Senior Loans: Investing in Private Debt Today is Possible

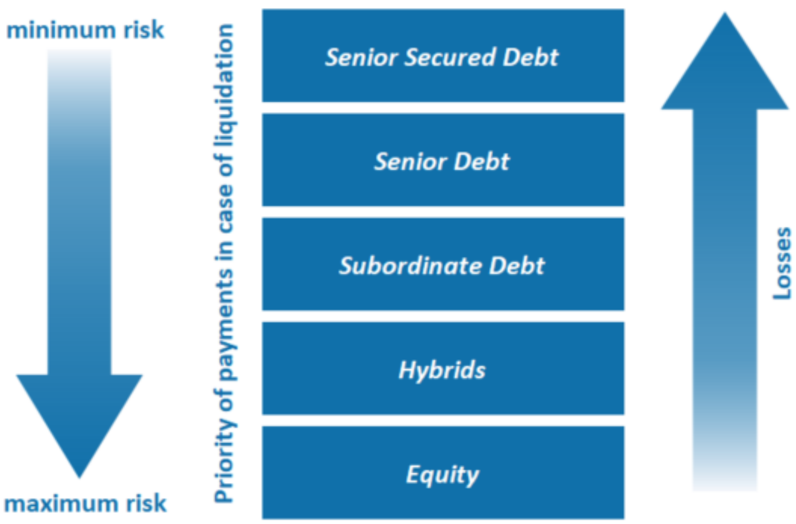
An Alternative to Traditional Corporate Bonds

In a market context where interest rates are at a historic minimum, investors are struggling to find investment solutions with interesting yields and simultaneously moderate credit risk.

Yet in recent years the exponential growth of an initially niche, non-traditional market segment has been noted: senior loans. The US loans market is the oldest and most mature; from 1999 until today the amount of debt in circulation grew from 90 billion to 890 billion USD with average yields around 4% to 5% per year.

What are senior loans?

Senior loans (or *leveraged loans*) are collateralized loans issued by banks or other financial intermediaries to non-investment grade corporates.



Companies generally use these types of loans as an alternative source of funding to finance normal business activities, as well as acquisitions, debt refinancing, and expansion projects - optimizing their capital structure.

They are called *senior* because in the case of insolvency the bond holder has seniority and must be repaid before the other creditors. Furthermore, historically they benefit from higher recovery rates compared to other debt instruments. In addition, these credits are often guaranteed by company collateral assets such as machinery or land, therefore offering higher guarantees than traditional unsecured senior bonds. Loans are then transferred to a commercial or investment bank which will securitize them, including structuring to placing the notes on the market.

Why invest in senior loans?

Mitigate the risk of interest rates thanks to the variable rate structure.

Senior loans are generally structured with variable rates so that the fluctuation of interest rates does not impact their market value.

In turn, the sensitivity of the portfolio to such fluctuations decreases, which ultimately provides important security in the case of increased volatility.

This increases their value and potential, especially when placed in the actual market context where after years of accommodative monetary policy the central banks seem to have coordinated action to normalize interest rates.

They present a lower credit risk than high yield bonds. Senior loans offer security in collateral and in the prioritization of issuer reimbursement, which is why their default recovery rates are much higher than other debt instruments. From 1998 to 2015 the average recovery value of senior loans was 80.1% in comparison to the 55.4% average of all unsecured senior bonds and 41.1% of only high yield unsecured bonds.

They are less liquid compared to traditional instruments. Given that these loans are less liquid they offer a higher return on investment. This presents a risk for those who might have liquidity needs but it is not an obstacle for those with medium to long-term investment objectives.

Low correlation with other asset classes. In a portfolio view, loans are able to provide better diversification, thus increasing the expected return and reducing the risk. The loans, as shown by the S&P/LSTA Leveraged Loan Index, have demonstrated over the past 10 years a low correlation with European government securities (0.14) and a negative correlation with the Treasury and U.S. corporate bonds (-0.36).

In addition, in the same period loans showed a moderate correlation with the U.S. stock market, the EU equity market, and emerging markets.

They show a low volatility with high yield corporate bonds or the equity market. This is due to the limited liquidity of the secondary market, the reduction of interest rate risk, and their seniority in the capital structure. They contribute to the stabilization of the portfolio by providing a considerable and steady cash flow.