio declined from an average of 0.52 for the 2000 to 2007 period, to -0.32 for the period of 2000 to December 2009. No other asset class was so adversely affected. However, whilst risks remain across all credit markets, the Sharpe Ratio is anticipated to migrate towards more normalised levels and away from the recently skewed figures, which are believed to be an aberration of the recent credit crisis.

Diversification benefits

Bank loans provide a diversification benefit when combined with other asset classes, as reflected by their low correlation. Similar to the impact the credit crisis had on Sharpe Ratios, the 0.77 correlation with high yield bonds has been significantly skewed as well. This is consistent with essentially all risk assets, as correlations tended towards one during the broad based sell-off. Reviewing the correlations before the credit crisis shows an even stronger diversification benefit with a correlation to high yield of only 0.57. Given the current low interest rate environment and escalating concerns about higher inflation, the allocation to this floating-rate asset class is well positioned to provide superior returns compared to other fixed income securities if short-term rates begin to rise (as was experienced in 2000 and 2005). If rates stay at current levels, the upside for capital appreciation is still significant. This is highlighted by the -0.31 correlation loans have with government securities⁶.

Table 1 on page 3 uses five hypothetical portfolios to illustrate the benefits of including loans as part of a high yield allocation. One portfolio consists of 100% high yield bonds; one comprises 100% high yield loans; and three portfolios have

TABLE 1: HIGH YIELD PORTFOLIOS

	HY	Loans	25% HY/75% Loans	50% HY/50% Loans	75% HY/25% Loans
Average Annual Total Return %	6.64	4.91	5.34	5.78	6.21
Annual Standard Deviation %	9.89	6.41	6.93	7.74	8.74
Sharpe Ratio (risk free rate @ 0.1%)	0.66	0.75	0.76	0.73	0.70

Source: Aviva Investors, North America. 12 February 2010.

varied exposures to both high yield bonds and loans. As demonstrated, the standard deviation of the portfolios that include loans is much lower than it is for the one without loans. Additionally, returns are not materially sacrificed with the addition of loans, and the portfolio's Sharpe Ratio is higher with loans included.

Review of default rates

Default rates for loans increased significantly in 2009. With the massive loan issuance in the few years leading up to mid-2008, underwriting standards declined as investors allowed over-leveraged capital structures with weak covenant packages to be placed in the market. The spike in loan default rates has been tremendous, peaking at 12.9%, but is expected to drop to 4% by the end of 2010, according to JP Morgan. This forecasted drop is largely based on "amend-to-extend" activity taking place, which is the term used when covenant relief is provided and loan maturities are extended by lenders for high-quality businesses; on loans restructured through bond deals; and on the general thawing of the credit markets, which is providing much-needed liquidity on several fronts. Indeed, the credit markets are pricing in significantly less default risk, as reflected in the approximately 30% increase in loan prices.

Expectations for recovery rates

Recovery rates for loans – and to a greater extent bonds – have been on a downward trajectory for various reasons. Covenant-

lite loan agreements, or loans with very little contractual protection for lenders with regard to financial maintenance metrics, allow more time to pass and damage to occur before creditors can intervene. Bank-loan-heavy capital structures mean more creditors with which to share recovery. Heavily leveraged capital structures limit recovery. In addition, there has been an increase in asset-based loans, which are senior to general first-lien loans.

Moreover, as a significant portion of the issuance from 2005 to 2007 falls into one of these categories, this does not bode well for recovery rates over the next few years. Approximately 80% of loans outstanding were issued in 2006 and 2007. Of these, covenant-lite and second-lien loans make up more than 20%. Between 2012 and 2014, approximately \$440 billion in loans will need to be refinanced⁷.

Attractive opportunities still exist in loans

Company fundamentals may be near the bottom for the recent recession. Several indicators support this: credit markets are functioning again, with companies raising capital; earnings deterioration is slowing; the systemic risk of the financial system has abated; and cautiously optimistic outlooks from corporate management teams are replacing the doomsday outlooks of previous earnings estimates. Whilst risks remain, the 2009 performance of the forward-looking

equity and high yield markets supports the view that the worst is behind us.

Market technicals continue to support loans. With strong mutual fund inflows and high investor cash balances, the support for new high yield bond issuance has been robust. As the prices of bonds are driven higher, so are the prices of loans. As noted earlier, the primary market in loans is quite muted, and we are seeing a significant move towards companies issuing bonds to refinance bank loans. This refinancing activity is typically done at par, benefitting the loan investor from the resurgence in the primary bond market.

Before 2008, the price of loans typically traded in a range very close to par, or 100 cents in the US Dollar – hence the name par loans. However, the credit crisis and the significant selling pressure from investors meant par loans quickly found a trading range in the low 60 cents in the dollar. With a current average price around 90 cents in the dollar, and acknowledging the significant rally, valuations are still attractive.

Conclusion

Bank loans have become an investable asset class for a much broader audience than has traditionally been the case. Loans offer diversification benefits due to their low correlation with other assets, a senior position in the capital structure and higher expected recovery rates than bonds. The recent credit crisis masks a very favourable long-term Sharpe Ratio that reflects superior risk-adjusted returns over several asset classes.

Consequently, a more normalised Sharpe Ratio is likely to re-establish itself over the coming years. Despite the rally this year, valuations remain attractive and are still priced at a 10% discount to par. Further, given the significant amount of refinancing that will be starting in a few years, it is crucial to have the expertise required to navigate through the volatility and opportunities that lie ahead.

General references made throughout the article are sourced to: Barclays Capital High Yield Corporate Update, January 5, 2010.

1. CLOs are structured investment vehicles that purchase loans and then use them as collateral to issue new securities of different seniority levels.
2. A recovery rate is the percentage of capital and/or income expected to be recovered post-default.
3. These agencies base credit ratings on the loan issuer's ability to pay interest and repay principal as scheduled. They rate issuers as below investment grade when the risk of non-payment of interest and/or principal is considered higher than investment grade counterparts. Issues rated below investment grade tend to have less financial flexibility, more leverage and greater default risk than those issuing investment grade loans.
4. Default Monitor, October 1, 2009.
5. The Sharpe Ratio is a measure of risk-adjusted return. It divides the asset or portfolio return in excess of the risk-free return by the volatility, or standard deviation, of returns over the period. The higher the Sharpe Ratio, the better the risk-adjusted return.
6. This negative correlation is a long-term average, interdispersed with periods where the relationship does not hold. However, given that the loan market is currently priced at a 10% discount to par, there is the potential for material price appreciation regardless of interest rate movements.
7. Barclays Capital, US Credit Alpha, June 19, 2009.



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Christopher is responsible for high yield bond and leveraged loan portfolio management.

EXPERIENCE AND QUALIFICATIONS

Christopher joined Aviva Investors North America, Inc. in 2002. He has more than 17 years of financial industry experience. Previously, he worked as a credit analyst for Standish, Ayer & Wood and for AIG.

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