RICHMOND CAPITAL MANAGEMENT
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Senior Bank Loans: Floating Rate High Yield

The "Senior Loan" asset class has been a hot investment topic in the last year and has gathered significant assets. The asset class traditionally was available only in a separate account or on a commingled fund basis but now is more widely available through exchange traded funds (ETFs). This report analyzes the asset class through the lens of the PowerShares Senior Loan Portfolio ETF (BKLN). BKLN is a passively managed ETF and was the first and is now the largest public senior loan vehicle available to investors (assets of $4.4 billion as of June 30, 2013).

What are Senior Loans?

According to the BKLN prospectus, "senior loans often are issued in conjunction with recapitalizations, acquisitions, leveraged buyouts and re-financings." These loans are also called leveraged loans, syndicated bank loans or floating-rate loans. The loans generally carry an intermediate term maturity but an interest rate that floats with a short-term interest rate (typically LIBOR) and resets monthly or quarterly. While the credit quality of the loans is enhanced by the senior status among other debt instruments, the loans are typically non-investment or speculative grade given the leverage undertaken to source the loan.

The Interest Rate Cycle

With short-term interest rates near zero, investors have been scanning the investment universe for an asset that both protects against rising interest rates and also provides an acceptable absolute yield. Senior loans appear to fit the bill (at June 30, 2013, the BKLN ETF had a yield of 4.35%). Because the underlying loans have floating rates, the coupons received should reset upward when the interest rate cycle turns. That said, the loans reset off of a short-term interest rate that will be directly impacted by Federal Reserve policy. Should longer-term interest rates rise without a corresponding increase in short-term rates (the yield curve "steepens" without a Federal Reserve rate increase) the coupon rate the loans pay will not reset upward when long-term interest rates increase. In this case, the loans may experience price declines along with other fixed rate assets.

The Credit Cycle

The more difficult investment question to answer is how the underlying loans will perform when the credit cycle changes. The senior standing of the loans will certainly be a benefit, but reflecting the poor credit quality of the issuer, the loans are of non-investment grade quality. To assess this risk, looking back at how the asset class has performed in prior credit cycles is informative. The main benchmark index for senior loans is the S&P/LSTA U.S. Leveraged Loan 100 Index. This index does not have a long history. The table at right summarizes the data for senior loans and other primary investment opportunities.

Date	S&P LSTA U.S. Leveraged Loan 100 Index	Barclays Aggregate	Barclays High Yield	S&P 500
2002	(0.09%)	10.26%	(1.41%)	(22.10%)
2003	9.85%	4.10%	28.97%	28.68%
2004	5.01%	4.34%	11.13%	10.88%
2005	5.00%	2.43%	2.74%	4.91%
2006	6.60%	4.33%	11.85%	15.79%
2007	1.73%	6.97%	1.87%	5.49%
2008	(28.18%)	5.24%	(26.16%)	(37.00%)
2009	52.23%	5.93%	58.21%	26.46%
2010	9.65%	6.54%	15.12%	15.06%
2011	0.62%	7.84%	4.98%	2.11%
2012	10.51%	4.21%	15.81%	16.00%
6 mos, 2013	1.93%	(2.44%)	1.42%	13.82%

Sources: Barclays, Standard & Poor's, Bloomberg

Analyzing the performance data, it is clear that senior loans are more correlated to high yield and stock returns than bond returns. The correlation table below reinforces that.

	S&P LSTA U.S. Leveraged Loan 100 Index	Barclays Aggregate	Barclays High Yield	S&P 500
Leveraged Loan 100 Index	1.00	(0.22)	0.94	0.69
Barclays Aggregate		1.00	(0.03)	(0.26)
Barclays High Yield			1.00	0.77
S&P 500				1.00

Correlations run using quarterly performance data for ten years ended June 30, 2013 Sources: Barclays, Standard & Poor's, Bloomberg

The lack of correlation between senior loans and bonds is both a blessing and a curse. The blessing occurs for investors looking to diversify a portfolio of fixed income only. Senior loans clearly would diversify such a portfolio (as would an allocation to high yield). The curse arises in a balanced portfolio. In this case, the diversification element is unclear as equity exposure is effectively added to a portfolio. Fixed income typically performs the "anchor to windward" function in a portfolio. One look at the index performance in 2008 clearly demonstrates that senior loans cannot be expected to perform well when the credit cycle turns negative, and should not be expected to perform that function. Investors who overlook that risk will surely be disappointed.

Fixed Income Data Bank

Index Returns

	Qtr.	1 Yr.	3 Yr.
Barclays Aggregate	-2.32%	-0.69%	3.51%
Barclays Int. Aggregate	-1.78%	-0.12%	3.03%
Barclays Govt/Credit	-2.51%	-0.62%	3.88%
Barclays Int. Govt/Credit	-1.70%	0.28%	3.14%
Barclays 1-3 Year G/C	-0.12%	0.74%	1.25%
Barclays 1-10 Year TIPS	-5.52%	-3.14%	3.42%

Source: Barclays *As of June 30, 2013*

Treasury Market Yields

	6/30/13	3/31/13
3 Month	0.03%	0.07%
2 Year	0.36%	0.24%
5 Year	1.39%	0.76%
10 Year	2.49%	1.85%
30 Year	3.50%	3.10%

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