Q&A

Bank Loans

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*In this Q&A, Portfolio Manager **Timothy J. Settel** discusses how bank loans compare to other fixed-income instruments and why they may offer a compelling investment opportunity. Mr. Settel also explains how Western Asset finds value in this sector by utilizing its deep research team to choose securities for inclusion within its portfolios.*

Q: How does a bank loan differ from a typical high-yield security?

TJ: Although similar in many ways, there are some distinguishing features that make loans unique. The first is that loans are senior in the capital structure and secured by specific collateral, which will provide some downside protection in the event of default. The second difference is that loans are a floating-rate instrument whereas high-yield bonds are predominantly fixed rate. So while both asset classes invest in the same type of credit risk, loans due to their senior secured status and floating rate of coupon, tend to be less volatile than high-yield bonds.

Q: What are some of the common misconceptions about bank loans that investors may have?

TJ: I believe the biggest misconception right now is that loans don't offer much yield given that LIBOR is extremely low, and many investors think LIBOR will stay low for quite a while. While we appreciate that rates could remain low for an extended period of time, it's important to note that almost every new issue and close to 70% of the entire loan market today has an average LIBOR floor in the range of 1% to 1.5%. The result is that the market today is trading at a spread of roughly L+475, which can provide a high level of current income and a relatively attractive yield in a low-interest rate environment. Looking out over the investment universe, a 5.25% yield looks very attractive to us on an absolute basis as well as from a risk/reward perspective.

The other misconception is that many people still view the loan market as a private and clubby market with limited liquidity. But the market has developed quite a bit over the past decade and today there are over 10 major dealers that provide daily trade execution, offering liquidity very similar to that of the high-yield market.

Q: What differentiates Western Asset's approach to bank loans?

TJ: Our process and our team. We are a research-intensive operation that diligently investigates all the credits we invest in. We use the same rigorous process for our loan investments similar to how we look at our high-yield investments, which means we do a bottom-up analysis on all of our credits with a supporting credit write-up and forecasted model. Our team is deep and experienced, which we believe provides us a significant competitive advantage.

Our objective is to maximize the income while avoiding defaults. Over the various cycles we have done a good job of meeting our objectives. While we have historically had one of the higher-yielding loan products out there, we have consistently been able to maintain a lower default rate than most of our peers and the index over the years. Further, due to our comprehensive research process, when we have experienced a default, our recovery rates have been higher than the broader market.

Due to our strong belief in our team and our process, we are typically willing to have a more concentrated portfolio than the competition. Our portfolio tends to have about 160–175 names, versus our competitors, who often have in excess of 300 names.

Q: You mentioned the research team. What characteristics does the team look for in respect to bank loans?

TJ: It's similar to our traditional high-yield analysis. We look for strong management teams, strong businesses—either number-one or number-two within their industries. We want companies that generate free cash flow even under stressed scenarios. For example, even during the 2008 recession, over 90% of the companies we held continued to generate free cash flow. We want companies that can differentiate themselves from the pack and companies that operate with relatively predictable cash flows that we can model. We also want companies that offer asset-protection of at least two-times the debt level. The demand on our part for asset protection has been the main reason why our default rate has been lower and our recovery rates higher than the broader loan market every single year since we launched our bank loan product 11 years ago. Finally, we only invest in companies that offer good relative value opportunities.

Q: Can you talk more about the changes in the bank-loan market and the prospects going forward?

TJ: Bank loans have become a more developed asset class over the years, and because of that, there have been a broader array of participants within the marketplace. Whether it's hedge funds or high-yield managers, they tend to trade in and out of the market fairly rapidly. That has increased the volatility within the market a little bit. In addition, covenants have become less restrictive and some disappear all together, resulting in covenant-lite loans becoming the norm. But on the flipside we have seen some positive developments, most notably the amount of leverage in the system has declined. Though CLOs are making a comeback, they are not as prevalent yet as they were in the boom years of 2006 and 2007. In addition, total return swaps are not as important as they were in the past. Total-return swaps, which were highly-levered vehicles, are nowhere in the market today, and they don't seem to be returning any time soon. So we've had a couple of competing forces here. At the end of the day, even though you've lost some covenant protection, and you've had some more volatility from relative-value players, you still have a higher quality instrument in the capital structure that offers reduced volatility and attractive risk-adjusted returns.

Finally, I would note that the size of the deals in the new-issue market has changed as well. The old market was very LBO driven where you'd get billion-dollar deals, and in some cases $10-billion deals and up. Nowadays, the more typical range for new issues is $200 million to the one billion-dollar range.

Q: How does Western Asset deal with that change in issue size?

TJ: We're fine with it and we think we are in a very good position. Our assets under management don't present any capacity issue where we would need the billion-dollar plus deals just to maintain our portfolios. But at the same time, we have enough assets under management and enough trading volume that we can get good new issue allocations.

Q: What are the risks in respect to investing in bank loans?

TJ: The risks are really no different than any other credit product. Our primary risk is default risk. Corporate fundamentals, at the end of the day, are the most important variable for us. In addition we need to deal with the broader macro-economic environment. Like any risky asset class, if we get a macro event or shock to the system, loans will trade down. The good news is that loans, by the virtue of their design, have traditionally been less volatile than other risky assets like high-yield bonds. From the onset of the credit crisis through about mid 2011, loans were uncharacteristically as volatile as high-yield. But now, we're starting to see evidence that loans are in fact getting back to the traditionally lower volatility product. For example we saw it in May of 2012 where loans outperformed high-yield in a volatile equity market period.

Q: What is the size of the bank-loan market in comparison to the high-yield market?

TJ: The market for loans is roughly $550 billion versus $1.1 trillion for the high-yield market. While the loan market is smaller than it was two years ago, assets tend to flow back and forth between the loan market and the high-yield market, with slow and steady growth in aggregate.

Q: What kind of investor should be interested in bank loans?

TJ: All kinds of investors, both institutional and retail, should be interested in bank loans. There's a bit of a change going on where investors were looking at loans as a tactical investment, but are now coming around to see the asset class as more of a strategic investment. Really this gets back to portfolio diversification. If you look at loans versus other asset classes, we're getting back to that period where the correlation between high-yield bonds and loans was in the 50%–60% range. Then if you look at loans versus all the other asset classes, the correlation is mostly below 10%, and in the case of Treasuries it's actually negative. For diversification reasons as well as the opportunity to earn high current income, we're seeing an increasing number of investor types express interest in the asset class. For example, demand for the product from insurance companies was the driving force behind our move to get an NAIC rating for our bank loan commingled vehicle. In summary, I believe there is a solid case for almost all investors to consider an allocation to bank loans within their portfolios.