BlueBay
Asset Management

Insights

Global leveraged loans: assessing long term value

February 2016

The current threat to global economic stability and commensurate increase in risk market volatility is, in our view, leading to an increasingly challenged backdrop for levered corporate issuers.

In the context of falling commodity and resource prices and declining base material demand, we are undoubtedly about to enter a period of elevated corporate defaults with specific (although not exclusive) pressure seen in the energy, metals & mining sectors. Given the nature of this distress, we are of the view that recovery rates on these defaults are likely to be below historical market averages. That said, excluding the energy sector, we are more constructive on market fundamentals and believe that, although rising from current low levels, defaults across the rest of the market will be relatively contained.

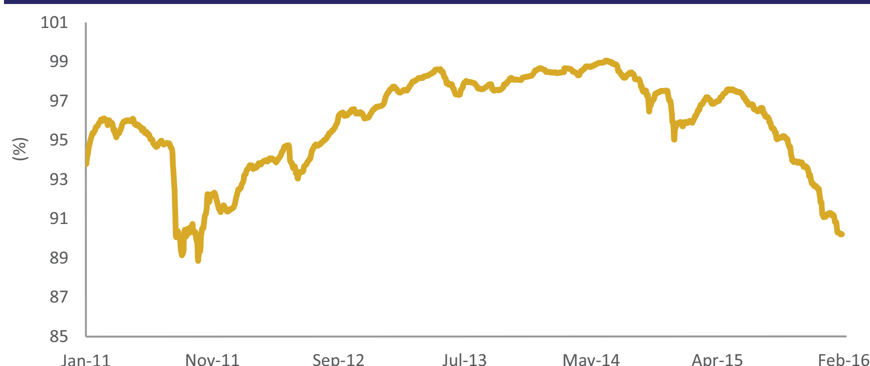
In the context of this environment and how we at BlueBay currently see the balance of risks, we believe exposure to the structurally more defensive Global Leveraged Loan asset class offers an attractive return profile, not only within Leveraged Finance but also across fixed income markets more generally.

In summary, we believe the asset class displays: attractive carry characteristics with a significantly lower level of price volatility to HY bonds, historically higher risk-adjusted returns, a low exposure to the commodities sector and consequently, significantly lower default expectations, high recovery rates on those that do default and a hedge to rising interest should we see the Fed continue along their tightening path.

Why now?

We believe spreads currently offered in the Loan market represent an attractive entry point. Stripping out energy, spreads currently trade above 2001–2002 recessionary levels. Meanwhile, average cash prices of the market as a whole are close to the lows, highlighting the "pull to par" potential.

Fig. 1 S&P/LSTA Leveraged Loan Index – Average loan price



Source: Bloomberg, as at 2 February 2016

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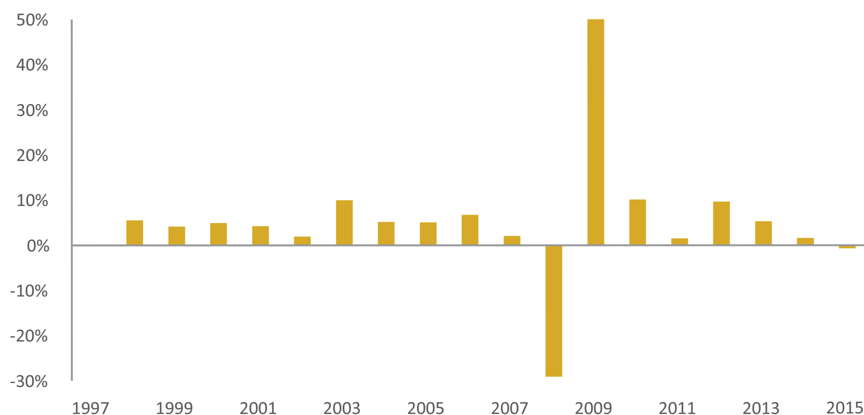
Although posting a negative return in 2015, this was only the second such instance in the last 18 years. Historic returns are shown below.

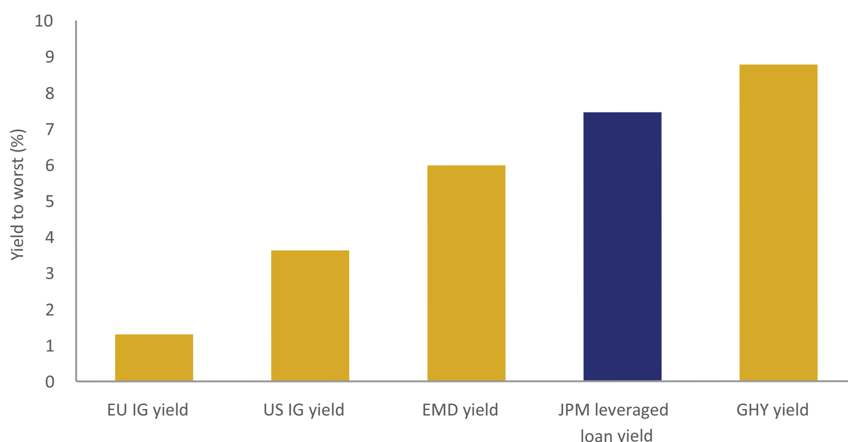
Fig. 2 S&P/LSTA leveraged loan returns



Source: Bloomberg, as at 2 February 2016

Not only are spreads currently appealing on an outright basis, versus the selection of credit markets shown below, loans appear similarly attractive (even more so when one considers the relatively low volatility of returns displayed by loans over time).

Fig. 3 Credit asset class yields

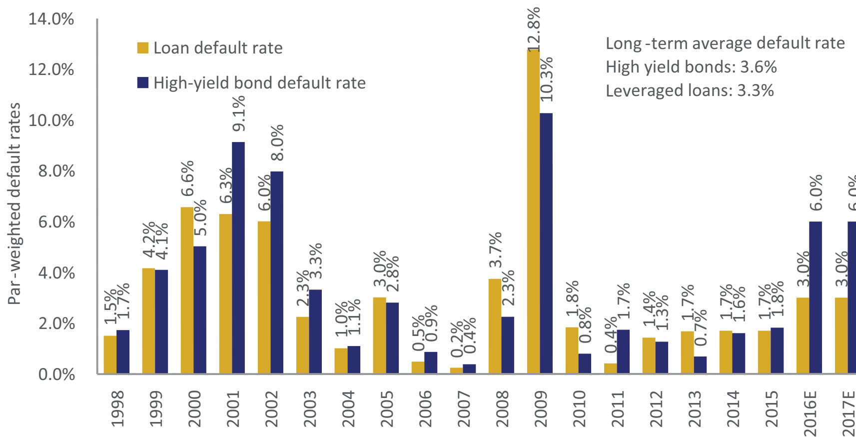


Source: BAML, JP Morgan, as at 29 January 2016

Like all credit markets, leveraged loans are not immune from exposure to the resources sector. That said, energy, metals and mining account for less than 6% of the non-defaulted loan universe (this compares favourably to HY bonds where similar sectors account for more than 20% of current outstanding's[1]).

Whilst loans will not therefore escape the inevitable uptick in defaults already underway in these sectors, we believe the effect will be less pronounced than elsewhere. To that effect, it is anticipated that despite the pain in the resources sector, leverage loan defaults will likely remain around or below their long term average of 3% (these sectors are forecast to account for around 1% of this default rate).

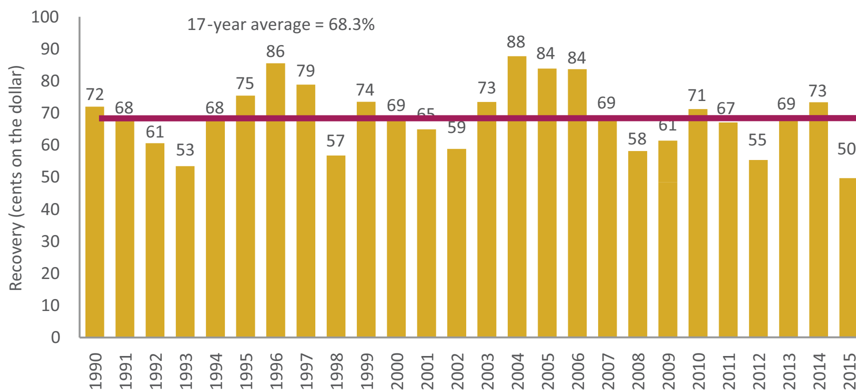
Fig. 4 High yield bond and loan default rates expected to rise [2]



Source: JP Morgan, as at 25 January 2015

Moreover, while accepting that there will be defaults in the loan sector, it is important to remember that recovery rates on those that default have traditionally been quite high in leveraged loans (averaging at just over 68% over the past 17 years). Although dipping at the end of 2015, the recovery rate ex-metals/mining/energy came in at 61% [1].

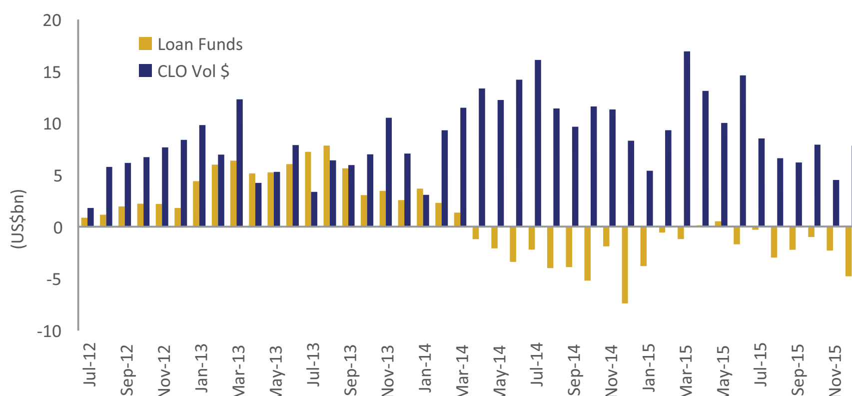
Fig. 5 First lien leveraged loan recovery rates



Source: JP Morgan, as at 9 December 2015

From a demand/supply perspective, the recent outflows from retail-orientated loan funds in the US, in particular, have been the focus of much attention. The chart below illustrates that in actual fact, the demand created by new Collateralised Loan Oblgations (CLO's) has done much to balance this outflow. While there may well be periods of imbalance going forward, this will simply provide a more favourable playing field for institutional buyers to dictate better terms and benefit from more favourable primary market pricing.

Fig. 6 Loan mutual fund flow versus CLO volume



Source: JP Morgan, as at 31 December 2015

In this context we expect loans to return approximately 4–5% during 2016. We believe this provides an attractive risk adjusted return and compares favourably to other credit asset classes.

This performance is not out of the ordinary when approaching a meaningful rise in default rates. The period leading up to the 2001 default cycle displayed a meaningful loan outperformance within leveraged finance. We believe the current default cycle has many parallels to the sector specific defaults occurring during the period evidenced in the table below and feel return prospects "this time around" could well be similar.

Fig. 7 When loans outperform bonds

	HY return	Loan return	Default rate
1998	3.0%	5.3%	3.4%
1999	2.5%	3.5%	6.3%
2000	-5.1%	4.9%	6.4%
2001	4.5%	4.2%	12.4%
2002	-1.9%	2.0%	9.1%

Source: BAML Global Research, as at 24 November 2015

Not only outperforming in a period of rising default rates, volatility-adjusted returns for loans compare favourably to other asset classes over the longer term in general. We expect this to be the case this year as well (and believe that even if we do enter a period of sustained rate rises that levered loans will perform accordingly). Leveraged Loans therefore provide a long term and increasingly timely market allocation.

Why BlueBay?

Our philosophy for the leverage finance asset class is based on downside capital preservation, utilizing a deep, bottom up credit process. Simply put, we seek to avoid investing in troubled credit. Our track record suggests that we perform very strongly in volatile markets, and we believe our strategy is ideally suited for the market environment we're entering. Our dynamic approach to management of the portfolio has resulted in a positive return profile over the life of the Funds, and our ability to outperform should increase in a higher default environment.

Given the volatility present in the market, we have focused on increasing the quality of our underlying portfolio and have increased the percentage of 1st lien exposure within it, positioned, we believe appropriately, for a period of increased stress and volatility. As mentioned, our bottom up credit selection process is particularly well suited to today's market conditions and our focus on investing in high quality issuers at compelling valuations ought to provide investors with an appealing level of carry in an attractively priced asset class.

In summary, we believe leveraged loans currently represent a key risk market allocation which provides a fixed income component combined with resilient sectoral exposure, downside protection in the form of higher recovery rates and a natural hedge against rising interest rates, allowing for positive outright and relative returns.

Note:

1 Source: JP Morgan, as at 1 February 2016

2 These forecast figures are based on assumptions and are subject to change without notice. There are frequently sharp differences between forecasts and actual results. These forecasts may also differ from those of other credit strategists or portfolio managers at BlueBay Asset Management LLP as a whole, and are not intended to be relied upon. BlueBay Asset Management LLP disclaims all liability or responsibility arising from any use or interpretation of, or reliance upon these forecast figures.

3 Ex-resources 2015 recovery rate was 61%

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