
Senior Secured Loans Myths Busted: 10 reasons you need to take a second look at the asset class

Invesco Australia

Executive summary

This paper provides a thorough examination of Senior Secured Loans, challenging common misconceptions and highlighting the asset class's potential as a valuable investment option.

Senior Secured Loans are often overlooked in favour of traditional bonds due to misconceptions about their safety, liquidity and portfolio fit. However, a closer analysis reveals that these loans offer unique advantages that make them worthy of consideration in investment portfolios.

Contrary to popular belief, Senior Secured Loans are not inherently riskier than bonds. In fact, they are secured and sit at the top of the capital structure, offering greater recovery rates in the event of default. This is further reinforced by the diversified nature of the loans market, which encompasses a wide range of industries and issuers.

Additionally, Senior Secured Loans exhibit impressive liquidity, with high trading volumes and daily pricing mechanisms. This liquidity, coupled with the loans' superior yield and minimal duration risk, makes them an attractive option for investors seeking income and capital preservation.

Senior Secured Loans have demonstrated resilience in the face of uncertainty and rising interest rates, outperforming traditional fixed-income assets during periods of economic turbulence. Their low correlation to other fixed-income assets and consistent income streams contribute to their appeal as a diversification tool within investment portfolios.

Despite their below investment grade rating, Senior Secured Loans have historically delivered stable total returns, with mark-to-market downticks being short-lived. Moreover, improvements in company fundamentals, such as declining leverage and healthy interest coverage ratios, provide further support for the stability of Senior Secured Loans in the years ahead.

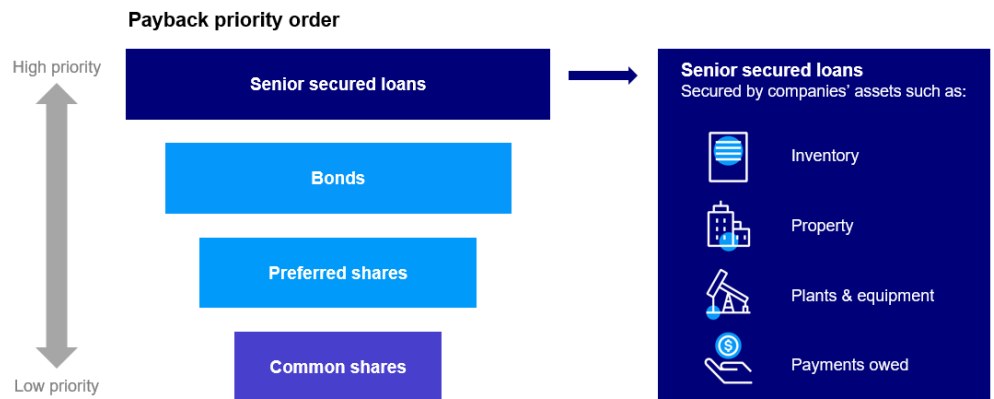
Myth 1: Bonds are safer than Senior Secured Loans

Simply put – this is completely backwards. Bonds are typically an unsecured, subordinated investment, while Senior Secured Loans are secured and sit at the top of the capital structure.

Senior Secured Loans are the senior most obligation and secured by the company’s assets, including inventory, property, plants and equipment and payments owed. They are also first in right of repayment as the company generates free cash flow.

As you can see from Figure 1, which illustrates a typical capital structure, Senior Secured Loans sit above bonds in the payback priority order.

Figure 1: Senior Secured Loans in the corporate structure



Source: Invesco. For illustrative purposes only.

In contrast, bonds sit below loans in the capital structure, are typically unsecured and subordinated in terms of right of repayment, and also generally mature after the loans.

If a company defaults, loan holders typically get 60 to 70% of their capital back, which is more than double the recovery rates from subordinated unsecured bonds.

With recessionary risks rising, being at the safest part of the capital structure has rarely been more important.

Myth 2: The Senior Secured Loans market is niche

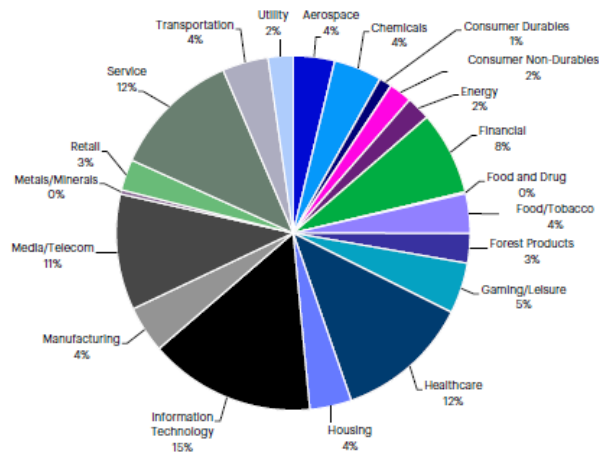
This couldn't be further from the truth. The Senior Secured Loans asset class is large and highly diverse with approximately 2000 issuers across more than twenty industries and a USA and Europe market valued at approximately US\$2.0 trillion.

Senior Secured Loans is an asset class that doesn't get much attention in Australia, but this is not true in the rest of the world. With a USA and Europe market valued at approximately US\$2.0 trillion, the asset class has significant scale and forms an important element of funding globally for a diverse collection of large companies.

Some high-profile companies that have used Senior Secured Loans for funding include T-Mobile, American Airlines, Four Seasons Hotels and Burger King. Half of the companies in Invesco's flagship US Senior Loan Fund would be in the fortune 1000 if they were public.

The market across the US and Europe is comprised of approximately half private and half public companies with approximately 2000 issuers across more than twenty industries. In the US, the loan market is bigger than the high yield bond market.

Figure 2: Senior Secured Loans market



Source: S&P/LSTA Leveraged Loan Index as at 31 December 2023.

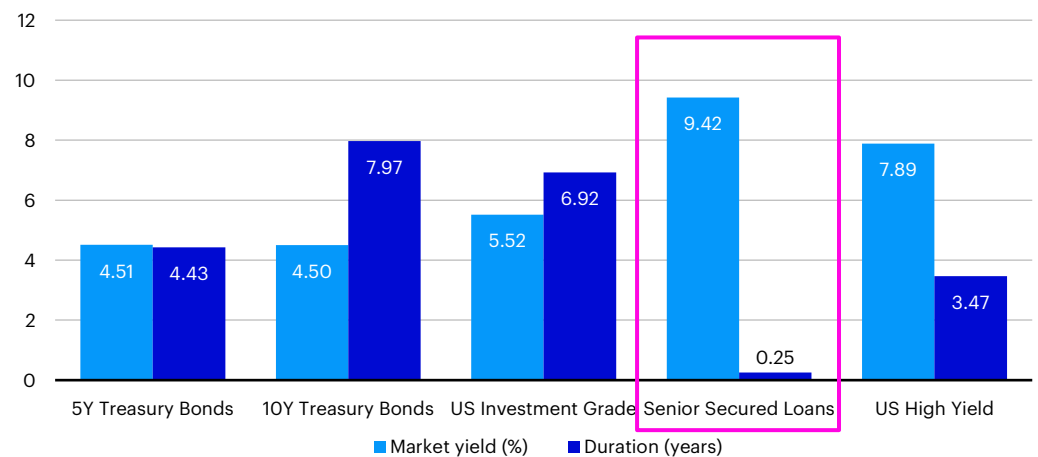
Figure 2 shows the diversification of the US Senior Loans market by industry. This level of diversification is critically important in an asymmetric asset class like credit where your upside is limited, and your downside can be significant if an industry is in distress, or a company goes into default. This contrasts to the Australian debt market, which is dominated by banks and residential property, and therefore highly concentrated by industry and issuer.

Myth 3: Traditional bonds yield enough

Traditional bonds expose investors to significant duration risk, when you compare this to Senior Secured Loans, you can access an asset that provides greater yield with little-to-no duration risk.

The reason investment grade and Government bonds performed so well over the last few decades is the same reason they have delivered negative returns in the current rising rate environment – they’re “all in” on interest rate risk, as highlighted by the dark blue bars in Figure 3.

Figure 3: US Senior Secured Loans yield/duration dynamic



Source: Barclays, JP Morgan, Credit Suisse, and Bloomberg L.P. as of May 31, 2024. The Bloomberg US Corporate Bond Index represents US investment grade, the Credit Suisse HY Index represents US High Yield and Credit Suisse Leveraged Loan Index represents the Senior Secured Loans. Loans utilise Yield to 3 year rather than Yield to Worst.

In contrast, senior secured loans are “all in” on corporate credit risk, with near zero interest rate risk.

Focusing on the light blue bars in the figure above, loans are offering a yield of 9.42% including the forward SOFR curve, which is more than double the current yields from treasuries and 3.9% higher than investment grade yields.

When compared to high yield bonds, which obviously have a much greater credit component, loans are providing a better coupon and a better yield despite the fact that they are senior secured and at the top of the capital structure, whereas High Yield Bonds are typically unsecured and subordinated. This would logically suggest that High Yield Bonds would actually provide a greater yield, something that is clearly not the case.

This is not just true of today. Over the last 10 years, US loans have provided the best median yield-to-worst of any traditional US or European fixed income asset class at 6.33%, beating US High Yield at 6.24% but with less volatility than high yield. No other fixed income asset class is north of 5.5%.

So, if you are looking to materially increase your yield and significantly reduce your interest rate risk, there is no better option than Senior Secured Loans to achieve this.

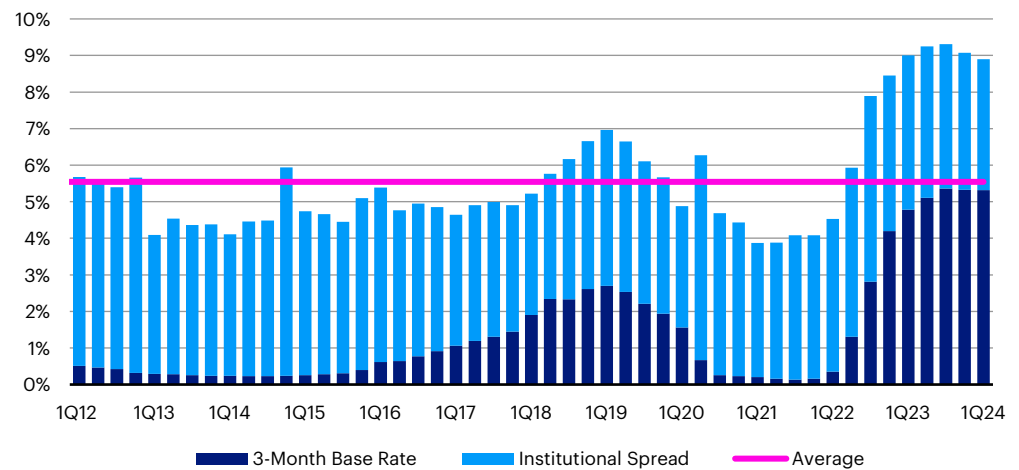
Myth 4: Elevated income won't last

Let's dive deep into Senior Secured Loans history and debunk the belief that the elevated income offered by Senior Secured Loans can't last. Through-out market cycles Senior Secured Loans have consistently delivered high levels of reliable income.

Total loan coupons are sitting at their highest levels in decades, and this doesn't seem likely to change soon. Actually, the forward curve would suggest elevated income levels are going to last for quite some time.

Loan income comprises of the base rate (dark blue bars), plus a credit spread (the light blue bars) as shown in Figure 4. As you can see, coupons rise and fall in lockstep with changes to base rates and over the last 12 years, the total coupon has averaged about 5.5% p.a. in US dollars (the pink line).

Figure 4: US Senior Secured Loans income



Source: Pitchbook LCD as of 31 March 2024. Base rate reflects the average during the quarter. Uses three-month LIBOR (prior to 2023) or SOFR (2023 or later) plus the weighted average institutional spread. Updated quarterly.

Right now, coupons are about 9% and remain well above the long-term average.

The forward curve would suggest that we are going to see perhaps one rate cut late this year, which means investors are going to clip that 9% for most of the year. This is far longer than forecasted at the beginning of the year when it was estimated the US Federal Reserve (the Fed) would cut rates six times in 2024.

Additionally, even when the Fed does start cutting, the easing cycle is expected to be far shallower than previously expected, with policy rates expected to bottom in 2026 at 4.25%. That would be 3.0% higher than the average of the last 10 years so if the long-term average for loans returns is 5.5% when base rates were 1.25% on average, you can see how loan coupons could remain well above historic levels even at the bottom of the rate cut cycle.

Myth 5: Below investment grade is risky

While the term “below investment grade” certainly has negative connotations, when it comes to Senior Secured Loans it pays to investigate what this term really means and how the asset class has performed over the long-term. Senior Secured Loans are made to large well-established companies and are back by assets – making them far safer than you might think.

Senior Secured Loans are, as we’ve already highlighted, secured by the assets of the underlying company and sit at the top of the capital structure. This alone provides a significant level of risk mitigation.

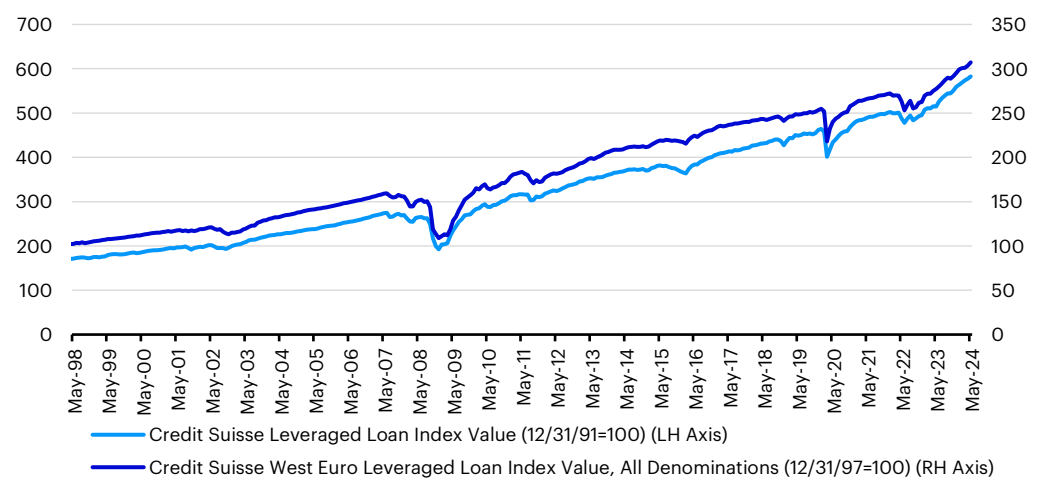
To clarify how Senior Secured Loans work, they are privately arranged loans issued to a consortium of banks and institutional creditors that provide companies with access to debt capital.

Generally, borrowers are corporates and the loans are typically dedicated to corporate purposes (such as capital expenditure), M&A-related transactions or refinancing debt. Importantly, Senior Secured Loans include credit risk mitigation mechanisms, such as comprehensive collateral packages (i.e. share pledges) and covenants.

Additionally, as we’ll explore later in the paper, the underlying fundamentals of these companies (generalised across the asset class) are strong.

Through the vast majority of periods since 1998, loans have produced a very stable and upwardly sloping line as shown in Figure 5.

Figure 5: Historical loan valuations



Source: Credit Suisse as of May 31, 2024

The mark-to-market downticks in loan valuations during the GFC and Covid were short-lived with very rapid and strong recoveries, which is testament to the senior secured status.

It’s important to note that you continue to get your high level of monthly income through these periods and, if anything, they present as buying opportunities for long term investors. As a result of this high current income (5.5% on average as referenced previously), price volatility is buffered with loans having only three years of negative returns over the past 32 years.

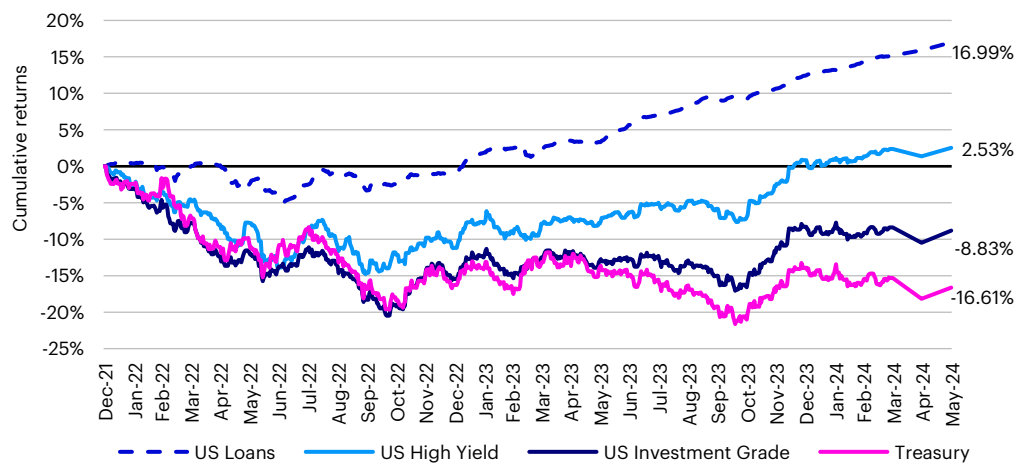
Myth 6: Uncertainty is bad for Senior Secured Loans

Myth 6 follows on from our talk of interest rate risk, not only does the lack of duration mean the Senior Secured Loans asset class offers a smoother ride, it offers direct complementarity to the ups and downs of bonds exposed to the impact of market sentiment on the yield curve.

Uncertainty is a guarantee for all investors trying to predict the future and over the last two years we have had uncertainty in many forms, from rate hikes to the possibility of hard or soft landings, yet still loans have produced strong positive returns of 17% cumulatively through this period with low volatility, benefiting greatly from the floating rate feature and senior secured status.

In contrast, traditional bonds have produced negative returns and been highly volatile, with treasuries losing 16.6% and investment grade credit losing 8.83%, while high yield bonds have recovered recently to be +2.53% cumulative.

Figure 6: US Senior Secured Loans returns compared to fixed rate bonds



Sources: PitchBook Data, Inc.; Bank of America Merrill Lynch; Bloomberg as of May 31, 2024. The Morningstar LSTA US Leveraged Loan Index represents US Loans, the ICE BofA US High Yield Index represents US High Yield, the ICE BofA US Corporate Index represents US Investment Grade, the ICE BofA Current 10-Year US Treasury Index-TR represents Treasury. An investment cannot be made directly in an index.

This is par for the course during rising rate periods. Loans typically outperform every other traditional fixed income asset class during periods of rising interest rates.

Due to their lack of duration, loans have little to no correlation to any other fixed income asset with the exception of high yield bonds and even there the correlation is 0.7. This is a great illustration of the benefits of including loans to help diversify defensive portfolios.

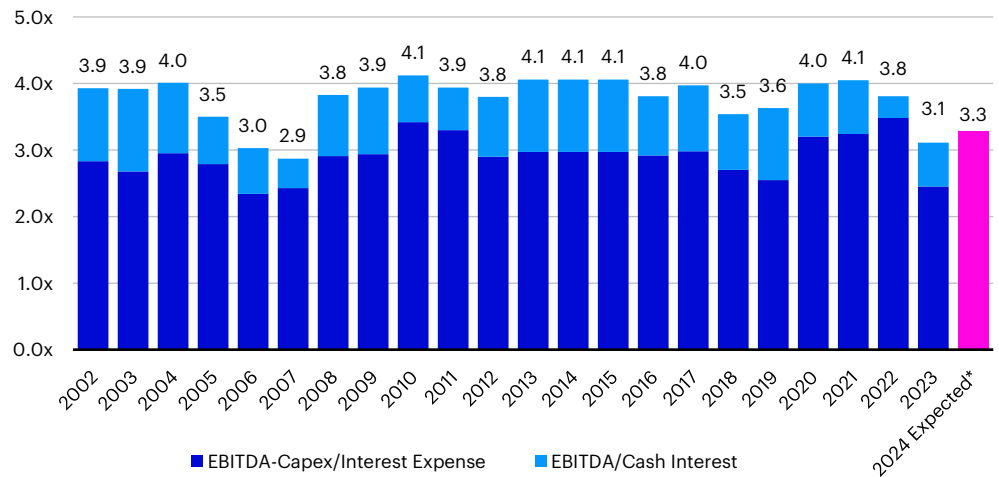
With uncertainty in the economic environment still ahead and talk of the “higher for longer” world, we would expect loans to continue to produce superior risk-adjusted returns because of their high coupon.

Myth 7: Company fundamentals are weak

As we've touched on already, Senior Secured Loans are all in on "corporate credit risk" and our data clearly shows that companies are in better shape than expected with leverage declining and interest coverage ratios remaining healthy.

There are two main measures of company fundamentals. The first is leverage and by this measure company fundamentals are improving with leverage (LTM Debt divided by EBITDA) lower today at 4.5 times than it was in 2019 when it was 4.8 times.

Figure 7: Interest coverage across the loan market



Sources: PitchBook Data, Inc. Interest coverage ratios of leveraged loans. Data through 31 December 2023, updated quarterly. *Based on Barclays research stating a 1% rate cut equates to a positive 3/8 turn impacting interest coverage ratios.

If we look at interest coverage ratios, which is a measure of the borrower's ability to service its interest costs, you can see ratios peaked at 4.1 times in 2021 and, not surprisingly, have declined as rates rise but are still at a healthy 3.3 times (expected) in 2024. Given the level of concern for interest coverage ratios is typically 1.5 times, this offers comfort that in general the companies within the Senior Secured Loans asset class are not likely to suffer distress anytime soon.

What's important to understand here is that this is the overall market data. It is the tail of companies with ratios less than 1.5 times that is important to manage and this 4-5% of the market is where active management really matters.

Starting in 1Q 2022, when the rate hiking cycle began, our team proactively completed several portfolio reviews, which included stress testing every company for rising rates, inflationary pressures and recessionary risks. As a result, the portfolio has been transitioned in favour of companies that are well positioned to weather the current and forward-looking environment. For example, we have taken our portfolio from 5% overweight Bs to 15% underweight Bs.

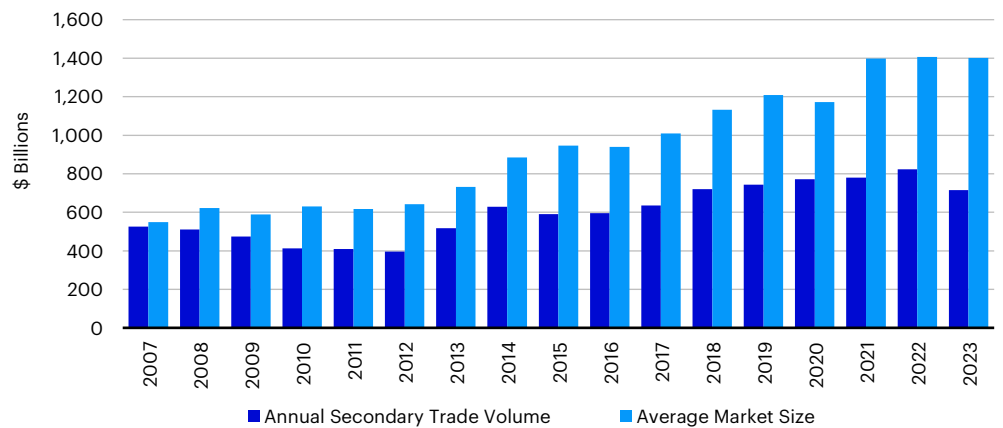
While we absolutely expect defaults to rise in the next one to two years (we expect defaults will rise to 3-4%, which is broadly that same percentage that has interest coverage ratios below 1.5x), the market has already priced in these expected defaults. So, if anything, with the market currently priced at 96 cents in the dollar, there is capital upside potential.

Myth 8: The Senior Secured Loans market is illiquid

Senior Secured Loans are daily priced and offer daily liquidity with over half of loans on issue trading on each day (more than double that of corporate bonds).

When it comes to liquidity, unlike other forms of private credit, Senior Secured Loans are daily priced and offer daily liquidity. The market has also grown consistently and significantly over the last fifteen plus years.

Figure 8: US loan market secondary trade volumes



LSTA Secondary Market Trade Data Study as of December 31, 2023. Credit Suisse Leveraged Loan Market Statistics as of December 31, 2023, annual update.

As shown in the Figure above, the US loan market has nearly tripled from US\$550 billion pre-GFC to be US\$1.4 trillion today and the annual secondary trading volume is approximately US\$800 billion p.a. over the last few years.

About half of the loans on issue trade each day, whereas for corporate bonds only 20% of issues trade on any given day.

The liquidity of the market allows for a number of daily liquid access methods including ETFs, daily liquid retail mutual and comingled institutional loans funds.

This can be a great complement to domestic loan market exposure, which is less liquid and dominated by Australian investors.

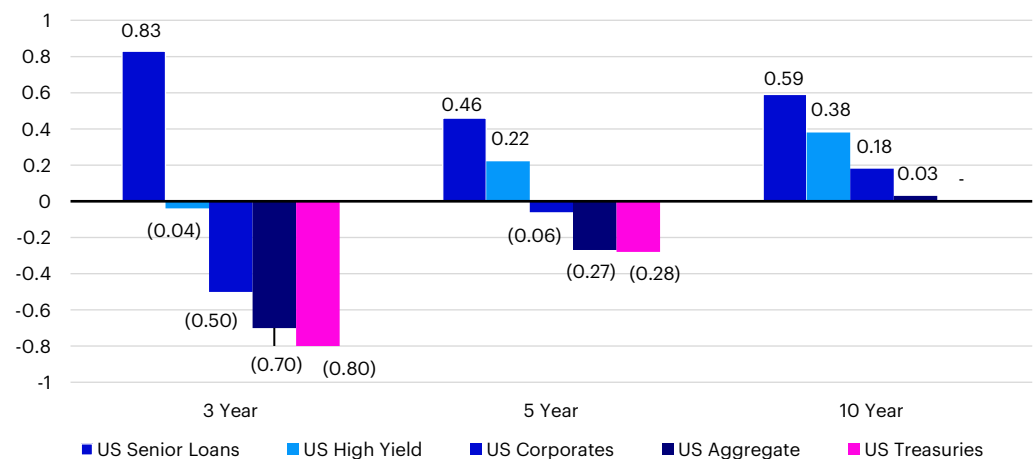
Myth 9: Markets price risk efficiently

For a low-risk asset class, we believe the market consistently prices Senior Secured Loans incorrectly – and the data backs us up.

A Sharpe Ratio doesn't lie. If you look at the Sharpe Ratios or the volatility adjusted returns of various fixed income assets, Senior Secured Loans stand out on top, as shown in Figure 9.

Over the 3, 5 and 10 year periods, loans have produced far superior risk-adjusted returns versus the fixed rate debt spectrum.

Figure 9: Historical Sharpe ratios for risk assets



Source: Credit Suisse, Bloomberg L.P., and Barclays Data as of 31 March 2024. Updated quarterly. US Senior Loans is represented by the Credit Suisse Leveraged Loan index, US High Yield by the Credit Suisse High Yield Index, US Corporate by Bloomberg US Corporate Index, US Aggregate by the Bloomberg US Aggregate Index, and US Treasury by the Bloomberg US Treasury Index. An investment can not be made in an index. Sharpe ratio utilizes annualized total return of 90-day T-Bills for the periods ending 31 March 2024. Past performance is not a guarantee of future results.

On the return side, this outcome is driven by the 4 to 5% p.a. spread you get paid above cash to more than compensate you for investing in below investment grade corporates.

On the risk side, as discussed earlier, the volatility of loans remains low because of the floating rate feature and senior secured status.

In fact, whether you consider risk as volatility, frequency of negative returns (only three in the last 32 years) or risk of permanent capital loss, Senior Secured Loans have consistently provided a low-risk outcome over the last 30+ years.

Myth 10: Loans don't fit in traditional portfolios

Senior Secured Loans may not fit neatly into the fixed income bucket – but that doesn't mean they don't belong in a client's portfolio. Loans are suitable for core allocations within diversified and income portfolios.

Hopefully by now we have convinced you that Senior Secured Loans have a role to play in client's portfolios. As a low-risk, complementary asset that delivers high levels of current income, there's a lot to like about the asset class.

Loans are suitable for a core allocation within both diversified and income focused portfolios.

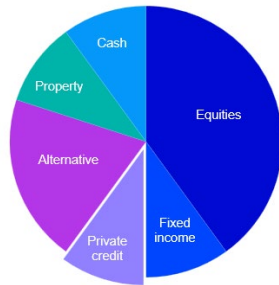
Within diversified portfolios, loans are a complement to core bonds as a means of diversifying away from fixed rate assets like government bonds. As discussed already, due to their floating rate nature, loans have little to no correlation to any other fixed income asset, with the exception of high yield bonds, and even there the correlation is 0.7. We typically see allocations to loans within diversified portfolios funded from fixed income and equities.

Within Income portfolios, loans provide a differentiated and complementary source of high income. We have demonstrated the consistency of income across all rate cycles, and we expect that coupons will remain elevated above historical levels even after the oncoming rate cut cycle is complete. For income portfolios, we typically see allocations to loans funded from fixed income and hybrids.

Figure 10 demonstrates how private credit allocations, like Senior Secured Loans, can fit into a portfolio.

Figure 10: Private credit's role in a portfolio

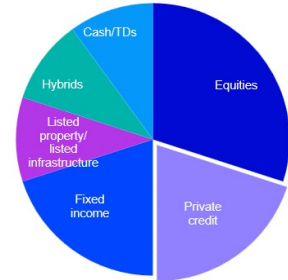
Diversified portfolio



Role: Complement to core bonds to diversify away from fixed rate assets to government bonds

Typical funding source: Fixed income and equities

Income portfolio



Role: Differentiated and complementary source of high income through a core allocation

Typical funding source: Fixed income and hybrids

Source: Invesco. For illustrative purposes only.

Conclusion

In busting the above myths, we hope to clearly highlight Senior Secured Loans as a compelling investment option, offering attractive yields, minimal duration risk, and diversification benefits. Debunking common myths surrounding these loans reveals their potential to enhance portfolio performance and resilience across various market conditions. As investors navigate an uncertain economic landscape, Senior Secured Loans present a valuable opportunity to optimise risk-adjusted returns and bolster income streams within investment portfolios.

Myth	Reality
Bonds are safer than Senior Secured Loans	Secured by a company's assets, sitting at the top of the capital structure, and having first right of repayment; Senior Secured Loans are safer than bonds.
The Senior Secured Loans market is niche	Senior Secured Loans have approximately 2000 issuers across more than twenty industries and a USA and Europe market valued at approximately US\$2.0 trillion.
Traditional bonds yield enough	Senior Secured Loans provide greater yield than bonds with little-to-no duration risk.
Elevated income won't last	Through-out market cycles Senior Secured Loans have consistently delivered high levels of reliable income.
Below investment grade is risky	Senior Secured Loans are made to well-established, global companies and are backed by a company's assets – making them far safer than you might think.
Uncertainty is bad for Senior Secured Loans	Senior Secured Loans offer direct complementarity to the ups and downs of bonds exposed to the impact of market sentiment on the yield curve.
Company fundamentals are weak	Companies are in good shape with leverage declining and interest coverage ratios remaining healthy.
The Senior Secured Loans market is illiquid	Senior Secured Loans are daily priced and offer daily liquidity with, on average, over half of loans on issue trading each day.
Markets price risk efficiently	Our data shows that Senior Secured Loans have consistently delivered superior risk-adjusted returns over the last 10 years.
Loans don't fit in traditional portfolios	Loans are suitable for core allocations within diversified and income portfolios.

Important information

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