INVESTMENTS®

INVESTMENT RESEARCH

Overb*loan* concerns?

Investment Research

Robert Hoffman, CFA
Executive Director

Lara Rhame
Chief U.S. Economist

Andrew Korz
Associate

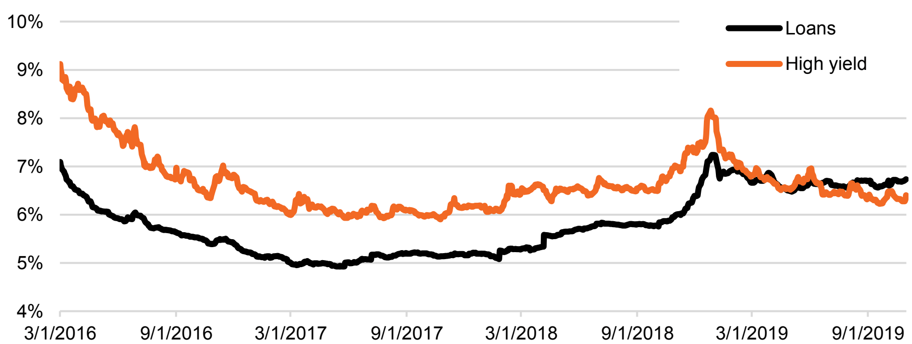
Kara O'Halloran, CFA
Associate

Contact
research@fsinvestments.com

For years, senior secured loans have been viewed as an attractive way to invest in corporate credit markets because they are exactly what their name implies: senior and secured. In the past year, however, a culmination of longer-term trends has changed the composition of the market and, we believe, requires a reexamination of the current state of the broadly syndicated loan market.

Senior secured loans and high yield bonds have traditionally shared one important characteristic: both asset classes are nearly entirely rated below investment grade. Historically, the high yield bond market, due to its status of often being unsecured and subordinated compared to loans, has traded with higher yields than loans – compensating investors for bearing the additional risk. In the past year, however, this trend has reversed – loans are now yielding more than high yield bonds. For context, this hasn't happened since December 2008, and loans yielded more than high yield a total of only six days between 2002 and 2018. The yield gap (high yield YTM minus loan YTM) has been negative for 115 days this year and counting.[1] We believe the higher yield on loans has more to do with the additional risks they now pose (as outlined below) and the compensation investors demand to hold them.

YIELD GAP: HIGH YIELD BONDS VS. LOANS



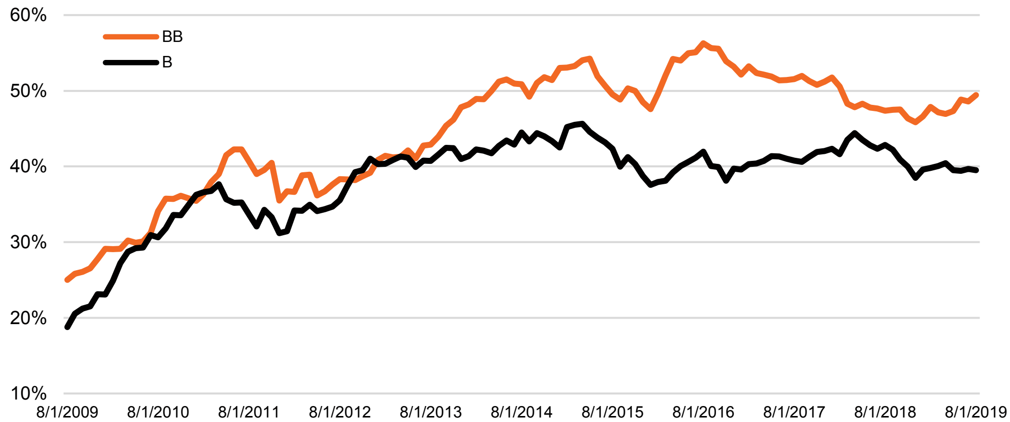
Source: ICE BofAML U.S. High Yield Index, S&P/LSTA Leveraged Loan Index, as of October 31, 2019.

Market composition

The ratings composition of the loan and high yield markets has drifted over the past 10 years, with each taking a markedly different path. The high yield market has seen an improvement in credit quality – with BB rated bonds now representing approximately 50% of the market, up from 25% in 2009. The loan market, however, has seen the quality of its credit mix steadily decline, with BB rated loans making up just under 30% of the market and B rated loans comprising almost 60%. In 2009, B rated loans comprised roughly 30% of the market. The high yield market today stands at its highest quality as measured by overall ratings composition since 2001, while the loan market is at its lowest quality in the history of the market.[1]

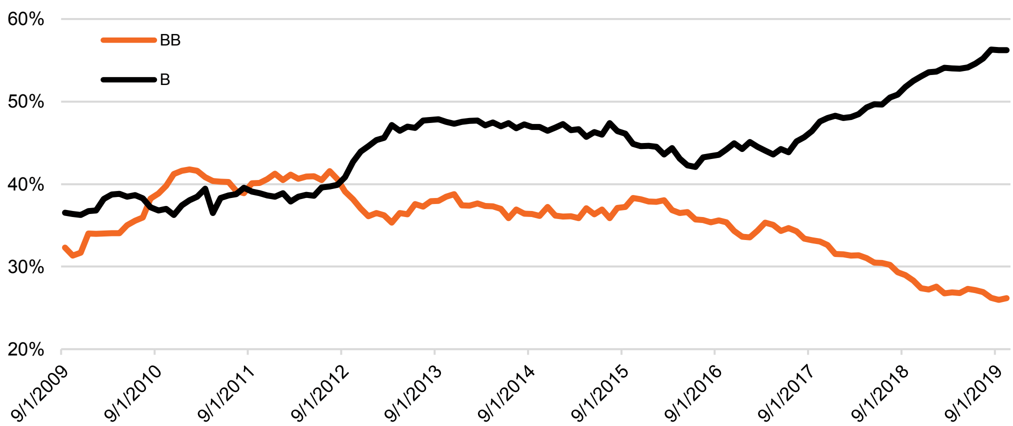
1 ICE BofAML U.S. High Yield Index, S&P/LSTA Leveraged Loan Index, as of October 31, 2019.

COMPOSITION OF HIGH YIELD BOND MARKET



Source: ICE BofAML U.S. High Yield Index.

COMPOSITION OF SENIOR SECURED LOAN MARKET



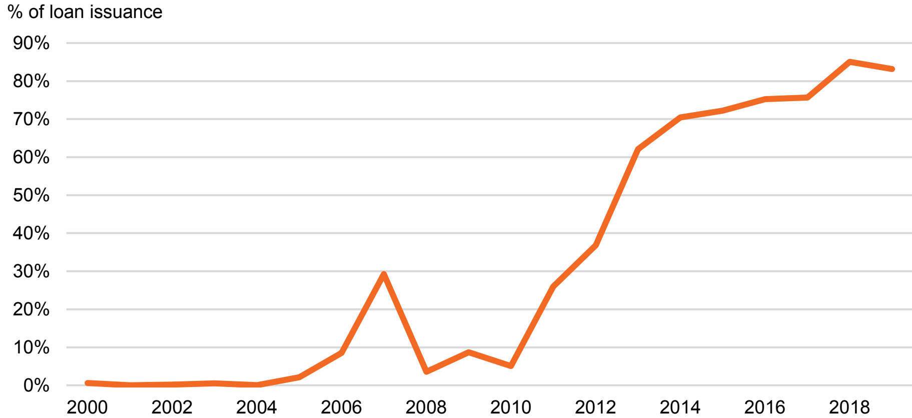
Source: S&P/LSTA Leveraged Loan Index.

Issuance trends

In addition to the ratings composition of the loan market, other trends have emerged over the past few years that we believe are causing investors to demand higher yields in return for owning loans. The prominence of covenant light, or "cov-lite," loans has taken headlines by storm, and for good reason. The issuance of loans with fewer covenants and lax protections for lenders has steadily risen over the last decade and now accounts for 84% of newly issued loans. That's up from 0% in 2004 and even 29% in 2007,[2] the peak before the financial crisis. While ultimately cash flow and collateral, not covenants, pay back lenders, we still believe this remains a concerning trend for investors.

2 S&P/LSTA Leveraged Loan Index, as of October 31, 2019.

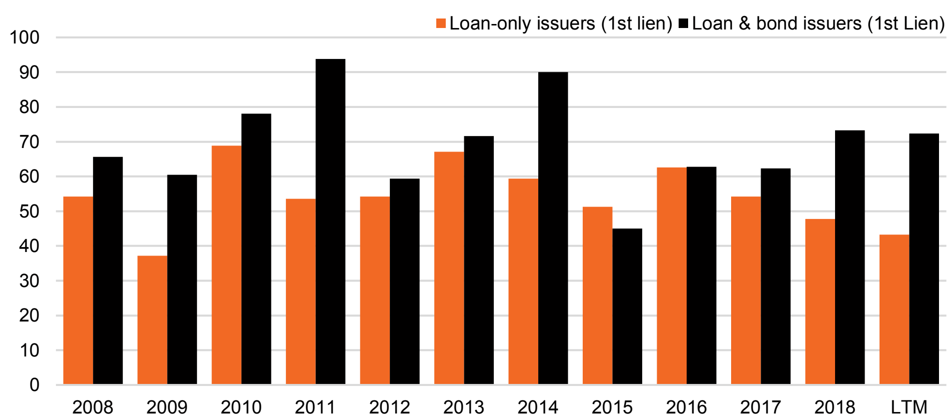
RISE OF COV-LITE ISSUERS



Source: S&P/LSTA Leveraged Loan Index, as of October 31, 2019.

A less-buzzworthy but perhaps more concerning trend is the rise of loan-only issuers. Loans typically benefit from debt below them in the capital structure taking the first losses in the event of credit problems. But with many companies issuing senior secured loans as the only debt in their capital structure, one of the primary benefits of being "senior" has been largely diluted. Today, 55% of the loan market is composed of loan-only issuers, compared to just under 40% in 2007. The existence of these borrowers alone is not worrisome – it's what happens when things go wrong that is cause for concern. The recovery rate on first-lien loan-only issuers over the past year is nearly 30% lower than that for first-lien issues where the borrower has both bonds and loans in their capital structure.

LOAN-ONLY VS. LOAN & BOND ISSUER RECOVERY RATES

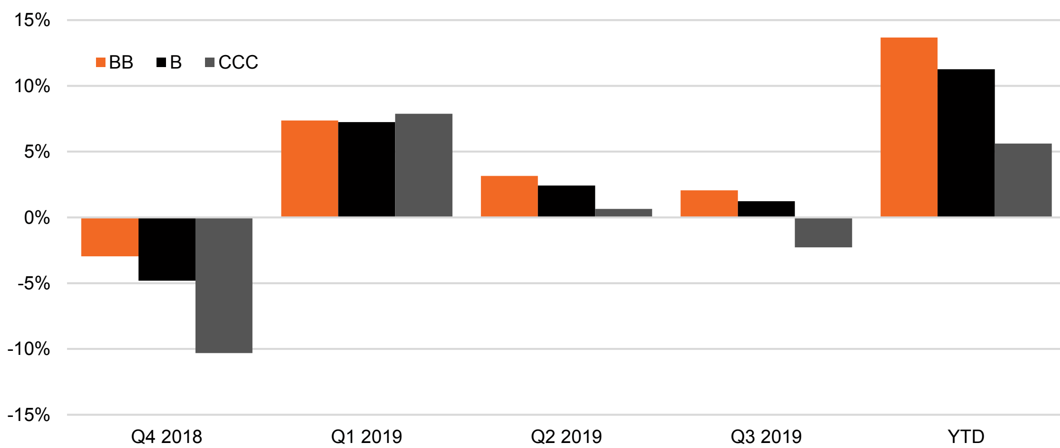


Source: S&P/LSTA Leveraged Loan Index.

Impact on returns

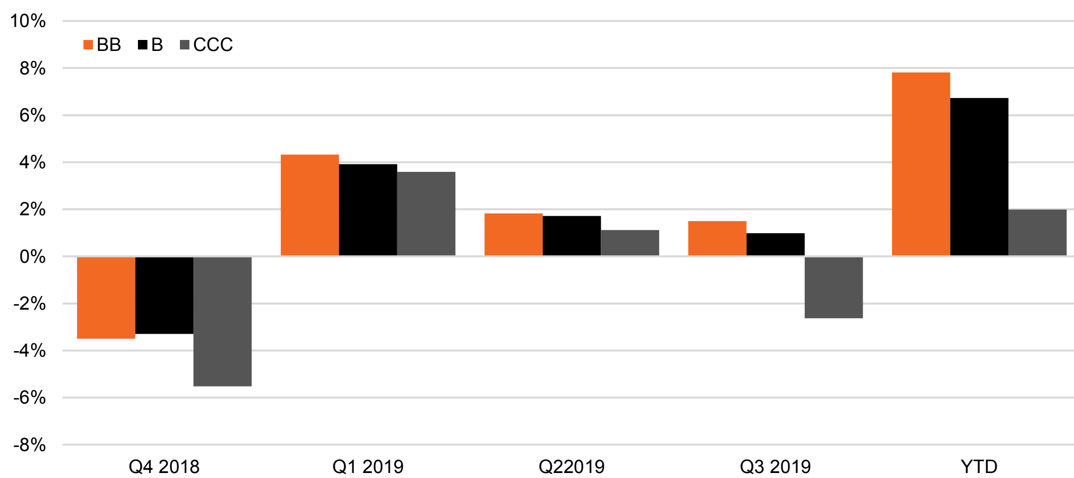
By most measures, returns for both high yield bonds and senior secured loans are reasonably strong in 2019, with both markets on pace to post results in excess of their long-term averages. However, in contrast to what we would typically expect in a "normal" strong year, investors are clearly showing a preference for higher-rated issuers compared to lower-rated issuers. The increasing composition of lower-rated issuance in the loan market could also be a contributing factor for why high yield bonds overall are strongly outperforming loans on the year.

HIGH YIELD BOND RETURNS BY RATING



Source: ICE BofAML U.S. High Yield Index

SENIOR SECURED LOAN RETURNS BY RATING



Source: S&P/LSTA Leveraged Loan Index

Conclusion

We are not advising writing off the loan market completely. In fact, we still think that good return potential exists – however, it may be more difficult to discern and require robust fundamental analysis. Investors should consider the changing composition of the market and its relative risks in comparison to other credit investments, like high yield bonds. The historical preference for senior secured loans as a safer alternative due to their seniority and security may no longer be as safe an assumption. The asset class can still offer compelling value and return opportunities, but we believe its place among other sub-investment grade asset classes has changed based upon these observations.