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The Price of Everything (Second of a Series)

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Loan prices for the most liquid leveraged names continued to drift lower this week in the wake of continued volatility in the public markets.

This despite – or perhaps because of – a Goldilocks-flavored jobs report last Friday. Labor data showed 155k in new jobs for November. Not great, but enough to help ease worries that a hotted-up economy is in need of aggressive Fed hikes.

Still, overall loan tone is not a joyous one. Outflows from loan mutual funds continued; last week recorded just over $1 billion. That was the third consecutive week of $1 billion-plus exiting retail accounts, and the first time such a streak has occurred in four years. That brings cumulative outflows to $5.4 billion in the past six weeks.

This helped drive November's returns for the S&P/LSTA Leveraged Loan Index down 0.90%, largely due to the almost 1.5% erosion of secondary Index prices.

That dynamic illustrates the other side of the liquid loan coin. Broadly syndicated loan managers buy and sell loans as a matter of course. They do it to balance portfolios for ratings, sectors, spreads, and price. Besides earning Libor spread, PMs can improve yield for investors by buying loans at a discount, and eventually selling them at par.

This well-established strategy of "building par" earns income upfront. But in volatile markets such as we're experiencing, secondary bids are being caught in the downdraft. That hurts overall returns and challenges managers.

One of the virtues of middle market loans is illiquidity. Prices aren't subject to the same market swings of their broadly syndicated cousins. In part this is the buy-and-hold nature of the providers. Also, it's tough to trade among a small group of lenders in a limited tranche size.

As we've noted often in this space, data on middle market secondary prices are limited and misleading. These "marks" represent more of a trading desk wish list than true values. Nevertheless, there's no argument that smaller loans trade by appointment, if at all.

The good news is that this illiquidity provides midcaps with some measure of protection from market swings. As our *Chart of the Week* clearly shows, when the large cap index plunged below 63 cents on the dollar at the worst point in the credit crisis, the middle market index never dropped below 70.

It's important to note that loan prices for midcap names represent the syndicated part of that market. Further out on the illiquidity spectrum are the private club transactions. These are compact groups of direct lenders with strong private equity relationships.

Sponsors view these credit commitments as key to aligning everyone's strategic interests. Selling exposure by existing lenders is not viewed positively by the PE owner. As one middle market veteran put it, "You couldn't pry this paper from our cold, lifeless hands.”