The Morningstar LSTA US Leveraged Loan Index Highlights a Growing Asset Class Popular With Credit Investors

Not without risks, bank loans are nonetheless more than a yield play.

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Once a niche asset class, banks loans have entered the mainstream. Measured by the Morningstar LSTA US Leveraged Loan Index,[1] the market value for broadly syndicated loans, typically structured as senior secured corporate debt, has nearly doubled over the past decade. In the US, the asset class is now larger than high-yield bonds. The comparison is relevant because leveraged loans share many characteristics with sub-investment-grade corporate debt. Both are favorites of credit investors.

There are key differences between the two asset classes though, which have important implications. Leveraged loans are floating-rate in nature whereas high-yield bonds typically have fixed-rate coupons, making them more sensitive to price changes in Treasury bond yields. So, when the US federal-funds rate rose more than 4 percentage points in 2022 and Treasury bond yields followed suit, the Morningstar US High-Yield Bond Index[2] declined more than 11% on a total return basis. By contrast, the leveraged loan index lost less than 1% that year. Meanwhile, yields on leveraged loans climbed into the double digits.

Bank loans are not without risk. Their economic sensitivity was on display during the global financial crisis 15 years ago, as well as in March 2020 during the "pandemic panic." That said, loans are interesting from a diversification perspective. Though many investors like to allocate to the asset class tactically, there's reason to consider a strategic allocation.

Key Takeaways

- The leveraged loan market has grown significantly, thanks in part to financing demand from private equity-backed borrowers and buying demand from collateralized loan obligations. Some investors use the asset class as a parking lot for private credit allocations.
- Thanks to higher interest rates, the Morningstar LSTA US Leveraged Loan Index's yield to maturity exceeds that of the Morningstar US High-Yield Bond Index by more than 150 basis points.
- Credit risk is a feature not a bug of the bank-loan asset class. The Morningstar LSTA US Leveraged Loan Index's credit-quality profile is lower than that of its high-yield bond counterpart. The index has declined sharply during recessions and periods of economic stress, though overall volatility has been lower than high yield over the past 15 years.
- A study from Morningstar Manager Research found the Morningstar LSTA US Leveraged Loan Index's low correlations with Treasuries, give the asset-class strategic appeal within a fixed-income allocation.

1 For a full discussion of index methodology, see "Construction Rules for Morningstar Leveraged Loan Indexes."
2 For a full discussion of index methodology, see "Construction Rules for Morningstar Bond Indexes."

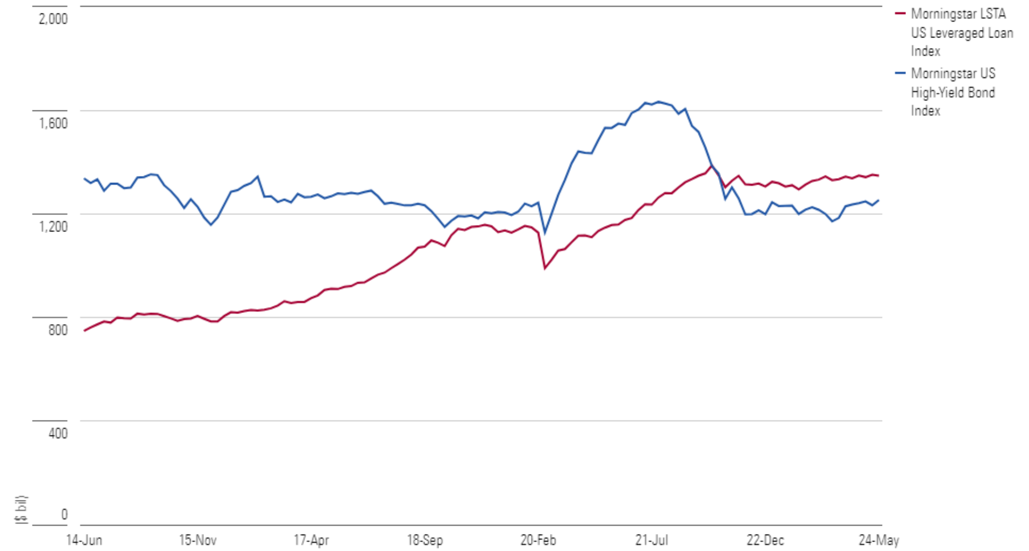
Leveraged Loans in a Rising-Rate World

For companies in need of financing, syndicated loans, a type of commercial credit facility, have real appeal. Compared with traditional credit lines, syndication (the process by which a group of lenders provide a commercial loan to a borrower) is often cheaper. That's especially true for borrowers rated below investment-grade. Loans from banks and other capital providers can finance mergers and acquisitions, back a recapitalization of a company's balance sheet, refinance debt, and fund operations. The loans are secured by collateral, most commonly receivables, and a robust secondary market has developed. Many leveraged loan borrowers are owned by private equity firms.

For investors there's also lots to like about the asset class. As senior secured debt, most loans are higher in the capital structure than bonds, which means their payback is prioritized. They are also floating-rate instruments. So unlike bonds, which lose value when interest rates rise, loan coupons move in line with borrowing costs. Collateralized loan obligations, special-purpose vehicles set up to hold and manage pools of leveraged loans, have been a key source of demand. Credit investors, including those looking to park "dry powder" while waiting for a private credit allocation to take shape, also find leveraged loans a convenient way station.

As displayed in Exhibit 1, the asset class has expanded significantly in the US, even before the aggressive rate hikes that began in March 2022 in response to sticky postpandemic inflation. Whereas the high-yield bond market is roughly the same size as it was 10 years ago, the loan market has nearly doubled over the past decade as measured by the Morningstar LSTA US Leveraged Loan Index's total market value. The index currently contains nearly 1,500 loan facilities. A range of industries are represented. Issuers include Cloud Software Group, Bausch Health Companies, and Whataburger.

Exhibit 1 The US Leveraged Loan Market Now Exceeds High-Yield Bonds in Size (Total Market Index Values)



Source: Morningstar Direct. Morningstar Index Total Market Value in Billions of USD as of 5/31/2024.

Rising rates have had a dramatic effect on leveraged loan yields. During the many years of low interest rates following the financial crisis, high-yield bonds yielded more than loans. But as displayed in Exhibit 2, the Federal Reserve's monetary policy campaign against inflation that began in March 2022 has sent loan yields onto a higher plane. "Coupon clippers" enjoyed many months of double-digit yields.

Exhibit 2 Rising Interest Rates Have Had a Dramatic Effect on Yields for Leveraged Loans

Source: Morningstar Direct. Morningstar Index Yield to Maturity %. Data as of 5/31/2024

Leveraged Loans Are Not Without Risks

The fact is, credit risk is a feature not a bug of the asset class. A handful of syndicated bank loans are actually investment-grade-rated. But as displayed in Exhibit 3, nearly two thirds of the Morningstar LSTA US Leveraged Loan Index's weight is currently consumed by B rated bonds. The asset class has an even lower credit-quality profile than the Morningstar US High-Yield Bond Index.

Exhibit 3 Leveraged Loans Carry More Credit Risk Than High Yield

Credit Rating Breakdown	Morningstar LSTA US Leveraged Loan Index (%)	Morningstar US High-Yield Bond Index (%)
AAA	0.00	0.00
AA	0.00	0.00
A	0.00	0.00
BBB	6.38	0.00
BB	22.05	51.74
B	62.63	36.32
CCC	6.24	10.98

Source: Morningstar Indexes. Data as of 5/31/2024.

How has this credit profile translated into behavior? In times of economic stress, the leveraged loan index has tended to decline sharply. In 2008, the global financial crisis and the Great Recession wreaked havoc on the asset class, with the Morningstar LSTA US Leveraged Loan Index falling 29% for the year, an even deeper decline than the Morningstar US High-Yield Bond Index's 24.7% fall. By contrast, the Morningstar US Core Bond Index actually rose nearly 6% in 2008, as investors flocked to Treasuries as a safe haven asset, while the US equity market sank more than 37%.

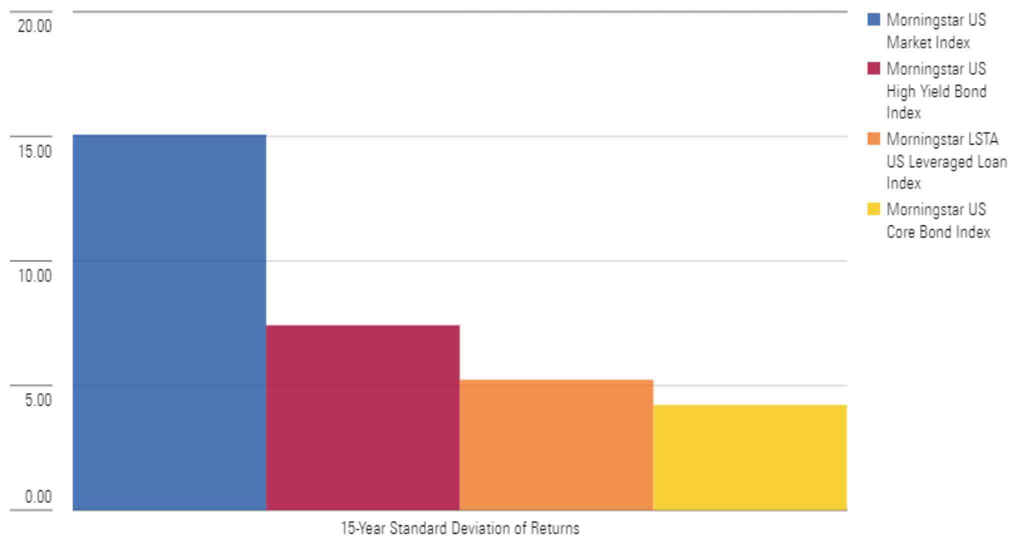
The pattern repeated in the first quarter of 2020, when covid-prompted societal lockdowns plunged the economy into recession and a pandemic panic roiled markets. Leveraged loans and high-yield bonds both fell nearly 13% that quarter, while equities fell more than 20%, and the US Core Bond Index gained more than 3%. By the end of the year, all four asset classes were in positive territory.

That was not the case in 2022, when both stocks and bonds sank deeply in response to generationally high inflation and the aggressive monetary policy response. Leveraged loans fared much better than bonds that year. Their floating rates provided a buffer from the pain of sharp rate hikes.

From 1999 to present, the Morningstar LSTA US Leveraged Loan Index has only notched a negative annual return three times, first in 2008, then in 2015 where it lost 0.7%, and most recently in 2022 when it lost 0.8%. The Morningstar US High-Yield Bond Index fell into negative territory in those same years. It also notched losses in 2000 and 2018.

Despite higher overall credit risk, bank loans have been less volatile than high-yield bonds. As displayed in Exhibit 4, the Morningstar LSTA US Leveraged Loan Index has had a lower standard deviation of returns over the past 15 years than the Morningstar US High-Yield Bond Index, which has been roughly half as volatile as equities. The Treasury-heavy Morningstar US Core Bond Index has provided a smoother ride though.

Exhibit 4 Leveraged Loans Have Been Less Volatile Than High Yield Though Bumpier Than Core Bonds



Source: Morningstar Direct. 15-Year Standard Deviation of Returns Data for Total Return Index Variants in USD. Data as of 5/31/2024.

Leveraged Loans in a Strategic Asset Allocation

Leveraged loans are often allocated to in a tactical manner. Yield-chasing is a natural temptation for those focused on income. The asset class is also part of the opportunity set for many credit investors weighing its relative risk-and-return profile against high yield and private credit. Since private credit investments can take time to allocate, leveraged loans are sometimes used as a temporary parking lot for "dry powder."

But Morningstar Manager Research has also pointed out a strategic use case. "Sharpening Fixed-Income Portfolio Allocations," [3] published in October 2023, drew on Morningstar index data since 2000 to present a series of Sharpe-optimized, US-focused portfolios to help investors strike the right balance between risk and reward. As displayed in Exhibit 5, absent constraints, the optimizer settled on a 30% weight to the Morningstar LSTA US Leveraged Loan Index, equal to the allocation to the Morningstar US Treasury Bond Index.

3 Kowara, Maciej and Lucas, Alec. "Sharpening Fixed Income Portfolio Allocations." Morningstar. Oct 31, 2023.

Exhibit 5 Morningstar Manager Research's Sharpe-Optimized, Unconstrained Portfolio Allocated 30% to Leveraged Loans

Name	Weighting %
Morningstar US Market Index	5
Morningstar US Corporate Bond Index	0
Morningstar US High-Yield Bond Index	3
Morningstar US Mortgage-Backed Securities Index	26
Morningstar US Treasury Bond Index	30
Morningstar Emerging Markets Composite Bond Index	6
Morningstar LSTA US Leveraged Loan Index	30

Source: "Sharpening Fixed-Income Portfolio Allocations." Data as of 9/30/23.

Explaining the results, study authors Maciej Kowara and Alec Lucas wrote:

> "*The optimizer made Treasuries, mortgages, and bank loans the workhorses of its portfolio. That's because for the whole period, Treasuries had a negative correlation with bank loans (negative 0.3 correlation coefficient) and a weak one with agency mortgages (negative 0.05).*"

Acknowledging that the study relies on historical data, the authors continue:

> *Although the future will not repeat the past, our use of resampled historical data to build Sharpe-optimized portfolios assumes key aspects of asset-class relationships will persist. Bank loans may not remain negatively correlated with Treasuries, but they are not likely to be highly correlated either. By design, bank-loan coupons rise when interest rates go up and, hence, when Treasuries weaken.*"

Current yields on leveraged loans may not persist. That said, inflation and interest-rate direction has been devilishly difficult to forecast. While an economic downturn remains a perennial risk, the Morningstar LSTA US Leveraged Loan Index highlights a growing asset class that can play an intriguing role as a portfolio diversifier, as well as an income source. M

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