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INSIGHTS

The Search for Yield Continues: *A Re-introduction to Bank Loans*

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203.621.1700 | **rocaton.com**

Executive Summary

With the Federal Reserve pledging to stick to its zero interest-rate policy until labor conditions improve, investors have been encouraged to lengthen duration and/or reach for yield. This has resulted in artificially compressed spreads and lower yields across fixed income markets and, one could argue, diminished compensation for taking on risk. For fixed income investors hoping to receive additional income by moving further out on the yield curve, the potential for rates to rise could translate to price losses that may offset any excess yield.

Bank loans, a relatively underutilized asset class among institutional investors, have several distinct characteristics that could offer benefits to long-term investors in today's low rate environment. These below-investment grade floating rate loans may generate modest levels of current income with little interest rate duration risk given the aforementioned floating rate nature[1]. The balance of this paper will provide a brief introduction to the asset class and present an argument why the current environment may be attractive for bank loans relative to traditional core fixed income and high yield bonds.

1 Unlike traditional fixed rate bonds, bank loans typically pay coupons that are adjusted every three months with moves in LIBOR. For example, coupons on bank loans are typically structured as the LIBOR rate plus a fixed spread which is determined based on the credit quality of the borrower. As the LIBOR rate moves up and down, so do the coupons paid to the lender.

Overview of Bank Loans

Bank loans, commonly referred to as leveraged loans or syndicated loans, are loans primarily made to below-investment grade companies that are syndicated by a lead bank to other banks and institutional investors. In their simplest form, bank loans look and feel like privately placed, floating rate, high yield debt. While investors may be inclined to refer to these instruments as "floating rate high yield bonds", there are key distinctions between traditional high yield securities and bank loans. The following table lays out some of the differences between the two asset classes.

As presented in the table above, bank loans have a number of distinct characteristics. The most obvious is the seniority in the capital structure and floating rate nature. It is also worth noting that approximately 80%–85% of the new issue bank loan market has a "LIBOR floor" as part of the floating rate feature[2]. If LIBOR falls below a specified floor, often 1.0%–1.25%, the loan will continue to pay coupons based on the floor level plus the additional spread. With 3 Month LIBOR currently around 0.3%, the LIBOR floor has allowed lenders to continue to receive modest levels of income. Additionally, the seniority in the capital structure has historically led to higher recovery rates for bank loans relative to high yield bonds.

Table 1:
Characteristics of Bank Loans and High Yield

	Bank Loans	High Yield Fixed Income
Qualitative Characteristics		
Coupon	Floating (Spread over LIBOR)	Fixed
Callability	Any time with small pre-payment penalties	Typically, after 5 years
Duration	Short	Intermediate
Security	Secured	Typically, unsecured
Capital Structure	Most senior	Below bank loans
Covenants	Yes	Minimal
Quantitative Characteristics (3.31.2013)		
Yield[1]	5.9%	5.7%
Price	$98.1	$105.2
Spread over U.S. Treasuries	395 bps	486 bps
Maturity	4.7 years	6.8 years
Long-Term Default Rates[2]	2.8%	3.8%
Long-Term Recovery Rates[2]	65%	44%

1 Represents yield-to-worst.
2 Based on long-term average beginning in 1995 through December 2012.

Source: Prudential; Bank of America Merrill Lynch; Credit Suisse.

Data as of March 31, 2013 unless otherwise noted.

Changing Conditions in the Bank Loan Market

There have been important evolutions in the bank loan market over the past several years that we believe make it more attractive and "investable". For starters, the size of the asset class has grown tremendously in just the past decade. At the end of 2002, the estimated value of the bank loan market was $734 billion. The market peaked in size at $1.6 trillion in 2008 and stood at $1.1 trillion as of December 31, 2012, a nearly 50% increase in the past 10 years. Moreover, the number of issues in the Credit Suisse Leveraged Loan Index grew from 607 at the end of 2000 to 1,395 as of March 31, 2013. This growth has created opportunity for investors as the market has increased in breadth and depth.

2 Information provided by Eaton Vance.

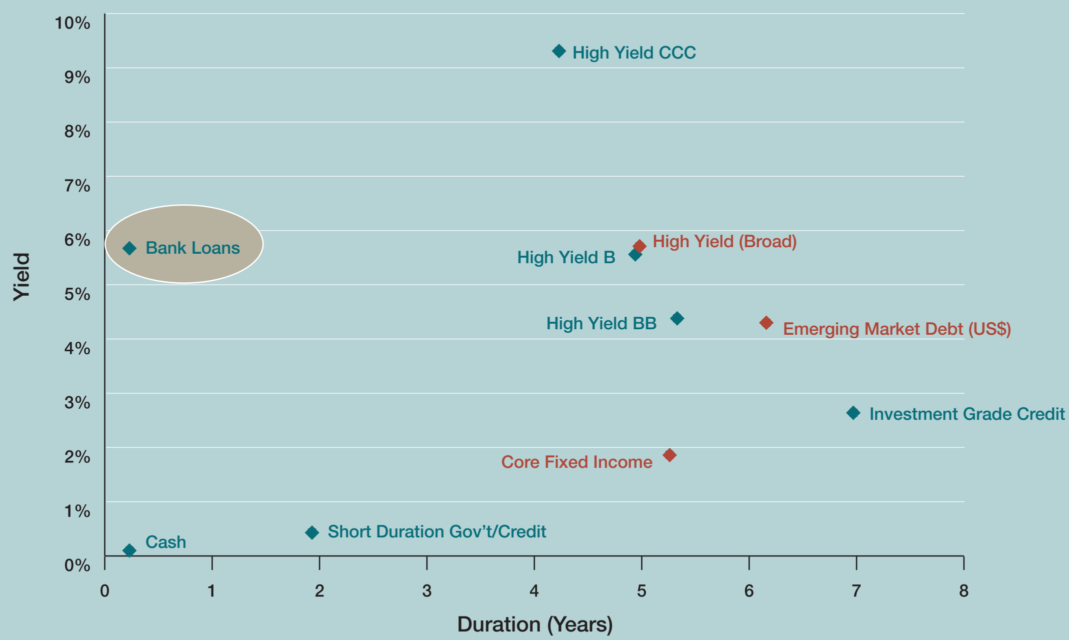
As the bank loan market has grown in size, its investor base has also evolved. Largely a result of the global financial crisis, the number of levered investors in this space has decreased meaningfully, which we would expect may lead to lower volatility in the future. The institutional base has grown, while hedge funds, CLOs and commercial banks are smaller players in the market (however, it is worth noting that CLO issuance has picked up more recently). Part of the reason for the shift in investor base is the introduction of accessible investment vehicles. Today there are approximately 40 institutional mutual funds available whereas just a few years ago only a handful of these products existed. In addition, there are over 30 commingled funds available to institutional investors. Further, several exchange traded funds provide investors with intraday liquidity in the bank loan space (although, the efficacy of such an investment is unproven given the short track record of many of these products).

The final notable change in the bank loan market is how the volatility profile of the asset class has shifted over time. Prior to 2008, the annualized standard deviation of returns for the Credit Suisse Leveraged Loan Index (since its inception in 1992) was only 2.3%. Over the last five years ending March 31, 2013, (since the onset of the credit crisis) the annualized volatility of the index has been 10.1%, more than 4x the realized volatility leading up to the downturn. While volatility has returned to a more "normal" level—over the past two years the index had an annualized volatility of 4.1%—it is clear that this asset class can no longer be considered a low volatility investment. Our March 31, 2013 Capital Market Assumptions have an expected annualized volatility of 8.8% for bank loans, which falls between the pre-crisis average of 2.3% and the post-crisis average of 10.1%.

Why today?

With the understanding that the bank loan market has changed, in some cases for the better, we believe today's market environment may provide a good entry point for investors looking to diversify a traditional fixed income portfolio. The most notable argument for adding bank loans is their floating rate nature. With U.S. Treasury rates reaching historically low levels, investors continue to be concerned about the outlook for fixed income returns in a rising rate environment. Given that the coupon rate on bank loans is typically reset every three months, investors have little interest rate risk. In fact, a rising rate scenario should benefit bank loans as income levels would be expected to rise alongside a pickup in interest rates. Bank loans may also serve as a hedge in an inflationary scenario. Given the high correlation between inflation and rising rates, the floating rate nature may offer investors a level of protection as rising income from bank loans would offset higher inflation. Note however, that because of the previously discussed LIBOR floors, rates have to rise in excess of the floor for the benefits of the floating-rate feature to be realized. Aside from their low duration and floating rate nature, bank loans generally offer a relatively competitive yield in relation to traditional fixed income asset classes and currently appear to be offering a better risk-adjusted (and possibly better absolute) return than high yield. The chart on the next page shows a comparison of current yields and duration levels for a number of fixed income asset classes.

Chart 1:
Duration vs. Yield –
March 31, 2013



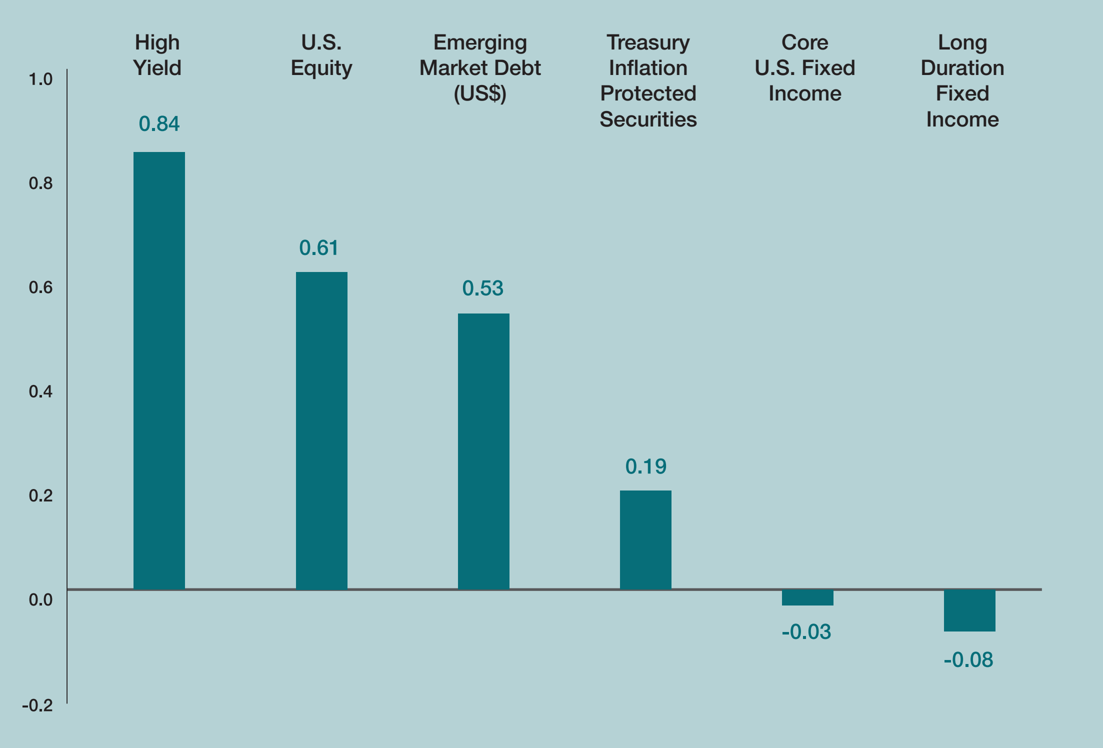
Sources: Bank of America; Barclays Capital; Credit Suisse. Represents yield-to-worst for each asset class.

Given the uncertain outlook for economic growth, the senior-secured nature of bank loans is another attractive feature of this asset class. As previously discussed, bank loans are senior to other forms of debt in a company's capital structure and are secured by assets of the company. In the event of another economic downturn, defaults would rise for below investment grade issuers but bank loans offer protection relative to high yield bonds through higher recovery rates given their seniority in the capital structure. Another feature of bank loans, which makes them attractive relative to high yield bonds, is that they typically contain debt covenants. These covenants are legally enforceable rules that borrowers and lenders agree upon at the time of a new issue and detail what issuers are required to do and what they are prohibited from doing. Bank loans are often issued with a detailed set of covenants that protect the lender from business deterioration, the incurrence of additional debt and declining credit quality as a result of mergers and acquisitions, whereas, historically, high yield bonds have contained a limited set of covenants. It is worth noting that many bonds issued prior to the credit crisis, both high yield and bank loans, contained few covenants. Changes in borrowing standards since the crisis have led to bonds and bank loans being issued with far more covenants than had been the case in the middle of the last decade.

Other reasons why investors might consider adding bank loans today include the potentially modest correlation to other asset classes and the prospect for higher relative returns in the future. The chart on the next page shows that over the last ten years, bank loans have had low to negative correlations with traditional fixed income asset classes commonly held by institutional investors. From a forward looking return perspective, based on Rocaton's March 31, 2013 Capital Market Assumptions, bank loans are expected to return 4.4% over the next 5-years[3]. This compares favorably to core fixed income and high yield which have expected returns of 1.2% and 2.4%, respectively. Importantly, over the next 5-years, we would expect that bank loans will produce higher returns than high yield with less interest rate and credit risk.

3 Rocaton's capital markets forecasts build in the assumption that LIBOR rates revert to a long-term equilibrium level of 3.40%. These are long-term forward looking expectations which may not be realized.

Chart 2:
Bank Loans Correlation to Other Asset Classes – Last Ten Years



Sources: Bank of America; Credit Suisse; J.P. Morgan; Barclays Capital.

Based on monthly data beginning April 2003 through March 2013

Challenges

As with any asset class, there are potential risks and challenges that must be addressed before making an investment. It is first worth noting that bank loans have received increased attention by retail and institutional investors in the last year. Over the 12-month period ending February 2013, Morningstar estimates that bank loan mutual funds had net inflows of $20.1 billion, putting total bank loan mutual fund assets at approximately $83 billion. Other fixed income asset classes have seen similar flows as intermediate-term bonds ($95.6 billion in net inflows), short-term bonds ($36.9 bn), multi-sector bonds ($24.9 bn) and emerging market bonds ($22.1 bn) all had net inflows greater than $20 billion in the last 12 months. Another challenge with bank loans is the lengthy settlement time for those managers implementing a bank loan portfolio. Unlike traditional fixed income assets which typically have a settlement time of one to three days, bank loans often settle seven to 17 days after the trade date with some settlements taking even longer. Finally, while much as been made about the floating rate nature of bank loans, higher interest rates may also make it harder for issuers of bank loans to service their debt. This is somewhat mitigated by the loans shorter-term maturity and the issuers ability to call the debt at anytime. Also, as previously mentioned, the LIBOR floors currently in place will ensure that the coupon rate which borrows must pay will not rise until LIBOR reaches a level of approximately 1.0% to 1.25%.

Conclusion

The demand for yield in fixed income has compressed yields and driven up prices on all fixed income assets. In a market environment where yield is hard to come by and the prospect for rising rates continues to be a valid concern for fixed income investors, bank loans can play a useful role in an investor's overall portfolio. For investors considering a dedicated investment in this asset class, a number of vehicles are available including separate accounts and commingled funds (or mutual funds for those who cannot access more institutionally oriented vehicles). For defined benefit investors not wanting to add the asset class on a dedicated basis, some opportunistic credit or high yield investment managers may have the ability to allocate part of their portfolio to bank loans. Defined contribution plans also have the ability to make this asset class available to participants. Rocaton would suggest considering the addition of bank loans to a defined contribution lineup as part of an "income" or "inflation hedging" option. For example, an income option could combine high yield, emerging market debt and bank loans while an inflation hedging option could include commodities, REITs, Treasury Inflation Protected Securities and bank loans. Regardless of the implementation choice, investors should strongly consider an investment in banks loans as an inexpensive option on rising rates and inflation with little duration risk, a competitive yield and seniority in the capital structure.