Fall 2014

Senior Loans – A Market Update

Introduction

From our vantage point, the senior loan market looks reasonably well situated right now, contrary, in many instances, to what we've been reading recently in the financial press. Senior loans (a/k/a "leveraged loans") were one of the best performing "high income" asset classes during the September through October risk-off period, and have a long track record of providing attractive risk-adjusted returns (*i.e.,* "Sharpe" ratios) to investors. In this short piece, we discuss a few of the key factors behind both recent loan performance and the current investment thesis. And, just maybe, deconstruct some misconceptions along the way.

New Issue Activity – Unexpectedly Robust at Times

New issue activity, which is the lifeblood of our market, and a generally reliable litmus test of overall market conditions, has been very healthy for most of 2014. In some periods throughout the year-to-date period, the pace and aggregate size of new deal flow has outdistanced overall demand by a meaningful margin (more on that below). Total market outstandings for the S&P/LSTA Leveraged Loan Index pushed past the $800 billion mark recently, and while new issue volume to date (about $362 billion through Nov 13) is down about 13% from the same point last year, the complexion of this deal flow has been generally healthier in that the bulk of the activity has been merger and acquisition related, as opposed to the simple refinancing and re-pricing exercise that defined much of 2013. Although the forward calendar is expected to slow as we near year-end (which is the typical seasonal pattern), we do expect overall financing activity to remain reasonably robust heading into 2015, assuming no unexpected downside surprises to U.S. economic growth.

The secondary market recently has also been very active throughout the year. Through 3rd quarter, annualized trading volumes, as reported by the LSTA Trade Data Study, stand at $634 billion, which, assuming the trend holds, will comfortably surpass 2007's $520 billion record. Along the way, overall asset level trading liquidity has been generally quite good. Periods of secondary market volatility have not been a function of fundamental credit concerns, but rather uneven market "technicals" (*i.e.*, the overall supply/demand equation).

Demand for Loans – Transitioning, but Still Healthy

To that point, supply, as noted earlier, has been surprisingly robust. Demand, on the other hand, has been in transition in recent quarters, coming primarily in the form of new CLO issuance and global institutional demand. CLO buyers have remained steadfast in their demand for loans, accounting for approximately $107 billion of inflows YTD through November 17, per S&P/LCD. Revised full year estimates now comfortably top $115 billion. Global institutional demand has been broadly based: pension funds (both public and private), insurance companies, endowments and, increasingly, the ultra-high net worth desks of large corporate banks. Some are investing in funds; many are opting for separate account structures. Typically, these are strategic asset allocations. Diversification and correlation play a large role in their decision making, which has historically resulted in longer-term commitments.

On the other hand, retail mutual fund and ETF buyers, after record inflows in 2013, have become decidedly neutral on the asset class, a function, in our opinion, of flagging belief that interest rates will rise any time soon (such a subjective topic!). Net outflows from the retail channel totaled approximately $9 billion for third quarter, and $8 billion on a YTD basis through September. It bears mentioning that this represents a less than 12% reversal of the full year 2013 inflow of approximately $70 billion. Still, persistent retail outflow has represented a damper on the market as loan managers must proactively create liquidity in advance of expected redemption activity (see "Liquidity and Settlements," below) in order to responsibly manage their open-end loan funds.

Market Values and the "Technicals" – A Bit of a Rebound

The result of this supply/demand dynamic has been a moderate decline in market values that started in early April. The peak to trough difference of the average bid within the S&P/LSTA Leveraged Loan Index during this period was 261 bps. Since the recent low, however, market technicals have regained some balance due to the aforementioned reduction in visible new issue supply and stabilizing - and more consistent - overall demand. While mutual fund/ETF flows remain negative, those outflows have recently been well off their highs. Further, CLO new build activity continues in earnest. As such, the average bid, based on this better balance, has been able to recover much of the lost ground (105 bps through November 17). We should also add that, credit spreads appear to have bottomed and in many cases moved up. So, all in, from a supply/demand perspective, the asset class appears to be set up in a reasonably good fashion for the coming year, when most market observers are predicting the U.S. Federal Reserve to finally get off the fence as far as short term rates are concerned.

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The Economic Cycle – Where We Stand

We believe we're still in the mid-expansion phase of the economic cycle, and all visible market indicators support that notion. Trailing default rates are low and, barring an unexpected negative turn in economic activity, are projected to remain that way for a while. There's still a slice of greater than average credit risk in the overall market, but that's largely relegated to a small number of pre-crisis LBOs that will eventually have to restructure. These are all pretty well known to the market, we might add. Of course, we'd be remiss if we didn't mention the wildcard: an exogenous event or series of events that drives risk out of the market, hard and fast. It is very difficult to effectively handicap that outcome.

"Covenant-Lite" – The Latest Thinking

There has been plenty of attention to covenant-lite ("cov-lite") loans, much of it warranted, but much of it based on misunderstanding and/or faulty assumptions. Cov-lite simply means that the part (or tranche) of the loan in which loan managers invest is not governed by a traditional supplemental set of restrictions, referred to as financial maintenance covenants. These tests, typically cash flow based ratios, allow the loan investor to be the first to negotiate with the borrower in the event of a breach.

Needless to say, that protection has worth, but the value proposition has been over-emphasized in our view. While a covenant breach allows investors to reset the yield higher on the loan, which typically has a positive effect on secondary trading levels, the value of a maintenance covenant should never be confused with the protection that comes from having a pledge on the issuer's collateral. Put another way, the substantially greater historical average recovery after default of senior loans, which is a hallmark of the asset class, is a direct by-product of being secured by the issuer's assets, not necessarily of having a set of maintenance covenants.

In addition, a less than comprehensive understanding of cov-lite often drives a view that there are no formal restrictions on the borrower whatsoever; *i.e.,* that these non-investment grade companies are getting money essentially free and clear of any limitations. In truth, there remains a battery of prohibitions embedded within a credit agreement that restrict actions of the corporate borrower. Those features are nuanced and not well understood by the average loan investor.

Leverage Levels for New Issue – Higher, But Not Irresponsible

There remains considerable bandwidth as far as the range of new issue leverage levels. The averages, loosely, are somewhere in the area of 4x senior secured leverage, with an extra turn or two of leverage in the form of unsecured debt. While these measures have been edging higher over the last few years, they do, from a secured lender's perspective, remain close to the historical averages for the asset class. And while the trend in leverage "creep" looks similar to what we saw in the 2005 - 2007 period, drawing a conclusion that we must therefore end up in a fashion similar to 2008 is dubious at best, given the nature of that unprecedented liquidity-driven correction. Excess cash flow leverage on company balance sheets was not the catalyst to that massive drawdown. Overall financial system leverage and the fear of systemic failure was the culprit.

Further, it can be a bit risky to look at leverage multiples in isolation. They have to be analyzed in conjunction with the level of cash flow coverage, *i.e.,* how many times an issuer's cash flow covers its interest expense and fixed costs. That figure, on average, is at an historical high, which indicates that the typical below investment grade borrower has sufficient headroom to absorb higher borrowing rates or declining cash flows, which, in most cases, are mutually exclusive developments.

Of course, we can't forget to highlight the Leveraged Lending Guidelines announced by the slate of federal banking regulators. We believe these directives are beginning to modify the behavior of corporate and investment bankers, but the process has been predictably slow moving (hence the U.S. Fed's apparent frustration and, as a result, occasionally quite pointed messaging). Longer term, the guidelines are expected to have a beneficial impact on credit quality, albeit not without the unintended consequences of potentially constraining capital formation and/or pushing the excesses into the unregulated non-bank part of the financial system. Time will tell.

Liquidity and Settlements – The Real Story

Let's first draw an important distinction between asset level liquidity and settlement mechanics. As noted earlier, what we refer to as "asset level liquidity" (*i.e.,* actual trading volumes, the number of loan dealer desks making a market in a given issue, and the width of the bid-ask spread) has been quite robust. In many cases, the loan market is more liquid in this sense than the high yield bond market.

Where the loan asset class differs from a public securities market is in the nature and mechanics of cash settlement. Given the essentially manual nature of loan settlements and the additional consents necessary to effectuate a trade, the

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average time it takes to settle cash from trading can vary considerably. Further, the timeframe can and does vary depending on the nature of the trade, *i.e.,* sales vs. purchases. The market convention, as per standards set by our industry association, the LSTA, is T+7 business days. Although overall industry averages are in excess of that target, some loan trades do settle within that time frame. In particular, when we sell a loan, T+7 settlement is not atypical. The timing of purchase settlements, however, is typically dependent on both the counterparty and the counterparty's seller. Also, new issue allocation funding can hinge on many variables including corporate actions, regulatory approvals, contractual agreements, etc.

So, in short, there does exist a mismatch between asset level liquidity and expected settlement times. This is an issue that is being discussed by the brightest minds within the asset class, but also one that's been addressed quite effectively by managers through now several periods of atypically high technical and fundamental volatility.

Risk Retention

The U.S. Credit Risk Retention Rules, as mandated under the Dodd-Frank Wall Street Reform and Consumer Protection Act, were adopted on October 22, 2014. The rules become effective two years after their adoption, so they will come into effect in October 2016. All CLOs issued prior to the effective date will be grandfathered and will not be subject to the new rules.

There is no doubt that the final risk retention rules will have a degree of impact on both the U.S. CLO market in particular and the U.S. leveraged loan market in general. While it is too early in the process to make any definitive assertions on the likely impact, it is not unreasonable to think that the CLO market landscape will change over the medium term, with perhaps reduced CLO issuance and fewer managers going forward. The new rules create barriers to entry for new managers, and challenges for small managers who manage only a few CLOs. In our opinion, CLO managers with scale, as well as access to long-term and captive capital, will benefit relative to smaller competitors. While the details of risk retention are still to be fully vetted over the two year period, the implementation of the final rules will probably be less impactful in the long term than some are anticipating.

In the short term, as the market digests the new rules, we might experience a reduction in CLO issuance, especially among managers of lesser scale, as investors question the longevity and endurance of the capital plans of these smaller managers. However, the U.S. leveraged loan market has managed to evolve and grow tremendously over the past 20 years despite previous regulatory and business changes. Over time, regulatory challenges, be it mark-to-market pricing (as we experienced in 2000-2001), standardization of documentation, the Volcker rule and now risk retention rules, have been met quite capably by the sell and buy side communities. It is our belief that the financial markets are quite efficient and capable of adapting and finding capital solutions to these new regulatory changes. As a final thought on this issue, we also firmly believe a rising short-term rate environment will effectively mitigate the potential impact of risk retention. Under that scenario, CLOs will be but one of several types of investors, institutional and retail alike, attracted to our floating rate asset class.

So Why Loans Now?

The fundamental thesis for loan investing continues to hold, despite the recent uptick in volatility and the uncertain prospects for an increase in rates. Risk-adjusted yield remains the name of the game. Loans provide a yield that's attractive on an absolute basis and, importantly, one that's devoid of any material amount of interest rate risk. For those concerned about taking greater credit risk, secured loans clearly carry less risk of loss given default than a typical unsecured high yield bond. Historical data clearly proves this to be the case. And, last but certainly not least, loans, by way of being secured by issuer assets and interest rate neutral, are inherently less volatile than most other high income producing asset classes. That's always been important to investors of all stripes, not the least of which being the new crop of asset allocating institutions we see now coming into the picture.

When rates do start to rise, floating rate loans can help provide both price stability and increasing income. That's a combination of benefits unique to the senior loan asset class.

Good Investing.

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