Asset Class Update: Leveraged Loans
Floating-Rate Securities Offer a Hedge Against Rising Rates

KEY TAKEAWAYS

- Leveraged loans are one asset class that can provide investors with a direct hedge against rising interest rates, as these are floating-rate securities whose coupons adjust to changes in short-term rates.
- In recent months, the improvement in technical and fundamental conditions in the leveraged loan market has renewed expectations that this asset class may return to its traditional primary attribute as an income-oriented investment.

What are leveraged loans?
Leveraged loans are bank loans to companies with below-investment-grade (high yield) credit quality that have been securitized. These securities provide a coupon—typically the 3-month London Interbank Offered Rate (LIBOR) plus an additional yield spread—to compensate for higher credit risk. [LIBOR is the market rate pricing for short-term bank lending, and it is heavily influenced by interest-rate targets set by the Fed.] As LIBOR rises or falls, this coupon automatically adjusts to movements in short-term interest rates (see Exhibit 1, page 2). For this reason, leveraged loans are less sensitive to interest-rate movements than traditional bonds with fixed-rate coupons whose prices fall when rates (yields) rise. Given today's record-low yield environment, the floating-rate nature of these securities may be attractive to investors anticipating a future increase in short-term rates (coupons will increase as rates rise). As of the beginning of March, investors were anticipating that the Fed would raise its target policy rate to 0.5% by the end of 2010. [For more characteristics of leveraged loans, see Know What You Own, page 3.]

Leveraged loans and high-yield bonds generally are issued by the same, highly indebted, below-investment-grade-rated companies, so these securities have considerably more credit risk than investment-grade bonds. However, leveraged loans have higher seniority in the capital structure than high-yield bonds, which means bank loan investors recoup liquidated assets before bondholders in the event a company enters bankruptcy. In addition, leveraged loans generally are collateralized loans, meaning they are backed by cash and receivables, as well as hard assets, such as manufacturing plants and property. Thus, leveraged loans historically have had lower default (i.e., a company fails to service its debt on time) and higher principal recovery rates than high-yield bonds, on average. Another major difference between these two below-investment-grade security types is that the floating-rate nature of leveraged loans means their coupons typically re-set every three months, making them much shorter-duration (less interest-rate sensitive) investments than high-yield bonds, which generally offer fixed-rate coupons at longer maturities.

Back from the brink
The loan market has significantly improved from its unprecedented displacement in late 2008, triggered by the financial crisis, deep recession and massive deleveraging (i.e., debt reduction) by financial institutions. From a fundamental perspective, quicker-than-expected improvement in the economy and the perceived creditworthiness of corporate America resulted in stronger loan repayment rates and fewer defaults than originally anticipated. The peak rate of loan defaults turned out to be lower than the 24% rate that was implied by the index's pricing (near 60 cents on the dollar) at the height of market distress in March 2009. As a result, the loan market rebounded sharply.

With the U.S. economy gaining traction and the Federal Reserve having kept its target short-term rate at an all-time low (near 0%) for more than a year, more investors may be looking for ways to hedge their fixed-income portfolios against the prospect of rising interest rates. One asset class that may answer the call: leveraged loans, which rebounded 52% in 2009 after their steepest decline ever in 2008 (-29%).

Spotlight on Fundamentals

With the U.S. economy gaining traction and the Federal Reserve having kept its target short-term rate at an all-time low (near 0%) for more than a year, more investors may be looking for ways to hedge their fixed-income portfolios against the prospect of rising interest rates. One asset class that may answer the call: leveraged loans, which rebounded 52% in 2009 after their steepest decline ever in 2008 (-29%).
November 2009, but has since fallen to just below 7.8% in February 2010, and is projected to decline closer to its long-term average of 3.3% by the end of the year.iv

During the past several months, technical conditions also improved. A major source of leveraged loan demand that helped drive new issuance and absorb booming supply prior to 2008—structured vehicles known as collateralized loan obligations (CLOs)—dried up amid the post-Lehman Bros. bankruptcy deleveraging. At the same time, a recovery in investor appetite for riskier securities boosted demand for loans over the past year. Meanwhile, new loan supply has been scarce, due primarily to the preference of many companies to refinance their outstanding loan debt by issuing longer-maturity high-yield bonds at relatively low fixed rates. After a disastrous 2008, these improving fundamental and technical conditions have been supportive of a rebound in pricing and greater stability in the leveraged loan market during the past year.

Valuations closer to normal range
Leveraged loan pricing has rebounded (on average) to about 92 percent of par, which is still below the market’s historical average (95%), but a far cry from the unprecedented low of 63% reached in early March 2009 at the peak of the financial crisis. One way to evaluate the valuation of leveraged loans is to compare its yield spread versus the group’s historical average. [Yield spreads are an indication of the credit risk relative to a benchmark interest rate, such as LIBOR or the yield on risk-free Treasury bonds. Wider spreads indicate a higher perceived risk of default, and vice-versa.] The average yield spread in the loan market fell from above 20% in 2009 to 6.5% today and is above its long-term average of 4.9%, thus representing a cheaper valuation relative to historical norms. However, given that the current default rate is well above the category’s historical average, this extra yield is probably appropriate to help compensate investors for the elevated credit risk. Thus, the category’s overall valuation is somewhere in the neighborhood of its historical norms (see Exhibit 1, below).

Meanwhile, with LIBOR at an all-time low of nearly 0%, it only has one direction to move: upward. The last two times the Fed has started a rate-raising campaign, 3-month LIBOR rates rebounded, causing upward adjustments in leveraged loan coupon rates (see Exhibit 1). Going forward, if economic growth in 2010 is better than expected, loan investors should receive a higher coupon if rates move upward and, because the average price of leveraged loans is a few percentage points below the category’s long-term average, there may also be the potential for further price appreciation (but not to the extent seen in 2009).

2010 outlook
During the past year, conditions in the leveraged loan market have stabilized and improved significantly. This likely comes as a welcome development for investors looking for this asset category to return to...
its more traditional roots of providing more steady performance, as opposed to the highly volatile returns it registered in 2008-2009. To be sure, the below-investment-grade quality of leveraged loans makes their prices susceptible to another unpredictable economic shock or financial market event. However, the current absence of new CLO issuance and other “hot money” leveraged investment vehicles has placed a large portion of the ownership back in the hands of more traditional buyers of securitized loans: pension funds, insurance firms and mutual funds. In addition, a continued trend of improving economic growth in 2010 would likely be supportive of a declining default rate, and provide a favorable backdrop for the asset category. As a result of these developments, investors may be more inclined to use leveraged loans in a fixed-income portfolio as a means of hedging the potential rise in short-term interest rates.

Know What You Own: Leveraged Loans

What: Floating-rate securitized loans (LIBOR + spread) issued by companies with below-investment-grade credit ratings.

Characteristics:

- Floating-rate: Leveraged loans offer coupons that typically reset every three months according to changes in short-term interest rates.
- Low interest-rate sensitivity: Unlike traditional bonds with fixed-rate coupons whose prices move inversely to changes in rates, the prices of leveraged loans are much less influenced by rate movements.
- Highly credit sensitive (and thus higher-yielding than most short-term bonds): The issuers of leveraged loans typically are highly indebted companies with below-investment-grade credit ratings. Investors are compensated for this high credit risk with higher yields relative to investment-grade bonds.
- Seniority in the capital structure: In the event of bankruptcy, leveraged loan investors typically recoup liquidated assets before bondholders (see exhibit, above right). Leveraged loans generally are collateralized (backed by cash, real estate, other assets), which has contributed to a lower historical default rate and higher rates of principal recovery relative to comparably rated (high-yield) corporate bonds.

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Investment decisions should be based on an individual's own goals, time horizon, and tolerance for risk. Past performance is no guarantee of future results.

Lower-quality debt securities involve greater risk of default or price changes due to potential changes in the credit quality of the issuer.

Although bonds generally present less short-term risk and volatility than stocks, bonds do contain interest rate risk (as interest rates rise, bond prices usually fall and vice versa) and the risk of default - the risk that an issuer will be unable to make income or principal payments. Additionally, bonds and short-term investments entail greater inflation risk - the risk that the return of an investment will not keep up with increases in the prices of goods and services, than stocks.

All indices are unmanaged and performance of the indices include reinvestment of dividends and interest income, unless otherwise noted, are not illustrative of any particular investment, and an investment cannot be made in any index.

Standard & Poor's/Loan Syndications and Trading Association (S&P/LSTA) Leveraged Performing Loan Index is a market-value-weighted index designed to represent the performance of U.S. dollar-denominated institutional leveraged performing loan portfolios (excluding loans in payment default) using current market weightings, spreads and interest payments. The Merrill Lynch High Yield Bond Master II Index is an unmanaged index that tracks the performance of below investment grade U.S. dollar-denominated corporate bonds publicly issued in the U.S. domestic market.

[I] All references to leveraged loan performance and statistics in this article refer to the S&P/LSTA Leveraged Performing Loan Index as of 3/8/10, unless otherwise noted. Source: Standard and Poor's, FMRCo (MARE).


[iii] The average price for the S&P/LSTA Leveraged Performing Loan Index hit a low of 63.01 on March 10, 2009, implying that the market was pricing in a 24% default rate. Source: Standard & Poor's, LCD Quarterly Review, 12/31/09.

[iv] Moody's projects the leveraged loan market annual default rate to fall to 4% by end of 2010. Default rate calculated by number of outstanding defaults divided by the number of issuers over the preceding 12 months. Source: Standard & Poor's, LCD Quarterly Review, 12/31/09.

[v] Average bid price and spread are from 1997-2010. Spread is the discounted spread and assumes discount from par is amortized over a three-year period. Source: Standard and Poor's, FMRCo (MARE) as of 2/28/10.

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