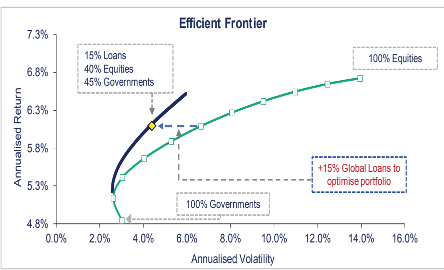
Taking a global view

Jim Fitzpatrick reveals how an active, global approach is key to investing in loans market

Senior secured loans continue to offer a relatively defensive combination of features (floating rate, well diversified, senior and secured), which make them, in our assessment, well suited to meet the needs of many institutional investors. With so many idiosyncratic features, it is perhaps no surprise that they can bring a welcome degree of diversification to fixed income portfolios.



At the same time, the investment environment has changed. Central banks have gradually moved away from quantitative easing, and the economic environment has the potential to introduce volatility for certain industries and individual borrowers.

We believe this presents an opportunity for active managers to capitalise on the increased dispersion of returns across geographies and between sectors, to generate alpha from asset allocation and security selection.

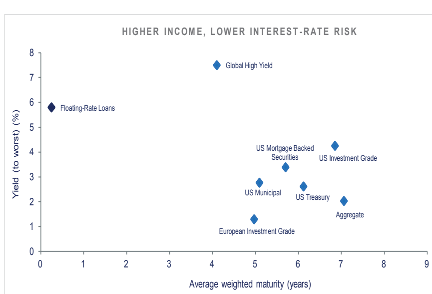
We believe it also reinforces the importance of an active, global approach underpinned by disciplined fundamental research if managers are to be able to navigate this new environment successfully.

Senior secured loans

Senior secured loans (loans), or bank loans as they are sometimes called, are private loans made to companies whose credit rating is sub-investment grade. They will typically be syndicated or shared across ten or more institutional lenders, and proceeds used for a variety of purposes, from consolidating debt and re-capitalising the company to funding acquisitions and leveraged buy-outs.

As the name suggests, a senior secured loan will be senior in a borrower's capital structure and secured on assets. Holders will typically have the first claim on the assets and cashflows of a company, with the loans themselves secured on assets which can be sold in the event of problems. The rights of lenders to protect their capital and the obligations on the borrower are set out in each loan credit agreement in the form of a series of covenants or requirements. Recovery rates in the event of default for loans have historically been significantly higher than for other creditors at 80 per cent in the US and 70 per cent in Europe.

Loans pay interest at rates that change periodically on the basis of a floating-rate lending rate, typically based on LIBOR or EURIBOR plus a fixed spread or risk premium reflecting the credit risk of the borrower. This floating-rate structure also means that loans tend to have a lower interest-rate duration, or sensitivity to interest-rate changes, than other fixed income securities with similar maturities.



With an estimated market size of $1.1 trillion in the US and €190 billion in Europe, well diversified by geography and sector, we believe the asset class makes it a good fit for the needs of many pension funds. If the projected benefits of the asset class are to be realised, however, we believe investors should be cognisant of the changing investment environment, and particularly the likelihood that we will see further volatility and increased dispersion of returns in the future.

Opportunity

This can be seen as an opportunity to generate alpha from asset allocation and security selection. However, if this is to be successful we believe it requires an ability to invest globally, in both Europe and the US. This gives managers the flexibility to protect investors on the downside and to capture upside opportunities during periods of market volatility. By taking a global approach to investing in the loans market, an investor increases the opportunity set and has the flexibility to allocate between geographies to take advantage of relative value differences across markets.

Perhaps even more importantly, we believe it requires disciplined fundamental research. Being highly selective, maintaining credit discipline and not 'buying the market' is critical if alpha opportunities are to be identified and challenging markets navigated safely. Assessing the business model, capital structure and whether an investor is being paid an appropriate risk premium to compensate both for the probability of default and loss given default are at the heart of making good lending decisions and delivering satisfactory returns to investors.

Written by Jim Fitzpatrick, head of global loans, CQS