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Private Credit vs. Public Debt (Last of a Series)

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For high-yield bond investors, March has been the cruelest month. First oil prices – often linked to bond prices – took a dive, from $54/bbl to $48 in just three weeks. Then last week the Fed hiked interest rates, and signaled they weren't done by a long shot. That combination of happenings compelled junk buyers to flee from retail funds to the tune of $5.68 billion last week.

As our *Chart of the Week* depicts, $8 billion in investor cash has departed from these funds so far this month. In contrast, retail loan funds have seen eighteen weeks of consecutive in-flows. During that period – since November 9 -more than $18 billion of cash has moved into floating rate assets.

In this special series comparing loans and bonds we've examined their relative yields, credit and interest rate risks, and sensitivity to market moves and business cycles. Let's look finally at duration risk and how well these instruments meet the long-term goals of their constituents.

Bonds are by definition long-term investments, typically ten years for non-investment grade issuers, and up to a century for the highest quality corporates. They also contain non-call provisions protecting investors from refinance risk. But depending on the rate environment and outlook, locking up your money that long can be a boon or a bear.

Leveraged loans carry less rate protection for the investor, but also make it easier to get your money out. Maturities are generally limited to seven years. Unlike bonds there are few non-calls (though occasional "soft" calls allow the company to refinance without penalty for M&A events), and loans on average are refinanced for other reasons after three or four years.

Of course being floating rate, with the issuer adjusting its Libor rate every few months, these loans have a duration risk that's effectively zero.

As last week's *Lead Left Spotlight's* guest Steve Nesbitt, the CEO of investment advisory firm Cliffwater, pointed out, institutions such as pensions, endowments, and foundations require 7% returns. High-yield bonds right now yield a shade over 6%, according to the Bloomberg USD High-Yield Corporate Bond Index.

Compare that to 6.16% where middle market loans are priced today, per Thomson Reuters' latest numbers. Which would you rather be, unsecured, fixed-rate, and junior? Or secured, floating-rate, and senior? Hence March's fund flow trends.

Not to mention the relative loss rates. In a recent report UBS analysts estimated US high-yield bonds had a twenty-year average annual loss rate of 2.8%, while leveraged loans weighed in at 1.3%, less than half that of bonds.

Regardless of loan and bond features, it all comes down to having the right manager. To quote Mr. Nesbitt, "The better managers have better underwriting skills and sourcing capabilities. As an investor we expect to pick up spread and manager alpha."