

# Loan Alpha from Capacity Constraint

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**Large loan strategies invest with low conviction.** They do this for liquidity at the cost of alpha. As it's difficult for a low conviction strategy to outperform, large managers have been overweighting CCC rated loans to enhance returns. However, low quality loans have [consistently underperformed](#). We believe this low conviction, low quality headwind is generally avoidable with *capacity constrained* strategies.

## Loan Strategy Average Characteristics by AUM



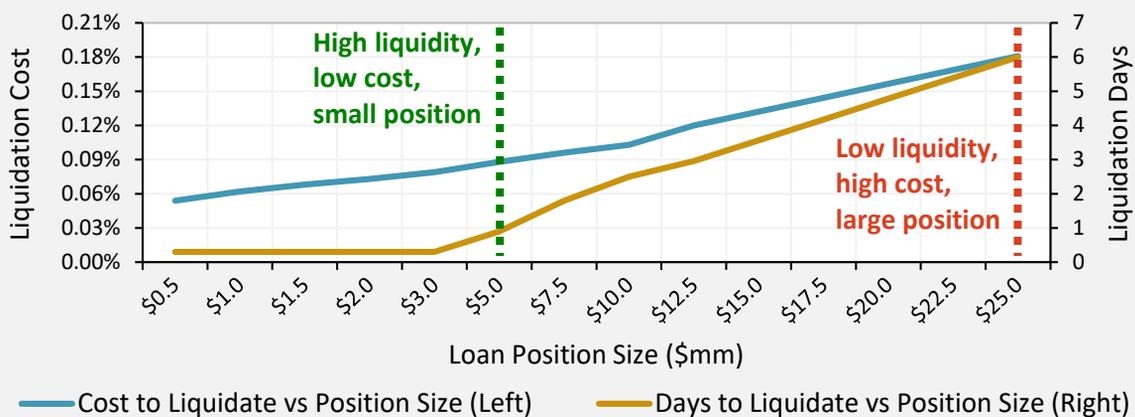
| Strategy AUM  | \$10B & Above | \$1B to \$10B | \$1B & Below | Loan Index |
|---------------|---------------|---------------|--------------|------------|
| YTD Return    | 4.82          | 5.21          | <b>7.22</b>  | 6.53       |
| # of Holdings | 385           | 263           | <b>167</b>   | 1460       |
| % CCC & Below | 9.22          | 6.94          | <b>5.79</b>  | 7.96       |

As of 10/31/2019. Source: Morningstar Direct Loan SMAs, Index: S&P/LSTA Leveraged Loan Index

**Capacity Constraint**, limiting the size of the strategy, allows a manager to target the full loan market without compromising liquidity, conviction, or transaction costs. It also means foregoing additional AUM and fee revenue to improve return potential, a trade-off large firms oppose at the investors' expense. Revenue from a \$1bn loan strategy doesn't move the needle of a trillion-dollar firm, while a \$20bn strategy does.

**For example**, the median S&P/LSTA Loan index issuance size is \$520mm, about the size of Cumulus Media's 3/31/26 term loan. A \$1bn loan manager holding \$5mm of the issuance, for a 0.5% portfolio position, can liquidate the position intra-day\*. A \$5bn manager holding \$25mm (0.5% position) would need 6 days to liquidate under *normal* conditions, at twice the transaction cost of the \$1bn manager. A \$20bn manager holding \$100mm (0.5% position), would need 24 days at 6 times cost. Instead, \$5bn+ managers opt to hold smaller, low conviction positions to improve liquidity and costs.

### Bloomberg Liquidity Analysis: Cumulus Media \$525mm 3/31/26 Term Loan



As of 12/13/2019. Source: Bloomberg.

**Size and investment opportunities are negatively correlated.** Large loan strategies have underperformed due to an inability to invest with conviction and preference for lower quality credit. Loan investors seeking to improve their risk-return potential should consider *smaller, capacity constrained* strategies.

**For more info** on capacity constrained loans, [our research can be found here](#).

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The S&P/LSTA Leveraged Loan Index is a market value-weighted index designed to measure the performance of the US leveraged loan market based upon market weightings, spreads and interest payments. Alpha gauges the performance of an investment against a market index or benchmark which is considered to represent the market's movement as a whole.

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