# Lending a Hand: Are Loans a Good Income Alternative to Bonds?

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In a rising interest rate environment, traditional fixed income assets may seem like a less palatable investment. Could loans be an attractive alternative for income? **Graham Rainbow, portfolio manager at Alcentra**, a BNY Mellon company, discusses.

**Are loans as an asset class an attractive proposition in what could be a more inflationary environment?**

In Europe, we think there is potential for rate rises in a few years, but not over the next 12–18 months.

Let's introduce the subject of loans a bit more specifically. Within this asset class, we are typically investing in loans with seven-year maturities at new issue, the underlying rates will reset every one, three or six months—normally at the borrower's option, that's in the contract—and most loans tend to repay within three to four years. As investors, we are simply looking to get capital back at the end of the contractual term or earlier.

Furthermore, banks will still lend cheaper loans to investment grade companies at around 0.1%–1.0%, then you have loans to sub-investment grade borrowers, where typically margins are in the range of LIBOR +3.5% to LIBOR +6.0%. That is the area we are talking about today. The other distinction to make is that these are not illiquid "direct lending" products. Direct lending is filling a gap where banks are more capital-constrained, are lending less, and therefore there is an opportunity to lend to the middle market at more attractive rates. However, it comes at a cost, which is zero liquidity. In the event of a problem you cannot trade that loan, as you are the sole lender.

**What is the difference between loans and bonds and what size is the European loan market?**

The loan indices will range from €125 billion to €180 billion in size, depending on the index. We have the ability to invest in U.S. loans if liquidity is needed. Traditionally, the main difference is bonds are fixed rate and were formerly in a worse security position compared to a loan. So if you had a default (and rule number one is to avoid those), the bond may recover you 30%–50%. The average loan recovery rate is about 70% because you are senior secured. There are more senior secured bonds in the market today and the recovery rate for those high yield bonds should

Not FDIC-insured. Not Bank-guaranteed. May lose value.

be higher than 30%–50%, but you should still see an overall recovery rate that is better for loans versus bonds.

Then the obvious difference is fixed rate versus floating rate and in the environment we have seen with rates falling all over the world, bonds have performed pretty well, but at some stage we must surely be at the end of that cycle.

**Is there a lack of growth in the loan market?**

The allocation to loans has remained strong because of the defensive nature of it during the past seven years. Over the past few years, the theme has changed but the flows have still been decent and the potential ability to grow funds in an asset class has been compelling. I think that over the next five years, loans will become more fashionable and it will likely become more of a standard rather than a niche investment.

**What about growth of the high yield bond market?**

The high yield bond market has grown significantly in Europe over the past few years and there has been a certain amount of refinancing from loans into bonds. The products sit side by side now. The growth in the loan market has seen banks pulling out and a gradual substitution within the market, with managers like us growing. This is a trend we think will continue. I'm cautiously optimistic of seeing more new issuance in 2017. But other than that, one characteristic of loans for borrowers is that you don't have some of the restrictions you have in high yield and a lot of the borrowers are actually private equity companies rather than publicly listed companies. They may seek loans with a bit more flexibility than high yield structures. So I think some slow growth in loans is on the horizon.

**Are defaults the main risk?**

When it comes to risk, I feel you need to look at fundamental versus technical aspects. If we look at fundamental default rates and what happened during the 2008/2009 financial crisis, too many companies had excessive leverage going into the crisis, the world became more distressed, companies saw earnings fall and leverage rise, they breached covenants and there was a peak in defaults. The default rate in post-crisis loans and bonds is about 1%, so the defaults after the crisis are really still focused on old pre-crisis loans and bad businesses. These are companies with broken business models and we would not touch them. New issue loans tend to be better capitalized and less likely to default.

Then, on the technical side, if you were a forced seller into the market, you had a very bad time in Q4 2008. You had a slump in prices before the defaults came through because of these forced sellers. Strategies today do not have this same forced selling characteristic, and with no ETFs in the European loan market, volatility has been much reduced and technical features should be more robust. So, defaults are still the main risk and credit selection and monitoring remain key. But even in another severe downturn, loans are better positioned today than they were in 2008 and should be less volatile than other asset classes.

**Why invest with Alcentra today?**

The strengths we bring are active management, fundamental bottom-up credit selection, a large bank of analysts and experience. It is not about rate rises over the next 12–18 months in Europe. It is about a switch from investment grade into loans because the returns are not there, from the U.S. into Europe because you want more diversification and out of cash into loans because of what is happening with cash yields.

**All investments** involve risk including loss of principal. Certain investments involve greater or unique risks that should be considered along with the objectives, fees, and expenses before investing. **Bonds** are subject to interest-rate, credit, liquidity, call and market risks, to varying degrees. Generally, all other factors being equal, bond prices are inversely related to interest-rate changes and rate increases can cause price declines. **Floating rate loan securities** may include irregular trading activity, wide bid/ask spreads and extended trade settlement periods. The value of any collateral, if any, securing a floating rate loan can decline, and may be insufficient to meet an issuer's obligations in the event of non-payment of scheduled interest or principal or may be difficult to readily liquidate. Although generally less sensitive to interest-rate changes than fixed-rate instruments, the value of floating rate loan securities may decline if their interest rates do not rise as quickly, or as much, as general interest rates.

**LIBOR** is a benchmark rate that some of the world's leading banks charge each other for short-term loans. It stands for London Interbank Offered Rate and serves as the first step to calculating interest rates on various loans throughout the world.

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