Corporate Loans – A Mature Segment of the High Yield Market
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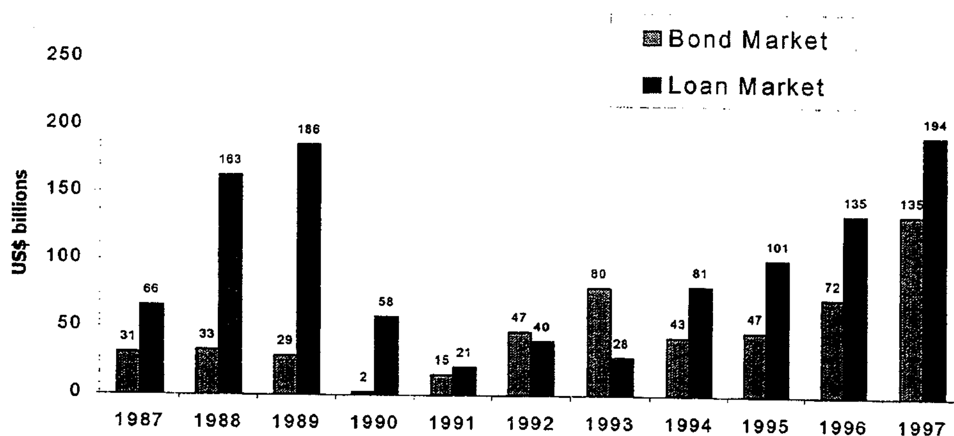
Corporate Loans – Market size, Buyers, new Developments

Although the loan market is comparable in size to the fixed income market, it was traditionally a low liquidity market controlled by large banks.



New Issuance of High Yield Instruments in US Capital Markets.

Banks would issue a loan, put it into a portfolio and would remember it only at the time of renewal. There is practically no bank in the world using a modern quantitative approach to manage loan portfolios. Over the last few years the situation has dramatically changed. There are a number of reasons for this.

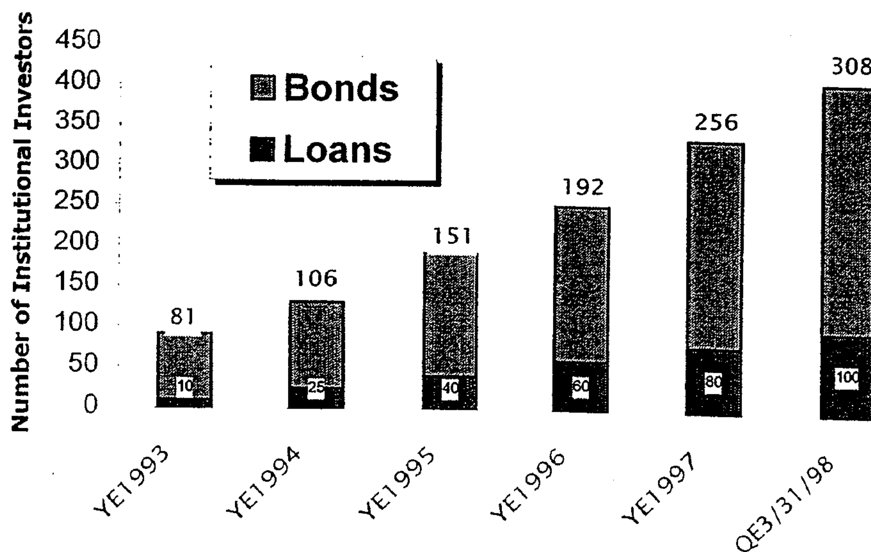
US and international banking regulators are moving banks in the direction of quantitative loan portfolio management, risk management and marking-to-market. This trend will pick up speed due to the consolidation of the US banking industry and increased concern of regulators about concentration of capital.

The Travelers/Solomon/Citibank merger of an insurance company, a commercial and an investment bank has paved the way to the abolishment of the Glass Stegall law. As a result of consolidation, loan issuance and loan portfolio management departments will report to a head of fixed income. Fixed income at Solomon Brothers is considered to be

one of the best quantitative shops on the Street. Even in the absence of a merger, JP Morgan has recently declared its loan portfolio as a trading, not holding portfolio and subordinated all the loan issuance, trading and portfolio management to the fixed income department. The consequences of this are enormous. First, instead of 8% of reserved capital needed to keep against a hold loan portfolio, JP Morgan will need to keep only a fraction of this. Second, by the rules of the Federal Reserve JP Morgan will have to mark this portfolio to market on a regular basis.

Over the last few years the investment community has discovered loans as a new asset class. The main reason for this is that there is a shortage of high quality securities with good risk/return characteristics. Although "Prime Funds" investing in BB industrial loans existed for over a decade, they have been reasonably small, never exceeding $5B. Overall the corporate loan market is near $2 trillion. Five years ago the first Collateralized Loan Obligation (CLO), SPV, was created. Presently there is over $80B in CLO's on the market. More importantly, a number of insurance companies and independent money managers are managing billions of dollars worth of loan and loan/bond combination portfolios. All of these money managers are used to quantitative technology to manage portfolios. Miscalculation of the relative values between loans and other types of fixed income instruments may result in big losses. Presently there is no quantitative portfolio system available to manage loan or bond/loan combination portfolios.

A number of brokerage houses (Merrill, Goldman, Lehman, Morgan Stanley, DLJ among biggest) have launched secondary trading desks and syndication departments for loans. All of the above have dramatically increased liquidity of the loan market and demand for



the analytical, pricing and risk management systems capable of working with loan portfolios.

Performance characteristics of Corporate loans.

Over the last 12 months Corporate Loans under-performed High Yield Bonds by 51bp.

Selected Fixed Income Returns – Last 12 Months

Treasury		0.19%
Government/Corporate		9.33%
Mortgage - Backed		6.11%
Corporate High Yield		7.92%
Corporate Loans	(non-distressed)	7.41%
Emerging Markets		(23.71%)

But from the Sharp Ratio point of view Loans are by far the best performer.

Returns and Standard Deviations
(June 1992 - April 1998)

	High Yield Loans [1]	High Yield Loans [2]	Mortgage Backed [3]	High Grade Corporates [4]	Ten-Year Treasuries	3-Month T-Bills	Large Stocks [5]	Small Stocks [6]
Avg. Monthly Returns %	0.73	0.94	0.61	0.73	0.65	0.38	1.65	1.34
Standard Dev.	0.50	1.06	0.93	1.38	1.91	0.09	3.04	3.65
Sharpe Ratio [7]	0.68	0.53	0.24	0.25	0.14	N/A	0.42	0.26

[1] Loan Pricing Corp. Leveraged Pricing Index
[2] Merrill Lynch High Yield Master Index
[3] Merrill Lynch Mortgage – Backed Master Index
[4] Merrill Lynch High Grade Corporate Mater Index
[5] Standard & Poor's Index of 500 Common Stocks
[6] Russel 2000 Index
[7] Total Return Minus Return on 91-Day Treasury Bills/Standard Deviation of Total Return

For investors concerned about down side of investments, corporate loans a offering supreme protection. The largest drop of 2.36% in the total value of aggregate loan investment happened in October of 1993.

Assets Class	Date	% Change
Bank Loans	**October 1993**	**(2.36)**
'B' High Yield Bonds	**August 1998**	**(6.77)**
S&P 500	**October 1998**	**(21.76)**

Conclusions:

Presented methodology for loan pricing is a powerful tool for High Yield loan and bond money management.