

THERE IS STILL TIME TO INVEST



Graham Rainbow, Managing Director and portfolio manager of the European Loan strategies at Alcentra talks about investment opportunities in senior secured loans and the latest trends and developments in the sector.

Alcentra, one of Europe's largest and longest established credit managers, is a specialist investment manager owned by BNY Mellon, with USD 22.6 billion in AUM, including USD 11.9 billion in European fund assets and USD 10.7 billion in US fund assets (as at 31 January 2014).

Senior secured loans have performed well in recent years. Is it too late to enter the asset class and, if yes/no, why?

It is not too late to invest in senior secured loans. In fact, opportunities to invest in this asset class are still strong and these loans can be an attractive option versus investments in other asset classes. Spreads within the market remain at historically high levels and, with interest rates set to rise, these products can offer positive returns and relatively low volatility. Investors will not make the 10%+ returns in the asset class today that were available immediately after the financial crisis but we think returns in the range of 6-9% look achievable - with the benefit of any interest rate rises feeding straight through to the bottom line. If you compare that with the returns and volatility of some other instruments, senior secured loans present a strong proposition. We believe they are less volatile than equities and sovereign debt instruments and we feel they could even offer better returns than some high yield bond instruments over the next two years.

Alcentra has favoured European senior paper to the corresponding US alternative for over two years now. Given market conditions this appears to have been the correct call, but how does their relative value look today?

We still see relative value in European secured loans over the US, driven by their better average returns per investment. The average yield for European credit is about 50 basis points higher than for corresponding US paper. European loans benefit from lower leverage versus their US equivalent and the level of documentation standards and covenant protection is certainly higher than in the US market. European spreads are also higher. From a performance perspective, European paper returned just over 9% last year, with US

returns closer to 5.5%¹. We wouldn't expect to see those return differentials every year, but the 2013 European versus US returns did offer an interesting contrast.

I quite often hear that there is little supply in the European senior secured loan market. Given your current preference for Europe, can you comment on this?

While the US loan market is significantly larger than its European counterpart Europe still offers good flows of senior secured loans to invest in. In fact, while a lot more money has flowed into US senior secured loans in recent years, the European market for these instruments is still significant at €144bn² and the supply of loans is growing. We feel European senior secured loans continue to offer both significant and strong investment opportunities. That is illustrated by the positive yield advantage European paper currently enjoys over US senior secured loans.

Assuming you were a pension fund manager starting to invest in senior secured loans, what would your geographical allocation look like? Geographical allocation can vary from fund to fund and the quality of investments selected and good research are critical factors in deciding which allocations are best. From a geographical perspective it was once common for most funds to be heavily overweight in US exposure versus Europe, which we feel is not optimal. Within the past 18 months investors have started to adopt a more balanced approach, allocating investments more equally and closer to a 50:50 split between US and European holdings - a strategy we feel has merit. Much depends on how return driven underlying investors are and how much risk they perceive there is in specific geographic markets at any given time.

¹ January 2014 S&P Capital IQ LCD

² Credit Suisse 2014 Leveraged Finance Outlook and 2013 Annual Review (February 2014)

You have pension funds from several countries invested in your strategy. Are they holding this allocation under their fixed income book or in their alternative segment?

The exact allocation positions adopted by funds vary significantly. The larger pension funds we deal with tend to hold these investments in their fixed income portfolios. That said, some funds may decide to allocate these investments to their alternatives portfolios instead. Within certain jurisdictions, investors may feel investments such as these that are not UCITS compliant and/or do not offer daily liquidity and are better suited to their alternative investment portfolios.

Weighted Average Yield to Maturity³



³ S&P LCD Research, Excel Data, 31 December 2013

ALCENTRA EUROPEAN LOAN STRATEGY HIGHLIGHTS

- A typical portfolio has loan positions in over 60 higher quality issuers
- Broad diversification by country and sectors in Europe (focus on North-/ Core Europe)
- Target return of 6-9 p.a. in EUR net with a conservative, fundamental bottom-up investment approach (although this is not guaranteed)
- Alcentra is a leading investment manager in the sub-investment grade universe with a strong foothold and good know-how in Europe.

**For more expert views from BNY Mellon's specialist investment managers:
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