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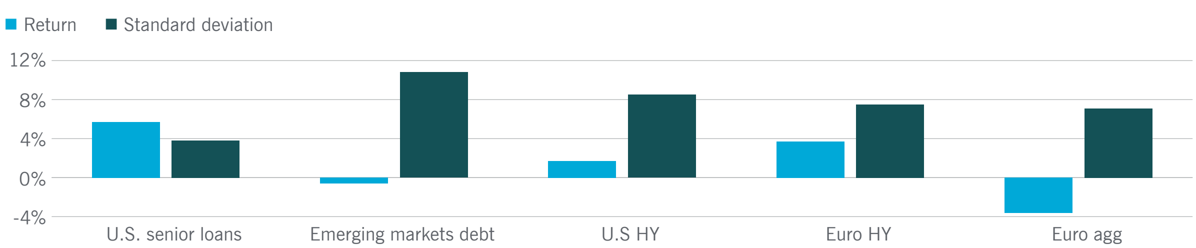
Five reasons European investors should not overlook U.S. senior loans

U.S. senior loans, also known as broadly syndicated loans, floating rate loans or bank loans, have shot into prominence since the U.S. Federal Reserve began hiking rates in 2022. Investors have taken notice of the attractive returns and remarkably low volatility provided by the asset class. While this market has grown to $ 1.4 trillion in size, it remains relatively misunderstood and under-owned by investors. In this piece, we provide five compelling reasons loans deserve a seat at the strategic asset allocation table for European investors.

WHAT ARE U.S. SENIOR LOANS?

U.S. senior loans are debt instruments issued by well known, below-investment grade companies typically with average EBITDAs over $500m.[1] These loans are structured and syndicated by banks to large groups of lenders including mutual funds, collateralized loan obligations (CLOs) and institutional investors. Notable issuers of loans include ride hailing and delivery service provider, Uber, fast food giant, Burger King and contact lens manufacturer, Bausch & Lomb, as well as American Airlines, Formula One and Hilton. Many issuers of U.S. senior loans are privately held companies, often backed by some of the largest private equity sponsors, including Blackstone, KKR and Carlyle.

Figure 1: U.S. senior loans have outperformed with rising rates



Source: Morningstar, 17th March 2022–30th June 2024. **Representative Indexes: U.S. senior loans:** Morningstar LTSA US LL TR Hdg EUR; **Emerging market debt:** JPM EMBI Global Diversified Hgd TR EUR; **US high yield:** ICE BofA US High Yield TR Hdg EUR; **Euro high yield:** ICE BofA Euro High Yield TR EUR; **Euro aggregate:** Bloomberg European Aggregate Bond TR EUR.

U.S. senior loans have three main features that set them apart from other comparable asset classes. Firstly, they are the most senior debt of a company, meaning loan holders have the highest priority of claims in the event of default. Secondly, loans are secured by assets such as physical and intellectual capital, equipment, accounts receivable and inventories. Consequently, assets can be transferred to loan holders if a company defaults, generally leading to higher recovery rates than other below investment grade credit, as shown in the table below.

	Default rate	Recovery rate
US high yield	3.4%	40.0%
US senior loans	3.0%	63.5%

Source: JP Morgan as at 30th June 2024. Data represents 25-year annual averages.

Finally, U.S. senior loans are issued with a coupon that pays a predetermined spread above a variable rate such as SOFR (secured overnight financing rate). Therefore, as rates rise, loan coupons reset and provide investors with higher income payments. It also means that loans have near-zero duration as these resets typically occur monthly or quarterly.

Figure 2: U.S. senior loans sit atop the capital structure of high yield companies and are secured by collateral

PLEDGED COLLATERAL

- Cash
- Current assets
- Inventory
- Property, plant & equipment
- Intangibles
- Stock

PRIORITY OF PAYMENT

U.S. senior loans ("broadly syndicated loans," "floating rate loans," "bank loans")

Senior (unsecured) debt (traditional bonds, convertible bonds)

Subordinated unsecured debt (traditional bonds, convertible bonds)

Preferred stock

Common stock (equity)

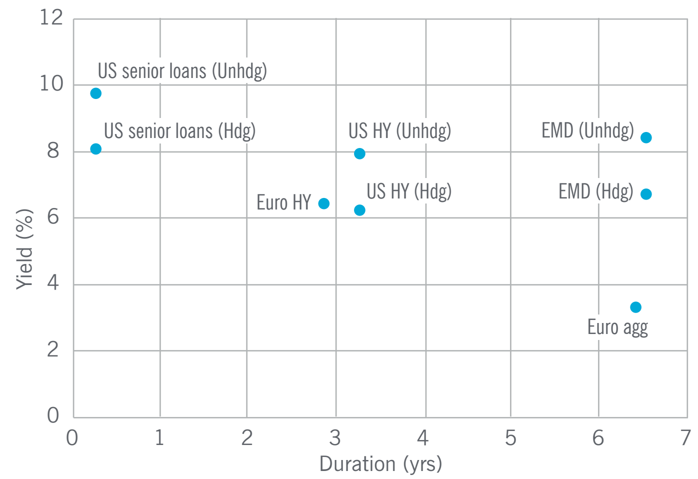
Why do U.S. senior loans make sense for European investors?

1. U.S. SENIOR LOANS OFFER A COMPELLING RISK-ADJUSTED RETURN

U.S. senior loans offer a high level of reward per unit of risk across several dimensions. When looked at from a yield per duration perspective, U.S. senior loans have one of the highest yields in fixed income coupled with very low sensitivity to interest rates. European investors may find similar levels of income in high yield bonds or emerging market debt, both of which carry significantly longer duration.

When examined from a Sharpe ratio perspective, U.S. senior loans stand apart from fixed income peers. The combination of high coupons and relatively muted price changes at an aggregate level, have enabled loans to generate high yield-like returns with investment grade-like volatility over the long term. As noted earlier, loans have near-zero duration which eliminates a major source of risk that besets bonds — interest rate risk. That said, US senior loans are subject to credit risk, therefore careful issuer selection is critical to success.

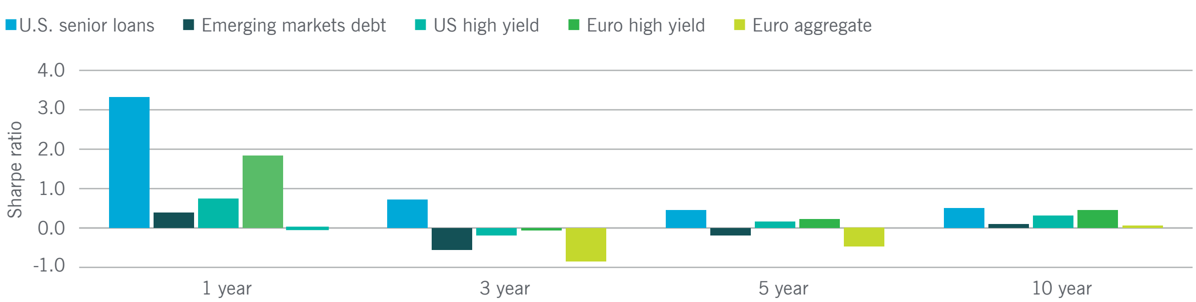
Figure 3: U.S. senior loans vs. other fixed income asset classes



Source: Bloomberg, JP Morgan, 30 June 2024. **Representative indexes: U.S. senior loans:** Morningstar LTSA US leveraged loan index; **Euro high yield:** ICE BofA Euro High Yield Index; **U.S. high yield:** ICE BofA US High Yield Index; **Emerging market debt:** JPMorgan EMBI Global Diversified; **Euro aggregate:** Bloomberg Euro Aggregate Bond Index.

USD indexes have both hedged (EUR) and unhedged figures. Hedged yields are calculated by subtracting the cost of hedging (as of 30th June) from the Unhedged yield.

Figure 4: Risk-adjusted returns for major fixed income asset classes



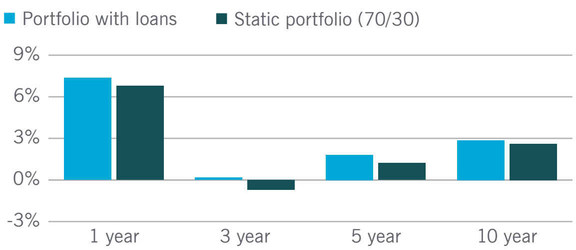
Source: Morningstar, 30th June 2024. **Representative indexes: U.S. senior loans:** Morningstar LTSA US leveraged loan index; **Euro high yield:** ICE BofA Euro High Yield Index; **U.S. high yield:** ICE BofA US High Yield Index; **Emerging market debt:** JPMorgan EMBI Global Diversified; **Euro aggregate:** Bloomberg Euro Aggregate Bond Index.

2. DIVERSIFICATION BENEFITS OF U.S. SENIOR LOANS ENHANCE THEIR APPEAL

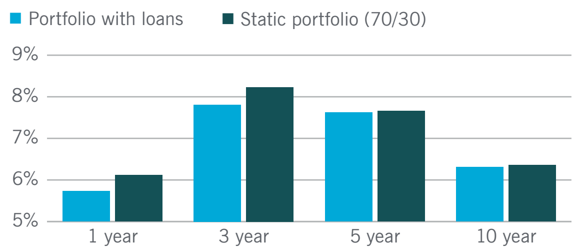
In addition to compelling risk-adjusted returns, U.S. senior loans bring diversification benefits to portfolios due to their lower correlations to other major asset classes. For instance, over the long-term,[2] U.S. senior loans have a correlation of just 0.3 to high quality European bonds and 0.61 to European stocks. In comparison, U.S. (and European) high yield has considerably higher correlations of 0.53 (0.55) and 0.73 (0.76) to European bonds and stocks respectively. The below is a simplified illustration of the advantages this asset class brings to a balanced European portfolio. Adding a 10% allocation of U.S. senior loans to high quality European bonds, increases portfolio returns while simultaneously reducing volatility.

Figure 5: Adding U.S. senior loans enhances returns and reduces volatility compared to a static portfolio

Annualized returns



Standard deviation



Source: Morningstar, 30 June 2024

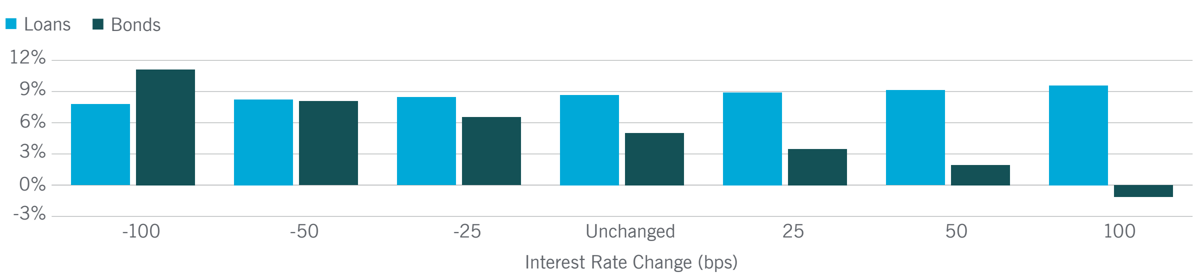
Static portfolio is a 70% bond/30% equities allocation. Bonds represented by Bloomberg Euro Agg Bond TR EUR and equities by MSCI Europe GR EUR. Portfolio with loans is a 60%bond/10%loan/30% equities. Loans proxied by Morningstar LSTA US LL TR HEUR Index.

3. U.S. SENIOR LOANS ARE RESILIENT

Contrary to widely held perceptions that loans only generate attractive returns in rising rate environments, they can also add value even when rates fall. With the U.S. Federal Reserve likely to initiate rate cuts, albeit at a measured pace going forward, investors can take some comfort in the versatility of loans in different interest rate regimes.

Figure 6: Senior loans may benefit a portfolio in periods of rising and falling rates

Hypothetical returns in various rate scenarios; total return, assumes a parallel shift in the yield curve



The chart does not represent the past performance or yield of any Nuveen fund. For fund performance information, visit nuveen.com.

Source: Bloomberg, Morningstar, Nuveen. 30th June 2024. **Past performance does not predict or guarantee future results.**

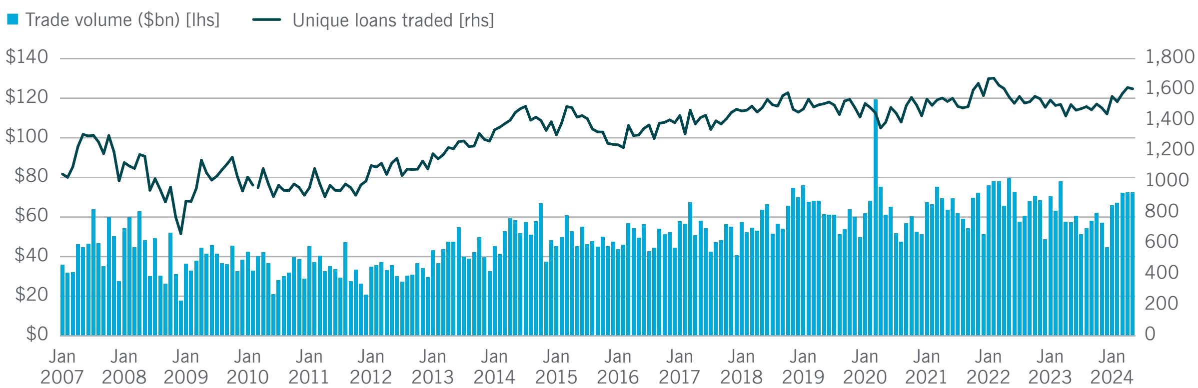
Representative Indices: Bonds: Bloomberg US Aggregate Index, **Loans:** Morningstar LSTA US Leveraged Loan index. Yield and duration data as of 30th June 2024. Loans use a loss-adjusted yield of 8.7%, derived by subtracting an estimated credit loss of 1.1% from a market yield of 9.8%. Credit loss estimate based on 25 years of default and recovery data from JP Morgan. Calculations are made using standard duration formula and assume instantaneous rises in interest rates and adjustments of benchmark yields on loans. Different benchmarks, economic periods, methodologies and market conditions will produce different results. The methodology and outcomes are purely illustrative. There is no assurance that any asset class or index will provide positive performance over time. **It is not possible to invest directly in an index.**

4. LIQUIDITY IN SENIOR LOANS PROVIDES FLEXIBILITY FOR INVESTORS

One of the most important attributes of U.S. senior loans is liquidity. Loans trade actively on the secondary market. In the 12-month period ending May 2024, the average total monthly trading volume in the U.S. senior loan market was approximately $60 billion and cumulative volume was roughly $740 billion, representing over 50% of total market size. Funds that invest in loans can offer daily or weekly liquidity to underlying investors.

This feature is important for two main reasons. Firstly, it facilitates the active management of portfolios by allowing managers to trade positions either for risk mitigation or return-seeking purposes. Secondly, it benefits end investors, as liquidity provides optionality to express their asset allocation and relative value views in real time instead of being locked up in multi-year investment vehicles.

Figure 7: U.S. senior loans are actively traded

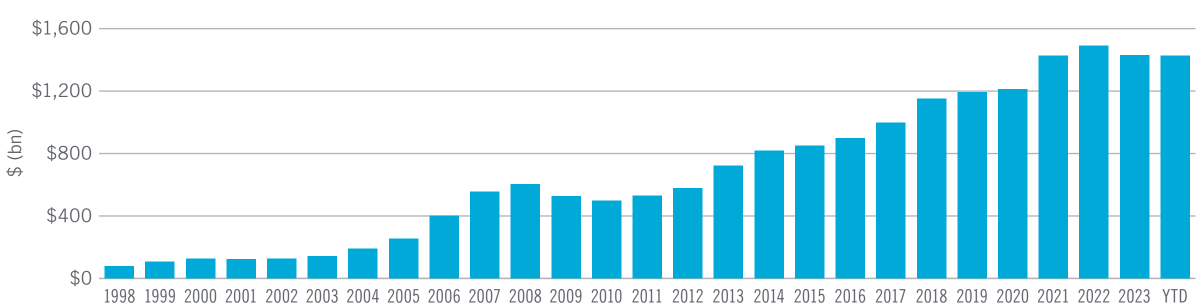


Source: Pitchbook data, 31st May 2024.

5. U.S. SENIOR LOANS HAVE MATURED FROM NICHE TO MAINSTREAM

At $1.4 trillion, U.S. senior loans can hardly be classified as niche. This rise has partly been fueled by robust issuance of CLOs, single securities backed by pools of debt, in this case, senior loans. CLOs currently make up two-thirds of the investor base in U.S. senior loans. These securities typically have a seven-to-ten-year life making them long-term investors in the asset class. In addition, institutional investors comprise nearly 30% of the buyer base, bringing further stability to the loan market.

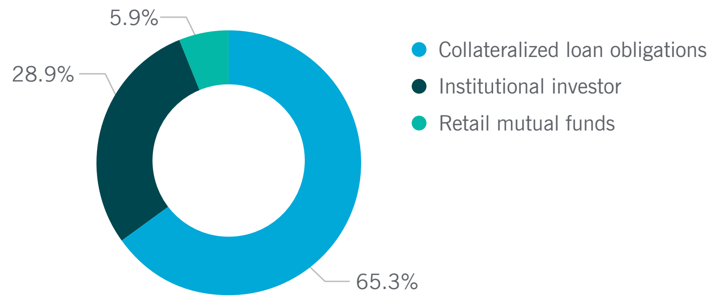
Figure 8: U.S. senior loans have grown steadily



Source: JP Morgan, S&P/IHS Markit 30th June 2024.

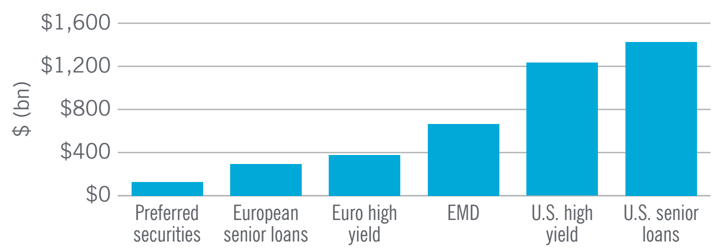
U.S. senior loans are now considerably larger than many other fixed income asset classes that are deemed mainstay in traditional portfolios, including emerging market debt, U.S. high yield and European high yield. Further, the asset class is several folds the size of European loans because borrowers in Europe are still reliant on direct commercial bank lending rather than broad syndication.

Figure 9: Investor base for U.S. loan market is predominantly institutional



Source: JP Morgan, 31st October 2023.

Figure 10: U.S. senior loans are larger than other mainstay fixed income asset classes



Source: JPMorgan, Nuveen. Data as of 30th June 2024. Senior loans are larger than other mainstay credit asset classes. **Representative indexes: Preferred securities:** ICE BofA Fixed Rate Preferred Securities Index; **Euro high yield:** ICE BofA Euro High Yield Index; **Emerging markets debt:** JP Morgan EMBI Global Diversified Index; **U.S. high yield:** ICE BofA US High Yield Index; **European loans:** Morningstar Western Europe LL Index TR; Senior loans: Morningstar US LL Index.

WHY NUVEEN FOR U.S. SENIOR LOANS?

For investors looking to access this exciting market, active management is key to success. U.S. senior loan indices are difficult to replicate and ETFs that proxy broad loan market exposure tend to underperform. For instance, the largest such ETF has lagged peers 70% of the time in the past 10 years.[3] Nuveen has invested in U.S. senior loans for more than 20 years, through multiple market environments and credit cycles. Our team of over 40 investment professionals oversees more than $41 billion in leveraged finance assets, giving us the scale, resources and access that are necessary for success. Our investment approach emphasizes: 1) active management through daily re-underwriting of credits to identify relative value opportunities in buys and sells, 2) a preference for larger, more liquid loans that allow us to be nimbler than peers, and 3) greater selectivity in the new issue market, seeking to avoid overpriced loans and weaker business models. An unwavering commitment to these tenets has enabled us to deliver compelling risk-adjusted returns for nearly a quarter of a century in the U.S. senior loan asset class.

For more details on how senior loans can play a role in your portfolio, please speak to your local Nuveen representative.

Endnotes

Sources

1 EBITDA stands for Earnings Before Interest Taxes Depreciation and Amortization

2 Over a 10 year period from 1st July 2014 – 30th June 2024. **Representative indices; European bonds:** Bloomberg Euro Agg Bond TR EUR, **European equities:** MSCI Europe GR EUR, **US high yield:** ICE BofA US High Yield TR HEUR. **European high yield:** ICE BofA Euro High Yield TR EUR, **U.S. senior loans:** Morningstar LTSA US LL TR HEUR

3 Invesco Senior Loan ETF (ticker: BKLN). Ten year look back from 2014–2023. Performance period is each calendar year. Peer category is Morningstar US Bank Loan Fund.

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