Welcome to Loan Land

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Everybody talks about yield, but nobody does anything about it.

In particular, the Fed's reluctance to be pinned down to a date certain when rates will rise has lent a "she-loves-me-she-loves-me-not" tone to investors' worries.

The buy-side has toggled all year between loans and bonds in search of optimal returns. Mutual fund flows have oscillated like metronomes. One week junk funds are cash magnets with investors convinced this low-rate environment will persist as far as the eye can see. Then global slowdown (hence default) worries send that cash scurrying for safe havens.

One would think rate hikes would be honey for floating-rate loan buyers, particularly the better-rated variety. Not so. According to Lipper FMI, more than $11 billion of loan fund dollars exited stage left this year. Indeed, with two exceptions, outflows have occurred every week since April 14 (*Chart of the Week*).

High-yield bond funds, in contrast, have had an astonishing run (until this week) of four weeks of inflows totaling $6.6 billion. Fixed-income buyers convinced themselves that the Fed's stance is constructive for the asset class. But new-issue unsecured junk averaged a 6.12% yield in October, while new-issue liquid loans in the same period weighed in at 6.2%. So much for relative value.

In contrast to aversion by funds, CLO managers are buying as many loans as they can get their hands on. Mid-October's bout of volatility helped lift all-in asset spreads, but higher repayments and shortage of new LBO paper this quarter may reverse that trend.

Adding to the unhelpful arbitrage mix has been stubbornly high triple-A liability spreads. A combination of regulatory pressures and dearth of providers have pushed average costs of top-rated CLO tranches from a 1Q 2013 low of L+115 bps to L+150 today.

Last month's regulatory ruling on CLO risk retention, while long-expected, has sent managers and arrangers back to their drawing boards. With a two-year window, the requirement that CLO managers must own at least 5% of the vehicle in equity is bound to result in envelope-pushing structures. Options being discussed include minority investors and financing of the manager equity.

The 2016 deadline has served as an accelerant to launching of new vehicles ($120 billion of volume is predicted for this year). But it has also put a damper on the long-term prospects for any but the most well-capitalized asset managers. CLOs have historically held the lion's share of leveraged loans, roughly 60%. And while the latest issuance boost has kicked up that participation to almost 68%, the dominance of these trusted vehicles may have peaked.

On the other hand, as we discussed last week's, BDCs are on a roll. Currently small potatoes ($60 billion) relative to CLOs or mutual funds, BDCs have raised almost $30 billion of capital this year, with the pipeline growing. The transparency and double-digit yield of these mostly public, dividend-paying entities are coming at the right time.

Now if we can get them interested in some triple-As…