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TRANSCRIPT

# Leveraged Loans: Risks, Rewards and Investor Protections

*Featuring:* ***Hamed Faquiryan***, Vice President, Fixed Income and Multi-Asset Class Research

**Interviewer**: Joining us today is MSCIs Hamed Faquiryan, Vice President Fixed Income and Multi-Asset class research. He'll discuss leverage loans and the risks and rewards associated with these free floating instruments. Hamed, thank you so much for joining us.

**Hamed**: Thank you for having me.

**Interviewer**: Absolutely. Well Hamed, let's start with the basics. What are leveraged loans and how do they fit into the fixed income landscape.

**Hamed**: Sure. So, leveraged loans are sort of the riskiest segment of commercial lending in the states. And they represent, sort of, lower rated credits which require both, you know, both higher default rates as well as higher compensation for investors to hold those higher credit risk instruments. And then, on top of that, the uses of the actual leveraged loans by the issuers is going to change case to case and how the leverage loan market came onto the scene in the late 80's with the leverage buy-out craze.

**Interviewer**: And you mention that compensation. What would make a leveraged loan more attractive in the current market environment compared to say, a more traditional fixed income product?

**Hamed**: It's a great question and what I would say is that there are two parts to that. There's the ongoing search for yield that is sort of a global phenomenonn that's coming as a consequence of low rates worldwide. And so leveraged loans sort of offer a certain compensation that you can't find in other parts of the fixed income landscape. And then additionally, we're seeing sort of from 2015 onward, is that the floating rate nature of the leveraged loan asset class was a hedge against monetary policy. Where rising rates were eating into a compensation that investors had sort of banked on. Floating rates assets mean that every time the Fed raises rates, you're getting more compensation for that. Now we've seen, sort of with recession fears, that this process has reversed a bit but those two components of the leveraged loan asset class are really what makes them very attractive.

**Interviewer**: Let's take a step back and look at some of the history surrounding sentiment for leverage loans. What have we learned over the past decades and how is research and development changing in this space? I know you're certainly an expert on this.

**Hamed**: Sure. So, I would say that over the last 10 years what we have seen is that leveraged loans as an asset class have really weathered very distressed market environments. We saw in terms of the global financial crisis, the oil and gas crisis, and then sort of the market sell-off that was sort of global at the end of 2018. And we've learned a lot in terms of both the nature of the asset class as well as the nature of the investor base. And so the investor base has changed pretty dramatically, you know, since the financial crisis. Where before they were sort of, really syndicated products which were a product of banks and a range of sort of working within a fairly illiquid market. And that sort of really opened up and become a really diverse sort of investor base where asset managers, hedge funds, all sorts of folks now own this paper. And this means that we have different types of capital as well as more capital in general really invested in this market.

**Interviewer**: And as investor demand increases, many issuers are issuing less restrictive more covenant loans. That being said, what are some of the risks associated with these and some of the trade-offs and are investors being compensated?

**Hamed**: It remains to be seen I would say. We've seen that light paper has gone from representing almost none of the market to representing a vast majority of the market.

**Interviewer**: Wow, that's a big change.

**Hamed**: Indeed, and this is sort of a product of several different phenomenom that are happening at the same time. As I mentioned the investor base has changed a lot. And sort of, if you're held tightly amongst a bank or a group of banks then that monitoring situation is a lot different than a diverse asset manager or a hedge fund owning that same paper because that's their ability to sort of keep watch and make sure that all these covenants are being maintained at all times. It's very different than that closely knit situation. So, going forward with what we'll see when a downturn eventually appears is weather cov light papers suffers significantly more than covenanted paper. And what we can see at the moment is that the hunt for yield is sort of ferocious enough that investors are willing to grin and bare it.

**Interviewer**: And on the heels of a market marked by high issuance with covenants as we just discussed, intense investor demands as well as low default rates. What do you seeing moving forward?

**Hamed**: I think what we see over the last year is really indicative of what we would see in the future. And what we saw was that the lowest rated of segments of the leverage loan market were sort of battered for a few months there when we thought we were entering a recession. Whereas in the high rated segments, the less leveraged parts of the leveraged loan market did just fine. And so this might be every man's sell-off is another man's buying opportunity. And so it's tough to say where it will all end up but it seems like the market is growing and continues to grow. If monetary policies shift back the way it had in 2015, 2016, we could see a real resurgence of the market again.

**Interviewer**: And then we could see investors using these products throughout the business cycle.

**Hamed**: Absolutely. If you're an investor that understands how stable your capital has to be at different parts of the business cycle to be able to participate in a really risky leveraged part of the fixed income space then you can absolutely take advantage of the leveraged loan market all throughout the business cycle.

**Interviewer**: Well Hamed, thank you so much for your insights into leveraged loans. Terrific to have you.

**Hamed**: Thank you.

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