Leveraged Loans: Characteristics and Performance

Leveraged loans have been an attractive asset class because they offer a substantial cash return, while also containing features that mitigate risk. The discussion below highlights loan features that mitigate risk, and reviews characteristics of the loan market today. High yield bonds are used as a comparative asset class.

- Floating vs. Fixed Rate: The vast majority of high yield bonds are fixed rate. In contrast, leveraged loans are floating rate, tied to LIBOR. In turn, when interest rates rise, LIBOR rises, loan interest payments rise – and loan mutual funds typically see inflows, not outflows.
- Capital Structure: Leveraged loans are typically the most senior liability in a company's capital structure and are usually secured by almost all of the company's assets. In contrast, according to S&P Capital IQ LCD's Weekly Wrap, as of Nov. 30, 2015, 80% of outstanding high yield bonds are senior unsecured.
- Default: The average default rate in the S&P/LSTA Leveraged Loan Index since its inception in 1998 is 3.2%. According to Moody's, in October 2015, the high yield bond default rate was approximately 4%, while the leveraged loan default rate was less than 2%.
- Recovery (and Loss Rates): According to S&P Capital IQ LCD, the weighted average historical loan recovery given default on senior secured loans has been 80.1 cents on the dollar. In comparison, the weighted average recovery given default on senior unsecured high bonds is 41.1%. Between a lower default rate and much higher recovery rate, the loss rate on loans is significantly lower than the loss rate on high yield bonds.
- Industry exposure: The loan market has modest exposure to the energy sector. As of December 2015, energy accounted for 3% of the Leveraged Loan Index. At the same time, it accounted for 13% of the S&P high yield bond index.
- Exposure to CCC names: Being senior and secured, loan ratings are typically higher than high yield bond ratings – and there tend to be fewer very low rated loans. As of December 2015, CCC assets accounted for 5% of the Leveraged Loan Index. They accounted for 13% of the S&P high yield bond index.
- Prices: Because loans are senior, secured and floating rate, secondary loan prices tend to be relatively stable. In 2015, prices in the S&P/LSTA Leveraged Loan Index have declined less than three percentage points. In contrast, prices on the Merrill Lynch High Yield Bond Index have dropped nearly nine percentage points.
- Return volatility: In addition to characteristics that make loan prices more stable, the majority of the loan investor base tends to be longer-term patient money, including CLOs and separate accounts. This reduces price and return volatility. As of November 2015, return volatility of loans, measured by the 12-month lagging standard deviation of returns, is 0.77% for loans vs. 1.76% for high yield bonds.