Easy Street: Loan ETFs Have Seen Dramatic Growth Among Investors

Howard Moore, LSTA

Investor interest in the senior secured floating rate loan asset class has grown dramatically in recent years, fueled by concerns over rising interest rates and the desire for risk-adjusted returns. In response, ways to access the loan market have increased, and among them are three exchange-traded funds that provide easy access to the bank loan asset class, full transparency and intraday liquidity. In March 2011, Invesco PowerShares launched the Senior Loan Portfolio (BKLN), the first passively managed bank loan ETF. The Highland iBoxx Senior Loan ETF (SNLN), which is also passively managed, launched in November 2012, with the SPDR Blackstone/GSO Senior Loan ETF (SRLN), which is actively managed, making its debut in April 2013. Each has attracted significant assets and projects growth to continue aggressively. The LSTA spoke with the manager of each to find out why.

Scott Baskind

Managing Director,
Invesco Senior Secured Management, Inc.

The PowerShares Senior Loan Portfolio ETF (BKLN) seeks investment results that generally correspond, before fees and expenses, to the price and yield of the S&P/LSTA U.S. Leveraged Loan 100 Index. The fund generally will invest at least 80% of its net assets, plus any borrowings for investment purposes, in senior loans that comprise the underlying index. Banks and other lending institutions generally issue senior loans to corporations, partnerships or other entities. These borrowers operate in a variety of industries and geographic regions, including foreign countries. It is non-diversified.

Mark Okada CFA

Co-Founder and Chief Investment Officer,
Highland Capital Management

Highland iBoxx Senior Loan ETF (SNLN) seeks to provide investment results that, before fees and expenses, correspond generally to the price and yield performance of the Markit iBoxx Liquid Leveraged Loan Index. It invests approximately 80% of its assets in component securities of the index.

Lee Shaiman

Managing Director
GSO Capital

The SPDR Blackstone/GSO Senior Loan ETF (SRLN) seeks to provide current income consistent with the preservation of capital. It invests substantially all of its assets in the Blackstone/GSO Senior Loan Portfolio, which seeks to outperform the Markit iBoxx USD Liquid Leveraged Loan Index and the S&P/LSTA U.S. Leveraged Loan 100 Index by normally investing at least 80% of its net assets in first lien senior secured floating rate bank loans.

Why are loan ETFs popular among investors right now, and is that demand coming from institutional, retail or retirement sources?

Okada: The loan asset class has been very popular based on what's been happening with interest rate volatility and getting exposure to the U.S. economy. The fact that ETF products have such easy access makes them a very good source of gaining exposure to bank loans. Loan ETFs are not very old; however, as time passes ETFs will become much more established. People are still a little bit skeptical, but as ETFs build a longer track record, build out their indexes and provide easier access, they will become even more popular over time. Demand is starting to come from all types of investors.

Baskind: Loan ETFs are popular for the same reason that loans in general have been attractive over the past 12–18 months and are projected to be going forward. First and foremost, it's the floating rate nature of the underlying asset class, which provides the potential for interest rate protection as investors are desirous of shortening the duration risk within their portfolios. It's also the desire of investors to seek high current income, and the loan market has historically provided relatively stable current distributions. Then there are the relative advantages versus other asset classes, particularly high-yield bonds. From a relative value perspective, loans and bonds are virtually trading on top of each other, but loans are senior in the capital structure, providing potential downside protection for investors from a collateral perspective. On a risk-adjusted basis, loans have exhibited a very strong Sharpe ratio for the better part of 2013. Given that volatility that has come from the Fed's desire to reduce stimulus, the ultimate impact on the interest rate environment has played very favorably for the floating rate asset class. The investor base is well diversified, although institutions hold a greater percentage of the overall market and the ETF.

Shaiman: There's a lot of interest in the asset class that is fueling the growth overall, and we see demand across the board: institutional investors, in the registered investment advisor and private wealth marketplace and the large wire houses. ETFs tend to have a broader investor base than an open-end mutual fund, which tends to be more driven by the private wealth channel, although there can be institutional share classes. ETFs are a very good product for daily liquidity because they can tap into both trading on the exchange and create and redeem via the authorized participant. ETFs also have daily transparency, versus other actively managed products, and investors can really monitor at the asset level what's happening with the fund. They may not know every asset, and they may not know every credit, but it's very helpful for investors to understand—particularly in sub-investment grade corporate credit—the kinds of companies and the names of the companies that we're investing in. I think it gives them a lot more comfort.

How do active and passive loan ETFs differ, and what should investors consider?

Baskind: In a passive strategy, the ETF is looking to capture the underlying characteristics and return of the index—we're not utilizing active credit views within the portfolio. We utilize a sampling strategy, not a replication strategy, in which we look to own a relevant portion of what is represented in the underlying index. The composition of a passive structure is materially different than that of the active ETF products, which are similar to an actively managed product. A passive strategy allows investors to fully understand the types of positions that the ETF is investing in given the underlying index. It also allows investors to utilize the product tactically, perhaps as a hedging tool or as a strategic allocation within a larger asset allocation mandate that allows investors to capture return while minimizing overall expenses.

Okada: When considering an active or passive vehicle, there are two things to consider: tracking error and fees. They are both related to one another. Tracking errors are a function of the manager's execution. Passively managed funds are meant to track an index as closely as possible, and fees are one of the reasons why you get tracking errors. Actively managed funds operate much differently in that the manager should be able to add value well above the index.

Shaiman: There are two major sources of alpha, or outperformance. One is the ability to make the investment choices based on credit quality. So through a cycle, we think loss avoidance is critically important to outperformance. In the loan asset class, the risk is fairly asymmetric—a good outcome means that we receive our interest and principal when due. There might be a small appreciation in a primary issue, because primaries are typically issued at a discount to par, and in most markets they often trade at a slight premium to par, but because loans are not a well call-protected asset class, there is very little ability for the asset to appreciate in value with time. So the upside is fairly limited, while the downside, if you make a credit mistake, can equal the full extent of the investment, although loans typically have much better recoveries than high-yield bonds, for example. The other source of alpha is the ability to capture some of that discount in the primary market. What we've seen is that typically in the index product, if something falls out, the manager will add a name, but not until it's actually in the index. So we can capture some of that in advance, plus we can buy names that may never be in the index, but that have the appropriate liquidity characteristics. Conversely, we are underinvested in the riskiest end of the credit spectrum, while the index has a riskier component. If you own the passive product and you're trying to minimize tracking error, you have to own that.

How do investors view loan ETFs in the current environment of rising interest rates?

Okada: The eventual rise of interest rates is pretty well telegraphed, but there are certainly differences of opinion on where the rate structure is going to be in the next year or two. Because bank loans are floating rate, they don't have the interest rate exposure and volatility that you would get in other fixed-income asset classes. For that reason, bank loans in a rising or a volatile interest rate environment are a safe haven. The other thing that can be lost in this topic is the attractive yield of bank loans versus other asset classes. You are not taking interest-rate risk, and concurrently you are also making the 4 or 5% returns that you likely wouldn't see in other instruments.

Baskind: Looking back to the third week of May 2013, when the Fed announced that it was considering tapering its bond purchases, the Treasury yield curve steepened and we saw a significant impact on longer duration assets. In May, loans were the only positive performing fixed-income asset class, and through August, loans significantly outperformed several other fixed-income asset classes, returning slightly north of 50 basis points during that period. High-yield bonds were down more than 1.9% and investment-grade bonds were down greater than 4.9%. So investors ultimately were rewarded for being early movers into the floating-rate asset class, and ultimately acted and behaved true to their underlying characteristics of a low-duration product. We have clearly moved into an environment where the majority of loans trade at or above par. Therefore, returns will likely be a LIBOR plus credit spread return environment going forward. Ultimately that allows for further stability within the loan asset class going forward.

Shaiman: The expectation of rising interest rates has been a big driver of interest in the asset class, particularly last year. As you know, last year probably saw the greatest growth among registered funds that invest in loans. Unlike bonds, there isn't an inverse relationship between the net asset value of a loan and the movement of interest rates. We think this cycle is going to be different for high yield as rates rise, because coupons are so low. An improving economy should be beneficial to a sub-investment grade investor, but if rates start to rise, it may outstrip the improvement in creditworthiness on the bond side. So that's where investors are looking to loans for that incremental return but with less exposure to rising rates.

How do investors view loan ETFs versus other loan product vehicles like CLOs, mutual funds, and others?

Baskind: ETFs can be one of the most liquid parts of the market to invest in. There are ETF-only investors from an underlying mandate perspective, and ETFs allow these investors to gain access to the loan market, which historically they've not been able to do. Loan ETFs have attracted strong interest from institutional investors, particularly asset allocators and managers that are looking to utilize loans within their larger portfolios. They are different than a CLO, which is a levered structured credit vehicle that provides a cash arbitrage type of return at an equity level and opportunities within rated notes from AAA to BB.

Shaiman: There's a lot of value in the ETF versus an open-end mutual fund allocation to the loan product because of cost, but you also get enhanced liquidity and significantly more transparency. The issue with the open-end mutual fund is that the price at which you execute is close of business NAV. So you may execute at 10 o'clock in the morning, but an investor won't know the level until the end of the day. With an ETF, you know the exact price at the moment you execute, and the result is that ETFs tend to trade very tight to the NAV throughout the day. Then there's the closed-end mutual fund product which are exchange traded, but the only source of liquidity for that product is on the exchange. Liquidity becomes a major issue with other options. Institutional investors can invest in CLOs through the tranches depending upon where in that layer cake of capital structure they want to be. Most managers have a significant minimum requirement for a separately managed account, so if you have a smaller allocation, an ETF will provide a liquid allocation, versus an illiquid allocation for those that allocate in that way.

Okada: Each of these product wrappers has a different consumer base that finds them appealing. ETFs are appropriate for individuals or large institutional managers wanting efficient and inexpensive access to and particular exposure. Additionally, ETFs provide instant liquidity through capital markets, although there is the element of execution risk which mutual funds don't have due to mutual funds' subscription and redemption transactions being values at closing NAV. This ease of access is the main reason why ETFs are so different. There is full transparency to the portfolio where the holdings are provided daily and priced intraday versus at close of business for pricing and quarterly for holdings disclosures for mutual funds. This daily holdings reporting obligation becomes somewhat difficult for an actively managed fund because of the fear of front running or replication of their active strategy. ETFs are very different than CLOs. CLOs are generally institutional products as they provide granular access to risk return profiles by using

multiple tranches that have different claims against the underlying loan's cash flows with correspondingly different projected return profiles. ETF shareholders have a shared claim against the underlying assets and have the same risk return profile of others invested in the ETF. Furthermore, separately managed accounts are typically for larger institutions that want to have specific portfolio construction profiles and structures, while commingled accounts are actively managed and usually for longer-term investors.

How do loan ETFs enhance a fixed-income portfolio?

Baskind: Loan ETFs provide short-duration exposure within a corporate credit fixed-income allocation. They allow a portfolio to be relatively insulated from interest rate movements, as floating-rate assets can provide that natural protection. There is also the strong current income that loans generate. But ultimately there is the credit protection that investors seek within the senior-secured, first-lien asset class of the loan market that provides natural protection in the event that the economy becomes uncertain or unstable and we enter a higher default environment. That combination of factors provides investors with a strong position within corporate credit. Traditionally, loans sit alongside high-yield bond allocations, but investors are now tactically utilizing loans in an overweight fashion, given the interest rate environment that we are currently in.

Okada: It depends on the investor, but we can look at typical pension funds as an example. Many of them have a large exposure to Treasurys in their fixed income portfolios. Some of them are rotating out of that exposure and replacing them with bank loans, including ETFs. They still pay very low fees, gain exposure to the bank loan asset class, and avoid interest-rate risk, so it's an asset allocation change. For example, a manager of an active fixed-income mutual fund may use ETFs in their books as a way to dampen interest rate volatility and boost current returns to the fund tactically. There are many other strategies, and whether they are strategic or tactical, there is very little friction in using ETFs in general.

Shaiman: The use of loans in a portfolio is both tactical and strategic. The tactical role is the concern over rising rates, but strategically loans have a place as part of the fixed-income component, and also the credit risk component, versus high-yield bonds. The fact that loans are at the top of the capital structure provides a stronger credit profile, and on a risk-adjusted basis, loans can be very interesting versus high-yield bonds. So as part of an overall fixed-income strategy within an investor's portfolio, there always should be both a tactical and a strategic allocation to the loan asset class.

How do you educate investors and prospective investors?

Baskind: Participants in the broader loan market and other managers have done a tremendous job of educating investors on the benefits of investing in this asset class. We help investors understand the types of companies that utilize the loan market, like Heinz, Hertz, Hilton and other large, global, well-known companies. This education process has also helped to stress the underlying benefits that the senior secured asset class can provide for portfolio management and asset allocation. The floating-rate asset class provides very short duration exposure which ultimately helps to position investors for a rising rate environment that they generally would not have in a fixed-income type portfolio.

Okada: We want investors to understand what they're getting into, why they're getting into it and what the benefits are, as well as the risks they're mitigating. It's incredibly important for managers to educate investors about how alternative fixed-income assets behave in different environments. As they find their way into mutual funds and registered products, the real danger is end investors who don't understand what loans are supposed to do and what their purposes are. You can never predict what's going to happen in the markets, so if there is a negative surprise, investors are more likely to stick with you if they are educated and they understand why they made the investment in the first place. Also, there can be real problems with a daily liquidity product. Investors can get in and out anytime they want, which can disappoint investors, because they may not understand that what they're getting into can be a surefire way to have short-term investors making bad trading decisions. That honestly increases the cost of managing funds, because you have to deal with redemptions and volatility. That is not good for a long-term total return, which is what we really care about.

Shaiman: Across the investor spectrum, there is a great deal more understanding of the loan asset class and how the loan asset class behaves. We see it through the growth of the loan asset class generally—we see investors across the globe and of every type and stripe allocating to senior-secured bank loans, and that's been a very healthy change in the loan market. That education is ongoing and continues. More recently, we have been spending a lot more of our time on the differences between the active versus the passive products. We've been in a relatively benign credit environment. Investors have done well just in having exposure to the asset class, and they haven't been penalized for any adverse credit selection that's endemic in an index.

What were some of the other discussions that come up?

Baskind: We have focused specifically on helping investors understand that the private non-exchange marketplace of senior-secured loans is not much different than its public cousin in the high-yield bond market, Many companies issue debt in both the high-yield bond form and the senior-secured loan form. So we help investors appreciate the quality of the underlying businesses that come to market. Many of the decisions revolve around the balance sheets of these companies. Many of them are investment-grade type businesses, but have levered balance sheets which causes them to come to our market as non-investment grade issuers. But overall they are very stable, mature, and often global businesses. Also, helping investors understand the liquidity provisions of the private market within the loan space, how loans trade and how they settle have been issues for us managers and the LSTA as well.

Okada: We have a lot of discussions about liquidity—How liquid is the loan asset class? Some people are still focused on the 2008 experience. Bank loans were down as much as the equity market, but that wasn't a function of illiquidity—bank loans were trading, unlike high-yield bonds. So we illustrate how they recovered in 2009, and they quickly become very comfortable with the asset class.

Why a loan ETF and why now?

Okada: Given the environment we're in, with the U.S. economy recovering and a lot of interest rate volatility, bank loans are in a unique position to provide defense in the form of not having interest rate exposure and offense in the form of high returns. ETFs are in a sweet spot, and are a great way to get exposure, because you have transparency and ease of access, while paying very little carrying cost.

Shaiman: Now continues to be a good time. We're still in a recovering economy, so the underpinnings of credit remain fundamentally good. We're certainly not at peak leverage on peak EBITDA, so we have a few more years of positive trends overall for credit which is critically important. The concern about rising rates is significant, and ultimately as the Fed starts to taper and the real pain that could be suffered in core fixed income has been of great concern to investors. You can't put all your eggs in the equity basket, particularly after last year where the S&P earned gross I think over 30%. Investors still need an allocation to fixed income, and lots of investors still need an income component to their investing, and it provides some hedge against rising interest rates, so we think this is a great product.

Baskind: It's the access to the loan market for investors that are focused on passive strategies and looking for index-like returns, and ultimately minimizing tracking error. Ultimately when we look at the product, given how it meets that passive strategy format, it helps investors gain that access and provide that stability that can be brought into their broader portfolios in terms of how the loan asset class can impact in a beneficial manner their allocation to the credit space.

Carefully consider the investment objectives, risk factors, charges, and expenses of the Fund before investing. This and additional information about the Fund can be found in the prospectus, which may be obtained by calling 1-855-799-4757 or by visiting the Documents tab above. Read the prospectus carefully before investing.

Leveraged Loans are loans to companies that typically already have a high amount of debt and are often characterized by lower credit ratings or higher interest rates.

Investing involves risk, including the possible loss of principal. Narrowly focused funds typically exhibit higher volatility. Also, the fund is non-diversified, and an investment in the Fund could fluctuate in value more than an investment in a diversified fund.

Shares are bought and sold at market price (not NAV) and are not individually redeemed from the Fund. Brokerage commissions will reduce returns.

There is no guarantee the fund will meet its investment objectives.

Liquidity Risk. At times, a major portion of any portfolio security may be held by relatively few institutional purchasers. Although the Fund generally considers such securities to be liquid because of the availability of an institutional market for such securities, under adverse market or economic conditions or in the event of adverse changes in the financial condition of the issuer, the Fund may find it more difficult to sell such securities when the Adviser believes it advisable to do so or may be able to sell such securities only at prices lower than if the securities were more widely held.

Non-Payment Risk. Senior Loans, like other corporate debt obligations, are subject to the risk of non-payment of scheduled interest and/or principal. Non-payment would result in a reduction of income to the Fund, a reduction in the value of the Senior Loan experiencing non-payment and a potential decrease in the NAV of the Fund.

Credit Risk. The Fund may invest all or substantially all of its assets in Senior Loans or other securities that are rated below investment grade and unrated Senior Loans deemed by Highland to be of comparable quality. Securities rated below investment grade are commonly referred to as “high yield securities” or “junk securities.” They are regarded as predominantly speculative with respect to the issuing company’s continuing ability to meet principal and interest payments. Investments in high yield Senior Loans and other securities may result in greater NAV fluctuation than if the Fund did not make such investments.

Interest Rate Risk. The Fund’s NAV will usually change in response to interest rate fluctuations. When interest rates decline, the value of fixed rate securities already held by the Fund can be expected to rise. Conversely, when interest rates rise, the value of existing fixed rate securities can be expected to decline.

Senior Loans Risk. The risks associated with Senior Loans are similar to the risks of below investment grade securities, although Senior Loans are typically senior and secured in contrast to other below investment grade securities, which are often subordinated and unsecured.

Ongoing Monitoring Risk. On behalf of the several Lenders, the Agent generally will be required to administer and manage the Senior Loans and, with respect to collateralized Senior Loans, to service or monitor the collateral.

All registered investment companies, including the Highland Funds, are obliged to distribute portfolio gains to shareholders at year's end regardless of performance. Trading the Highland iBoxx Senior Loan ETF will also generate tax consequences and transaction expenses. The information provided is not intended to be tax advice. Tax consequences of dividend distributions may vary by individual taxpayer. There is no guarantee that dividends will be paid. To receive the distribution, you must be a registered shareholder of the ETF on the record date, and must have placed the ETF trade prior to the ex-date. Distributions are paid to shareholders on the payable date. Past distributions are not indicative of future trends. Please consult your tax professional or financial advisor for more information regarding your tax situation.

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