the myth of overcrowding in the bank loan market

By John Bell & Kevin Perry, Bank Loan Portfolio Managers
Cheryl Stober, Bank Loan Product Manager

may
2014

Bank loan retail mutual funds grew 82.5% in 2013, as measured by total net asset value.[i] This headline-grabbing figure has bank loan investors wondering if the market is overcrowded, eroding potential benefits that attracted investors last year. We do not believe the bank loan market is overcrowded and think bank loans are still attractive. Even with sizeable retail inflows, mutual fund assets comprise only a small portion of the total bank loan market, and the growth of retail assets has not meaningfully altered the dynamics of the bank loan market. In our view, signs of overheating are notably absent—price stability remains intact and spreads are above historical averages.

KEY TAKEAWAYS

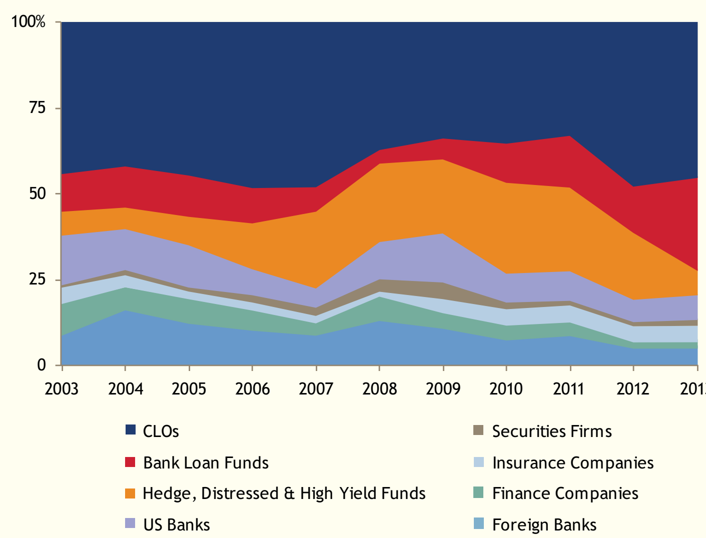
- The growth of retail bank loan assets has not meaningfully altered bank loan market dynamics.
- Signs of an overheating bank loan market are notably absent—price stability remains intact and spreads are above historical averages.

A SIZABLE MARKET WITH MODERATE SHIFTS

The bank loan market is estimated to be in excess of $1 trillion and larger than the high yield market.[ii] The bank loan market continues to grow, supported by a slowly expanding economy and robust corporate health. For example, the par amount outstanding of S&P/LSTA Leveraged Loan Index grew by over $130 billion in 2013. Part of this growth was due to $607 billion of new issuance. Some market observers noted this level of issuance with alarm, as if new money were crowding into the asset class and spurring low-quality issuance. However, unlike other fixed income asset classes, one third of the bank loan market typically turns over in a normal year, since the average life of a bank loan is approximately three years. Any discussion regarding bank loan issuance needs to be understood in this constant-rotation context. In reality, 61% of 2013's issuance was refinancing and recapitalization of existing loans. In contrast, leveraged buyouts (LBOs), which represented an average 24% of new issuance prior to the global financial crisis, totaled only 13%.

So what types of investors are purchasing bank loans? Domestic and foreign banks, insurance companies, finance companies, securities firms, institutional and retail funds, and structured products such as collateralized loan obligations (CLOs) broadly represent the diverse investor base for bank loans. More narrowly, hedge, distressed and high yield funds also purchase bank loans alongside more traditional bank loan funds.

BANK LOAN INVESTORS OVER TIME



Source: Lipper FMI and S&P Capital IQ LCD as of 12/31/2013.

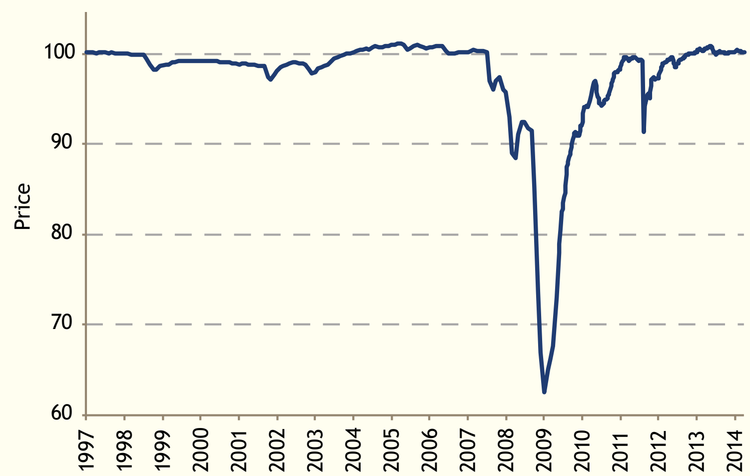
While retail bank loan funds experienced strong flows over the past couple of years, retail mutual funds and exchange-traded funds (ETFs) represent a small part of the bank loan market, with positions totaling less than $200 billion. In fact, the biggest source of demand for newly issued bank loans in 2013 came from CLOs, which purchased 45.2% of new issuance. A simple annual average shows that CLOs have been responsible for 41.7% of bank loan demand over the past 12 years. Bank loan funds, retail and institutional, purchased 26.7% of new issuance in 2013, about double the amount purchased in 2012. Retail mutual fund growth occurred at the same time as a similar magnitude dip in participation by hedge, distressed and high yield funds. The composition of mutual funds participating in the bank loan market has changed slightly as retail investors have adopted the asset class. However, the overall distribution of investor types in the broad market has not changed significantly, and we believe the changes to date have not adversely impacted market technicals.

OVERCROWDING SIGNALS ABSENT

One of the appealing aspects of the bank loan asset class is its price stability. Bank loans typically have no more than minimal call protection and often are paid off quickly, with an average life of three years. With refinancings occurring at par, bank loan prices tended not to vary much throughout history, with the exception of the global financial crisis, as shown in the chart at right. If the bank loan market were overheated, we would expect loan prices to exceed 101, with demand pushing prices to elevated levels. Despite the growth in retail funds last year, the median bid of bank loans spent most of 2013 and the first quarter of 2014 in the 100.0 to 100.5 range.

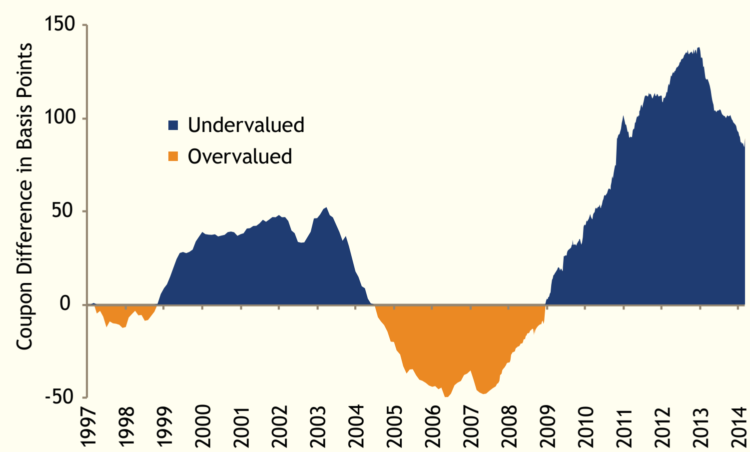
With prices at fairly normal historical levels, we think coupons are the other objective factor to assess market overcrowding. The historical weighted average coupon for bank loans is LIBOR+344 basis points. Recent coupons of LIBOR+433 basis points are above historical averages and do not suggest overcrowding, as shown in the lower chart at right. As discussed above, the bank loan market has experienced steady rates of refinancing, a trend we believe will continue as interest rates rise. In the face of such consistent supply, we would expect coupon levels closer to historical tights, or at least historical averages, if the market were overcrowded today.

MEDIAN BID OF THE S&P/LSTA LEVERAGED LOANS INDEX



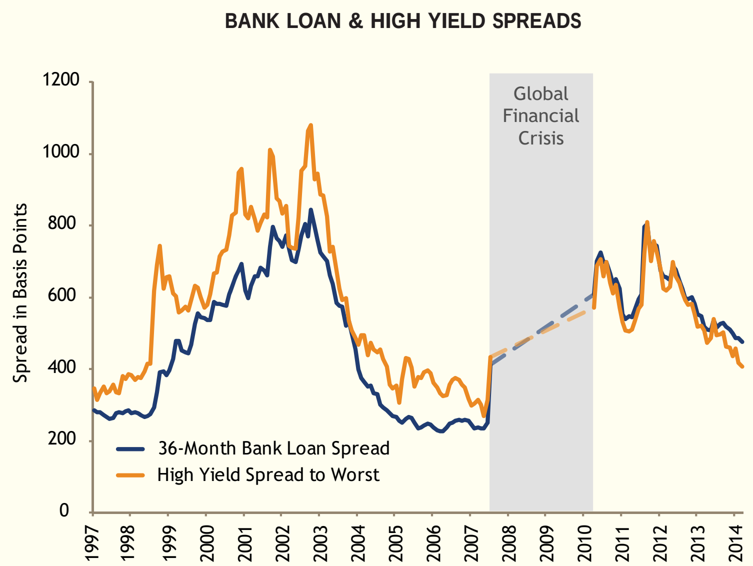
Source: S&P/LCD from 1/1/1997 to 3/31/2014.

DIFFERENCE IN WEIGHTED AVERAGE COUPON BETWEEN ACTUAL & AVERAGE SINCE INDEX INCEPTION



Source: S&P/LCD from 1/1/1997 to 3/31/2014.

Another way to assess valuation in the bank loan market is to compare yields of bank loans, which are typically senior and secured, to high yield debt. The best way to compare bank loans and high yield is to look at high yield on a spread-to-worst basis and bank loans on a 36-month spread basis.[1] As shown in the chart at right, prior to the global financial crisis, high yield spreads were above bank loan spreads, compensating investors for assuming higher risk. Post-crisis, however, bank loans and high yield have had very similar spreads, with bank loan spreads slightly higher in more recent periods. Just prior to the crisis, the high yield and bank loan markets spent several years at significantly below average spreads, and in our opinion, this same combination would be a warning sign of overcrowding. Since these signals are missing, it suggests to us that bank loans generally offer attractive yields on an absolute basis and relative to high yield.



Sources: S&P/LCD and Credit Suisse from 1/1/1997 to 3/31/2014. Data from the global financial crisis excluded.

SUMMARY

Over the past two decades, bank loans have grown into an asset class that tends to operate in recognizable ways. While a broadening investor base has brought new attention to this asset class, it has not altered the bank loan market, or the triggers we would expect to see in an overcrowded space. In our view, the price and spread characteristics associated with overheating are not apparent in the market.

[1] *Both conventions measure the same concept (the expected life of the underlying security) for each asset class. Spread to worst is a spread based on the lowest yield an investor could receive if any call were exercised or the bond reached maturity, which implicitly incorporates the market's view of a security's likely tenor. The 36-month spread for bank loans reflects the typical 3-year average loan life.*

ENDNOTES

[i] *Lipper FMI and S&P Capital IQ LCD as of 12/31/2013. Unless otherwise noted, bank loan market data in this paper sourced from this Index data.*

[ii] *Loan Syndication and Trading Association Trade Data Study, 1/27/2014.*