Three Reasons Leveraged Loans Remain Compelling in Today's Market

A favorable investment climate, solid returns across market cycles, and the benefits of floating yields all continue to make leveraged loans an attractive addition to fixed income allocations. Steven Oh, Global Head of Credit and Fixed Income at PineBridge Investments, provides his views on the current state of the loan market and what to expect looking ahead.

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Q: *Why are loans an attractive asset class in the current environment?*

A: Leveraged loans have provided strong total returns over the past several years, particularly considering the low rate environment, and we expect the segment to remain a bright spot for fixed income investors for several reasons.

First, today's investment climate remains a constructive, stable backdrop for loan issuers. The outlook for 2017 US GDP growth is in the 2%-3% range[1], with unemployment near long-term lows and the beginning signs of wage growth acceleration. Coverage ratios (EBITDA-capital expenditures/interest) are near all-time highs. The current default rate of 1.36% is well below its historical average and is forecast to increase at a gradual rate[2].

Second, leveraged loans should continue to generate attractive relative performance. These securities have proven to be a stable asset class across a wide range of market cycles. Indeed, there have been only two years of negative returns since 1997[3]. They provide a high level of current income compared to other bond segments, which can make them very favorable for adding a steady income stream to a portfolio. They also rank at the top of the capital structure, so recoveries are generally higher than for high yield bonds.

[1] Source: Moody's Investor Service, as of 30 August 2017.
[2] As of 31 August 2017.
[3] Source: S&P Leveraged Loan Index.

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2016 Camradata Asset View Award, based on their in-house proprietary model, Camradata IQ, for USD Loans, PineBridge Total Return Aggregate. Source: Copyright 2016 by Camradata. The Camradata Independent Quantitative (IQ) scores is a ranking reflecting five statistical factors (excess return, information ratio, wins-losses, hit rate and downward strength) measured over a three year period.

WINNER
Asset View
AWARDS \ 2016
USD Loans

Third, leveraged loans can provide a hedge against rising interest rates, since spreads are typically based off of three-month LIBOR and adjust periodically.

Q: *Do you believe that the opportunity to invest in loans will be sustainable?*

A: The leveraged loan market has more than doubled in the past decade to US$930 billion, with over 900 issuers[4]. It is now a mature market that offers positive benefits to issuers and investors alike, with both greater transparency and liquidity than in the past. This also provides expanded choice in terms of security selection to help skilled active investors differentiate returns.

Q: *How does the European market compare to the US?*

A: While smaller and less liquid, the European loan market continues to exhibit strong fundamentals, with spreads similar to the US market. Economies across the region have continued to improve, and security demand has remained high relative to supply, while default rates have trended lower. Investor appetite for CLOs – one of the largest European loan market participants – has also substantially increased this year and is now quite strong.

Q: *Will that affect your portfolio positioning?*

A: Given that the US market is considerably larger, the vast majority of our holdings are US domiciled; however, we are constantly evaluating relative value between the US and European markets. We shift allocations between the US and Europe based on our determination of relative value.

Q: *How do you analyze companies?*

A: We conduct a detailed bottom-up credit analysis combined with top-down economic views. It is highly credit intensive and involves a globally coordinated team approach.

Q: *What are you typically looking for when deciding whether to invest?*

A: We seek companies with sustainable business models, and consistent, positive cash flows. We also focus on fixed charge coverage, liquidity, and operating cash flow to ensure the amount of leverage is appropriate given the industry sector. Companies in cyclical industries should have less leverage and more liquidity to ride out commodity cycles.

[4] Source: LCD US Research, SPLSTA Fact Sheet as of 30 September 2017.

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Q: ***How much more significant will company analysis be in this asset class compared with traditional assets?***

A: In our view, fundamental credit analysis is the key to success in the leveraged loan asset class. Issuers are generally rated BB or B, and therefore have higher levels of risk compared with investment-grade issuers.

Q: ***What is your outlook for the segment?***

A: Our outlook remains strong. The segment has likely already captured the bulk of its recent capital appreciation potential. Still, with yields in the 5% range, these securities should continue to offer a significant income advantage and provide attractive coupon-driven performance for the foreseeable future, coupled with their defensive attributes in a rising rate environment.

The primary risk associated with leveraged loans is default risk. The key to avoiding credit loss is extensive analysis and monitoring of credits. We are constantly evaluating current spread levels in context of the broader market and any sign of possible individual credit deterioration.

In the current environment, barring any major geopolitical event, we believe spread levels remain very attractive, with investors being well compensated for both illiquidity risk and default risk.

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