

# Adding Alpha to Leveraged Loan Portfolios

## Flexibility and Relative Value Analysis are Key Drivers

Senior secured loan mandates are rising in popularity as interest rates trend higher amid growing political risks in Europe and the U.S., and greater global macroeconomic uncertainties.

At PGIM Fixed Income, we are frequently asked, “Why loans? Why allocate to loans *and* high yield bonds? Just loans? Just bonds? Direct lending vs. syndicated lending?”

While there are many contrasting views and opinions, in our view, many of these issuers are of similar credit quality, indeed sometimes *pari passu* from the same issuer, and so flexible mandate parameters and ‘relative value’ analysis can be the key drivers of performance.

### Key attributes of loans

Leveraged loans are first lien senior secured obligations at the top of a corporate capital structure. As a result, they are usually less volatile than unsecured issues, and can offer downside protection and higher recovery rates in the event of default.

Indeed, downside protection is the primary reason loans can outperform high yield bonds in a high default environment. Conversely, if default rates are expected to be generally low through an economic downturn, loans are likely to underperform bonds.

Loans are floating rate assets and as such provide an interest rate hedge during periods of rising rates—an environment the U.S. is in already and one that may be approaching in Europe.

Loans are ‘prepayable.’ This is a weakness compared to high yield bonds as it removes the ability for capital gains in the new issue market and limits further upside potential, which can be material. In the secondary market, a loan trading above par can repay at par on notice. This is one of the weakest facets of loan buying—having to assess prepayment risk and associated potential losses.

Additionally, post-financial crisis, high yield bond investors have regularly demanded a greater ‘all in’ spread to loan investors. This, coupled with call protection and a low default and rate environment, have been the main sources of high yield bond outperformance relative to loans in recent years.

### Investing in both loans and bonds

Ultimately, investors may benefit by choosing an asset manager with capabilities in both sectors. There are good and bad loans, just as there are good and bad high yield bonds. A manager that can find attractive opportunities in both sectors can build a stronger portfolio and better manage loss avoidance than one with a limited investment universe. Flexibility is especially valuable in the European loan market, which is small and relatively illiquid, lacking sufficient depth to be both selective and reasonably diversified.

For a mandate with issue and issuer flexibility, an asset manager can select credits that offer strong fundamentals and relative value. This flexibility can reduce market overweights to particular sectors, for instance cable or retail, and enables managers to select more attractive issuers, especially if a company offers only loans *or* bonds. If a company issues both loans *and* bonds on a *pari passu* basis, then a relative value decision can be made which also takes into account technicals and liquidity, as well as spreads.

### Tracking relative value of spreads

The chart below illustrates the spreads of single-B rated European and U.S. issues across the loan and bond markets. As you can see, relative value varies across sectors through cycles and macro events such as the U.S. energy crisis in 2015 and the European sovereign crisis in 2011.

This picture still can be misleading, however. Within the U.S. loan segment, for instance, there is a wide variation in spread levels due, in part, to distressed sectors such as energy and retail, despite all issues being rated single-B by the credit rating agencies.

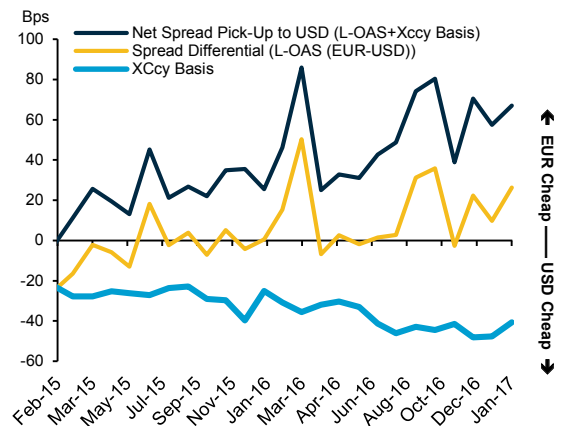
### Tracking relative value across markets

Tracking cross-market issuers on a Euro vs. USD basis, as well as a loan vs. bond basis, is another useful valuation tool. These results, combined with our relative value analysis that compares issuer fundamentals, outlooks, and spreads in a particular geography by industry, provides a platform to assess which issuers appear attractively valued relative to a global name.

The spreads of global high yield bonds denominated in Euro vs. USD are shown above. As you can see, on

a swapped basis, Euro high yield spreads offer greater value than U.S. spreads. At least part of this differential, however, is required as the European market is relatively less liquid than the U.S. market.

### Spread Differential of Select Dual Currency Issuers Tracked By PGIM Fixed Income (Median EUR - USD L-OAS)<sup>2</sup>



Separately, a proprietary option model also helps to assess relative value. Using option valuation, and assumptions about interest rates and spread volatility, the model assesses the value of call protection to adjust the spreads on a like-for-like basis for loans and bonds.

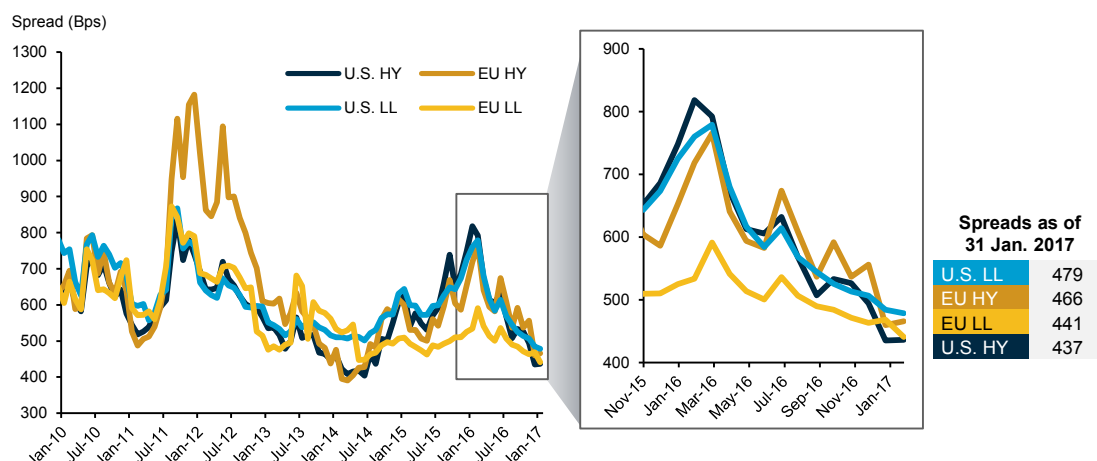
By expanding the investable universe and employing a combination of these relative value tools, portfolio managers are likely to identify value and generate extra alpha, leading a portfolio to outperform the market across a cycle.

### Adding alpha via hedging and trading

Finally, a number of traditional loan investors may avoid high yield bonds due to their inherent interest rate risk. In this instance, it may be prudent to consider a portfolio of both loans and bonds, with interest rate risk neutralized to the benchmark via swaps or treasury futures. Alternatively, investors may consider a high yield bond mandate with a LIBOR benchmark, with interest rate risk hedged to LIBOR.

While some investors like the idea of ‘direct lending,’ this is an area we frequently caution. An actively-managed, liquid portfolio with a large number of credits can improve returns by avoiding defaults and making trading gains which can, in part, offset losses. Conversely, direct loans lack the early warning signals of marked-to-market pricing and, because they are relatively illiquid, the investor may be subject to credit events and the vagaries of a restructuring.

### European and U.S. High Yield Bond and Bank Loan Spreads: Single B-Rated<sup>1</sup>



Source: IPE Magazine, March 2017. This information contained herein represents views and opinions as of 10 Feb. 2017. Past performance is not a guarantee or a reliable indicator of future results. An investment cannot be made directly in an index.

<sup>1</sup>As of 31 Jan. 2017. Source of U.S. and EU data: Credit Suisse. Bond spreads represent spread to worst. Loan spreads represent 4-year discount margin 5-year swap adjusted. <sup>2</sup>Sources: PGIM Fixed Income and Bloomberg as of 3 Feb. 2017. Callable bond spreads are adjusted for interest rate and credit spread volatility. 2017-0828



**Jonathan Butler**  
Managing Director  
Head of European Leveraged Finance  
PGIM Fixed Income

[www.pgimfixedincome.com](http://www.pgimfixedincome.com)



**PGIM** FIXED INCOME