Libor benefits and changing regulations

Chris Mawn, portfolio manager at Highland Capital Management, discusses how firms can exploit rising Libor for yield extraction using bank loans

As we head into the 2016 homestretch, investors remain fixated on the Federal Reserve and risks of volatility associated with the next anticipated interest rate increase. The long shadow of central bank policy influence on the real economy and risk markets remains omnipresent. Though fundamentally, the timing of the next hike is less important than the pace of hikes along with the final terminal rate. There is, however, another important benchmark interest rate whose recent sharp trajectory upward has received scant attention in the midst of this Fed policy drama but merits greater consideration.

A triple down the line for Libor

Libor, the London Interbank Offered Rate, has been on the rise recently, reaching its highest levels since 2009, and nearly tripling over the last year alone *(Fig. 1)*. Libor is a benchmark rate that some of the world's leading banks charge each other for short-term loans. It serves as a benchmark reference rate for debt instruments, including government and corporate bonds, mortgages, student loans and credit cards, among other financial products. And the stair-step movement we saw this summer went largely unnoticed as markets focused instead on central bank policy and rallies in stocks and high-yield and government bonds, which dominated the financial headlines. But now that some of the effects of rising Libor have manifested themselves, the financial world has started to take notice as floating-rate products look cheap and investors adjust allocations in response.

Not the usual suspects

Historically, the movement in Libor can be traced to actual or expected Federal Reserve policy. This held true in December 2015 when the Fed made their first rate move in nearly a decade and Libor moved accordingly. However, the more recent moves in Libor appear instead to be pricing in recent regulatory reform related to money markets funds set to become effective on 14 October of this year. These changes demand that certain money market funds adopt a floating net asset value (NAV) versus a constant $1 per share value. In addition, the new rules will also impose liquidity fees and redemption gates. The reforms are meant to protect those money market funds from potentially "breaking the buck," the phenomenon that occurred during the financial crisis with one prominent money market fund in particular called The Reserve Primary.

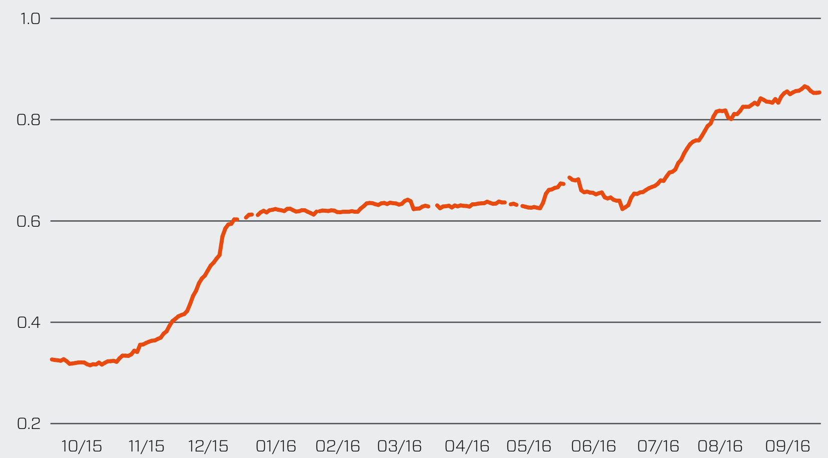
This regulatory shift has resulted in large flows out of the money market funds affected – namely the prime funds that invest primarily in short-term floating-rate corporate debt and commercial paper – and into cash and government funds *(Fig. 2)*. Outflows in these funds have lowered demand for corporate floating-rate debt tied to the benchmark Libor rate, which has driven an increase in Libor and thus corporate unsecured borrowing costs. Longer term, we would expect Federal Reserve interest rate policy to reassert its influence over Libor potentially driving it higher still in the future.

Bank loan benefits

We believe that senior secured floating-rate loans, also referred to as leveraged loans or bank loans, are among the assets that could benefit from the move in Libor. As the name suggests, floating-rate loans are structured with floating interest rates that are periodically reset at a spread above Libor.

This means income on the loans "float" higher as short-term rates like Libor rise. So unlike fixed-rate bonds whose prices move inversely to interest rates, loans, with near-zero duration, benefit from a rise in interest rates as their coupons adjust higher

Fig. 1: 3-month Libor (USD), 1 year (Sept 2015 - present)



Source: ICE Benchmark Administration

commensurate with the move in Libor. As a result, leveraged loan funds have already started to see a pronounced pick-up in positive net capital flows, as investors are lured to the appeal of loans' relative value in a higher rate environment *(Fig. 3)*.

One caveat with respect to loans is that post-financial crisis, many bank loans came with a Libor floor, somewhat limiting the near-term potential gains. According to S&P, roughly 93% of loans today have an average Libor floor of 95 bps *(footnote LCD Comps Data 8/18/16)*. With Libor at 85 bps, there is still a 10-bp gap between the Libor spot rate and the average floor. So loans with a Libor floor of 95 bps or higher will need to wait for Libor to trade through their respective floors before their income starts to grow again. However, many loans have a 75-bp floor while others have no floor at all and therefore immediately stand to benefit from the recent rise in Libor.

Loans as a defensive asset class

The senior secured floating-rate bank loan asset class is a large, liquid and transparent capital market. With significant growth over the last 20 years, bank loans have transitioned from a somewhat unknown aspect of credit to a mainstream asset class gaining recognition among both the retail and institutional investment community. Loans are generally used by below investment-grade companies for debt refinancings, balance sheet recapitalizations and to fund strategic acquisitions or leveraged buyouts. In addition to the floating-rate component of their coupon, loans come with several other desirable attributes that make our outlook for loans constructive regardless of the forthcoming rate environment.

First, loans enjoy seniority in the company's capital structure, meaning loan investors are paid before other creditors and before equity holders in the event of a default. Second, they are secured by first lien claims on all tangible and intangible assets of the corporate borrower. While leveraged loans come with heighted credit risk versus investment-grade credit, and the rising rate environment increases default risk across the credit space, loans are among the best positioned below investment-grade credit instrument in the event a default occurs. Loans offer higher recovery rates (80%) and therefore lower credit cost versus unsecured high yield bonds (41% recovery) in the same default scenario, according to data from S&P Capital IQ LCD. In addition, loans have historically exhibited low correlation to other risk assets.

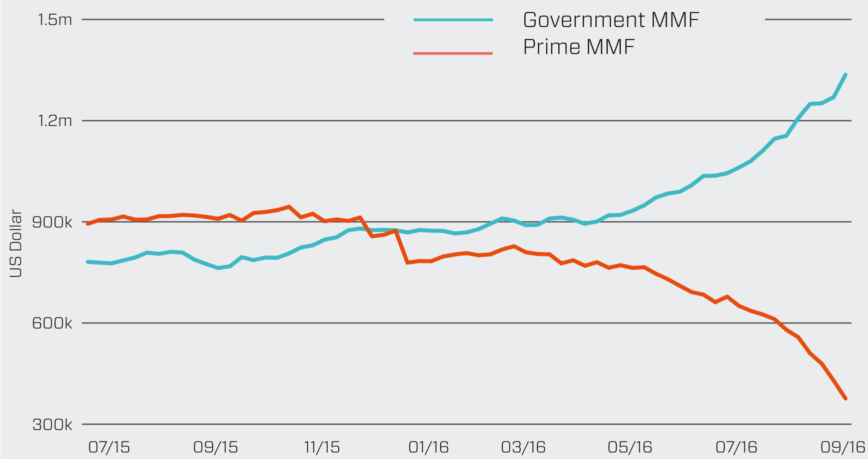
The attractiveness of loans is evident too in the risk assessment of the asset. Technical risk at present appears low given strong positive inflows for the asset class as noted previously and tied back to the money market fund reform. Fundamental risk looks manageable even in a low-growth environment where modest GDP should still drive higher revenues, cash flows and earnings supporting credits with reasonable leverage and strong interest coverage. And valuation risk is attractive as loan yields trade wide to high-yield bonds after adjusting for interest rate risk and credit costs.

To beta or not to beta

Looking ahead, investors face a number of potential and wide-ranging headwinds with slower global growth, continued commodity price volatility, Brexit ripples and uncertainty around central bank policy chief among them. In a low-growth, low-yield – and thus by definition low-return – world, US credit could prove a relative outperformer. At the same time, this type of backdrop may present significant hurdles for equities given historically high valuations. The seniority, security and floating-rate nature of bank loans therefore merit serious consideration in a thoughtfully balanced and diversified fixed income portfolio.

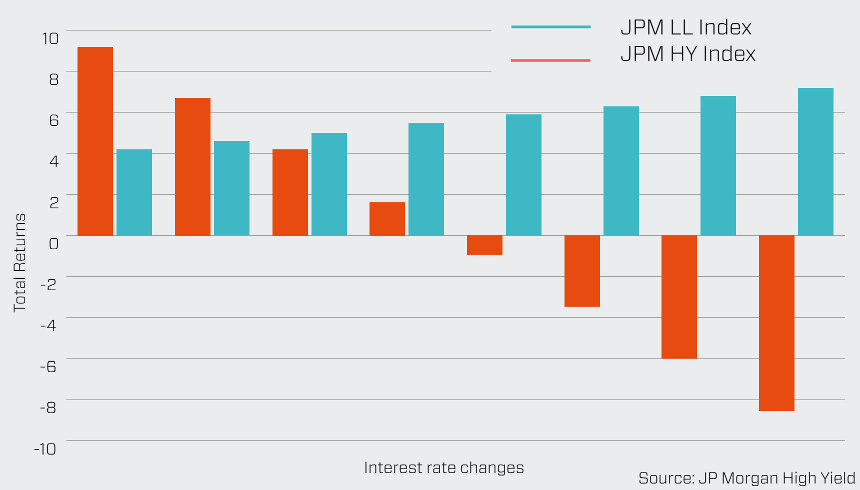
There are several ways to gain exposure to bank loans including separately managed accounts, CLOs, actively managed mutual funds, and actively and passively managed ETFs. For investors new to bank loans or those looking for low-cost beta access to the asset class, a passively managed loan ETF could offer such exposure, along with the increased transparency and liquidity generally provided by an exchanged-traded product wrapper. There are also alpha-generating opportunities in the bank loan universe provided by actively managed mutual funds, separately managed accounts and CLOs; however, despite what we see as a positive outlook for the asset class, it is still important to select an experienced credit manager who can get the fundamentals right and find undervalued opportunities within the bank loan universe to generate returns in line with the higher fees that may come with active fund management.

Fig. 2: Prime funds vs government funds



Sources: Bloomberg; ICI Institutional Money Market Funds Prime/Government Total Net Assets; as of 28/9/16

Fig. 3: Illustrative return loans vs bonds



Source: JP Morgan High Yield