

## Babson Capital on finding relative value in global loans

- by Leela Parker

**Babson Capital Management's Mike Freno and Babson Capital Europe's Zak Summerscale, both managing directors and members of Babson Capital's Global Loan Oversight Committee, spoke to Thomson Reuters LPC about the U.S. and European loan markets, and finding relative value opportunities in market inefficiencies.**

**How are the U.S. and European loan markets distinct and how do these differences make a relative value strategy attractive to investors?**

**Mike Freno:** Largely, these two markets will ultimately tend to be correlated, but one market may lag the other in a downturn or an upswing. Due to market inefficiencies there are opportunities to find relative value where things may have been mispriced in the two markets due to the issuance's base currency or other technical or fundamental factors. The main difference between the two this year, in our opinion, is more a result of technicals. The U.S. market has had a growing retail market coupled with a more active primary market. Europe is different from that standpoint. There is not a significant open-ended retail platform in Europe for investors and new issuances in Europe have been a bit more muted. In the first part of the year, the U.S. had the benefit from retail inflows. Of course, we've now had six to seven consecutive weeks of outflows, which is putting some pressure on the asset class.

**Zak Summerscale:** In Europe, as regulated by the UCITS, loans are not considered securities. It is not permitted to market loan product to European retail investors. This means we saw over \$40 billion flow into the U.S. loan market and the European equivalent was negligible. As a result we saw euro spreads lagging. But looking at European corporate credit, the vast majority of corporate credit is doing fine, particularly in core European countries. There is the obvious impact on sentiment and the risk-off trade due to the well publicized peripheral European sovereign issues, but companies are less levered than previously and corporate credit is much better placed. It is worth remembering that there is no exposure to European banks in the secured loan market.

**How would you distinguish between exploiting investments in cross-border transactions vs. exploiting inefficiencies the U.S. primary and European secondary markets, for example?**

**ZS:** There are cross-border transactions, meaning companies that are issuing debt in multiple currencies. However, when there are loans issued in two currencies and they are mispriced, this is a low-risk way to pick up additional yield. Cross-

border transactions are the easy low-hanging fruit. With Babson's global loan platform, we have the ability to spot buying opportunities. U.S. dollar-only investment platforms don't have the multi-currency capability. However, the majority of returns will not come from those types of arbitrage opportunities, but more so from taking advantage of broader differences and inefficiencies between the two markets.

**MF:** Certainly the U.S. secondary market has backed up. If you felt going into August that loans were attractively priced, they are more attractive now in terms of yield. In terms of new issuance, it's still difficult to predict where the primary market will land in terms of pricing, but in our opinion the U.S. primary market will likely present some of the most attractive opportunities on a risk-return basis. Still, opportunities exist in the secondary. It's not solely a primary market, but depending on the levels of the new deals, the U.S. primary market may be the place to put the first dollar you have.

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**Until recently we have seen tremendous amounts of cash flowing into U.S. leveraged loans. But, in August we saw huge outflows from bank loan mutual funds. Without another loan buyer, what is the long term impact of this loss of capital – especially in the absence of a robust CLO bid?**

**MF:** Inflows into retail mutual funds remain a relatively small part of the overall investor base, which is still dominated by institutional investors and CLOs. We are of the view that CLOs will come back. However, we expect their market share to continue to decline for the foreseeable future. Open-ended retail and institutional funds provide flexibility to investors and as a result can add to volatility. But, from an investor perspective, the potential supply-demand situation can be a positive. It is our view, that to attract unlevered money to the asset class, there will have to be wider spreads than what we've seen from the pre-crisis, CLO dominated market.

**ZS:** In our opinion, the risk-return looks very attractive for loans with spreads back at levels

last seen in December 2009. We think the sell-off in loans is driven by technicals and people are forgetting about fundamentals.

**How much investor education is required in terms of deploying a global loan strategy?**

**ZS:** There is an education process. People are more familiar with the U.S. market. There are also investors who have never invested in loans, which requires a lot of education, but there is also a lot of interest in the defensive characteristic of loans and in the risk-return profile.

Loans are pretty short-dated. Even though you can have market dislocation, these loans mature. You don't have to wait long term. In the next three to four years these returns will come. Compared to longer-dated instruments, loans have real maturity dates and have companies with significant enterprise value behind them. This has provided real traction.

With the recent pullback, it should be an even better opportunity to market those characteristics, in particular the downside protection provided by loans. We have only scratched the surface in terms of investors out there.

**MF:** We are focused on bringing investors up to speed. In particular with the European market, there is an education regarding the differences between corporate credit issuers in core Europe and periphery Europe when it comes to below-investment-grade product. I think most investors are grasping and appreciating the strategy.

**Where do you see more distressed opportunities? How significant is the refinancing cliff now?**

**ZS:** Distressed opportunities in Europe will be driven by the maturity wall in 2013 and 2014 where over levered companies can't refinance and will be forced to restructure. However most of these names are already well flagged in the secondary market and as a firm we continue to focus on companies with a sustainable level of senior secured leverage.

**MF:** We are still in a very, very low default rate environment. For the past year and a half companies have been able to improve balance sheets and improve cost structures. Companies that have done that should be able to survive. The maturity wall has been reduced significantly, and good companies are able to access credit markets. In the near term, the refinancing wall is less of an issue in the U.S. than in Europe. Maturities have been pushed out with bond-for-loan takeouts, refinancing in the loan market, etc. The fear of a huge wall coming due concurrent with CLOs' reduced ability to reinvest has been somewhat mitigated.