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Leveraged loans or high yield bonds?

Finding the best income solution in a rising rate environment

UBS Asset Management

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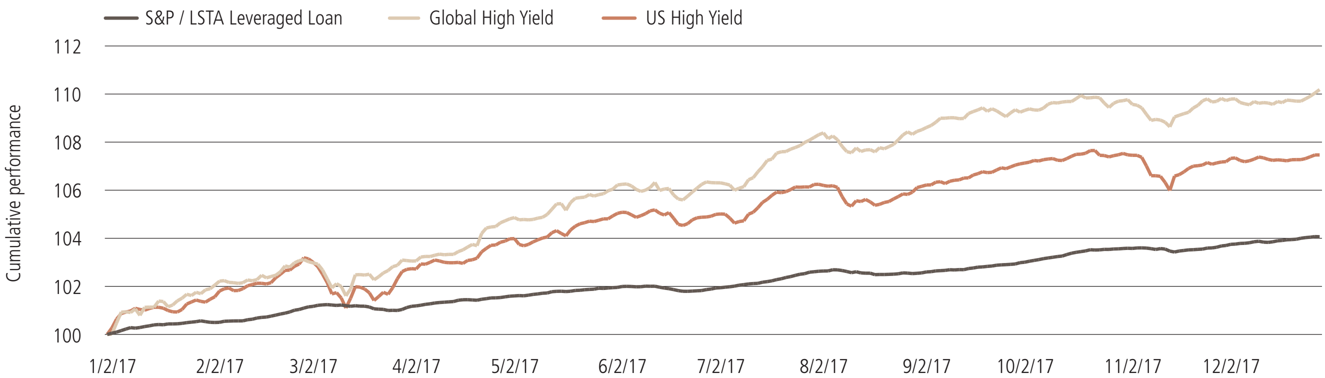
Investors seeking attractive levels of income, combined with low sensitivity to interest rates are likely to consider both leveraged loans and floating rate high yield bonds (either physical floating rate notes or those created by combining a fixed rate coupon bond with an interest rate swap). Leveraged loans, often referred to as 'bank loans', and floating rate high yield bonds have become a key focus area, given the likely continued path of interest rate normalization by central banks in the coming years. More importantly, both investments offer investors **an income solution** combined with **minimal interest rate risk**.

This piece highlights the main differences and looks at the benefits of having exposure to floating rate high yield bonds versus loans. However, let us first address the key similarities of these two investments. Bank loans and floating rate bonds are both sub-investment grade, with coupons that are periodically re-set according to Libor plus a spread. This spread is based on the bond issuer's credit quality, and re-set periods are typically three months apart for both investments. As such, both have near-zero duration or low price sensitivity to interest rate changes.

Limited upside price appreciation for loans versus high yield bonds

One key difference is that bonds have better call protection, which protects bond investors from an early call by the issuer. More importantly, this allows for further price appreciation in an improving market environment. In contrast, loans are continuously callable at par, and therefore experience significant negative convexity; their price stays at or near par during a strong market environment, negating any upside potential. Furthermore, the extensive refinancing of loans at lower yields risks generating lower income, even as Libor increases. A clear example was in 2017, when rising US interest rates were a key concern for investors. In this environment, one might have expected loans to outperform high yield bonds. However, the returns from high yield were more than double the returns from loans.

How did loans perform versus high yield in 2017?



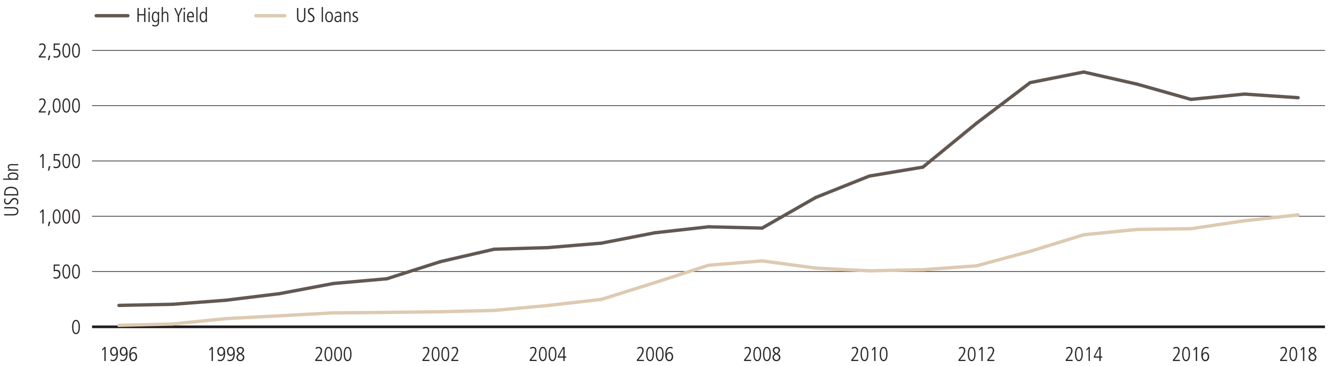
Source: Bloomberg. Data as at 29 December 2017.

This underperformance of loans was largely due to the degree to which they were continuously refinanced at no premium during the year due to the strong demand from investors. As loans have no premium for an early call, and typically trade closer to par than high yield bonds, their **price upside potential is limited** in comparison. Conversely, when high yield bonds are called by the issuer, there can at times be a significant gap between the trading price and the call price due to the embedded premium, resulting in material price gains for high yield bond investors in these instances.

Weakening loan covenant quality since the Global Financial Crisis (GFC)

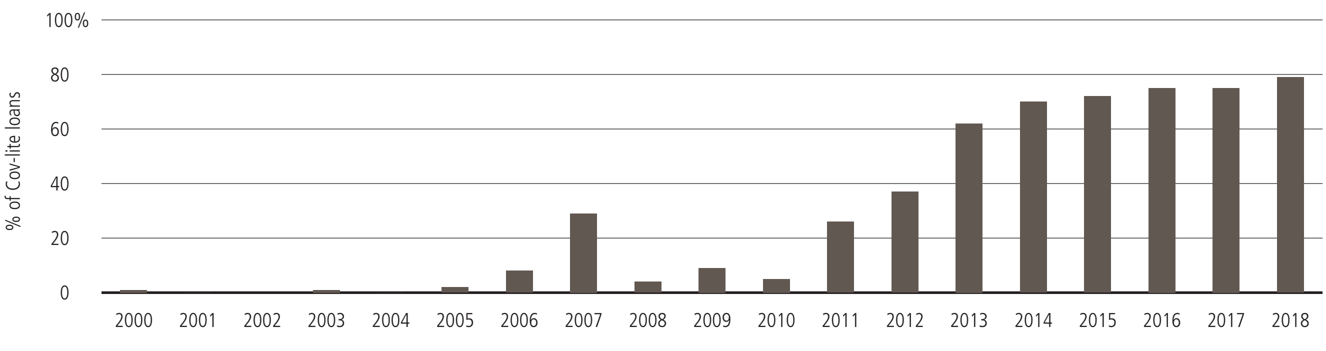
Covenants are legal provisions in debt contracts intended to preserve the ability of issuers to pay interest and principal when due, as well as protect investors in the event of a default or restructuring. For example, some covenants may restrict the issuer's ability to pay dividends, or to take on additional and more senior liabilities. The two main types of covenants are maintenance covenants and incurrence covenants. Maintenance covenants apply throughout the life of the security, while incurrence covenants only apply when the issuer actually issues new debt. While roughly half the current size of the high yield bond market, the loans market has grown more rapidly in comparison over recent years, see below graph. In the wake of this rapid growth, the loan market has also seen a **loosening of covenants**, leading to weaker loan covenant quality similar to that of the high yield bond market. To illustrate, 'covenant-lite' (defined as no maintenance covenants) loans represented less than one fifth of the loan market in 2010, see below graph. Today, they now account for more than three quarters of the total loan market. This sentiment is also echoed by the Moody's Loan Covenant Quality Indicator for the US loan market, which is currently below 4.0 and classified by the rating agency as "weak".

Growth of High Yield Bond / Loan Markets



Source: BofA Merrill Lynch Global Research, ICE Data Indices LLC, S&P LCD. Data as at 30 April 2018.

Historical % of Cov-lite loans



Source: LCD. Data as at 30 April 2018.

This weakening of covenant quality in the loan market has helped attract issuers who may have otherwise issued high yield bonds, thus accounting for some of the recent rapid growth in the 'issuer friendly' loan market. However, for investors, it has reduced one of the key attractions of loans when compared to high yield bonds. While long-run recovery rates for loans are still higher than for high yield rates (mid 60's versus low 40's), this relative advantage may be eroded in the future, given this **convergence of covenant terms** between the two asset classes. When defaults do eventually start to pick up, recovery rates for loans may in fact be closer to those for high yield bonds than what historic data would imply.

Lower liquidity for loans

With regards to final settlements, the procedures for loans are less standardized than bonds, which can sometimes lead to uncertain settlement timeframes. As such, despite their senior position in the capital structure versus bonds, the uncertainty of settlement periods mean that **loans are less liquid**. To illustrate, the average settlement period for loans is around 17 days. In contrast, bond settlement occurs on a specified date, which is typically trade date + 2 days (T+2). During periods of market stress, the lower liquidity and longer settlement periods of loans can lead to sharper price declines, as loan funds and Exchange Traded Funds (ETFs) face the mismatch between daily liquidity requirements and longer settlement periods. Many loan funds experienced such stress during the 2007/2008 financial crisis, evidenced by how loan prices fell much further than those in the high yield market. In short, being higher up the capital structure may not adequately compensate investors for the lower liquidity of loans during times of market stress.

Lower transparency for loans

Loans typically have fewer market makers than do high yield bonds. Loans are also not UCITS eligible investments, and thus have less regulatory involvement and oversight compared to bonds. In addition, loans are **private and unregulated**, which limits the disclosure of financial information only to holders and potential qualified investors. Furthermore, loan issuers may not file any public financial information, making it more challenging for outside investors to monitor and track information related to this asset class.

Summary

There are times when the leveraged loan market can provide attractive investment opportunities, but our preference in the current market lies with high yield bonds. This is primarily due to their **greater price upside potential, better liquidity, greater transparency and faster and more consistent settlement**. Additionally the historic relative strength of loan covenants has weakened substantially over recent years, further adding to our conviction.

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