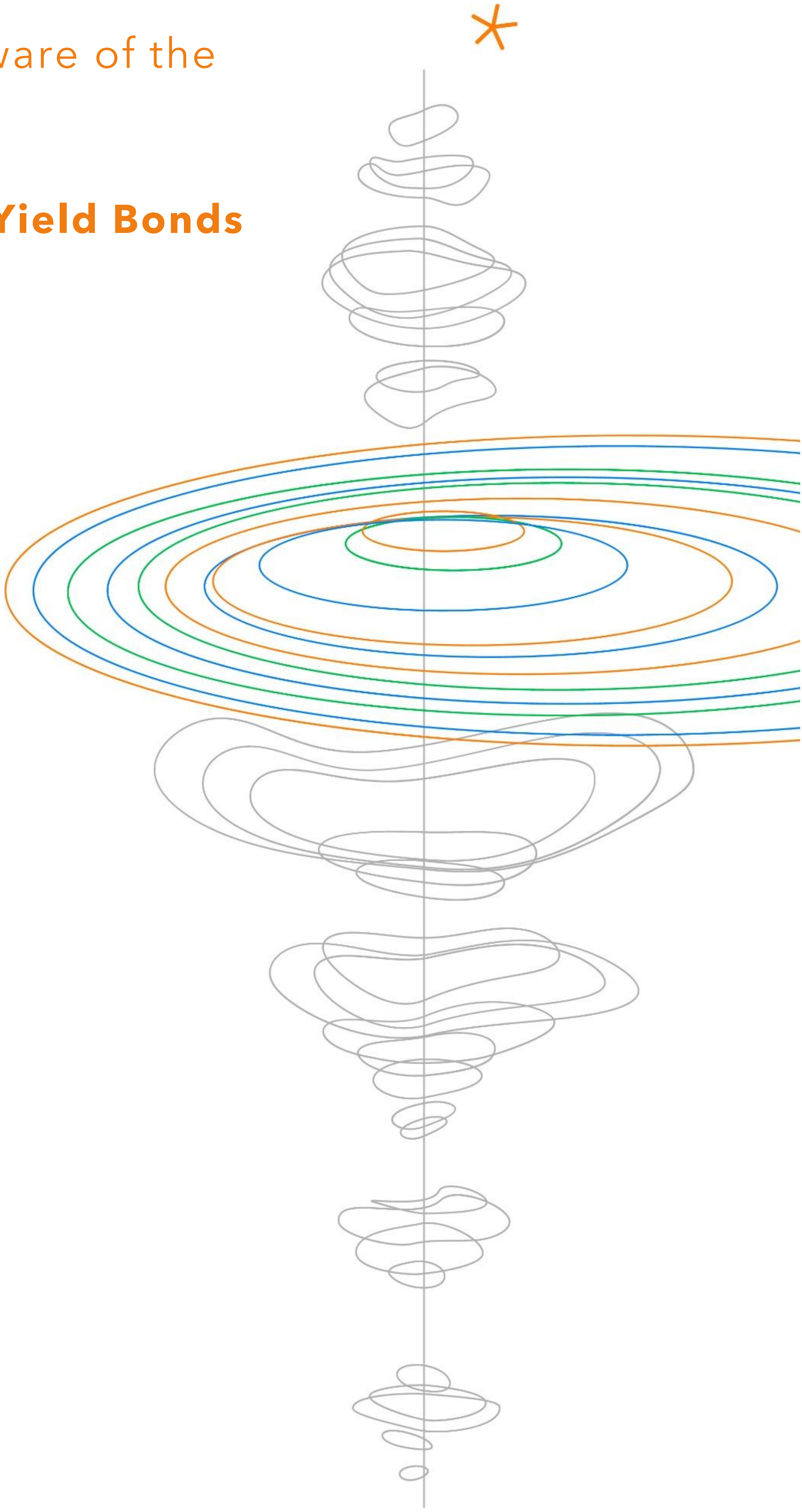
# Leveraged loans: beware of the return asymmetry

## **Bank Loans vs. High-Yield Bonds**



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**Executive Summary**

Bank loans and high-yield bonds both offer attractive yields in the fixed income market today.
For investors hunting for yield, it is hence important to understand the differences between these two instruments and the caveats to bear in mind when comparing them.

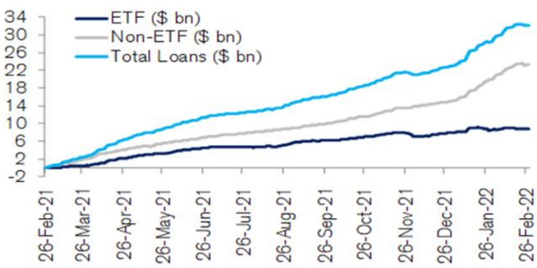
This note highlights and examines the 3 key elements that make these two instruments so different and that we believe investors are too little aware of:

- Long term performance
- Instrument features (callability and return profile)
- Risk concentration and credit quality in the current market cycle

# INTRODUCTION

Leveraged loans have become a very popular credit asset class over the last year. As a floating rate leveraged credit income proposition, loans are a natural choice at a late stage of the credit cycle. Central banks' monetary tightening, as well as reduction of quantitative easing policies, usually results in support for such assets while investors tend to switch out of High Yield bonds into loans to avoid suffering from higher rates. Over the last twelve months, leveraged loans have indeed attracted billions of inflows: inflows for leveraged loans funds amounted to +$32.2bn, whereas outflows for HY funds totaled -$0.8bn, as highlighted in Figure 1 and 2.

- Figure 1: Flows into Leveraged Loans



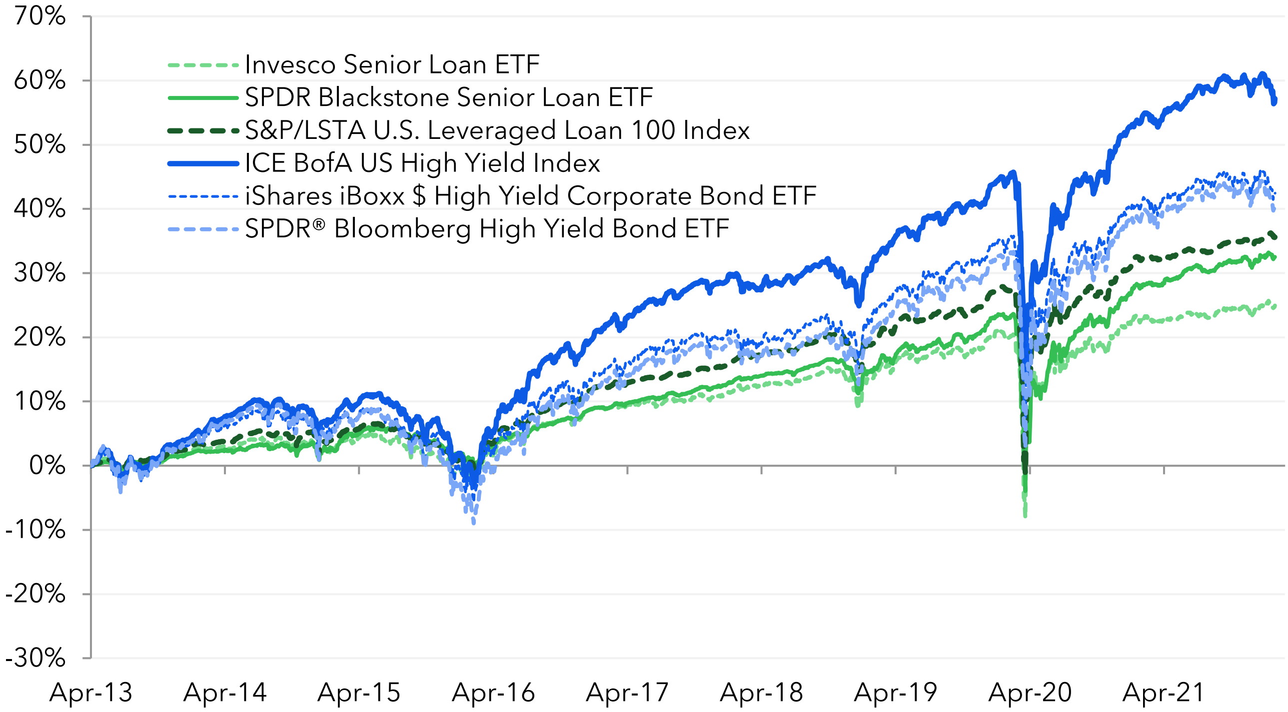

- Figure 2: Flows into High Yield Bonds


Source: Credit Suisse, 03/01/2022

Because of the flows pouring into loans, the performance of the asset class was excellent and made it the year-to-date top performer. Investors should, however, put this short-term success into a historical perspective to assess the real potential of the loan asset class.

From a longer-term point of view, leveraged loans' performance entail unappealing characteristics: on average lower returns for similar drawdowns during crisis as compared to the High Yield fixed rates. While it is probably very hard to perfectly time the potential short-term outperformance of leveraged loans, investors historically would have been much better off by just holding onto their High Yield investments. Figure 3 and Table 1 highlight this point.

Figure 3: Leveraged Loans and High Yields bonds: long term performance
*(Cumulative returns of bank loans and HY since 2013)*




Data: Bloomberg, as of 02/28/2022.
Warning: Past Performance is not indicative of future results.

Table 1: 5y and 10y risk/return metrics

| | Annualised return | Volatility (monthly) | Sharpe Ratio | Max Drawdown |
|---|---|---|---|---|
| **5Y** | | | | |
| ICE Bofa US High Yield Index | 4.7% | 7.6% | **0.48** | -21.5% |
| iShares iBoxx $ High Yield Corp.Bond ETF | 3.9% | 7.1% | **0.40** | -22.9% |
| SPDR® Bloomberg High Yield Bond ETF | 4.0% | 7.7% | **0.38** | -24.7% |
| S&P/LSTA U.S. Leveraged Loan 100 Index | 3.6% | 5.5% | **0.46** | -22.8% |
| SPDR Blackstone Senior Loan ETF | 3.7% | 6.8% | **0.39** | -24.3% |
| Invesco Senior Loan ETF | 2.5% | 5.0% | **0.29** | -26.7% |
| **10Y** | | | | |
| ICE Bofa US High Yield Index | 5.8% | 6.6% | **0.79** | -21.5% |
| iShares iBoxx $ High Yield Corp.Bond ETF | 5.0% | 6.5% | **0.60** | -28.7% |
| SPDR® Bloomberg High Yield Bond ETF | 4.4% | 7.0% | **0.54** | -32.8% |
| S&P/LSTA U.S. Leveraged Loan 100 Index | 4.5% | 4.4% | **0.88** | -22.8% |
| SPDR Blackstone Senior Loan ETF | 2.8% | 5.4% | **0.40** | -28.4% |
| Invesco Senior Loan ETF | 3.0% | 4.1% | **0.58** | -32.2% |

Sources: Bloomberg as of 28/02/2022
Past performance is not indicative of future results
(1) the SRLN ETF was launched in April 2013, hence 10y data are actually since inception.

Two primary observations can be made from Table 1:

- Investible instruments (i.e., ETFs) seem to underperform indices (both loans and bonds), which are not fully replicable due to many very illiquid positions.
- Historical long-term returns highlight that the HY asset class exhibits better performance with an annual outperformance over the last 10y ranging from 139 to 172 bps per year depending on the ETF considered as a comparison.

**In our view, the reasons for such a disappointing relative historical outcome for leveraged loans are to be found in the embedded technical properties of leveraged loans.**

# 01. DOUBLING DOWN ON RETURN ASYMMETRY

- **Key take-aways of this section**

  - Issuers' option to refinance Leveraged Loans at no cost reduces upside potential[1]

  - …. while High Yields bonds are protected from early redemption risk and can even benefit from such events[2]

The underperformance of the leveraged loans in the long run is directly related to the callability structure of these instruments: loans are callable at 101% one year after issuance and at 100% thereafter. This leads to two main drawbacks:

- Loans are straight at issuance, already call-constrained, which leaves little mark to market upside for investor from the start.
- When positive credit developments occur (be it a corporate event like a M&A or simply on the back of strong organic growth), the strict callability feature usually allows issuers to renegotiate down coupon levels.

Hence, little return left for loans that do not trade significantly below par. A good way to assess how much upside potential is left in the leveraged loans market is therefore to look at the average trading price on the secondary market. After the strong repricing from the Covid crisis depressed levels that occurred in Q2 2020, this average trading price has recently settled around 97.69%. With the bulk of the market being callable at 100%, not much upside is left on the table apart from a decaying carry.

- Figure 4: Secondary loan prices are still historically elevated


Source: Crédit Suisse 28/02/2022

As a comparison, the average price of the ICE BofA Global High Yield Index (HW00) is hovering around 95.85, arguably close to 2 points lower than where loans stand. There are, however, two big differences investors should keep in mind:

1. High yields bonds are not callable at 100: as of end of February 2022, 17% of the HW00 constituents were not callable[1] at all, while the remaining 83% often benefit from call premiums (half of the coupon level is the standard).

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[1] Callability structure: A provision is an indenture that allows a bond to be redeemed before maturity. Callability allows the loans to be called at the discretion of the issuer, within certain limits and at a certain price – usually at par.
[2] Make-whole provisions:
Contrary to loans, High Yield bonds indentures prevents callability from a longer initial period (so called non call period – usually 3 to 5 years) and embed call premiums to compensate investors for an early redemption. Moreover, most of the High Yield bonds can benefit during the initial non-call period from a make-whole provision that close to fully compensate investors for previously scheduled coupon payments (i.e. based on the net present value).

2. Most of the High Yield bonds can benefit during the initial non-call period (3 years to 5 years is the standard) from a make-whole provision[2] (i.e., a lump-sum payment based on the net present value of previously scheduled coupon payments); onerous for issuers, these are a real boost for investors' returns.

Limited upside is arguably a feature of most credit asset classes, characterized by proverbial asymmetric returns. Consequently, one could expect this lower upside to be compensated by more benign downside risk and a stronger credit quality of the loan market on average. However, as we argue next, it is quite the opposite that we see.

# 02. THE LATE CREDIT CYCLE HARVEST TENDS TO BE MORE CHAFF THAN WHEAT

- **Key take-aways of this section**

The loan market tends to have a lower credit quality due to:
- weaker legal documentation
- more aggressive financing structures
- higher concentration risk (with a bias to Technology)

The potential size of the downside risk depends of course on the overall credit default risk embedded in the Leveraged Loan market. Yet, it is common knowledge that when an asset class becomes 'fashionable', like loans today, it tends to attract more debt issuance and (default) risks are often increasing. This usually happens for loans along three channels:

1. Weaker legal documentation:
The notoriously 'covenant light' loans tend to be due to the late cycle context of leveraged loan issuance, including weaker protection that allows issuers to take more debt, to extract more cash for the shareholders and lower expected recoveries in the extreme scenario of a restructuring.

2. Heavy sector concentration:
As it is easier to raise debt in the loan market than in the usual HY bond market, loan investors tend to accumulate risk in the industries that are less in favour in the late cycle phases. By investing in leveraged loans, investors today are heavily loading onto Technology as highlighted in Table 2 (tech and software representing close to 17% of the Index).

- Table 2: SPDR Blackstone Senior Loan ETF, Invesco Senior Loan ETF and ICE Bofa US High Yield Index Top 10 industry groups

| **SPDR Blackstone Senior Loan ETF** | | **Invesco Senior Loan ETF** | | **ICE Bofa US High Yield Index** | |
|---|---|---|---|---|---|
| Software | 13.63% | Software | 12.76% | Energy | 13.42% |
| Commercial Services | 6.56% | Media | 8.42% | Healthcare | 9.87% |
| Retail | 6.53% | Pharmaceuticals | 7.93% | Media | 8.29% |
| Healthcare Services | 5.52% | Retail | 6.41% | Financials | 7.53% |
| Media | 5.49% | Telecommunications | 5.79% | Basic Industry | 7.32% |
| Entertainment | 5.47% | Commercial Services | 5.79% | Telecommunications | 7.16% |
| Sovereign | 4.91% | Entertainment | 5.75% | Leisure | 6.74% |
| Airlines | 4.59% | Insurance | 5.63% | Services | 6.10% |
| Telecommunications | 3.92% | Healthcare Services | 5.11% | Capital Goods | 6.09% |
| Computers | 3.49% | Airlines | 4.66% | Retail | 5.20% |

Source: Bloomberg February 2022

3. Lower credit quality:
The leveraged loans issuers are much more often private equity funds' investments. Such investors usually prefer maintaining high levels of debt in the capital structure: in 2021 for example, 46% of the loans issued

where for acquisitions and dividends to shareholders, whereas for High Yields bonds 76% of new debt proceeds were directed towards debt refinancing and general corporate purpose [3].
When dealing with below Investment Grade debt, default risk is naturally the main worry on investors' minds. The weaker the average credit quality of the investment universe, the higher the default risk will be. Today, there is a sharp difference between the average asset quality of leveraged loans and high yield bonds' markets: the credit rating distributions are totally opposite with high yield bonds skewed towards BB (53% of the H0A0 Index) whereas leveraged loans are heavily skewed towards single B (72% of the SRLN ETF) as summarized in Table 3.

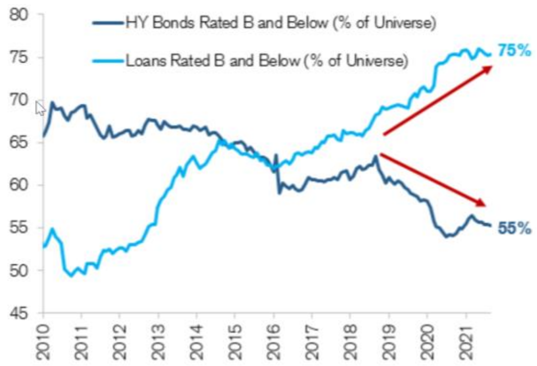
- Table 3: SPDR Blackstone Senior Loan ETF, Invesco Senior Loan ETF and ICE Bofa US High Yield Index distribution by rating as of 01/28/2022

| **SPDR Blackstone Senior Loan ETF** | | **Invesco Senior Loan ETF[4]** | | **ICE Bofa US High Yield Index** | |
|---|---|---|---|---|---|
| BB and above | 9.8% | BB and above | 31.6% | BB and above | 53.1% |
| **B** | **72.0%** | **B** | **55.3%** | **B** | **36.2%** |
| CCC and below | 14.8% | CCC and below | 2.2% | CCC and below | 10.7% |
| Non-Rated | 3.3% | Non-Rated | 2.1% | | |

Source: Bloomberg and ICE, February 2022

The rating divergence between the Leveraged Loans and the HY markets has never be that high:

- Figure 5: Percentage of HY Bonds and Leveraged Loans rated B and below




Source: Crédit Suisse 28/02/2022

Hence, investors in loans expose themselves to significantly higher risks, without being compensated for them appropriately.

# CONCLUSION

On the back of consistently positive inflows over the past year, Leveraged Loans have outperformed High Yield Bonds. However, investors should keep in mind that this is probably not a longer-term phenomenon for very good reasons:

- Given their call features, and given their current prices, there is not a lot of potential upside left in Leveraged Loans.
- Today, Leveraged Loans have a higher risk concentration and a notable lower overall credit quality than High Yields bonds.
- In the long run, Leveraged Loans underperform High Yields bonds because they are more prone to drawdowns when financial markets go through a real crisis due to the average lower credit risk management standards applied to them and the higher sector risk concentrations in this investment universe.

[3] JPM, High Yield Bonds and Leveraged Loans Market Monitor published January 3rd 2022
[4] *Cash and quasi cash such as govies are exclude, hence sum is not equals to 100%*

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