Insights
Index Investing

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Capturing Leveraged Loan Beta

How Index Strategies Can Be an Effective Vehicle for Loan Market Exposure

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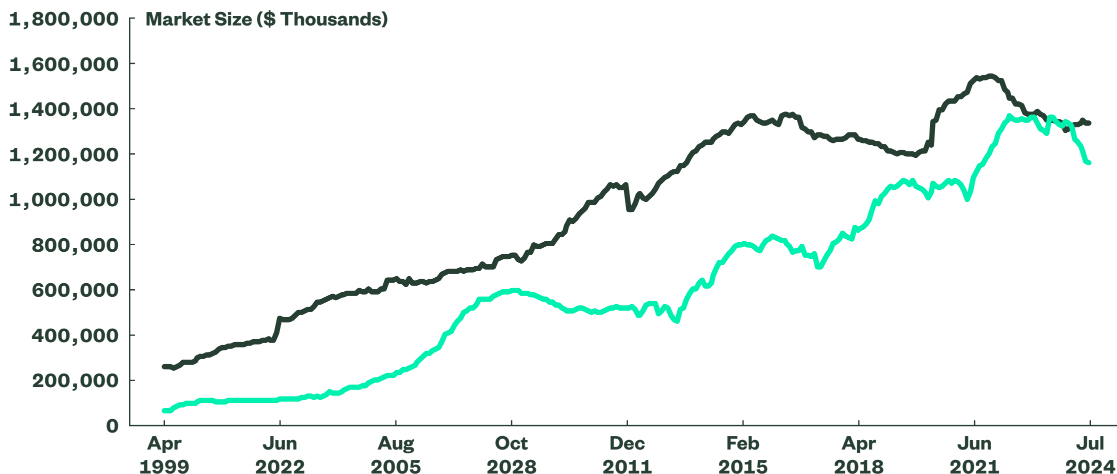
- **Leveraged loans have in the past been an institutionally-invested asset class, but adoption has been increasing since the early 1990s. However, unlike most other asset classes which have evolved to include a passive investing option, loans largely remain an actively-managed corner of the market. Given the growth of the market, advancements in trading technology, and deeper trading markets, it is now possible for investors to gain beta exposure to loans via an indexed, or passive, approach.**

- **We have designed and implemented a loans indexing strategy that closely aligns to the performance contour of the asset class and is meticulously structured to manage and mitigate various issues related to settlement times, trading costs, liquidity, and accessibility that have proven challenging in the past. In this piece, we explain some of the trading and portfolio construction techniques that we employ to give investors a less expensive, credible index-tracking option for beta exposure to leveraged loans.**

Cracking Open the Market

Given the significant growth of the asset class — it's now on par with the size of the high yield bond market (Figure 1) — tapping into leveraged loans is a massive opportunity for duration-free spread as part of a structural credit allocation. The growth of the asset class itself has opened trading markets, increased the number of potential trading partners, and amplified liquidity, broadly.

Figure 1
The Size of the Leveraged Loan Market Has Swelled



Source: Bank of America, as of July 31, 2024.

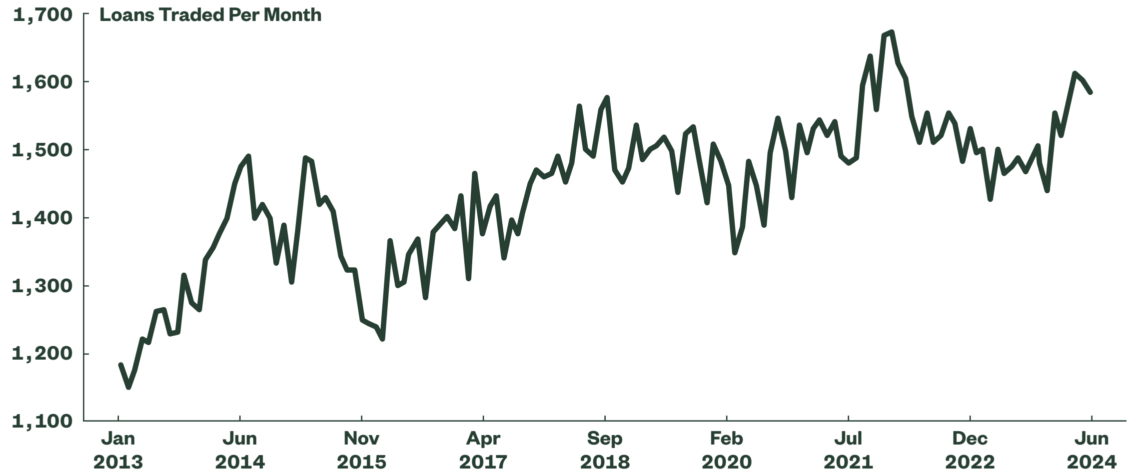
Hurdles to investing in leveraged loans have existed for decades, and have made loan investing via indexing exceedingly difficult. These hurdles include high transaction costs, thin liquidity at times, inconsistent accessibility, opaque pricing, and protracted settlement times. Additionally, since a loan is not a security, the plumbing and operational burdens associated with loans make them difficult to invest in at scale.

As the market structure (depth, breadth) for loans has continued to evolve and the asset class has expanded in both size and adoption by investors, many of these challenges have become more manageable. This has opened the door for sophisticated implementation techniques, similar to prior evolutions in high yield (HY) and emerging market debt (EMD) portfolio construction and trading. Advancements that help dismantle historic barriers to loan index strategies include:

- **Increased trading volume** Growth and investor demand in the asset class has increased trading (Figure 2), which has put downward pressure on transaction costs, and increased the velocity of trading in more mid-sized names.
- **Improved trading technology and insight** Price frequency and transparency has improved, with more quotes and platforms facilitating the increased buyer and seller activity.
- **Electronic trading** Relationships with counterparties include portfolio trading in loans, where dozens — if not more — of loans may be traded at once, showcasing the increased efficiency of loan markets. Over 20 dealers were live on the Octaura electronic trading platform as of September 30, 2024.[1]

In short, the challenges that once restricted loans from being sampled — and thereby indexed — are no longer insurmountable.

Figure 2
Loan Trading Activity Has Increased Significantly



Source: Barclays, LSTA as of July 31, 2024.

More on Sampling

The sampling process seeks to replicate the key risk dimensions of an index (i.e., a beta) by selecting a subset of the constituents of that index. Should that subset align with the most important risk drivers of an index — such as duration, key rate exposure, credit quality, and industry weights — the sample used can track the benchmark performance very closely.

For sampling in loans, the most important elements to ensure close performance tracking of the index are flexibility and optionality in selecting the underlying exposures. Alignment to those key risk characteristics will keep performance relatively close to that of the index.

In addition, the increased flexibility in choosing what to buy will importantly reduce otherwise considerable transaction costs. Including the dimensions of liquidity and loan availability in security selection, in aligning the overall portfolio risk characteristics, will prove crucial in meeting objectives.

Indexing in Loan Strategies: Insightful Portfolio Construction

Specific elements of the investment process can be implemented to make indexing an effective and viable approach for managing and tracking leveraged loan exposures.

Monthly Liquidity

While the industry has grown and developed across most areas, loan settlement remains somewhat primitive. At its base level, a leveraged (senior, bank, or floating-rate) loan is an agreement between a borrower and a lender, administered by an agent bank that maintains a record of interested parties. When trades occur, cash flows move through this agent bank — a manual process that can take days, weeks, or longer. While average settlement times sit near t+8, many loans can take considerably longer. This can impact how a daily liquid vehicle may invest its assets, and the US Securities and Exchange Commission has taken a hard look at open-end loan funds for this reason.

To address these long settlement times, our initial strategy has been built with monthly liquidity rather than daily. While daily liquidity may be necessary for certain investors, our view is that most institutional clients do not need it, especially when considering the high and unnecessary transaction costs that come with it. Daily liquidity may also increase tracking error volatility (TEV) due to excessive rebalancing. While it may not be as impactful as pure performance, TEV is important for index managers and their clients in determining whether the product meets their objectives in tracking an exposure's beta. Daily liquidity products will often include high yield bonds or cash in their loan portfolio to act as a liquidity buffer, which can also drag on the performance of a daily liquidity strategy.

By building our strategy with monthly liquidity, we can meet the liquidity needs of our institutional clients and minimize transaction costs while maintaining consistent alignment to the representative beta.

Primary Market Trading

Another important aspect of the portfolio construction process is participation in primary markets, also referred to as the new issue market. Made up of brand-new loans and refinancings of existing credit facilities, primary markets represent an opportune way to obtain exposure to the asset class without paying transaction costs. As loans mature or refinance, or are otherwise removed from the market (and the index), a new loan will typically take its place. Particularly in periods such as 2020 and 2021, and again in early 2024, primary markets have proven to be an effective source for replenishing the portfolio.

On top of this, participation in primary markets has been proven to add incremental value relative to index performance. Leveraged loans price at a slight discount in primary markets, and by the time index providers add the loans to benchmarks, days or weeks later, they have adjusted to par. While the value-add in any singular new issue is small, when new issues predominate an index portfolio with several hundred loans, the incremental return can accumulate significantly. In 2020 and 2021, our index high yield portfolios added 20–30 basis points (bps) of relative return by taking advantage of the new issue premium, aided by large waves of refinancing.[2] In our view, loans could add a similar, if not higher, new issue premium.

Performance Expectations

As the growth of the asset class and advancements in market structure and portfolio construction push loans indexing closer to other more complex betas (high yield, emerging markets), we are comfortable assessing performance expectations versus various benchmarks (tracking error), and where that would sit versus peers. Using observations from a variety of highly sampled portfolios (i.e., those holding fewer than 50% of the index constituents), we believe that an index loan strategy can similarly deliver the representative beta and closely track the underlying benchmark by holding **35%–50%** of the underlying benchmark constituents. Actual results depend upon the index chosen and any level of customization.

As we look at our custom BB/B equal-weight $500M+ strategy, considerations for tracking error include the following:

- **Versus the broad Morningstar LSTA or Credit Suisse Leveraged Loans Indices**
  These indices will include smaller loans (sub-$500M in size) which are more thinly traded. They will also hold a market weight to CCC loans. TEV versus these most-common indices is expected to be highest, 50–80bps, driven by episodic, volatile markets where CCC loans can move sharply in either direction and pricing will lag (and then catch up).

- **Relative to a broad index with a $500M floor** Versus the Morningstar LSTA US Leveraged Loans $500M+ Index, TEV expectations drop to 25–40bps, driven by a small number of CCC loans included in the index but does not include the impact from smaller loans.

- **Relative to a broad index with all leveraged ratings categories** TEV expectations for our custom BB/B equal-weight $500M+ strategy range from 15–35 bps over time. This is driven by the degree of sampling (just under 50% of coverage), and the higher-quality and relatively liquid nature of the B and BB-rated universes.

In general, TEV versus any index will increase if that benchmark includes more lower-rated and/or smaller loans. Liquidity and accessibility in these cohorts make it difficult to reliably buy or sell, and the lack of liquidity will lead to lags in price changes. This lag will cause performance dispersion with the rest of the more-liquid loans universe.

What About the Illiquidity Premium for Smaller Loans?

Smaller loans, particularly those under $500 million, are typically purchased by CLOs and private credit investors (market pricing will reflect this) and locked away. During periods of market stress and recovery, there can be a lag in the valuations of these loans relative to the rest of the index constituents, thereby causing performance deviation and higher TEV.

Sub-$500 million loans make up roughly 11% of the Credit Suisse Leveraged Loan Index and 9% of the Morningstar LSTA US Leveraged Loan Index, as of July 31. However, our analysis shows that excluding the sub-$500 million loans has had a minimal performance impact over the last one to three years, and only a moderate impact of 10–25 bps over the last five to 10 years (Figure 3). Notably, many active loans managers will also underweight, or exclude, these smaller, illiquid loans from their strategies.

Figure 3
Excluding Sub-$500M Loans Has Moderate Impact

Trailing performance as of July 31, 2024	1-year	3-year	5-year	10-year
Credit Suisse Leveraged Loans Index	10.42	6.22	5.35	4.69
Credit Suisse 500M+ Lev Loans Cohort	10.41	6.21	5.24	4.44

Source: Credit Suisse.

Active versus Index Loan Strategies

As most market participants now know, active managers have faced persistent challenges in outperforming their benchmarks. Trading costs and liquidity can be negatively impacted when fundamental research drives portfolio construction and selection, and fees will always hinder returns. Furthermore, the performance of individual loans tends to correlate, decreasing the dispersion between similar names and dulling the impact of fundamental research. As a result, index loan strategies can aid investors through thoughtful portfolio construction and trading by experienced index managers who can implement sampling effectively while attending to trading costs and participating in primary markets.

The Bottom Line

With advancements in fixed income trading and increases in the depth and breadth of loans markets, leveraged loans are poised to be more accessible to index-focused investors, similar to other complex betas such as high yield and emerging markets debt. By aligning our investors' needs with our indexing and sampling process, we can increase attention to the more important areas (reducing tracking error, minimizing trading costs) at the expense of less important areas (monthly liquidity, security selection).

By following the same overarching process we have successfully employed in these other complex asset classes, and paying attention to the intricacies of the loans asset class, we hope to provide investors with a reliable, representative leveraged loans beta at an attractive price point relative to incumbent active peers. We look forward to discussing how our leveraged loan indexing process can help you to meet your investment goals. Please contact your Relationship Manager to learn more about our loan capabilities.

Endnotes

1 Octaura, State Street Global Advisors.

2 State Street Global Advisors.

About State Street Global Advisors

For four decades, State Street Global Advisors has served the world's governments, institutions, and financial advisors. With a rigorous, risk-aware approach built on research, analysis, and market-tested experience, we build from a breadth of index and active strategies to create cost-effective solutions. As pioneers in index and ETF investing, we are always inventing new ways to invest. As a result, we have become the world's fourth-largest asset manager* with US $4.37 trillion† under our care.

* Pensions & Investments Research Center, as of December 31, 2023.
† This figure is presented as of June 30, 2024 and includes ETF AUM of $1,393.92 billion USD of which approximately $69.35 billion USD is in gold assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated. Please note all AUM is unaudited.

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