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# Leveraged loans: Senior, secured and increasingly systematic

## The Case for a Strategic Allocation

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## Executive summary

- **A core allocation, not a tactical trade.** Leveraged loans have matured into an approximately $2 trillion global asset class that increasingly belongs in the strategic core of institutional portfolios, offering senior secured, floating-rate income with near-zero duration.
- **A differentiated, well-rewarded return stream.** High carry, first-lien protection and low rate sensitivity deliver one of the strongest returns-per-unit-of-risk in fixed income, while diversifying away from duration-heavy bonds and richly valued equities.
- **A now genuinely indexable market.** Record secondary volumes, rapid electronification, faster settlement, deep CLO (Collateralized Loan Obligation) demand and credible benchmarks have, for the first time, made loan beta accessible with public-market transparency and cost efficiency.
- **A constructive entry point.** Elevated all-in yields, a cautious-central-bank and sticky-inflation backdrop, and credit stress that looks selective rather than systemic together reinforce the near-term case.
- **Access is shifting from active to systematic.** In a carry-dominated, callable market, persistent alpha is structurally hard to sustain—reflected in the near-universal, multi-year underperformance of active loan funds net of fees.

## Features of leveraged loans

A leveraged loan is a floating-rate loan extended to a company with a below-investment-grade credit rating (typically BB+/Ba1 or lower). Banks originate the loans and, rather than holding them, syndicate them to institutional investors such as CLO managers, loan funds, insurers and pension funds. The US leveraged loan market stands at roughly $1.5 trillion, while the European market is around €360 billion: together forming half of the broader leveraged-finance universe, alongside high-yield bonds.

Five features define the asset class:

1. **Senior secured status.** Loans sit at the top of the capital structure and are secured against the borrower's assets, giving lenders a first-priority claim in bankruptcy and, historically, higher recoveries than unsecured high-yield bonds.
2. **Floating-rate coupons.** The coupon resets periodically at a reference rate (typically SOFR in the US or Euribor in Europe) plus a credit spread, so income rises and falls with short-term rates rather than being fixed at issuance.
3. **Syndicated, institutional structure.** Loans are distributed broadly across many lenders, creating a large, tradeable secondary market, though one that settles more slowly than bonds.
4. **Callability.** Loans are typically prepayable at or near par with minimal call protection, so borrowers can refinance freely when spreads tighten. This caps price upside, as a strengthening credit refinances away rather than rallying to a premium.
5. **Low duration.** Because coupons float, loans carry almost no interest-rate duration, unlike most of the fixed-rate bond universe.

## Benefits

These structural features translate into direct benefits for portfolio construction and asset allocation:

- **Elevated income potential:** Loans appeal to income-seeking investors through their higher yield and coupon levels versus most fixed-income subsegments. Their yield per unit of volatility ranks among the highest across fixed income, given that the majority of total returns from carry.
- **A natural rate hedge:** With near-zero duration, floating-rate coupons reset higher as base rates rise, largely neutralizing the interest-rate risk that erodes fixed-coupon bonds, a valuable ballast when duration and credit sell off together.
- **Seniority and security:** Loans sit at the top of the capital structure with a first priority claim that is typically a secured claim. Across the US and Europe, they have historically experienced 60 to 70%+ in recoveries, whereas unsecured high-yield bonds historically recover only 30 to 50%.
- **Diversification and resilience:** Loans exhibit low correlation to most fixed income, as well as other growth assets, proving particularly valuable in inflationary regimes. (Figure 1). Over the past three decades, US and European loans have posted negative returns in only three calendar years.

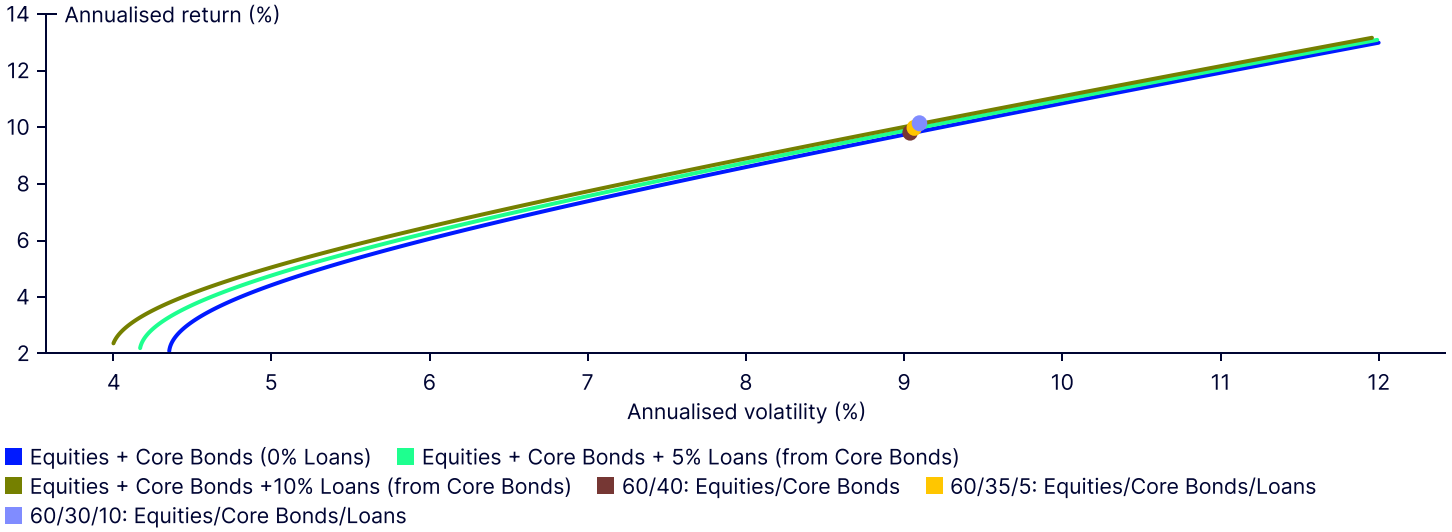
**Figure 1: Correlations**

| US Leveraged Loan Correlation with: | | Euro Leveraged Loan Correlation with: | |
|---|---|---|---|
| US Treasuries | -0.16 | Euro Treasuries | 0.22 |
| US Agg | 0.12 | Euro Agg | 0.32 |
| US Corp | 0.45 | Euro IG Corp | 0.63 |
| US HY | 0.78 | Euro HY Corp | 0.82 |
| EM HC | 0.63 | EM HC (EUR H) | 0.63 |
| S&P 500 | 0.58 | EuroStoxx | 0.53 |

Source: Bloomberg. As of 31 July 2026. Bloomberg, S&P, JP Morgan, Credit Suisse and Stoxx indices are used as representative proxies. Indices are unmanaged and cannot be invested in directly; they bear no fees or transaction costs. Past performance is not a reliable indicator of future results.

**Implementation:** Loans serve both strategic and tactical roles: a persistent allocation captures the credit and liquidity risk premium through cycles, while tactical sizing can lean into rising-rate or late-cycle carry environments. Funded from the fixed-income sleeve, even a modest loan allocation has historically improved a traditional 60/40 equity/bond portfolio's efficient frontier for the US (Figure 2).

**Figure 2: Adding leveraged loans improves the 60/40 opportunity set**




Source: Bloomberg, as of 31 July 2026. Bloomberg US Aggregate Index, S&P 500 Total Return Index and S&P UBS Leveraged Loan indices are used as representative proxies. Indices are unmanaged and cannot be invested in directly; they bear no fees or transaction costs. Past performance is not a reliable indicator of future results.

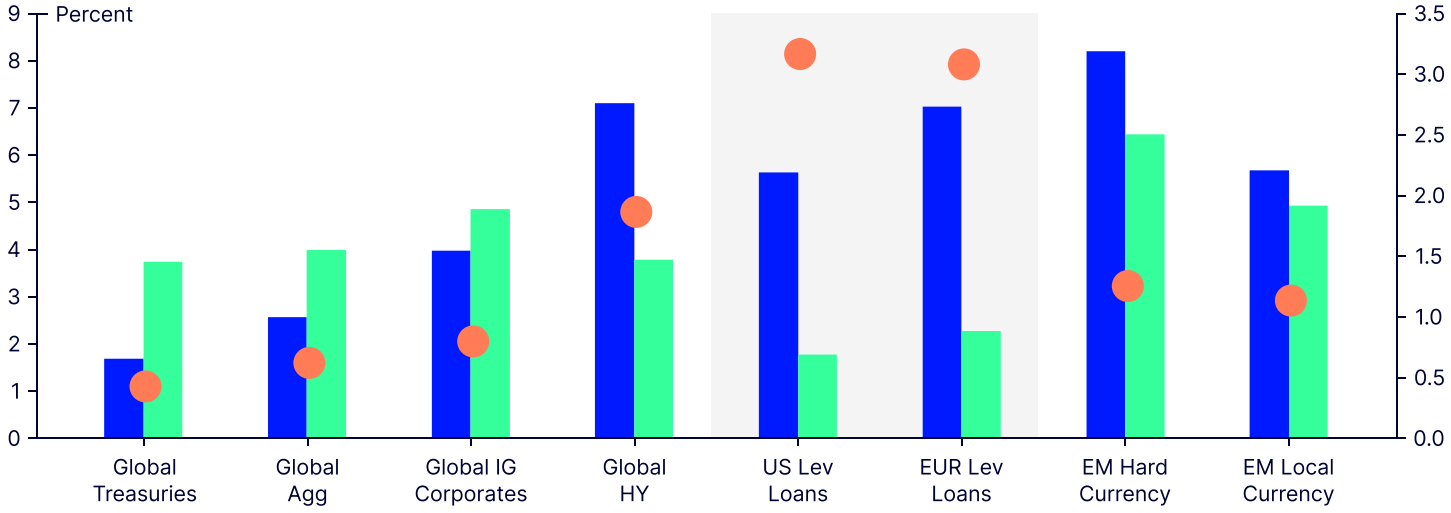
## Risk/reward profile

Leveraged loans carry a specific set of risks that investors must consider. The key risks are:

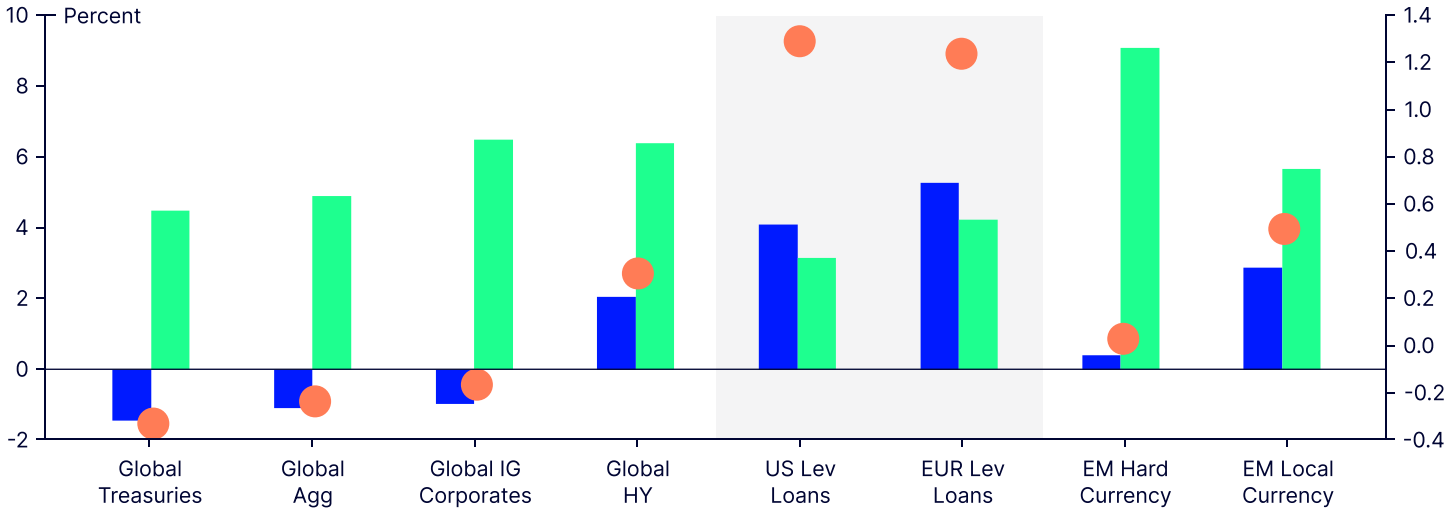
- **Credit and default risk:** Borrowers are sub-investment-grade and therefore more vulnerable to financial stress, credit-cycle turns and growth downturns, with defaults and liability management exercises rising from cycle lows.
- **Covenant erosion:** Covenant-lite structures now dominate issuance (over 90% of the market), stripping out the financial-maintenance tests that historically gave lenders early warning and negotiating leverage before distress hits.
- **Sector-specific pressures:** Concentrations in vulnerable sectors can rapidly reset cash-flow assumptions and drive clustered distress, as seen in the early-2026 software sell-off.
- **Liquidity and settlement risk:** Although secondary markets are deepening and electronifying, loans still settle far slower than bonds or equities, constraining rapid portfolio adjustment, particularly during stress when bids thin out.

Crucially, investors have historically been well compensated for these risks. Leveraged loans have consistently delivered **returns per unit of risk that rank among the strongest in fixed income,** across US and European markets and over multiple cycles. (Figure 3).

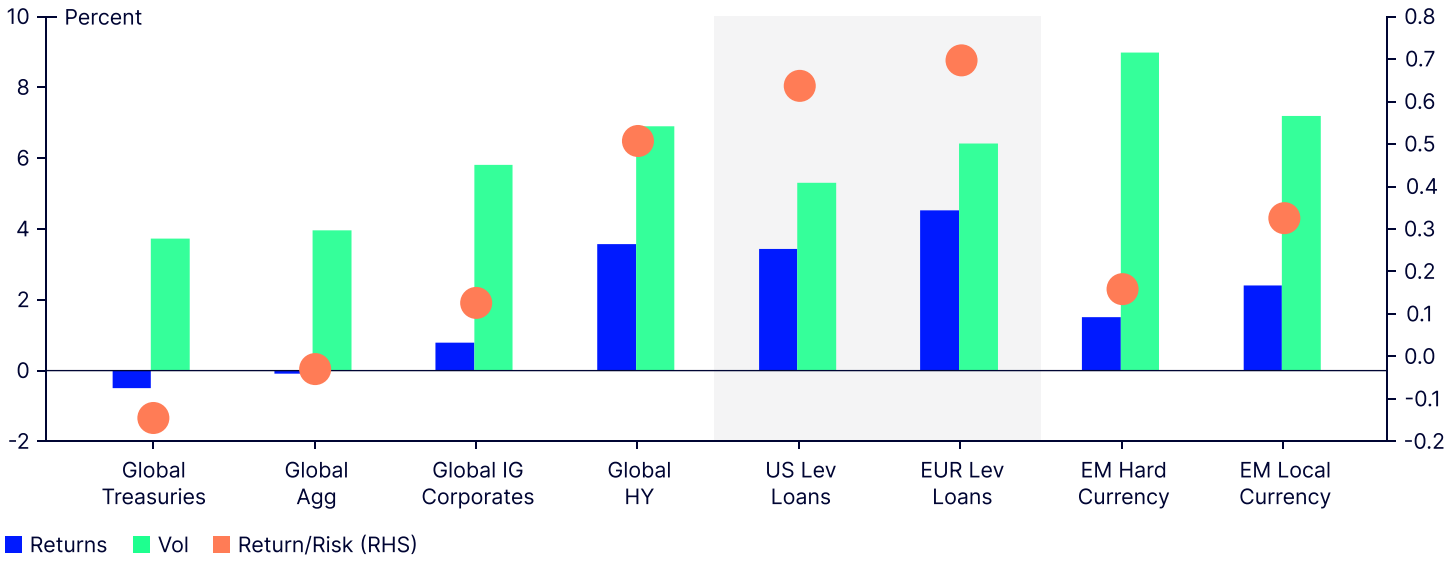
**Figure 3: Returns per unit of risk**
**Last 3 years**




**Last 5 years**



**Last 10 years**




Source: Bloomberg. As of 31 July 2026. Bloomberg, JP Morgan, Credit Suisse and Stoxx indices are used as representative proxies. Indices are unmanaged and cannot be invested in directly; they bear no fees or transaction costs. EUR-hedged returns shown for US and global indices. Past performance is not a reliable indicator of future results.

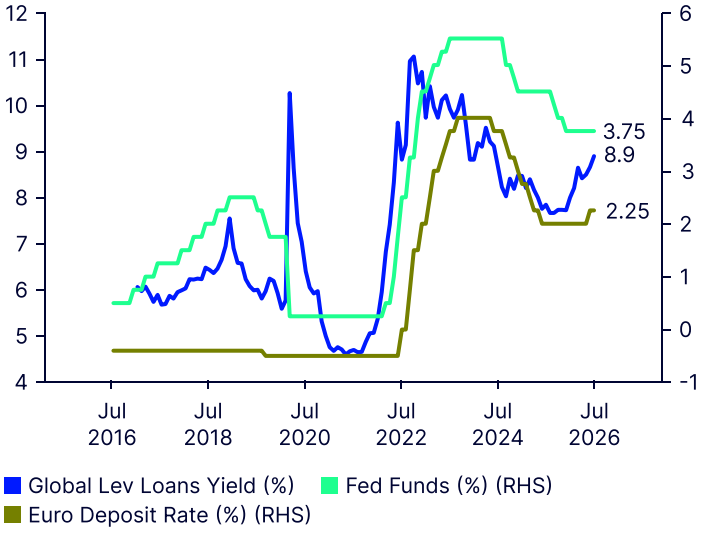
## Why now?

The current investment rationale rests on several supports:

- **Attractive yield levels versus history:** Leveraged loan all-in yields remain well above recent history and poised to remain so in the medium term, supported by still-elevated short-term rates and a cautious central-bank backdrop amid sticky inflation and energy-price uncertainty. (Figure 4)
- **Defaults stabilizing:** Loan defaults have run above historical medians (Last 12 Months US: 5.0% vs ~2.5–3%; Europe: 3.6% vs ~2%),[1] driven by refinancing pressure and emerging AI-driven obsolescence risk. Yet both sit well below prior-cycle peaks, and the dislocation looks increasingly selective rather than systemic, concentrated in software and a weaker tail, with recent signs of stabilization.
- **Supportive technicals:** New CLO formation (excluding Resets, Refinancing) remains healthy (YTD ~$90bn US, ~€35bn Europe) and continues to absorb new loan supply, even if running behind last year's record highs (2025: ~$210bn US, ~€60bn Europe).[2]

Together, elevated income, broadly stable fundamentals and resilient demand create a reasonably constructive backdrop.

**Figure 4: Central banks shift toward hold/hike rates supports coupon income**




Source: Bloomberg. As of 31 July 2026.

## Why alpha is structurally difficult to sustain in loans

Inefficiencies clearly exist in the leveraged loan market, but they are difficult to monetize *persistently*, for several structural reasons:

- **Returns are carry-dominated.** With most of the return coming from income rather than price appreciation, there is limited upside to capture through security selection—and the asymmetry runs against the investor, not for them.
- **Callability caps the upside.** Loans are typically callable at or near par, so a strengthening credit refinances away rather than rallying to a premium. The borrower, not the lender, captures improving conditions.
- **CLO ownership makes selling correlated.** With CLOs holding a majority of the loan market under near-identical CCC limits and overcollateralization tests, downgrades trigger mechanical, simultaneous selling of the same distressed names. Bids vanish precisely when active managers most need to exit, making orderly liquidation at scale nearly impossible.
- **Recovery equations are shifting.** With issuance dominated by PE-sponsored, covenant-lite deals, liability management exercises (LMEs) have overtaken traditional defaults, increasingly diluting recoveries through non-pro-rata, up-tiering transactions that reward insiders over minority lenders and erode the creditor control active managers rely on.
- **Trading frictions constrain implementation.** Transaction costs and liquidity limits inhibit the high turnover that active strategies need to express best ideas and continually refresh their views.

None of this means active management is without value. Documentation vigilance and disciplined risk management can add value when the game is downside avoidance, particularly in dislocations such as the early-2026 software sell-off. But investors should be realistic: in a high-carry, callable market, persistent outperformance over a full cycle, net of fees, is hard to sustain. The evidence bears this out across both the US and Europe, as shown below.

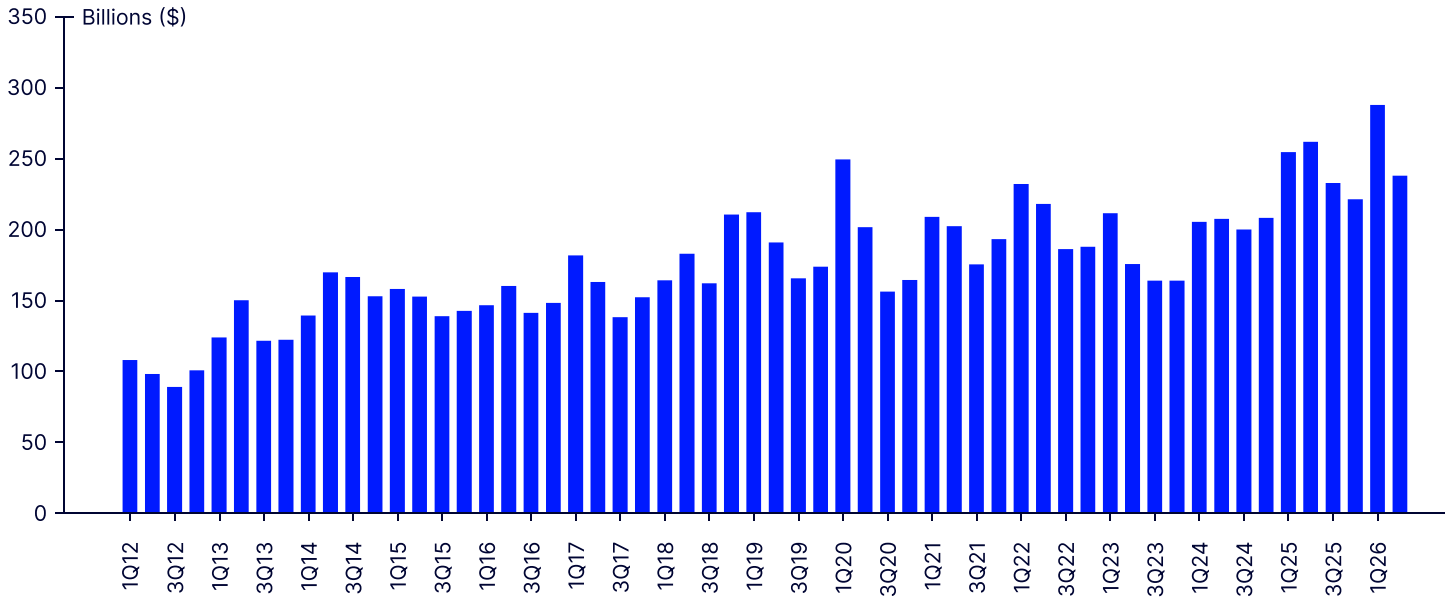
**Percentage of leveraged loan funds underperforming their benchmarks**

| | Comparison Index | 1 Year (%) | 3 Year (%) | 5 Year (%) | 10 Year (%) | 15 Year (%) | 20 Year (%) |
|---|---|---|---|---|---|---|---|
| **US Loan Funds*** | S&P UBS Leveraged Loan Index | 73.0 | 89.6 | 95.3 | 98.2 | 100.0 | 100.0 |
| **European Loan Funds**** | Prospectus benchmark of individual funds | 44.4 | 88.2 | 100.0 | 100.0 | — | — |

* Source: Latest S&P SPIVA US Scorecard. As of year end 2025.

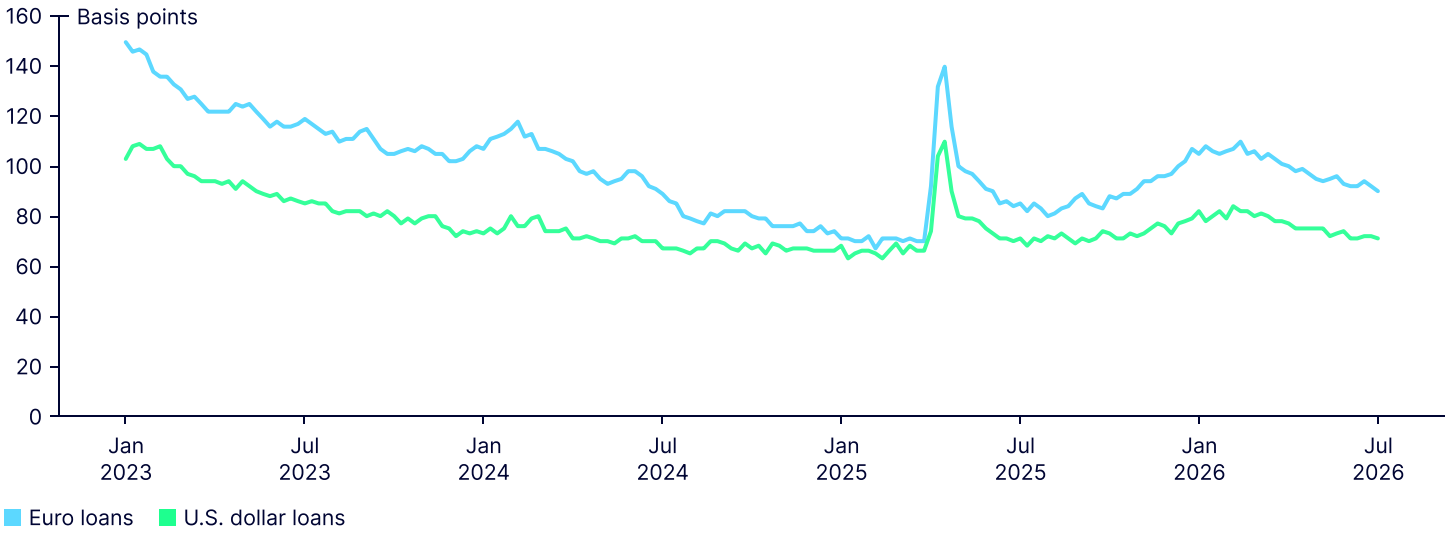
** Source: Morningstar category "EEA Europe Loan Fund". As of 30 June 2026.

## Figure 5: Growth in US secondary market loan trading volume




Source: LSTA. As of 30 June 2026.

## Bid-Ask spreads for first-lien term loans




Source: S&P. As of 30 June 2026.

## Market structure improvements

The leveraged loan market has evolved from a bespoke, operationally intensive asset class into a broader, more data-rich and increasingly tradable one—most notably in the US, with Europe following. **Trading volumes and price transparency:** US secondary volumes hit a record $526bn in H1 2026, with LTM activity at an all-time high of $978bn: roughly 665 loans and $4bn traded daily.[3] European secondary turnover has historically run at €80–85bn a year and is growing.[4] Rising volumes signal a maturing, more liquid market with better price transparency and declining bid-ask spreads in the long term (Figure 5).

- **Electronification:** Platforms led by Octaura, alongside MarketAxess and Bloomberg, are replacing voice-and-chat negotiation with automated protocols, real-time analytics and straight-through processing. In the US, electronic penetration remains just 8% (versus 33% for high yield), but the climb from 1% in early 2024 and 6% a year ago points to further gains.[5]
- **Operational improvements:** ClearPar, Versana, Octaura and FIS's new Trade & Distribution Manager now automate affirmation, matching, documentation and reference data end-to-end. Settlement is the clearest proof point: European par settlement improved to a 30-day median, gradually coming down from 55 days in 2021, while US settlement converges toward its T+7 standard.[6]
- **Investor base:** In the US, CLOs remain core buyers, but retail interest is rising on attractive yields, with Leveraged Loan ETF assets (ex-CLO ETFs) reaching $20 bn by August 2026, deepening price discovery.[7]

The result is a self-reinforcing ecosystem of better data, execution, and liquidity. Loan indexing is no longer merely theoretical: market structure now genuinely supports it.

## No longer whether, but how

The differentiated return stream and genuine diversification qualities of loans are long-established; their increasingly systematic accessibility is the new and compelling chapter. For allocators seeking resilient income in an uncertain macro environment, the question is no longer whether to hold leveraged loans, but how efficiently they can be owned.

## Endnotes

1,2 Source: Goldman Sachs Global Investment Research. As of 31 July 2026. Default rates are Issuer Weighted numbers.

3 Source LSTA. As of 30 June 2026

4 Source: S&P's Global Market Intelligence (for years 2008–2023). State Street Investment Management estimates (2024 onwards).

5 Source: Ocatura. As of Q1 2026.

6 Source: For US Loans: LSTA, European Loans: LMA. As of 31 July 2026.

7 Source: JP Morgan Research.

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* This figure is presented as of September 30, 2026 and includes ETF AUM of $2,285.83 billion USD of which approximately $171.88 billion USD 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 Investment Management are affiliated. Please note all AUM is unaudited.

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