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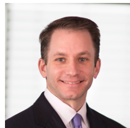
Senior Secured Loans: 101

INSIGHTS

At $1.8 trillion, the global senior secured loan market has grown substantially over the last 15 years. Here, we break down the key characteristics of the asset class and touch on how investors can access the many potential benefits on offer.



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Senior secured loans in the broadly syndicated market offer a unique blend of attractive yield potential with some protection against both credit and interest rate risk. At a high level, the asset class has the potential to provide attractive risk-adjusted returns and a number of other benefits, including:

- Multiple layers of credit risk protection,
- Security in the form of asset-backing and covenant restrictions,
- Low relative volatility,
- Relative value opportunities,
- Greater price transparency and liquidity relative to private credit.

Figure 1: Senior Secured Loans by Other Names

BANK LOANS	FLOATING-RATE LOANS	LEVERAGED LOANS
These loans are underwritten by a lead bank and syndicated to other banks.	The interest rate on the loan is not fixed; it typically resets every three months in line with changes in market interest rates.	When a company borrows, it increases theleverage on its balance sheet.

Sources: For illustrative purposes only.

What Are Senior Secured Loans?

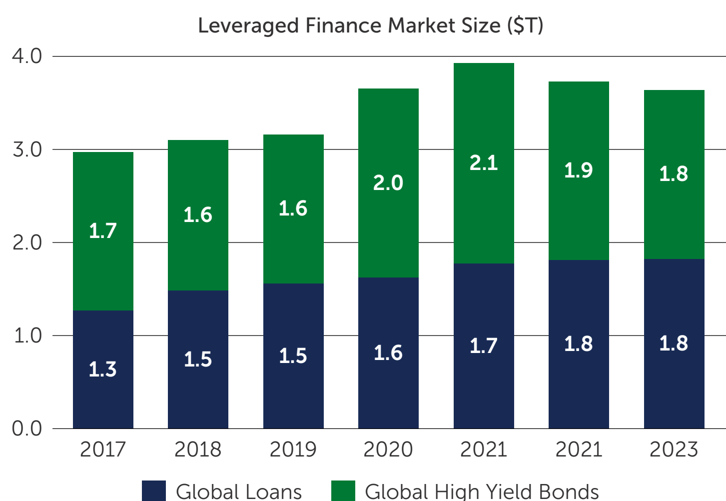
Senior secured loans are commonly issued by below-investment grade companies and can be used for a range of purposes, from financing acquisitions, to refinancing existing debt, to supporting expansion plans. The majority of loans are issued for privately held companies and therefore come with the support of a private equity sponsor or sponsors. These loans pay a floating interest rate—a base rate (usually SOFR or Euribor), plus an additional fixed margin—to compensate for the credit risk of lending to a below-investment grade company.

Broadly syndicated loans are underwritten by a lead bank and syndicated (or sold) to other banks and institutional investors. Unlike the private credit or direct lending market, broadly syndicated loans are often syndicated to a large number of lenders—commonly 100 or more. As a result, there is an active secondary market for these loans. As an example, more than $700 billion of loans traded in the U.S. during 2023, which represented just over half of the market.[1] This provides investors with access to liquidity even during challenging periods, as well as greater transparency as daily mark-to-market valuations reflect the view of perceived risk and relative value of the loan.

1. Source: LSTA Monthly Trade Stats. As of May 15, 2024.

Since the financial crisis, the broadly syndicated loan market has grown substantially in the U.S. and Europe. At roughly $1.8 trillion, it's now comparable in size to the global high yield bond market **(Figure 2)**. The majority of borrowers tend to be large companies with diverse businesses that generate anywhere from $100 million at the very low end to $1 billion or more in annual EBITDA. This differs from the private credit market, where borrowers, for the most part, tend to be smaller in size. In addition, the loan market is higher quality compared to the private credit market, with 24.7% of the market rated BB- or higher.[2]

Figure 2: The Loan Market is Comparable in Size to the High Yield Bond Market



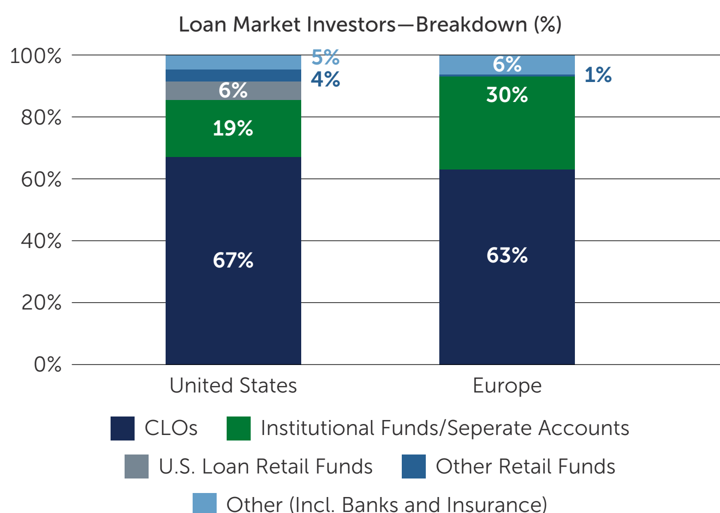
Sources: Credit Suisse; Bank of America. As of December 31, 2023.

There are a number of ways investors can access the broadly syndicated loan market, including:

- Separate accounts
- Commingled funds
- Retail funds
- Collateralized loan obligations (CLOs), which are essentially structured vehicles investing in a pool of loans

CLOs represent 60–70% of the outstanding loan market, and due to their closed-end nature, provide a very steady source of demand for loans **(Figure 3)**. For comparison, retail funds represent less than 10% of U.S. loan market demand and a minimal portion of European demand. What this means is that most of the demand and activity for this asset class is supported by institutional investors, which can help mitigate outflows and keep loan prices stable, even during periods of heightened uncertainty or volatility. In addition, an active secondary market allows cash to be quickly and efficiently invested without delay.

Figure 3: Institutional Investors Comprise Majority of Loan Demand



Source: Barings; Barclays Research; Kanerai; Lipper; EPFR; Pitchbook LCD and HFR. As of December 1, 2023.

Why Invest in Senior Secured Loans?

For investors, senior secured loans offer a number of potential benefits.

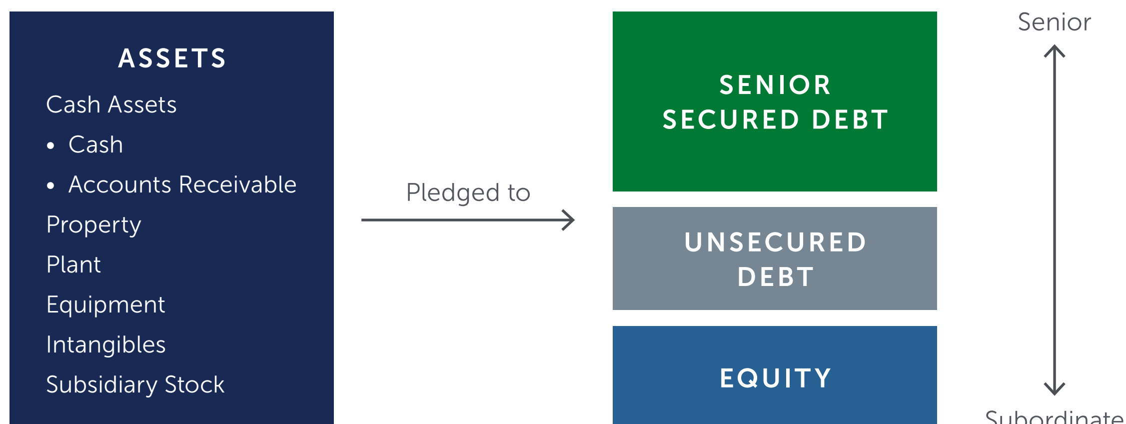
1. MULTIPLE LAYERS OF CREDIT RISK PROTECTION

Senior secured loans are typically senior to other outstanding junior and subordinated debt, as well as equity, in an issuing company's capital structure. This seniority means that the loan's interest and principal payments must be paid before those lower in the priority order. This is important in the event of a default, as lenders and equity holders that are more junior in the capital structure provide a cushion against losses for loan investors. It also means that companies and their sponsors are often motivated to proactively work with senior lenders before a stressed or distressed situation arises, to identify agreeable and potentially attractive solutions.

2. Source: S&P. As of May 30, 2024.

Senior secured loans are also secured by some or all of a borrower's assets. Many different assets can be used as collateral, including real estate, equipment, vehicles and intangible items like software or trademarks. This security provides investors with additional credit risk protection as secured loans typically have a first-priority claim on a borrower's assets.

Figure 4: Loans are Senior and Secured



Source: Barings. For illustrative purposes only.

2. HISTORICALLY LOW DEFAULTS AND HIGH RECOVERY RATES

Given that senior secured loans are issued to below-investment grade companies, investors may be concerned about the potential for defaults. But it's worth noting that the long-term average default rate for U.S. and European loans has historically been relatively low, between 2% to 3% per annum for both markets.[2] Further, given their seniority and security, when there have been defaults, loans have offered historically high recovery rates relative to other asset classes. For instance, from 1987 through 2023, the recovery rate for senior secured loans was just over 70% of the initial invested amount.[3]

That said, default and recovery rates, when viewed in isolation, do not necessarily reflect the impact to total returns for a loan. This is because the interest paid during the life of a loan adds to the total return, while the active secondary market allows investors to add or reduce their exposure to the loan over the life of their investment. Within a broadly diversified portfolio, these characteristics can partially offset the impact of principal losses.

3. RELATIVELY LOWER VOLATILITY

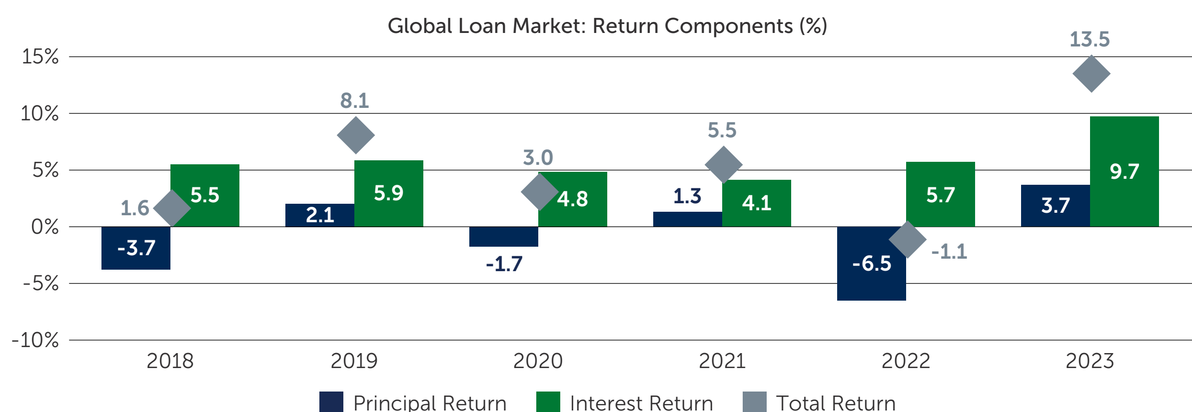
Compared to other asset classes, loans have also historically exhibited low volatility. In the last 10 years, for example, global loans have exhibited approximately two-thirds of the annualized volatility of global high yield bonds, and a third of the volatility of global equities.[4] This is primarily due to the floating-rate coupon on offer, which results in lower interest rate duration—or less sensitivity to changes in rates. In the context of a broadly diversified portfolio, this can help reduce overall volatility and increase the long-term, risk-adjusted return potential.

3. Source: Morningstar; LSTA. As of April 30, 2024.
4. Source: Moody's Annual Default Study. As of February 26, 2024.
5. Source: Credit Suisse; Bank of America; MSCI. As of April 30, 2024.

4. POTENTIAL FOR ATTRACTIVE AND STABLE RETURNS

Another key characteristic of broadly syndicated loans is the income component, or the coupon, which contributes to the potential attractiveness and stability of the total return. For context, the long-term average return for the market is around 4% to 6%, which is similar to the average coupon—particularly in a lower-rate environment.[5] While the potential for price appreciation also contributes to total return, it has ultimately been the level of support from the income component that has minimized the number of negative years in the loan market **(Figure 5)**. In fact, over the last 25 years, there have been only three calendar years in the U.S., and four in Europe, with a negative total return.[6]

Figure 5: Income Component Provides Stability to Loan Returns



Source: Credit Suisse. As of December 31, 2023.

5. POTENTIAL FOR DIVERSIFICATION

Because loans exhibit low correlations with other asset classes, they can also serve as an effective diversifier in a broader fixed income portfolio. Over the last 10 years, the global loan market has exhibited a low to negative correlation with traditional investment grade markets and a less than perfect correlation with other higher-yielding fixed income markets.[7]

How to Capitalize on the Opportunity

Looking across the senior secured loan market, we see potentially attractive opportunities in both the U.S. and Europe. However, the factors driving each of these markets can—and often do—vary. This is partly due to the differing economic outlooks for each region, as well as the potential impact of geopolitical events on each market. It is also a result of the technical factors such as new issuance volume, CLO issuance, and flows in and out of retail mutual funds.

In particular, changes in technical and other factors can cause the market price of a security to decouple from its underlying fundamental value. Investors with long-term horizons may be able to capitalize on these market dislocations by buying securities that are underpriced, or selling securities that look rich relative to their fundamental value.

6. Source: Credit Suisse. As of December 31, 2023.
7. Source: Credit Suisse. As of December 31, 2023.
8. Source: Credit Suisse; Bank of America; J.P. Morgan; Bloomberg. As of October 31, 2023.

Given how quickly market prices can react to changes in technical factors, a strategic allocation to senior secured loans can facilitate the timely capture of evolving relative value opportunities—and position investors to benefit from the compelling income potential during periods of stability. A global strategy can also provide access to a larger and broader opportunity set, giving managers—and by extension investors—the flexibility to capture opportunities as they emerge across the two regions.

What to Look for in a Manager

While we see many benefits to investing in senior secured loans, it is also important to consider the potential risks. Although this asset class is senior in the capital structure, investors may still be exposed to principal losses in the event of default or price volatility. For this reason, and to make the most of the investment opportunity, we believe it is critical that investors partner with active managers that have a presence across geographies and the ability to analyze and price idiosyncratic credit risk.

Other key characteristics to look for in a manager include:

- **A large and deeply resourced team.** The senior secured loan universe consists of nearly 1,600 issuers.[8] To truly be able to underwrite the fundamentals of a company, you need a large research team that has the scale to perform the rigorous credit analysis required. Having team members in each region that regularly interact with trading counterparties and meet with local management teams and sponsors is also crucial, especially when it comes to evaluating relative value opportunities across geographies.
- **Experience through cycles.** Given the evolution of the loan market over time, it's also important to partner with a manager that takes a disciplined approach and has proven experience through market cycles. Although different environments bring varying challenges and opportunities, long-tenured managers with deep relationships across the market are better-positioned to navigate periods of uncertainty.
- **A global presence.** It's important to partner with a global manager who has the flexibility to quickly and efficiently capitalize on relative value opportunities as they arise across regions, sectors and credits. Being able to provide dynamic solutions in evolving markets is key, and can ultimately put investors in the best position to achieve attractive, long-term, risk-adjusted returns.

9. Source: Credit Suisse. As of December 31, 2023.

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