GLOBAL SENIOR SECURED LOANS: ATTRACTIVE POTENTIAL YIELD WITH HISTORICALLY LOW RELATIVE VOLATILITY

In the low-yield environment of recent years, many investors have found it challenging to meet their yield targets. While additional yield has historically been achievable by taking on added risk, investors may be hesitant to add too much risk to their portfolios, especially as the economic cycle matures. In this environment, senior secured loans may be an option worth considering, as the asset class offers a unique blend of attractive yield potential with some protection against both credit and interest rate risk.

Senior secured loans are commonly issued by below investment grade companies and can be used for a range of purposes such as financing acquisitions, refinancing existing debt and supporting expansion plans. The loans are underwritten by a lead bank and syndicated (or sold) to other banks and institutional investors. They pay a floating interest rate—a base rate (LIBOR), plus an additional fixed coupon—to compensate for the credit risk of lending to a below-investment grade company.

EXAMPLE:
INTEREST RATE PAID BY SENIOR SECURED LOAN BORROWER
Base rate: LIBOR of 2.5% + Fixed coupon/spread: 3.5% = Total Rate: 6.0%

At a high level, senior secured loans have the potential to provide attractive risk-adjusted returns and other portfolio benefits, including:

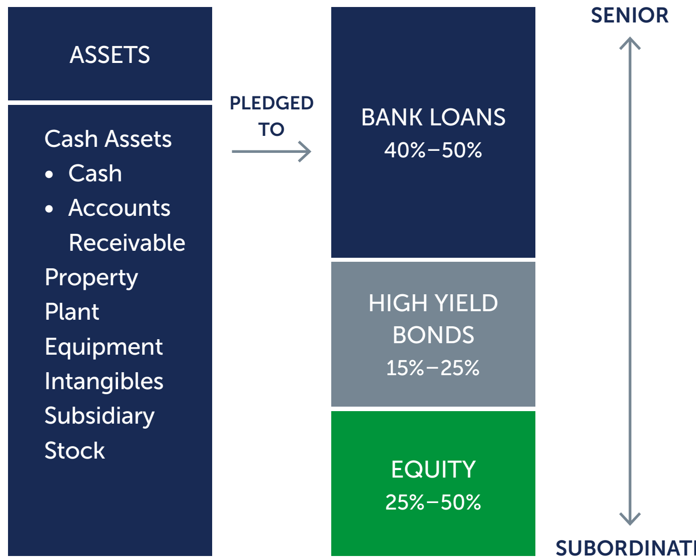
- Credit risk protection through capital structure seniority
- Security in the form of asset-backing and covenant restrictions
- Hedge against rising interest rates
- Diversification benefits / low correlation to equities and other traditional asset classes

Key Characteristics

MULTIPLE LAYERS OF CREDIT RISK PROTECTION

Capital Structure Seniority: Senior secured loans are typically senior to other outstanding debt, including high yield bonds, in an issuing company's capital structure. This seniority means that the loan's interest and principal payments must be paid before other creditors receive payment. In the event of default, senior loan holders also typically get paid back ahead of bondholders, equity holders and other creditors. More junior in the capital structure, equity and high yield bonds can provide a cushion against losses for loan investors (FIGURE 1).

FIGURE 1: REPRESENTATIVE CAPITAL STRUCTURE



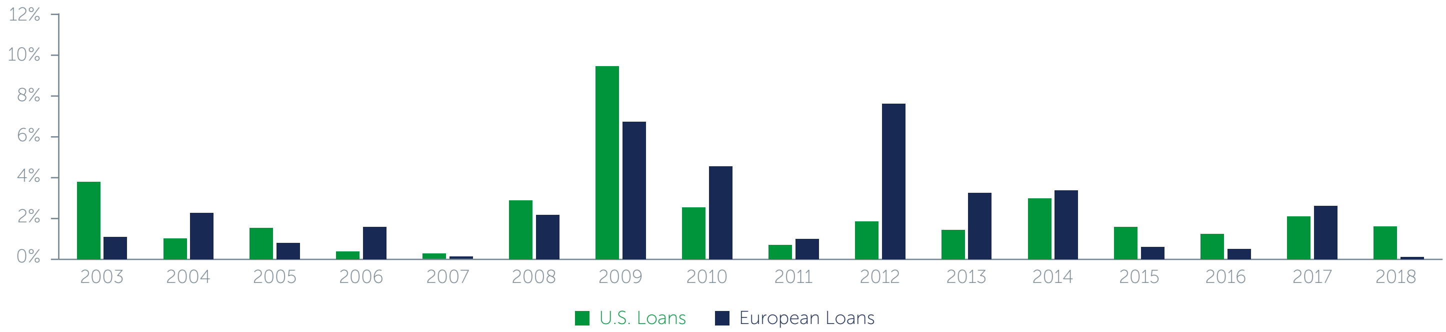
SOURCE: *BARINGS.*

WHAT ARE LIBOR FLOORS AND HOW WILL THEY IMPACT LOANS GOING FORWARD?

A LIBOR floor sets a minimum base rate to be paid on a floating-rate instrument, in this case a senior secured loan. Following the global financial crisis, as interest rates fell to historically low levels, the base rate component no longer offered investors an attractive return. Consequently, LIBOR floors have become common features on newly issued loans.

Currently, loans with LIBOR floors may be particularly beneficial in Europe, given their potential to enhance spreads in regions with lower rates. Going forward, rates in the U.S. and Europe will likely rise at different times and at different paces. As such, the presence of LIBOR floors must be considered as it will impact how quickly a rate rise will be reflected in a loan's coupon payment.

FIGURE 2: HISTORICAL DEFAULT RATES



SOURCE: *CREDIT SUISSE LEVERAGED LOAN INDEX (U.S.); CREDIT SUISSE WESTERN EUROPEAN LEVERAGED LOAN INDEX (EUROPE). AS OF DECEMBER 31, 2018.*

Security: Senior secured loans are secured by some or all of a borrower's assets. This security provides investors with additional credit risk protection as secured loans typically have first-priority claim on a borrower's assets in the event of default.

Covenant Restrictions: Investor interests are further protected by covenants, which are contractual restrictions within the loan's credit agreement that set minimum standards for a borrower's financial conduct and performance during the term of the loan. For example, the borrower may have limitations on the ability to incur additional debt and pay dividends if they are not meeting certain financial requirements.

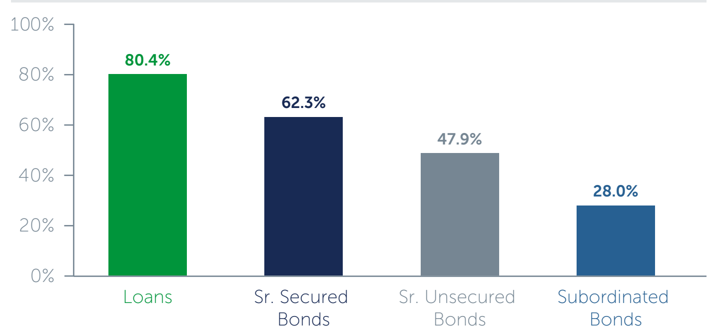
While there is concern in the market regarding an increase in covenant-lite transactions, we don't believe this is necessarily as worrisome as some investors believe. Covenant-lite does not mean the absence of all covenants, rather it refers to loans that lack maintenance covenants, or covenants that require a borrower to meet minimum levels for financial metrics, such as debt-to-EBITDA, at regular intervals.

Based on our observations, there is little data showing that covenant-lite loans lead to lower recoveries. Rather, recoveries are all about the underlying quality of the business. Larger, more established companies tend to have more tools at their disposal to help avoid losses—they may be able to sell non-core business, for example—which has historically led to relatively high recovery levels. With this in mind, as larger companies enter the market, it's not unusual to see some document flexibility, as these tend to be better-quality companies. With smaller businesses and less liquid businesses, higher standards of protection may be more critical.

DEFAULTS IN REASONABLE TERRITORY DESPITE MARKET VOLATILITY

Because senior secured loans are issued to below-investment grade companies, investors may be concerned about the potential for defaults. However, outside of select industry sectors that continue to face headwinds (retail and energy), defaults overall remain below historical averages (FIGURE 2). Because these loans are secured by collateral, they have also historically offered high recovery rates relative to other asset classes. For instance, as of February 2018, the recovery rate for senior secured loans was just over 80%, meaning that in the event of default, for every $1,000 invested in senior secured loans over the period, an investor would have received (recovered) an average of $804 (FIGURE 3).

FIGURE 3: GLOBAL AVERAGE CORPORATE DEBT RECOVERY RATES MEASURED BY ULTIMATE RECOVERIES (1987–2017)



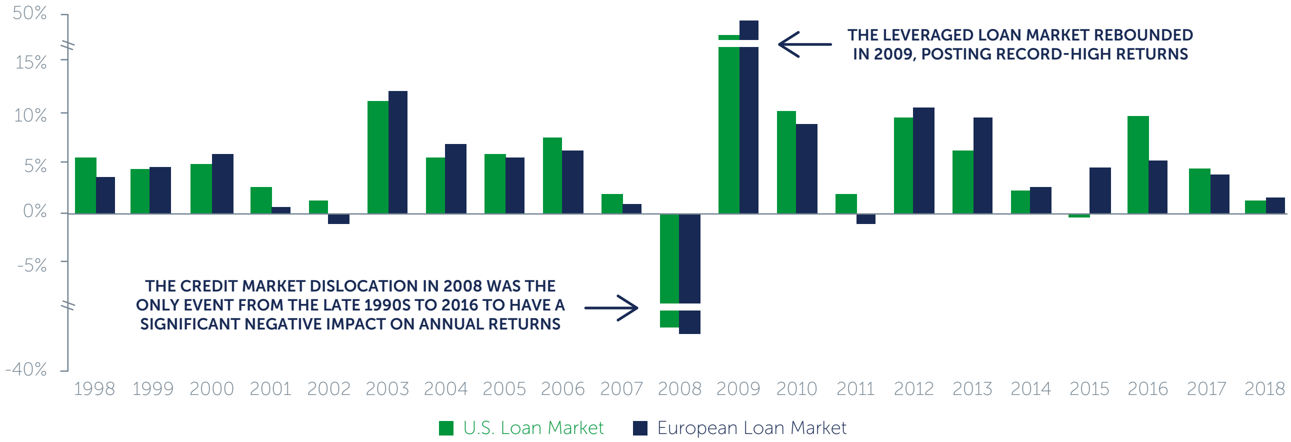
SOURCE: *MOODY'S CORPORATE DEFAULT AND RECOVERY RATES. AS OF FEBRUARY 2018.*

SENIOR SECURED LOANS BY OTHER NAMES

The following terms are also used to describe senior secured loans:

- ***Bank loans*** (the loans are underwritten by a lead bank and syndicated to other banks)
- ***Floating rate loans*** (the interest rate on the loan is not fixed; it typically resets every three months in line with changes in market interest rates)
- ***Leveraged loans*** (when a company borrows, it increases the leverage on its balance sheet)

FIGURE 4: U.S. AND EUROPEAN LOAN MARKET RETURNS



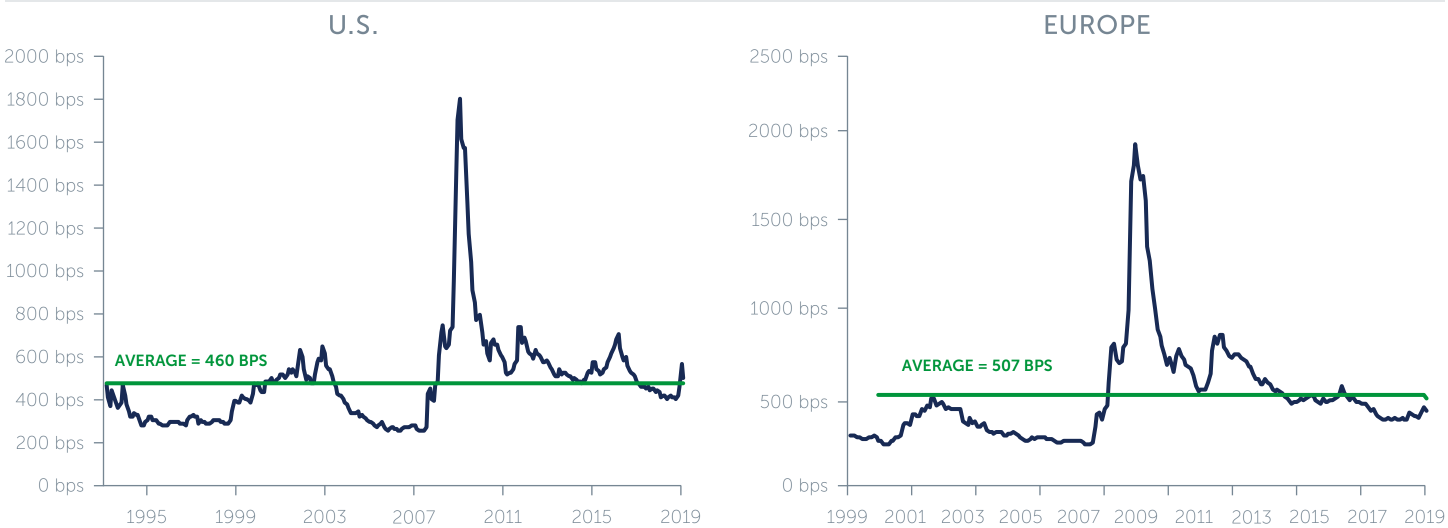
SOURCE: *CREDIT SUISSE LEVERAGED LOAN INDEX (U.S.); CREDIT SUISSE WESTERN EUROPEAN LEVERAGED LOAN INDEX (EUROPE). AS OF DECEMBER 31, 2018.*

ATTRACTIVE LONG-TERM RETURNS

Over the last 20 years, leveraged loans in Europe and the U.S. delivered positive returns over multiple credit cycles and economic downturns (FIGURE 4). The credit market dislocation in 2008 was the only market event during that period to have a significant negative impact on annual returns. Although both leveraged loan markets declined that year, they rebounded in 2009, posting record-high returns.

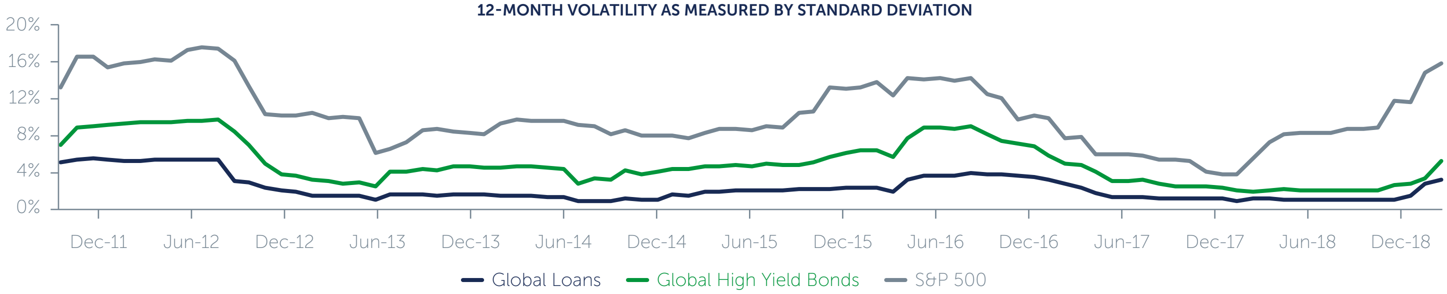
One of the main reasons investors are drawn to senior secured loans is the potential for attractive spreads relative to other fixed income investments. Historically, U.S. and European loans have offered an average spread of 460 and 507 bps over LIBOR, respectively (FIGURE 5).

FIGURE 5: U.S. AND EUROPEAN LOAN SPREADS



SOURCE: *CREDIT SUISSE. AS OF JANUARY 31, 2019.*

FIGURE 6: GLOBAL LOANS HAVE HISTORICALLY DEMONSTRATED LOW VOLATILITY



SOURCES: *BANK OF AMERICA MERRILL LYNCH; CREDIT SUISSE. AS OF DECEMBER 31, 2018.*
GLOBAL LOAN INDEX IS THE WEIGHTED AVERAGE OF THE CREDIT SUISSE LEVERAGED LOAN INDEX AND THE CREDIT SUISSE WESTERN EUROPEAN LEVERAGED LOAN INDEX.

FIGURE 7: CUMULATIVE MARKET RETURNS DURING PERIODS OF RISING RATES[1]

U.S.

	CS GLOBAL LEVERAGED LOAN[2]	CS LEVERAGED LOAN	BARCLAYS U.S. AGGREGATE	BARCLAYS U.S. CORP. IG	BARCLAYS U.S. CORP HIGH YIELD
February '94–February '95	N/A	10.38%	0.01%	-0.99%	1.55%
June '99–May '00	4.40%	3.93%	2.11%	-0.04%	-3.21%
June '04–June '06	13.58%	12.64%	6.54%	6.22%	17.85%

EUROPE

	CS GLOBAL LEVERAGED LOAN[2]	CS WESTERN EUROPEAN LEVERAGED LOAN	BARCLAYS PAN-EURO AGGREGATE	BARCLAYS PAN-EURO CORP. IG	BAML EURO CURRENCY HIGH YIELD
October '99–October '00	5.67%	8.56%	6.86%	6.33%	-3.95%
November '05–June '07	12.88%	14.28%	2.41%	3.20%	17.21

SOURCE: *CREDIT SUISSE, BARCLAYS, BANK OF AMERICA MERRILL LYNCH.*
1. NON-U.S. INDEXES ARE HEDGED TO USD.
2. GLOBAL LEVERAGED LOAN INDEX IS THE WEIGHTED AVERAGE OF THE CREDIT SUISSE LEVERAGED LOAN INDEX AND THE CREDIT SUISSE WESTERN EUROPEAN LEVERAGED LOAN INDEX.

PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS.

How Senior Secured Loans Fit into a Portfolio

POTENTIAL DIVERSIFICATION BENEFITS

One of the main reasons for including senior secured loans in a portfolio is the potential diversification they can add. This has been highlighted in recent years by their historically low volatility compared with other asset classes (FIGURE 6) as well as lower correlation. In the context of a broadly diversified portfolio, this may potentially reduce the portfolio's volatility and increase its long-term risk adjusted return potential.

LOWER INTEREST-RATE SENSITIVITY

Rising interest rates are a chief concern for most fixed income investors. There tends to be an inverse relationship between interest rates and the price of a fixed income security—when rates increase, the value of fixed income assets decreases, with the value of longer-dated bonds generally impacted the most. Senior secured loans, which offer floating rate coupons, can decrease sensitivity to short-term interest rates, and have historically provided some degree of protection against rising rates in the U.S. and Europe (FIGURE 7).

Seeking Relative Value

A global approach to investing in senior secured loans can help investors capitalize on relative value opportunities in the asset class. For example, while the U.S. and European senior secured loan markets both offer exposure to below investment-grade credit, the factors driving each market can vary. As a result, loans issued by the same company, with the same terms, can and have traded at materially different valuations if one is denominated in euros and the other in dollars.

A range of technical factors including new issuance volume, CLO issuance and flows in and out of retail mutual funds, can also create relative value opportunities. Changes in these technical factors can cause the market price of a security to decouple from its underlying fundamental value. Investors with long-term horizons may be able to capitalize on these market dislocations by buying securities that may be underpriced or selling securities that may look rich relative to their fundamental value.

One example of such an opportunity occurred from mid-2015 through the first quarter of 2016. As energy prices fell, U.S. loan mutual funds, which have greater exposure to energy than European loans, experienced notable outflows. In addition, because there was no equivalent pressure on the European side—UCITS[1] have only a very limited ability to hold loans—European loans fared much better than U.S. loans, with the divergence in price based on technical factors rather than fundamentals. That was one period when U.S. loan spreads decoupled materially from those in Europe, and it was an opportune time for active managers, like Barings, to take advantage of the relative value created.

Given how quickly market prices can react to changes in technical factors, a strategic global allocation to senior secured loans can facilitate the timely capture of evolving relative value opportunities in the global market. A number of technical factors can influence market prices and potentially lead to opportunities for active mangers, including:

- ***Retail mutual fund flows*** are an example of a market technical that can be driven by sentiment, which may have very little impact on the underlying financial health of companies issuing senior secured loans. That disconnect between sentiment and fundamentals can create attractive value opportunities. The fact that loans are not available as an investment option for retail investors in Europe is another factor that can drive differences between the markets.
- ***CLO issuance***, as noted earlier, generates relatively steady demand for senior secured loans and can help mitigate the ebb and flow of retail demand for the asset class. This counterbalancing effect may help keep loan prices more stable than they might otherwise be. Of course, there are also times when CLOs may trade cheap relative to their underlying loans, creating a specific value opportunity within this subset of the asset.

WHAT TO LOOK FOR IN A MANAGER

Senior secured loans offer potentially attractive yields (even after adjusting for default risk), as well as some degree of credit and interest-rate risk protection. To make the most of the investment opportunity—and to best navigate the highly specific idiosyncratic events at the asset class, sector, company and individual security level—it is critical that investors partner with active managers that have a presence across geographies and the ability to analyze and price idiosyncratic credit risk.

Barings has a global team dedicated to investing in below investment grade credit. With more than 70 investment professionals, the team has a local presence across different regions and a long-term track record of managing both U.S. and European loans. Our local presence is critical to our ability to dig deep into each individual issuer, while our global footprint allows us to pivot toward regions and companies where we see the best opportunities.

Conclusion

Senior secured loans can offer investors a unique blend of attractive yield potential and some protection against both credit and interest rate risk. In addition, the asset class can potentially provide: ***Multiple layers of credit risk protection, less volatility, attractive long-term returns, diversification benefits and relative value opportunities.***

RISK PROFILE

While we see many benefits to investing in global senior secured loans, it is also important to consider the potential risks. Although this asset class is senior in the capital structure, investors may still be exposed to losses in the case of issuer defaults. Securities rated below-investment grade may have a greater risk of default and investors should consider such risks in the context of their overall investment portfolios. Investors may also be exposed to price fluctuations and/or losses, which can result from changes in overall market conditions or issuer-specific fundamentals.

At Barings, our primary goal is to deliver attractive risk-adjusted returns for our clients. To best manage risk, we conduct rigorous, bottom-up credit analysis in our initial underwriting process and regularly track key credit metrics to ensure the investment thesis for each credit that we invest in remains intact.

1. Undertakings for Collective Investment in Transferable Securities

Barings is a $303+ billion global financial services firm dedicated to meeting the evolving investment and capital needs of our clients and customers. Through active asset management and direct origination, we provide innovative solutions and access to differentiated opportunities across public and private capital markets. A subsidiary of MassMutual, Barings maintains a strong global presence with business and investment professionals located across North America, Europe and Asia Pacific.*

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**As of December 31, 2018*

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