

Leveraged Loans

Liquid Loans Are Largest Laggards

As coronavirus concerns drove selling across most major asset classes, liquid loans underperformed the broader index. We adjust for differences between the LL100 and the broader index to isolate the underperformance due to liquidity and highlight liquid loans that have sold off the most this week.

Global concerns about the spread and potential economic effects of COVID-19 took a toll on markets this week, with major equity indices around the world experiencing consecutive multiple percentage point losses to start the week. The loan market specifically lost more than half of its year-to-date total return in the first three days of the week, while the Leveraged Loan 100 Index (LL100), which includes the largest facilities in the market, has now turned negative for the year, lagging the broader index by nearly 70bp.

The underperformance is important because many investors use liquid loan indices to express a view on leveraged loans or even to hedge portfolios. The two main loan ETFs are BKLN and SRLN, both of which use liquid indices as benchmarks. BKLN tracks the LL100, while SRLN has two benchmarks, with the Markit iBoxx USD Liquid Leveraged Loan Index the primary benchmark and the LL100 the secondary. Retail outflows from ETFs have totaled over \$1bn in the past five weeks, a contributing factor to the underperformance.

In 2019, investors showed a strong preference for higher quality and more liquid loans, which led to outperformance for the LL100 compared with the overall loan index (LLI). The LL100 outpaced the broader index by roughly 2% last year, returning over 10.6% (Figure 1).

To begin the year, the opposite was true across the board, as a beta rally resulted in CCCs leading in returns and the higher-quality 100 most liquid loans lagging the most. Through last week, the LLI had outperformed the LL100 by roughly 40bp. As global concerns about COVID-19 shocked markets this week, wiping out most of the outperformance of lower rated loans, the basis between the LLI and LL100 continued to widen to just under 70bp (Figure 2). This suggests that several factors are causing the performance gap, as the LL100 has underperformed regardless of changes in overall market conditions.

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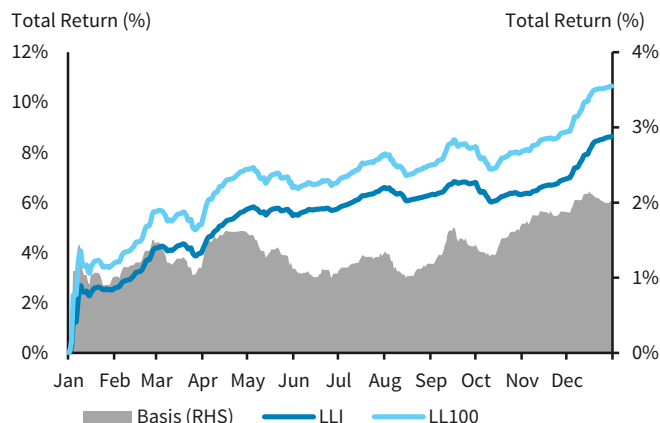
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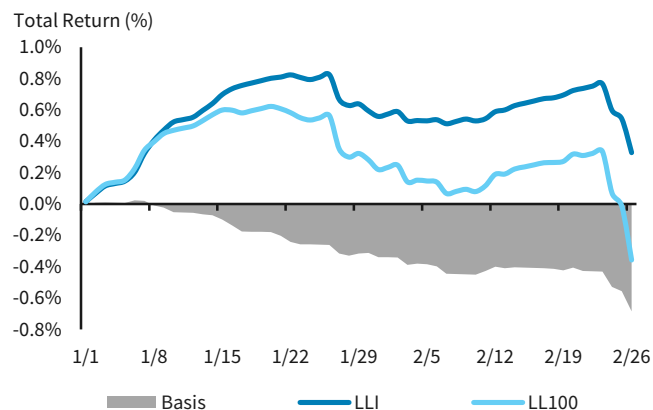
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FIGURE 1. The Most Liquid Loans Led the Market in 2019

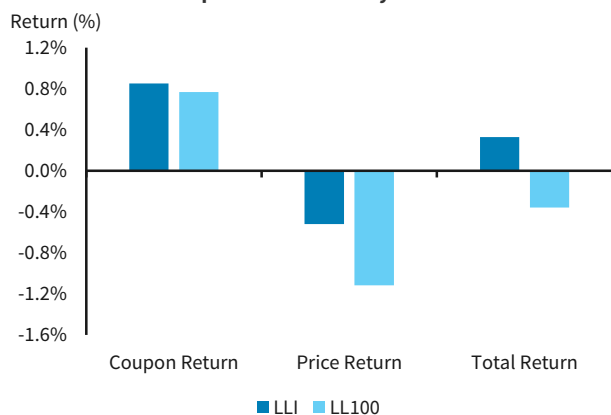
Source: S&P LCD, Barclays Research

FIGURE 2. Liquid Loans Have Underperformed in 2020, with Their Basis Widening during the Recent Sell-off

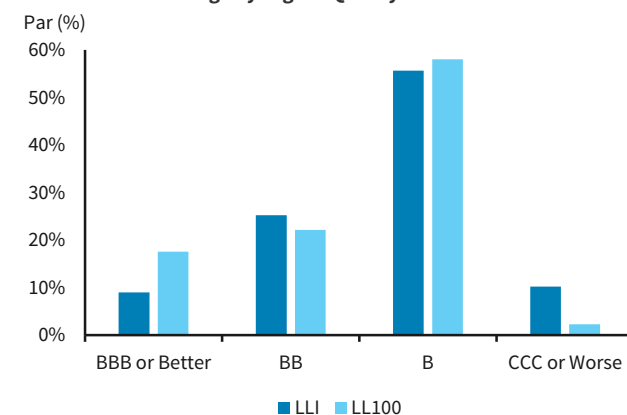
Source: S&P LCD, Barclays Research

The LL100's underperformance year-to-date has been a result of both carry and price moves (Figure 3). The nominal spread of the liquid index is approximately 50bp lower than that of the LLI and has been a drag of roughly 8bp in total return compared with the overall index so far this year. However, the main source of the underperformance has been adverse market moves, with the price return of the LL100 year-to-date at negative 1.12%, compared with a loss of 0.52% for the LLI. This implies that investors are selling the most liquid loans first during a downturn - a trend we have noted before in the bond market.

One reason that the LL100 has a lower nominal spread is the higher quality of the largest and most liquid loans. While the percentages of loans in the BB and B buckets are fairly similar, the LL100 has a much smaller allocation to CCC loans and more BBB loans (Figure 4). Given the outperformance of higher-beta credits in January, it is not surprising that the LL100 trailed the index to start the year. However, CCCs sold off the most this week, and the LL100 continued to lag despite the smaller allocation to low-quality loans.

FIGURE 3. LL100 Underperformance Mainly Due to Market Value

Source: S&P LCD, Barclays Research

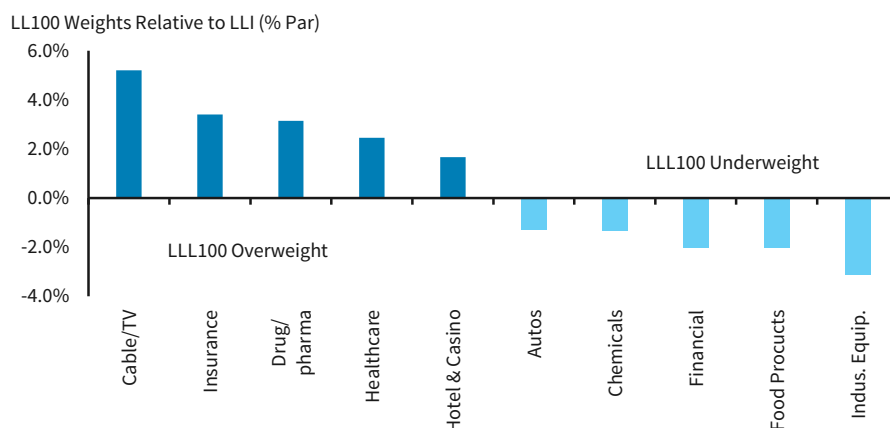
FIGURE 4. LL100 Is Slightly Higher Quality Than the Broader Index

Source: S&P LCD, Barclays Research

Beyond ratings and spread, sector differences are also affecting the returns of the indices. Figure 5 highlights the five sectors that the LL100 is most overweight and underweight relative to the LLI. Given that COVID-19 concerns have been the primary source of return volatility so far this year, it is helpful to think in terms of sector exposure to these risks. The LL100 is overweight the healthcare and drug/pharmaceutical sectors, which have generally benefited from

increased global health concerns. In addition, the LL100 is underweight autos and chemicals, which screen as more exposed. Ultimately, the overall sector mix points to a benefit for the LL100. This implies that the other differences in the indices are driving the underperformance, despite the tailwind of the sector skew.

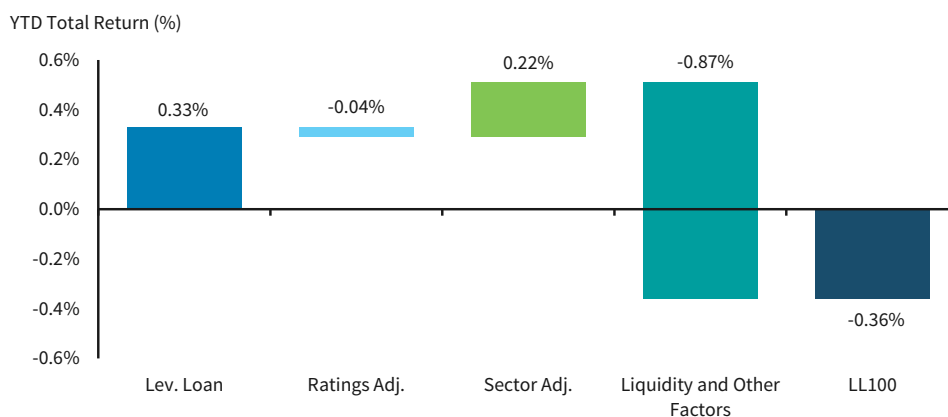
FIGURE 5. LLI versus LL100 Sector Skew



Source: S&P LCD, Barclays Research

To isolate the underperformance due to liquidity, we adjust for the rating and sector differences between the indices discussed above. Figure 6 shows the LLI adjusted to match the sector and rating weights of the LL100 in order to quantify the effects of each factor. The LL100 has faced a headwind of 4bp so far this year given its higher-quality ratings mix. Based on the sector weight differences highlighted in Figure 5, the LL100 has benefited by 22bp. After making these adjustments, there is an 87bp lag in the LL100's performance, and while this is likely a combination of several factors, we believe the largest driver for this differential is liquidity.

FIGURE 6. Factor Differences between LLI and LL100



Source: S&P LCD, Barclays Research

Given the meaningful underperformance due to liquidity, there could be a reversion of this trend if sentiment shifts. While liquid loans have underperformed throughout the year, suggesting that the trend has been somewhat persistent, the recent sell-off has caused the basis to widen even more. As a result, investors who are looking for relatively attractive entry points should consider liquid tranches that have declined as a result of moves due to liquidity. Figure 7 displays the largest price decliners in the LL100 this week (through Wednesday's close) that are B+ rated or higher and fell at least \$1. While several issuers declined as a result of idiosyncratic or earnings-related events, we think there could be opportunity to buy into higher-rated and more liquid loans at a more attractive price.

FIGURE 7. Largest Price Declines This Week in the LL100

Issuer	Maturity	Amount Outstanding (\$ mn)	Original Spread	S&P Rating	Current Price (\$)	Weekly Price Decline (\$)
Michaels Stores Inc	1/30/2023	2,226	250	BB-	93	-3.5
Sinclair Broadcast Group	8/24/2026	3,300	325	BB	95	-3.0
Cineworld	2/28/2025	3,325	250	BB-	95	-2.4
CenturyLink Inc	3/15/2027	5,000	225	BBB-	98	-1.5
Formula One	2/1/2024	2,902	250	B+	98	-1.5
Level 3 Communications	3/1/2027	3,111	175	BBB-	98	-1.5
Multiplan Inc	6/7/2023	3,200	300	B+	96	-1.5
Bass Pro Shops Inc	9/25/2024	2,970	500	B+	99	-1.3
Blackstone CQP Holdco LP	9/30/2024	2,600	350	B+	99	-1.3
Micro Focus International PLC	6/21/2024	2,600	275	BB-	96	-1.3
Buckeye Partners LP	11/1/2026	2,250	275	BBB-	100	-1.1
SBA Telecommunications Inc	4/11/2025	2,370	175	BB+	99	-1.1
Change Healthcare Holdings	3/1/2024	5,100	275	B+	99	-1.0
Johnson Controls Power Solutions	4/30/2026	4,200	350	B+	99	-1.0
LifePoint Hospitals Inc	11/16/2025	3,115	375	B+	100	-1.0

Source: S&P LCD, Bloomberg, Barclays Research

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Term Loan (USD 99.00, 27-Feb-2020 20:08 GMT, Bloomberg)

BUCKEYE PARTNERS LP, CD/J/K/M

1st Lien (USD 100.00, 27-Feb-2020 19:41 GMT, Barclays)

CENTURYLINK INC, A/CD/CE/D/J/K/L/M

CHANGE HEALTHCARE HOLDINGS INC, J/K/M

1st Lien (USD 99.00, 27-Feb-2020 20:07 GMT, Bloomberg)

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Term Loan B 2025 (USD 95.00, 27-Feb-2020 20:01 GMT, Bloomberg)

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Term Loan B (USD 95.00, 27-Feb-2020 20:24 GMT, Bloomberg)

FORMULA ONE WORLD CHAMPIONSHIP LTD, D/J/K/L/M/N

Term Loan B (USD 87.00, 27-Feb-2020 20:07 GMT, Bloomberg)

LEVEL 3 COMMUNICATIONS INC, J/K/M

Term Loan B (USD 98.00, 27-Feb-2020 20:04 GMT, Bloomberg)

MICHAELS STORES INC/OLD, A/D/J/K/L/M

Term Loan B New (USD 93.00, 27-Feb-2020 20:05 GMT, Bloomberg)

MICRO FOCUS US INC, CD/J/K/M

Term Loan B 24' (USD 96.00, 27-Feb-2020 20:07 GMT, Bloomberg)

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Term Loan B New (USD 96.00, 27-Feb-2020 20:09 GMT, Bloomberg)

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Term Loan (USD 99.00, 27-Feb-2020 20:23 GMT, Bloomberg)

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Term Loan B (USD 100.00, 27-Feb-2020 20:12 GMT, Bloomberg)

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