Leveraged Loans

Reflecting on the Returns of Retail Funds

CORE

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As outflows have continued, loan managers' transaction costs have increased, hampering performance. The relative outperformance of ETFs has been driven by benchmark differences, as a liquidity premium has returned to the market.

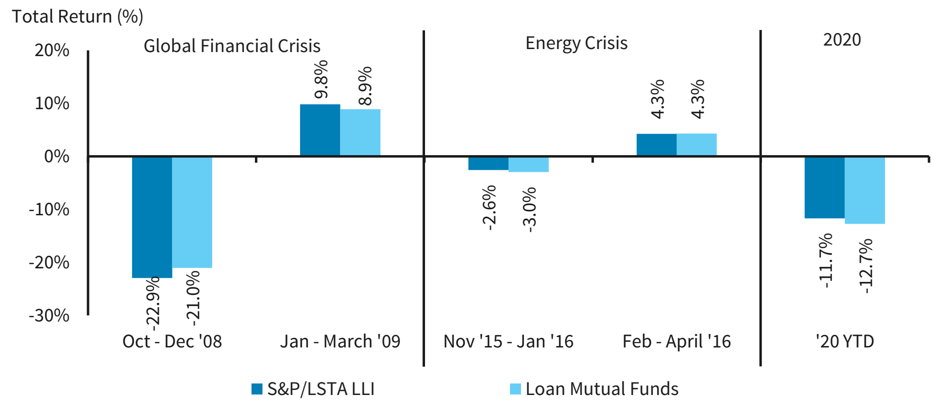
The recent rally in risk assets has taken loan index prices $7.6 higher through Wednesday's close. Another positive sign was the reopening of the new-issue market, with the first price talk announcement in a month occurring earlier this week. While retail outflows have persisted, the absolute level of outflows has declined in recent weeks.

Retail funds make up a smaller portion of the buyer base for loans than for bonds but are still meaningful, especially as the CLO pipeline remains subdued (*CLOs Take More of the Demand Pie*). The trend of outflows in loan retail funds in 2019 has continued in 2020, with more than $28bn of outflows so far this year (from a base of just under $100bn to start the year). Those outflows represent a greater portion of loan funds than of high yield funds, presenting an even bigger challenge for loan managers. Not surprisingly, similar to bonds, loan mutual funds have also underperformed the market this year.

Loan mutual funds have lagged the S&P/LSTA Leveraged Loan Index (LLI) by about 100bp year-to-date, with fees explaining only a small portion of the underperformance. The average loan mutual fund fee is 55bp annually, leaving 85bp of underperformance net of fees. Impressively, the underperformance of loan fund managers is only slightly greater than that of bond fund managers despite transaction costs that are often even higher in the loan market since turnover ratios are generally lower. For example, in 2019, the turnover ratio was 0.6x for loans, compared with 1.5x for high yield. According to LSTA, the average bid-ask spread at the end of March was roughly $3.7, more than three times the levels in November and December of last year. As a result, the drag on performance from trading tied to flows should be greater for loan funds than for bond funds, all else equal. While cash balances, portfolio products, and some liquid bonds can limit these transaction costs somewhat, the modest underperformance implies that managers were, in aggregate, not overweight beta, as lower-quality loans have lagged.

In addition, with the relatively lower turnover in the loan market, liquidity tends to dictate performance to a greater extent. Earlier this year, the most liquid loans underperformed, as more liquid loans lagged the market even when adjusting for ratings and sector differences (*Liquid Loans Are Largest Laggards*). That trend continued during the rapid sell-off in early and mid-March, only to reverse materially in the rebound over the past two weeks, with more-liquid loans now outperforming their less-liquid peers for the year even when making the same adjustments.

FIGURE 1. Loan Index and Mutual Fund Returns in Periods of Market Stress



Note: Mutual fund returns are weighted average based on assets at start of period.
Source: Barclays Research, Bloomberg, Lipper

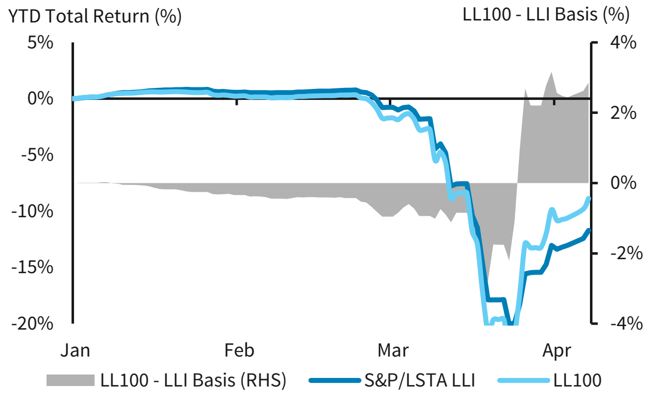
Loan ETFs, on the other hand, have outperformed the broader index thus far by more than 300bp. This outperformance can be attributed entirely to differences in the benchmark tracked by ETFs compared with the loan index. Specifically, the Leveraged Loan 100 Index (LL100), which includes the largest facilities in the market, is the benchmark for BKLN, which accounts for 55% of loan ETF assets under management.

Last year, investors showed a strong preference for liquidity, with the LL100 outperforming the broader index materially. That was not the case in 2020 until the past few weeks, with the LL100 underperforming the LLI by more than 2% through March 23. Since then, though, the market has rallied significantly, with liquid loans leading the way. Currently, the LL100's year-to-date total return is almost 3.0% higher than that of the LLI (Figure 2).

The comparison between these two benchmarks is clouded by differences in the characteristics of the two indices. Specifically, the LL100 is higher rated, with BBB or above-rated loans representing just 9% of the LLI but more than 17% of the LL100. To isolate the performance driven by liquidity, we adjust for the rating and sector differences between the indices.

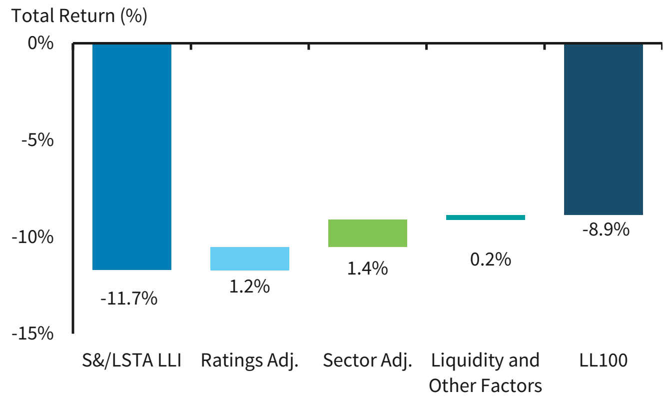
As seen in Figure 3, ratings account for 1.2% of the performance differential this year. Said differently, if the LLI had the same ratings weights as the LL100, the performance gap would have been 1.2% narrower. We do the same analysis in regard to sector differences and find the remainder to be driven by a combination of other factors, with liquidity likely the biggest component. Therefore, the benchmark has pushed ETFs into more liquid and higher-quality loans, which has been superior positioning thus far. Finally, we note that BKLN, for example, is trading at a 0.43% premium to net asset value, versus 0.20% at year-end 2019, providing a small boost to total returns. Once again considering that transaction costs are higher, ETFs have been effective at tracking their benchmarks.

FIGURE 2. The LL100 Has Outperformed the S&P/LSTA Leveraged Loan Index by Roughly 300bp in 2020



Source: Barclays Research, Lipper

FIGURE 3. Much of the Outperformance of the LL100 Can Be Attributed to Ratings and Sector Skew



Source: Barclays Research, S&P LCD

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