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What are Senior Secured Loans and why invest in them?

Invesco | 25 January 2017

Bond investors have enjoyed a multi-decade bull run in yields, fuelled by unsustainable post-Global Financial Crisis stimulus. But "the times, they are a-changing." With portfolios exposed to rising rates, investors navigating the inflection point in the political and macroeconomic landscape are being challenged to question long-held beliefs about money, investing and retirement. Senior secured loans offer a high level of stable monthly income by investing in liquid floating rate loans to a diverse group of global companies. Senior secured loans are uniquely suitable for diversified, income and retirement portfolios.

This paper explains the unique features and benefits of senior secured loans, and reasons for incorporating an allocation to them in portfolio construction.

WHAT ARE SENIOR SECURED LOANS?

Companies can finance their business by borrowing money (issuing debt) or by selling an interest in their business (equity). Debt and equity form the basis of a company's capital structure. When a company repays its obligations, debt holders are repaid ahead of equity holders (see Figure 1 below).

Senior secured loans are a primary source of funding for companies (typically sub-investment grade - see terms and definitions) to finance their growth or daily operations. As their name suggests, senior secured loans are the most senior part of the capital structure and are secured (or backed) by the borrowing company's assets.

The process of issuing a senior secured loan is shown in Figure 1 (overpage). It shows the debt arrangements between the borrowing company, the issuing banks, and the markets the loans are traded in.

Senior secured loans offer a unique combination of appealing characteristics, summarised in Figure 2 *(overpage) and explained in more detail later in this paper.

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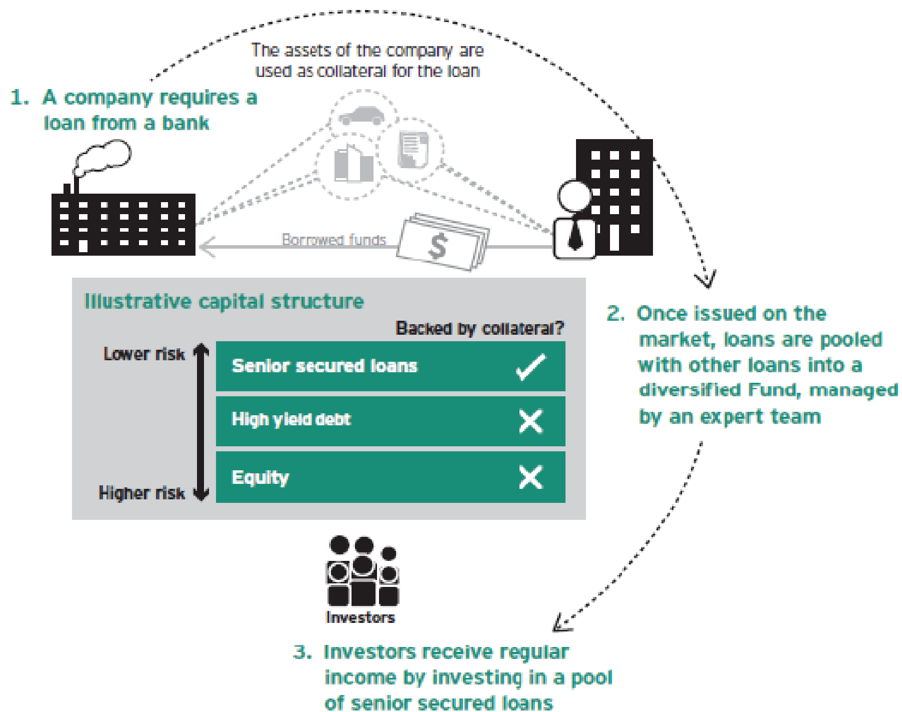
Figure 1: Senior Secured Loans – overview



Source: Invesco

Figure 2: Senior Secured Loans – features and benefits

Feature	Benefit
Stable income	Consistent monthly income stream and strong risk-adjusted returns
Floating rate	Income rises when interest rates rise, providing a hedge against inflation
Liquidity	Liquid US$1 trillion-plus market with consistently high trading volumes allows ready access to funds
Diversification	Diverse group of large, mature and global companies; complementary with other assets in a traditional portfolio
Senior secured	Highest priority to be repaid; capital security in the event of a default.

Source: Invesco

WHERE DO SENIOR SECURED LOANS FIT IN A PORTFOLIO?

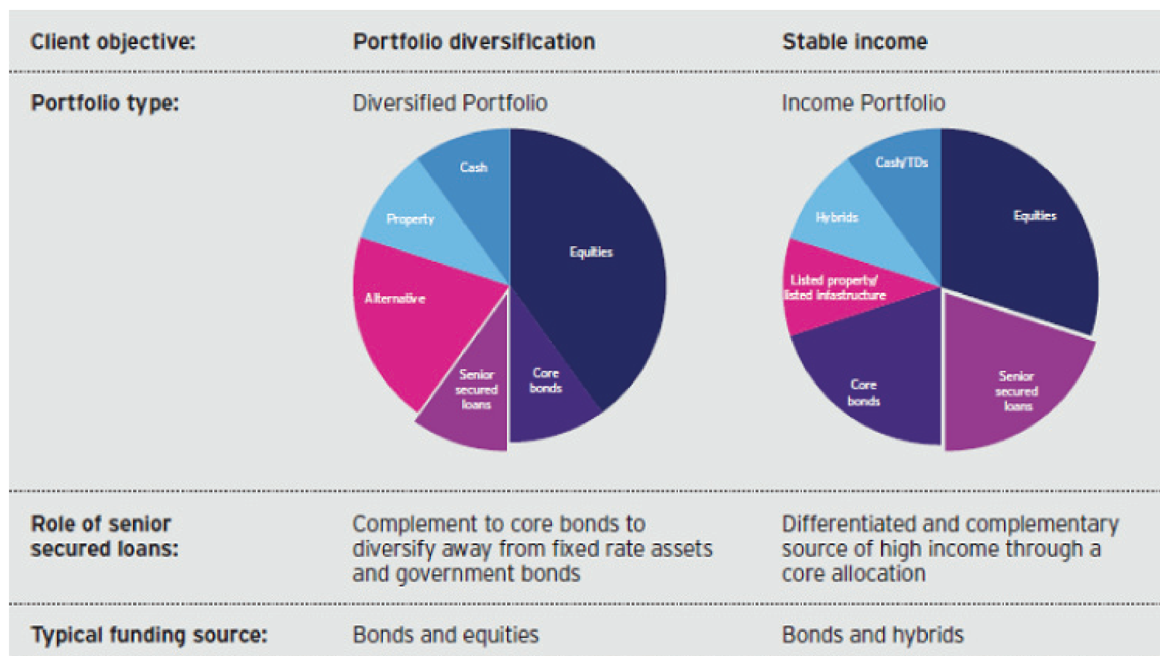
Senior secured loans exhibit both growth and defensive characteristics and lie somewhere between equities and investment grade bonds in the risk/return spectrum. They are therefore best categorised as a "mid risk" asset class with an approximate 50% growth / 50% defensive split.

Over 30 years of data shows that senior secured loans generally behave in a broadly consistent and stable manner:

- Stable returns with low volatility – Annualised volatility of main asset classes over three years to 30 September 3016:
  senior secured loans 2.8%pa
  US high yield bonds 6.1%pa
  investment grade bonds 3.2%pa
  global equities 11.5%pa (hedged in A$)
- Low frequency of negative annual returns – only one negative year in the last 23 (for $A hedged investors) for senior secured loans compared to four in 23 for Australian equities (ASX 300) and six in 23 for global equities (local currency returns; source: Invesco).

Senior secured loans can be used to either complement fixed income assets within a diversified portfolio, or as a core part of an income-focused portfolio, as shown in Figure 3.

Figure 3: Senior Secured Loans – role in portfolios



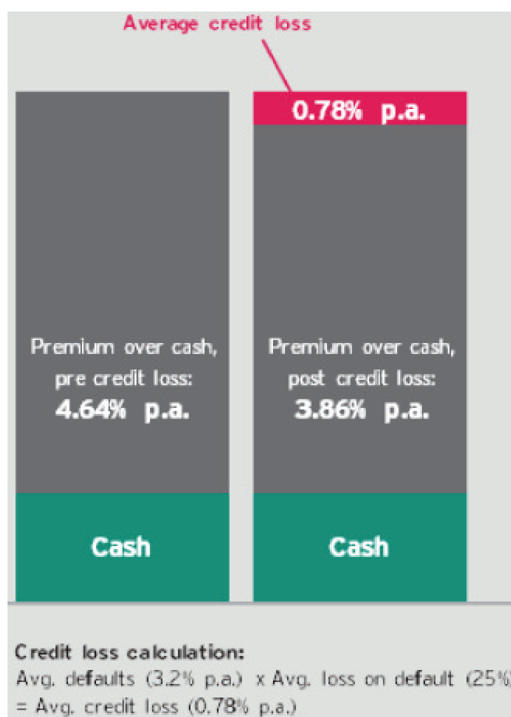
Client objective:	Portfolio diversification	Stable income
Portfolio type:	Diversified Portfolio	Income Portfolio
Role of senior secured loans:	Complement to core bonds to diversify away from fixed rate assets and government bonds	Differentiated and complementary source of high income through a core allocation
Typical funding source:	Bonds and equities	Bonds and hybrids

Sources: Invesco. For illustrative purposes only.

SENIOR LOANS MAINTAIN THEIR SOLID PREMIUM OVER CASH

Senior secured loans have historically provided a solid premium over cash with minimal credit loss, resulting in a very strong risk-adjusted return for investors. The current pricing is broadly in line with historic averages, so investors should expect to maintain their solid premium over cash, assuming ongoing benign default rates and high levels of recoveries.

Figure 4: Senior Secured Loans – historical market experience
(31 January 2000 – 31 December 2016)



Sources: Credit Suisse Leveraged Loan Index – for illustrative purposes only. Historical spread, price and yield reflect pre credit crisis average from 31 January 2000 – 31 December 2016 (excluding 2008 – 2009). Data as at 31 December 2016.

HOW DO SENIOR SECURED LOANS BENEFIT INVESTORS?

The key benefits of senior secured loans are explained in more detail below, along with why now is an opportune time to invest in them.

Stable income

Senior secured loans deliver a consistent monthly income stream and strong risk-adjusted returns. As Figure 5 shows, senior secured loans have delivered a consistent yield (in US$

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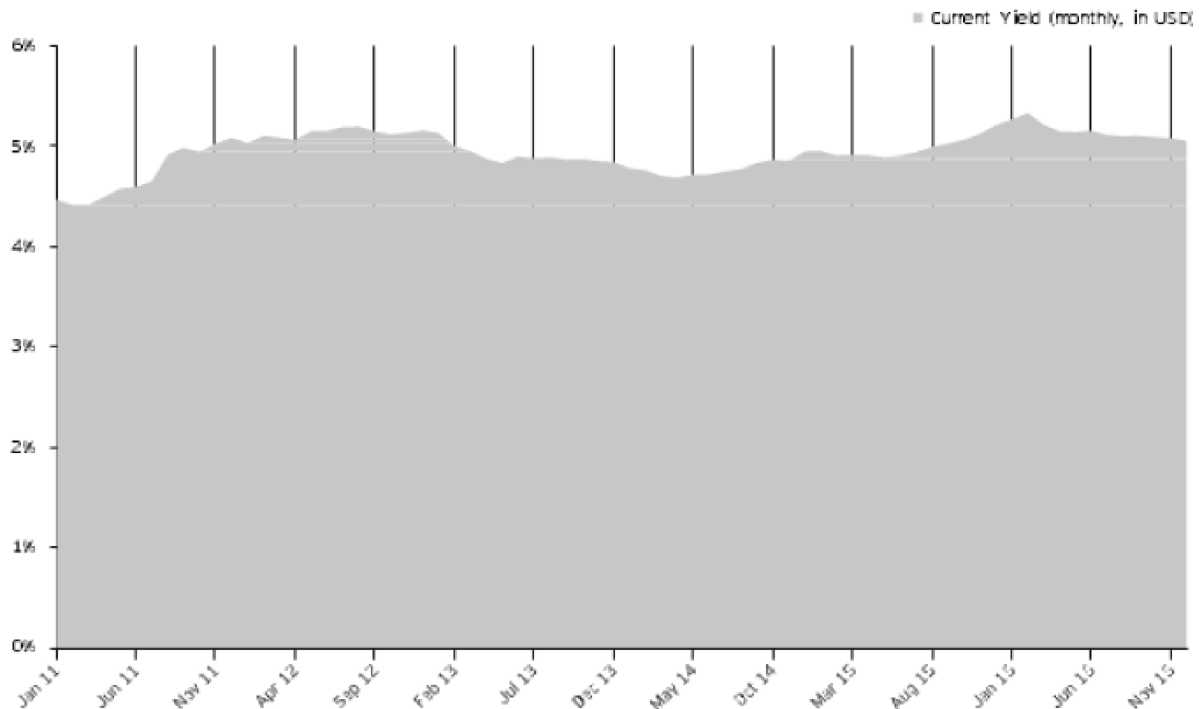
terms) over time. The yield would have been higher for Australian dollar-hedged investors, given the interest rate differential between Australia and the US over this period.

Figure 5: Senior Secured Loans - current yield
(January 2011 to December 2016)



Sources: Invesco. Credit Suisse Leveraged Loan Index. Data as at 31 December 2016.

Why now?

- We are in a low return environment on the back of historically low interest rates, and this has flow-on impacts across all asset classes.
- Senior secured loans continue to offer compelling spreads (margins) over cash of 4% to 6% per annum, with very low loan default rates. Of companies that default, recoveries are very high due to senior secured loan holders being paid before all other security holders in the capital structure.

Floating rate

Traditional bonds (e.g. government or corporate bonds) pay coupon interest at a fixed rate that never changes. Senior secured loans, by contrast, pay interest at a floating (or variable) rate. A key benefit of this dynamic is that income from floating rate loans increases when short-term rates rise, and loan prices exhibit low sensitivity to rising interest rates, as shown in Figure 6 (overpage).

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Figure 6: Comparison of fixed versus floating rates in different rate cycles

	Rising interest rates		Falling interest rates	
	Income	Prices	Income	Prices
Floating rate (i.e. senior secured loans)	Will adjust to changes in interest rates	Less sensitive to changes in interest rates	Will adjust to changes in interest rates	Less sensitive to changes in interest rates
Fixed rate (i.e. government bonds)	Is fixed	Adjusts to changes in interest rates	Is fixed	Adjusts to changes in interest rates

Source: Invesco

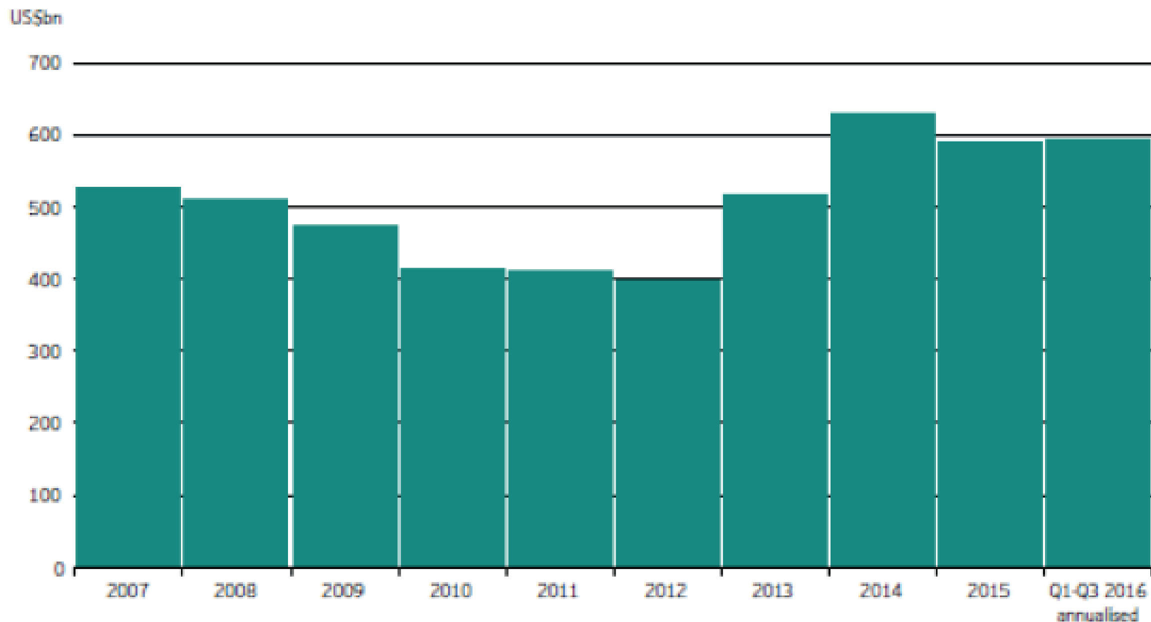
Why now?

- Global interest rates are at historical and unsustainably low levels. Hence, traditional government bonds and investment grade credit are at risk of capital loss when rates inevitably rise.
- Senior secured loans' floating rate structure means they will benefit when rates rise, acting as a hedge against inflation.

Liquidity

Since the late 1980s, increased appetite for senior secured loans from institutions has resulted in tremendous growth in market volume. These days, the global market in senior secured loans is large and liquid, currently valued at around US$1.1 trillion. Moreover, trading volumes in senior secured loans remain high regardless of the market environment, as shown in Figure 7 (overpage).

Figure 7: US Senior Secured Loans – annual trade volumes



Source: LSTA. Data as at 30 September 2016.

Why now?

- Increased supply of senior secured loans worldwide as companies prefer them as a source of capital.
- Diverse and growing investor base ensures a healthy supply/demand dynamic, resulting in pricing stability and liquidity.

Diversification

Senior secured loans offer diversification benefits on two main fronts. Firstly, given their floating rate structure, senior secured loans typically perform differently from equities and fixed income securities over time, offering greater complementarity within a fixed income or balanced portfolio. In adidtion, a portfolio of senior secured loans can be highly diversified by industry (as shown in Figure 8 overpage) and issuer.

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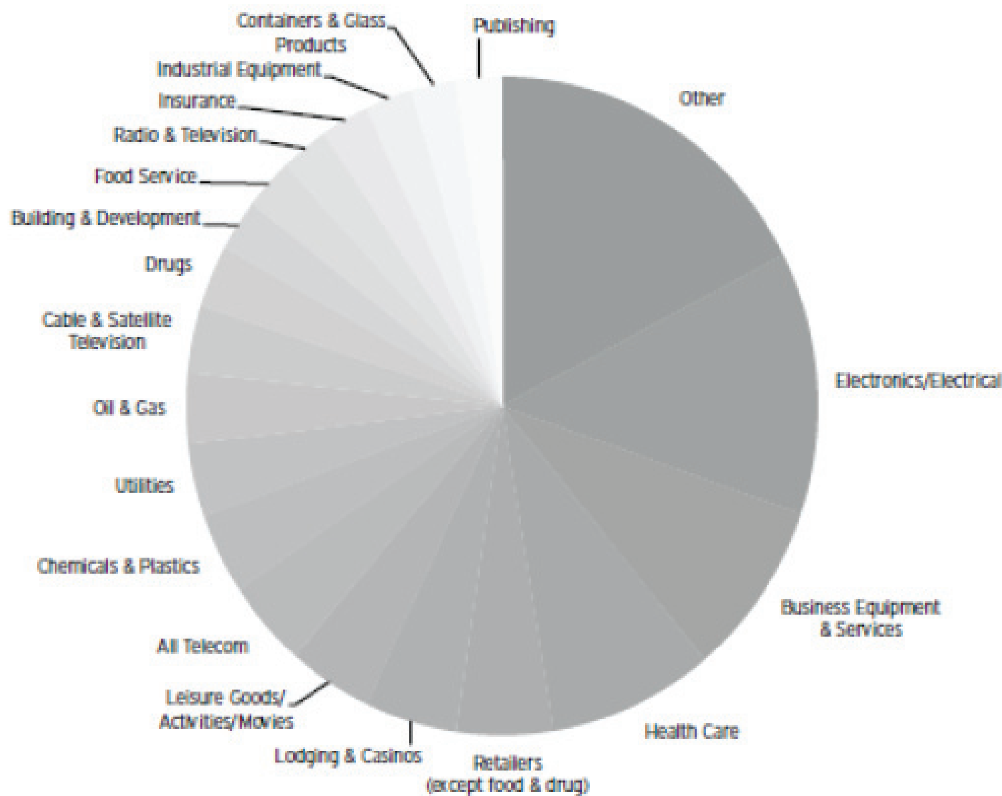
Figure 8: US Senior Secured Loans – diversified by industry



Sources: S&P/LSTA Leveraged Loan Index. Data as at 31 December 2016

Why now?

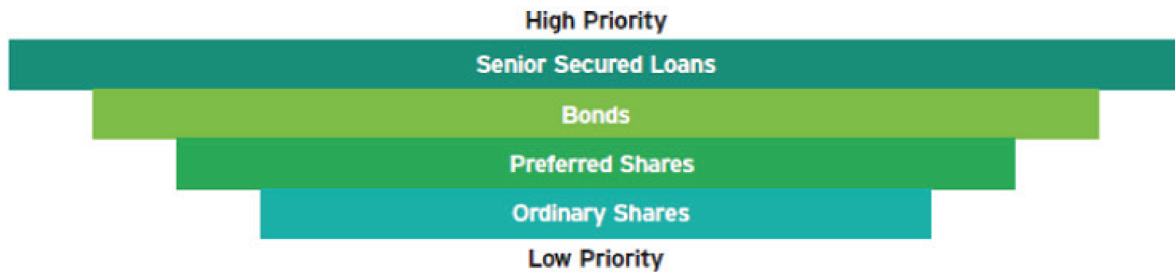
- Given uncertainty in markets, investors are seeking new sources of diversification.
- Australian investors are overexposed to Australian assets, particularly financials and resources.
- Senior secured loans offer broad, global diversification by industry and company, including global brands like Burger King, Dell, Hilton, Chrysler, and Formula 1.

Senior, secured

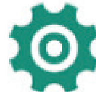
The "senior" aspect of senior secured loans refers to the fact that they lie at the top of a company's capital structure (Figure 9 overpage). Thus, in the event of a company's financial distress (e.g. a loan default), senior secured loan holders are first to be paid back before all other holders of securities in the capital structure. This favourable payback priority order is crucial.

The "secured" aspect of senior secured loans refers to the fact that they are secured by collateral such as property. This results in much higher levels of recoveries than unsecured bonds (e.g. high yield) and equities.

Figure 9: Senior Secured Loans – payback priority order



Senior secured loans are secured by companies' collateral such as:



Sources: Invesco

Why now?

- We are in unchartered waters with governments and central banks starting to unwind post-GFC stimulus packages.
- With uncertainty in markets and economics, investors are best positioned at the safe end of the capital structure (i.e. senior secured loans).

CONCLUSION – SENIOR SECURED LOANS: IT'S TIME TO ROTATE

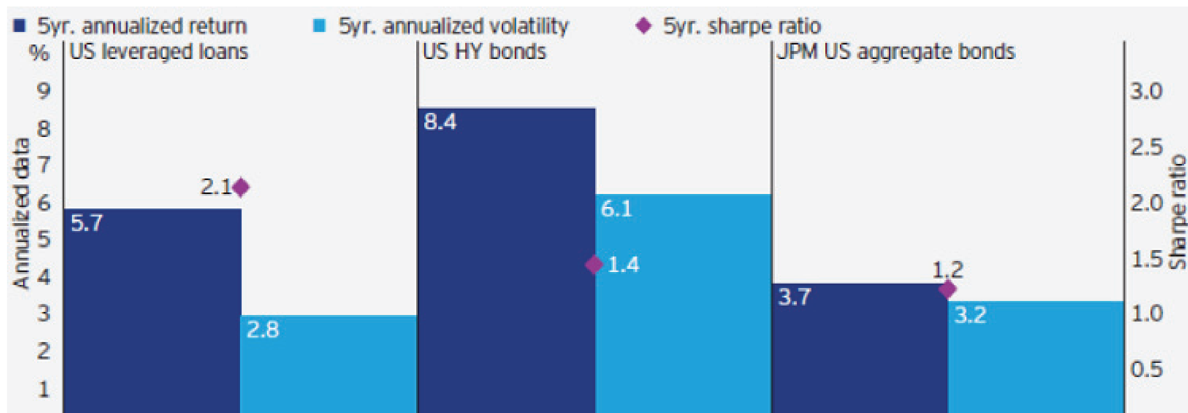
Entering 2017, senior secured loans present an attractive allocation opportunity amid supportive overall credit conditions for borrowers and the benefits that should accrue to owners of floating rate instruments during periods of rising interest rates. As explained above, and shown in Figure 10, loans have provided a combination of strong current income with relatively low volatility given their defensive position in the capital structure and short duration.

The asset class delivered strong performance in 2016, providing investors with favourable absolute and volatility-adjusted returns of 9.88% (Credit Suisse Leveraged Loan Index as at 31 December 2016). As has been the case throughout the post-GFC era, volatility in senior secured loans has been relatively muted because their senior secured status has helped absorb short bouts of uncertainty while the floating rate feature of the asset class has

insulated loans from the pressure felt by longer duration assets late in last year, once interest rates began to rise.

Figure 10: Senior Secured Loans - return-for-risk vs other fixed income instruments

The US loan asset class has delivered a more attractive Sharpe Ratio than other credit investing opportunities. This dynamic is expected to persist in 2017.



Sources: JPM Leveraged loan Index, JPM US HY Bond Index and JPM US Aggregated Bond Index as of Sept30 2016, Latest available data. Past performance is not a guarantee for future results. An investment cannot be made in an index. Returns stated are total returns.

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SENIOR SECURED LOANS – COMMONLY USED TERMS

Important information

Collateral	Assets pledged by a borrower to secure a loan and subject to seizure if the borrower defaults.
Correlation	How securities or asset classes move and perform in relation to each other.
Coupon rate	The stated interest rate on a debt security when it is issued.
Credit risk	The risk that the issuer of a debt security will default on its commitment to pay interest and repay principal.
Credit spread	The spread between Treasury securities and non-Treasury securities that are identical in all respects except for quality rating.
Credit Suisse Leveraged Loan Index	Index designed to mirror the investable universe of the $US-denominated senior secured loan market.
Default risk	The risk that a company will be unable to make required payments on its debt obligation.
Duration	The change in the value of a fixed income security that will result from a 1% change in interest rates. Duration is expressed as a number of years. The bigger the duration number, the greater the interest rate risk.
Floating rate	A floating interest rate is an interest rate that is allowed to move up and down with the rest of the market or along with an index. This contrasts with a fixed interest rate, in which the interest rate of a debt obligation stays constant for the duration of the agreement.
Interest rate risk	Risk that the value of a fixed income security falls if interest rates rise.

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LIBOR	The London Interbank Offered Rate is the daily reference rate based on the interest rates at which banks borrow from other banks in the London wholesale money market (interbank market). LIBOR is among the most common benchmark interest rate indexes used to make adjustments to adjustable rate mortgages
Liquidity risk	The risk that an investment's lack of marketability will prevent it from being bought or sold quickly enough to prevent or minimise a loss.
Loan syndication	The process used by the Primary Bank to break the loan into smaller pieces which are then invested in by other investors.
Recovery rate	The proportion of the recovered debt amount that would be achieved when collateralised assets are sold in the event of a default. A recovery rate of 100% means that there is no loss to the investor.
Sub-investment grade company	A company whose debt has been rated BB+ or lower by key ratings houses Standard & Poor's or Moody's.

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