CREDIT WHERE IT IS DUE: THE BEAUTY OF BANK LOANS IN THE US AND EUROPE

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Investors on both sides of the Atlantic are increasingly alive to the bank loan opportunity.

This is a market that is well developed in the US and coming of age in Europe. That is perhaps unsurprising when you consider that the characteristics of this asset class could almost have been designed with current market conditions in mind.

Of course, there are very big differences between the conditions applying in the US and in the Eurozone. In the former, monetary policy tightening is underway in an economy that is operating at nearly full employment. In the latter, the policy rate of the European Central Bank (ECB) is zero in a single-currency bloc in which parts are plagued by chronic unemployment.

But the beauty of bank loans is that their special characteristics make them a compelling investment opportunity in both sets of market conditions. Their variable-rate structure provides protection against rates rising, as they have been in the US. And the high ranking of loans in corporate insolvencies, due to their senior secured status, ought to deliver stronger recovery rates than unsecured high-yield bonds would, should an economic downswing trigger a rise in defaults.

For European investors seeking returns in a zero-interest rate environment, loans offer more attractive yields than those generally available on fixed rate assets in the region.

Why bank loans?

Bank loans issued by companies with a sub-investment-grade credit rating typically offer a higher coupon than investment grade credits do, and spreads remain attractive in comparison with those of most other debt instruments. That means a head start for loan investors in the hunt for yield.

This advantage has become more pronounced recently due to the floating-rate nature of loans. Loan coupons consist of a base rate – LIBOR in the US and EURIBOR in Europe – plus a spread. In most cases, the base rate is floored at 0%, 0.75% or 1.0%. In the US, LIBOR has moved above the base rate floors, meaning that any fresh rate increases will feed directly through to investors.

In contrast to the US Federal Reserve's policy bias toward tightening, the ECB remains in accommodative mode in an effort to spur economic growth across the Eurozone. So in Europe, the base rate floors provide protection against the movement in EURIBOR, which has become increasingly negative over the past year.

Loans rank high in the capital structure of issuing companies. They are classified as senior secured debt, while investment grade and high yield bonds are generally classified as senior or subordinated *unsecured* debt. Because loans are typically secured by most of the issuer's assets, loans typically have higher recovery rates in the event of default than those of high yield bonds.

Another important feature is that, in the event of a default, bank loans may continue to make interest payments. That is typically not the case with either high-yield or investment-grade bonds.

In Europe, bank loans have an added appeal for investors: the European loan market has essentially no commodity exposure in terms of metals, energy, and mining concerns, which adds stability during the current travails of the natural resources sector.

European leveraged loans generally are a stable asset class, and the economic fundamentals in Europe are good, with continuing earnings growth. As in the US, European leveraged loans are below investment grade, and therefore carry higher risk relative to investment grade bonds. But amid stable to improving fundamentals, the outlook for defaults remains low and the market is currently supported by strong technicals.

Key to this strong demand is the biggest single source of customers for European bank loans: collateralised loan obligations (CLOs). CLOs hold leveraged loans as collateral for their secured debt investors, so as the CLO market grows, so too does the demand for leveraged loans. In 2016, European CLO issuance increased by over 20% to nearly €17 billion, according to Standard & Poor's, and CLOs are off to a strong start in 2017.

As with the US market in relation to the Fed's policy, European loans offer protection against the ECB's eventual shift in policy from maintaining a low rate environment to a policy of rate increases. While that event may seem a long way off, it logically has to happen at some point. When European interest rates finally do increase, traditional fixed-rate investors will suffer, whereas floating-rate bank loan investors will benefit as rate increases will be passed through to them.

Examining the risks

Despite the benefits of bank loans in both the US and Europe, some investors continue to have some aversion to the asset class. The poor performance of loans during the financial crisis must surely have something to do with it, perhaps on the principle of once bitten twice shy. That is understandable but, we believe, based on a faulty analysis.

Yes, default rates rose in 2009, reaching 9.6%. That is higher than seen during previous recessions, but the rate then fell sharply in 2010. In other words, the fundamentals of the bank loan market were not to blame. Rather, an abundance of over-leveraged investors were forced to offload loans at fire-sale prices, with the predictable result that loan valuations were pushed down to historically low levels.

Like any other investment, bank loans are not