Insights

Leveraged loans

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Offering ongoing stability and the potential for attractive returns against a volatile investment backdrop

Recent volatility displayed within global risk markets has we believe once again served to underline the case for an allocation to leveraged loans.

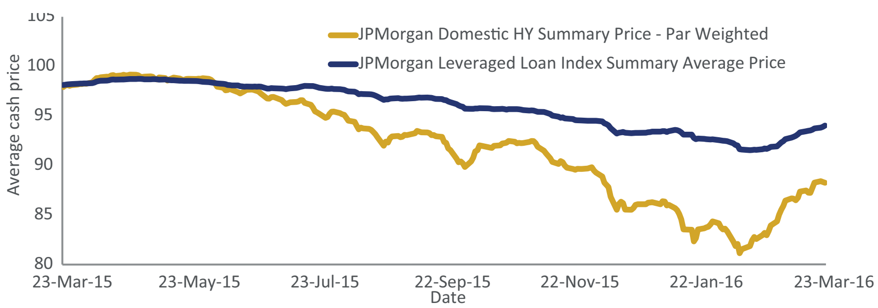
Sitting at the top of the credit capital structure, we have seen loans in both Europe and the US display remarkable resilience and consistency of returns through the course of the year so far (as we would have expected). At the height of the market weakness in mid-February, European leveraged loans (as measured by the JP Morgan European Leveraged Loan Index) posted losses of around -75bps (to 16 February 2016), while the equivalent figure for European high yield (HY) bonds was -350bps (as measured by the BAML European Currency High Yield Constrained Index). Similarly, over these timescales, US loans returned approximately -150bps (JP Morgan US Leveraged Loan Index) while US HY bonds returned -475bps (BAML US High Yield Bond Index) over the same period.

Although leveraged loans have not participated to the same degree in the rally witnessed since mid-February (European and US loans having now posted positive returns on the year of +80bps and +168bps respectively (as measured by the respective JPMorgan indices), versus European HY bonds returning +163bps and US HY bonds returning +325bps (to 31 March 2016)), this is exactly the stability of returns and protected downside that we would expect to see from the leveraged loan asset class and which we have witnessed over time, as indicated by the charts below.

A less volatile asset class

US loan price volatility over the past year has been significantly lower than that displayed by US HY bonds - particularly highlighted during early 2016 (Fig. 1).

Fig. 1 Loan versus bond average price



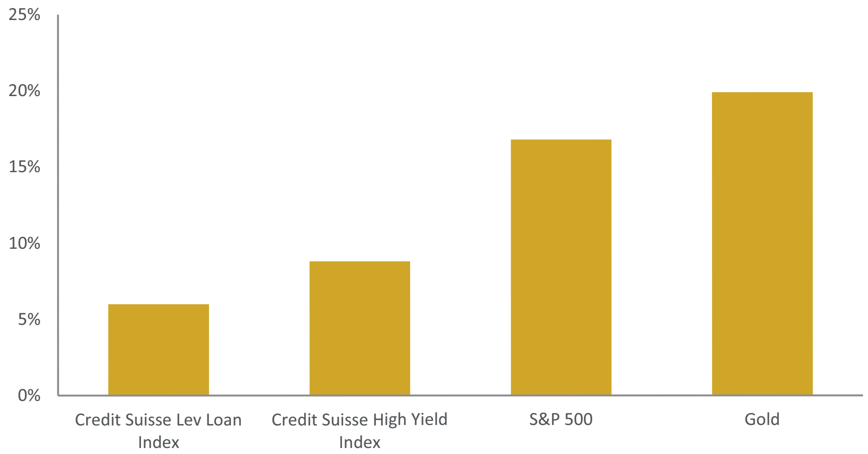
Source: JPMorgan, as at 24 March 2016

RBC Global Asset Management

The relative stability of loan price action in relation to bonds (and indeed other major asset classes) is exactly what we have observed and come to expect over time (Fig. 2).

We believe now is an opportune moment to express positive views on the asset class

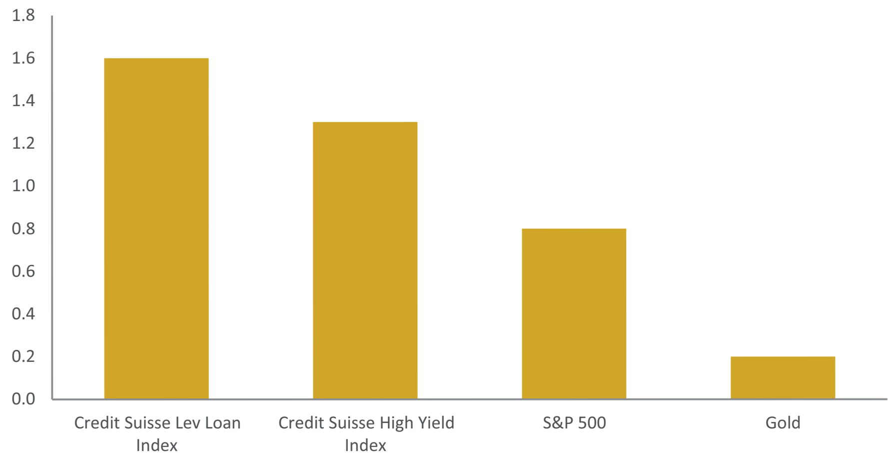
Fig. 2 Annualised volatility



Source: Credit Suisse, Bloomberg. Data from Jan 2009-October 2015

Expressing the return achieved from each of these asset classes in the context of the volatility experienced, highlights the risk-adjusted effectiveness of loans as a broad asset class (Fig. 3).

Fig. 3 Return per unit of risk



Source: Credit Suisse, Bloomberg. Data from Jan 2009-October 2015

Why consider an allocation to leveraged loans now?

Acknowledging the long-term merits of loans as an asset class, it is still important to challenge whether now is the right time to invest? However, we believe the following reasons suggest that now is indeed an opportune moment to express a positive view on the asset class.

1) **Compelling relative value:** The exaggerated return profile displayed by the HY bond portion of the leveraged finance market has resulted in a significant contraction of the bond versus loan spread over recent weeks. In the US, HY bonds have outperformed (by around 100bps in recent weeks) bringing the spread differential between the asset classes back to 'normal' levels of approximately 160bps (US loans yielding less than bonds). However, European loans currently have a higher yield, with European HY bonds outperforming significantly over the past month. In our view, this represents a compelling relative value entry point into the loan portion of the asset class.

2) **Outright levels of yield:** In addition to the relative value displayed against HY bonds, it's important to acknowledge that outright yields are equally attractive in our view at ~7% in US leveraged loans and >6% in Europe (measured by the respective JPMorgan loan indices to a three year take-out). Given the defensive

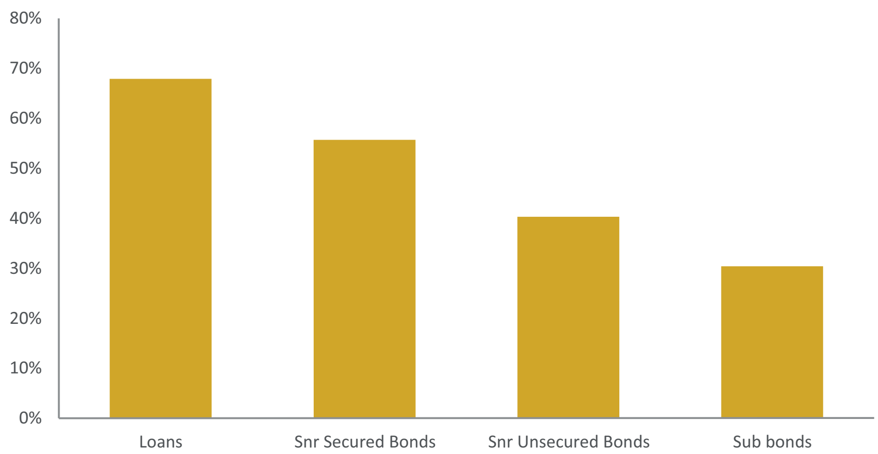
nature of the asset class (described below), we believe these to be compelling levels.

3) **Volatility to remain elevated:** We believe volatility within risk markets will likely remain elevated over the medium term with economic fundamentals, global monetary policy and commodity prices likely to remain in a state of flux. As displayed above, we believe in this environment loans can offer a more impervious return profile.

4) **Rising default rates:** We expect a significant increase in resource-related defaults over the course of the next 12-18 months. Given the resources sector represents around only 5% of the global loan market, we expect loan defaults to track markedly lower than HY bonds over the coming months, which could contribute to lower price volatility.

5) **Recovery rates:** While there will be some default activity in the loan market, the structurally senior nature of the asset class has meant that recovery rates within loans are significantly higher than elsewhere in leveraged credit (as evidenced in Fig. 4). We expect this could continue to be the case going forward.

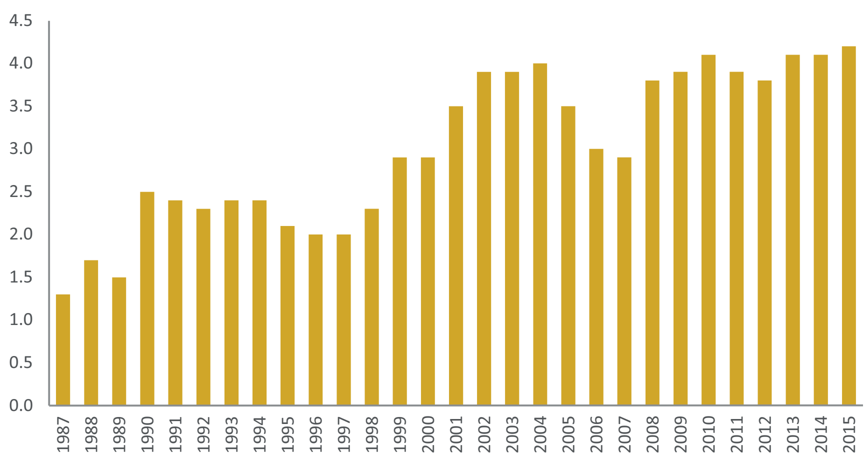
Fig. 4 Historical recovery rate



Source: JP Morgan, as at 31 December 2015

6) **Debt affordability:** Leverage multiples within the sector have plateaued and are beginning to show some signs of marginal decline (improvement). Of note in the last quarter, US loan issuers grew EBITDA by 6% year on year; we believe this compares favourably to the 3% growth shown for non-commodity HY bond issuers. Most importantly, as evidenced by the cash interest coverage chart (Fig. 5), the ability to service this leverage is much greater than we saw during 2005-2007: i.e. debt is much more affordable today.

Fig. 5 EBITDA/cash interest



Source: S&P Capital IQ data, as at 31 December 2015

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7) **Balanced demand:** Following a long period of outflows, US-based retail funds are now finally witnessing a reversal in this trend. In Europe, the retail investor base has no impact on demand; rather, we believe the institutional and bank investor base is of much greater significance. Importantly on the latter, we are now witnessing increased participation once again as banks are forced to invest negative-yielding capital. At the moment, in our view demand appears to be well supported on both sides of the Atlantic.

Taking the above factors in combination, we believe the leveraged loan asset class represents a prudent investment at this stage of the cycle. Similarly, we feel there are strong reasons to employ a global approach to deploying this strategy.

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The merits of a global approach

1) **Diversification:** The flexibility to consider corporate issuers in both Europe and the US allows us to deploy our highly-selective credit investment criteria across a wider range of assets allowing us to 'cherry pick' the best value issuers to even greater effect.

2) **Attractive yield on spread levels:** As mentioned previously, loans in both the US and Europe still enjoy attractive headline levels of yield, trading around 7% in the US and upwards of 6% in Europe (equating to similar spreads in both regions of around 600bps). Given the comparable spreads on offer, we feel there are attractive opportunities on either side of the pond.

3) **Diverging corporate cycles:** It is generally acknowledged that the European corporate business cycle is still in an expansionary/recovery phase. A global approach allows us to access potential beneficiaries of this growth in Europe while balancing with a more defensive approach to the more mature stage of the US cycle.

4) **Supportive monetary policy:** Diverging policy cycles in the US and Europe offer differing opportunities. On the one hand, an accommodative backdrop in Europe allows access to policy-induced corporate support, while the prospect of rising interest rates in the US gives access to increasing floating rate returns.

5) **Second order European Central Bank effect:** Although not directly impacted by ECB corporate bond activity, European leveraged assets have the potential to benefit from their activity as investors are crowded into more 'yieldy' asset classes.

In summary, we believe that global leveraged loans represent a compelling asset allocation choice. A structurally senior, income producing asset class displaying low levels of return volatility is, in our opinion, well suited to today's increasingly uncertain risk markets.

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