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Yields less low

We like the $1 trillion leveraged-loan market no more at this writing than we did two weeks ago. Yes, we acknowledged in the issue of *Grant's* dated July 13, the floating-rate, senior secured obligations of speculative-grade borrowers stood up under the melting heat of the 2008 crisis. But three-quarters of today's loans lack even basic covenant protection. Structure and yield are likewise deficient.

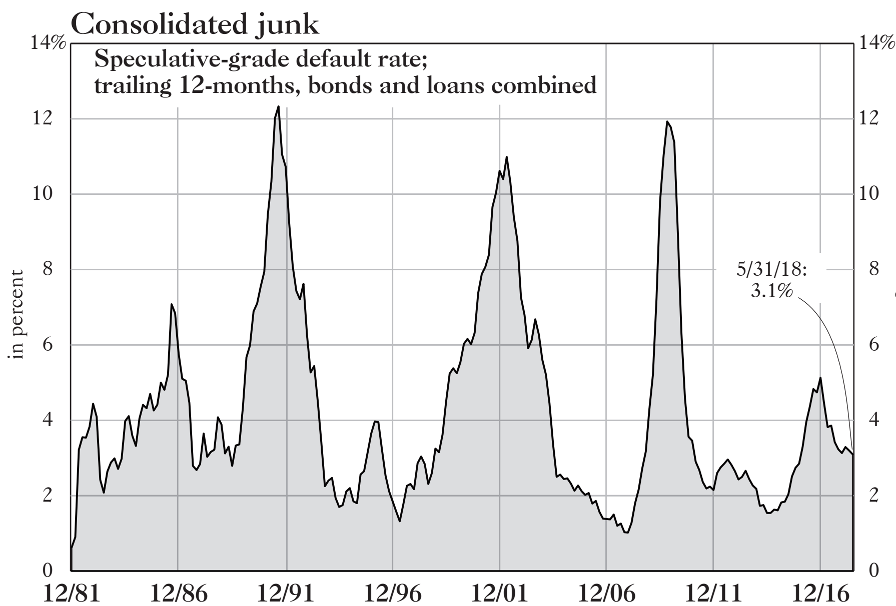
The critique continues in the essay now unfolding. In it, we delve into the risks that the purveyors of loan funds and loan ETFs would rather not dwell on. That demolition work complete (at least for now—more coming soon), we suggest income-producing alternatives in floating-rate Treasurys and tax-exempt bonds.

Leveraged loans—the curious shorthand name given to loans to encumbered corporate borrowers—formerly resided on the balance sheets of the banks that originated them. Different today is the public's participation in those credits. Assets under management of loan-focused mutual funds and their ETF counterparts reached $177 billion at the end of last month, up from about $60 billion in June 2007, according to the LCD unit of S&P Global Market Intelligence. The ETFs and mutual funds—sometimes called "prime-rate funds"—absorbed 23% of new-loan issuance in the first six months of the year, excluding amounts allocated to banks. That's up from 13% in calendar 2006.

Leveraged loans are the must-have income asset of the year. Through June, loan funds attracted $12.6 billion, while junk-bond funds relinquished $22.6 billion, according to Thomson Reuters Lipper. The Loan Syndications and Trading Association (LSTA) calls the intake of $5.7 billion in May and June "the best two-month period in years."

Loan-fund managers are happy to explain the secret of their success. For instance, they observe, junk bonds offer just 10 lonely basis points of yield pickup over loans, among the narrowest spread differentials on record. Bonds, being subordinated to loans, ought to pay higher yields. The trade group invokes modern portfolio theory to contend that loans provide diversification for higher returns and lower volatility. And if modern MPT doesn't make you want to stand up and salute, the red, white and blue just might. "Investing in loans is patriotic," the copy in a 2016 LSTA marketing brochure reads, "in that they finance great American companies that are well known and used every day, like American Airlines, Hilton Hotels and Burger King."

Maybe it's pure patriotism that leads the great Americans who manage the loan funds to offer their investors daily liquidity. It's an implausible claim, just the same, as loans are inherently illiquid. An average of $5.1 billion American-issue junk bonds trade on an average day, compared with $2.6 billion of loans (yes, the junk market is bigger than the loan market, but only by 27%). The Securities and Exchange Commission requires that bond transactions be settled in two business days but lays no such stricture on loans.



source: S&P Global Market Intelligence's CreditPro.®

Muni sampler

	duration in years	net of fees and after-tax* yield to worst	tax equivalent to Treasurys**	spread over equivalent Treasurys	NY tax equivalent to corporates†
iShares National Muni Bond ETF (MUB)	6.0	2.35%	3.97%	107	5.1%
VanEck Vectors AMT-Free Long Municipal Index ETF (MLN)	7.2	3.09	5.22	234	6.6
MLN ETF assuming bonds are not called	10.2	3.74	6.32	330	8.0
iShares New York Muni Bond ETF (NYF)	6.0	2.14	3.61	71	4.6

* Assumes 0% state and local income taxes. Note, however, that residents of states that levy income taxes would be exempt from federal income taxes on munis but subject to state income taxes on munis issued by other states.
** Assumes 40.8% tax rate.
† Assumes 53.5% tax rate.

sources: BlackRock, Inc., Van Eck Securities Corp. and *Grant's*

LSTA prescribes a seven-day settlement interval but acknowledges that 11 days is closer to actual practice.

"Right now," Brendan Whittington, senior analyst at corporate credit specialist BulwarkBay Investment Group, LLC, informs colleague Fabiano Santin, "we're dealing with a term loan that we bought almost a month ago, and it still hasn't settled." How a mutual fund could make good on a claim of daily liquidity in such a viscous asset class has stirred controversy in Washington.

In 2016, the SEC issued a rule to require loan funds to lay bare four times a year in quantitative terms the liquidity characteristics of their loan portfolios; the rule was to go into effect at the end of this year. Wall Street protested, and the Republican-dominated SEC yielded. On March 14, the commissioners voted 3-to-2 to scrub the quantitative-reporting obligation—now an annual "discussion" will do.

Robert L. Jackson, one of the two dissenting commissioners, had this to say:

> The Commission today takes the unusual step of re-proposing an already final, unanimously approved rule to give mutual-fund investors less, not more, information about the risks that they face. I fear that the result will be to allow large institutions to avoid the costs of a liquidity crunch, leaving Main Street investors holding the bag.

If loans don't trade like securities, it's because they're not securities. "U.S. common law considers loans to be private contracts between borrowers and lenders and not securities," Santin relates. "By investing in such contracts, the lender has access to privileged information from the company that public investors—in those instances where the issuer also has public equities or bonds—do not. Loans usually trade in minimum denominations of $1 million, while corporate bonds can be bought and sold in pieces as small as $1,000. Broker-dealers must report bond trades to FINRA's Trade Reporting and Compliance Engine (TRACE) within 15 minutes of execution, and the trade is immediately available to public scrutiny. There is no such obligation in the opaque leveraged lending market.

"Loans," Santin continues, "are typically transferred between buyers and sellers via assignments, often with a built-in $3,500 assignment fee payable to the borrower's agent bank, or via participation agreements. Whereas an assignment is characterized as a true asset sale from the seller to the buyer, a participation agreement holds that the lead banker in the syndication remain the holder of title to the loan. What that striking fact means is that the ultimate investor-participant is exposed to counterparty risk. If the bank fails, the secured investor-participant would wake up to discover that he is an unsecured creditor-participant, as in the failure of Penn Square Bank in 1982."

Sympathetic as we are to deregulation, we expect that Commissioner Jackson will have the last laugh—if, at that moment of truth, anyone is laughing.

There are other difficulties. Although often promoted as virtually free of interest-rate risk (the yields float with Libor), leveraged loans would be vulnerable if money-market interest rates collapsed. Nearly 70% of leveraged loans issued in the second quarter came without a Libor floor, up from 58% in the first quarter and 7% in 2016, according to data from Bloomberg, L.P.

The Invesco Senior Loan ETF (BKLN on the Big Board), seven years old, is the largest leveraged-loan ETF extant. It manages $7.9 billion, of which a minimum of 80%, so its mandate holds, must be invested in the hundred biggest loans that constitute the LSTA/S&P leveraged-loan index. As of July 20, 55% of the fund was exposed to at least double-B-rated assets—the highest rating in the speculative-grade universe—compared with 41% for the U.S. leveraged-loan market as a whole. Because the fund's loans are among the most liquid—they are typically issued by the largest and most presentable junk companies—the fund may be seen as an occupant of the credit-quality penthouse. Still, it's the penthouse of speculative credit.

According to S&P Global Market Intelligence, the rolling 12-months speculative-grade default rate has averaged 4.3% since 1981. Naturally, defaults spike in business-cycle downturns—in the past three recessions, the average default rate for the three years ended in the year of peak defaults was 5.75%. (For reference, those years were 1991, at 12.6%; 2002, 11.0%; and 2009, 12.1%.)

Low interest rates, weak covenant protection (if any), little or no call protection and hollowed-out capital structures cast a shadow over the value proposition of the 2018 loan market. BKLN pays a current yield to worst of 5.6% while charging a 65 basis-point management fee. Let's see what total return a conservative investor can expect.

"Suppose," Santin speculates, "we hit a pothole in the cyclical road—nothing like Armageddon—and BKLN's default rate turns out to be 5% in the next three years. Assume a 55% recovery rate—historically low for the reasons given in the prior issue of *Grant's*. Say that Libor and credit spreads hold steady and the fund's shares trade at NAV. The *pre*-tax return for the BKLN holder would be all of 2.4%. We arrive at the figure this way (we, too, are quants): a yield of 5.6% times (1 minus the default rate of 5%) minus the default rate of 5% times the loss rate of 45% (the reciprocal of the 55% recovery rate) minus the management fee of 0.65%. Voilà: 2.4%.

"Nor is 2.4% the worst-case outcome," Santin goes on. "Credit spreads could widen and discounts to NAV deepen. The oil bust pushed average loan prices to 90 cents on the dollar in 2016 from more than 99 cents in 2014. Those prices fell to 91 in the 2011 European sovereign affair (before Mario Draghi uttered the words 'whatever it takes') and to the low 60s in the liquidation of 2008–09. All in all, investors might get better returns in two-year Treasury notes offering a definite 2.57% a year—heights unseen since 2008."

There are alternatives. Cash is one: The 13-week Treasury bill touched 2% last week. Near-cash is another: The Treasury's April 2020 floating-rate note, whose coupons reset quarterly with reference to the 13-week bill rate, changes hands at a price to yield 2.7% (*Grant's*, Jan. 26, 2017).

Or do you, noble, high-earning and law-abiding reader, pay taxes?

The highest American earners are privileged to pay a rate of 40.8% at the federal level on interest income derived from Treasury securities (37% of income tax plus that 3.8% Obamacare surtax). The yields on 2-, 10- and 30-year Treasurys stand at 2.63%, 2.96% and 3.10%, respectively, before tax. The after-tax residue comes to 1.56%, 1.75% and 1.83%. For reference, the May report on consumer prices from the Bureau of Labor Statistics showed a 2.9% year-over-year rise in the CPI.

High-grade municipals present an alternative to the risky, unsatisfactory returns on leveraged loans and to the less risky, slightly less relatively unsatisfactory returns on Treasurys. Triple-A-rated tax-exempt securities at the 2-, 10- and 30-year points on the curve offer yields of 1.59%, 2.46% and 3.02%, respectively. For the top-bracket taxpayer, these yields deliver tax-equivalent yields of 2.69%, 4.16% and 5.10%. You can, of course, do better by lengthening duration and slumming it a bit in credit quality.

It can't be said that munis, in comparison to Treasurys, are cheap. On the contrary, the 10-year triple-A-rated Bloomberg Muni index yields 83% of the yield on 10-year Treasurys, not far from the post-2000 low of 80%, which was set in 2007, and much below the 120% level reached in 2012 or the 100% seen in 2016. There's more relative value at the long end, with the 30-year triple-A-rated Bloomberg Muni index sporting the nearly identical yield as Treasurys of similar tenor, though tax-exempts have been cheaper by this measure, too. In fact, they have been cheaper in every year of the past decade.

Perhaps, thanks to the Supreme Court, state and local credit quality may be on the upswing. Thus, on June 21 the justices decided to permit states to tax online sales to state residents. Six days later, the nine held that public unions cannot coerce non-union public employees to pay dues. The decision, John Mousseau, paid-up subscriber and chief executive officer and director of fixed income at Cumberland Advisors, advises *Grant's*, should tilt bargaining power to governments and away from unions in negotiating workers' retirement compensation.

We asked Mousseau where he is investing funds for municipal-bond-holding clients.

"If someone gave us $5 million in a new portfolio," he replied, "we would probably have it invested in three weeks to a month. We generally try to have some general-obligation bonds but probably much more what you would call essential-service revenue bonds. Things like water, sewer, transportation, etc., because you get paid and your lien is on the activity and not on the municipality itself. As we've seen with Detroit, you end up in Chapter 9 bankruptcy and you're basically being treated as an unsecured creditor."

Mousseau cited the 2014 escape of the Detroit Institute of Art from the clutches of the city's creditors, whose demand that the museum sell its Van Goghs and Renoirs to satisfy the claims of the bondholders U.S. District Judge Gerald Rosen brushed aside. "In the end," said Mousseau, "the judge rules that you can't ruin the character of the city and nailing the bondholders. So, that is the issue, and we would much rather own a water bond or a sewer bond where we get paid every time someone flushes the toilet."

For the DIY investor, there are muni-bond ETFs to explore. For illustration, the iShares National Muni Bond ETF (MUB on NYSE Arca) has $9.9 billion of market cap. Single-A- and triple-B-rated segments represent 16% and 5% of assets, respectively; the balance is double-A or higher. Duration is 5.9 years and the yield to worst is 2.35% after fees and taxes for those happy denizens of states that levy no income tax; or 3.97% on a tax-equivalent basis. Compare to the 2.90% available from Treasurys of comparable duration.

Sufferers of blue-state income-tax exactions may prefer to do their bond buying in the state in which they permit themselves to be fleeced (at rates of 12.7% in New York and 13.3% in California, for instance). Thus, the iShares New York Muni Bond ETF (NYF on NYSE Arca) manages $304 million in net assets with six years of duration and 2.14% in yield after fees and taxes, or 3.61% on a tax-equivalent basis, which represents 70 basis points over Treasurys.

The yields aren't much, but they're better than the after-tax returns available in corporate-bond or leveraged loans. Wealthy New York City residents pay an overall income-tax rate of 53.5% (37% in federal plus 8.82% in state plus 3.88% in local and another 3.80% in Obamacare surtax). Generously assuming no default or markdown in prices, the BKLN leveraged-loan ETF yields 4.97% after fees, or 2.31% after tax, which is not much higher than the after-tax yield on the NYF.

"Value, such as it is, seems concentrated at the longer end of the curve," Fabiano Santin concludes. "How high the 30-year Treasury yield can climb—and stay—will depend on long-term inflation, on which we all have our opinions but only a clairvoyant has the facts. Assuming that bonds are not called, more than 300 basis points in tax-equivalent yield is available for those willing to venture into those not-so-shallow waters. The VanEck Vectors AMT-Free Long Municipal Index ETF (MLN on NYSE Arca) has a duration of 10.2 years and trades at an after-fees yield to maturity of 3.74%. To residents of states that don't charge income taxes, this represents a tax-equivalent of 6.3% when compared to Treasurys. To put it differently, to a resident of a non-tax-state such as Florida, the MLN yield is equivalent to 8% on interest earned from corporate bonds or loans to the New Yorker at the highest bracket. Cheaper, open-ended funds are available, such as the Vanguard Long-Term Tax-Exempt Fund, which charges nine basis points per year versus 24 basis points in the MLN."

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