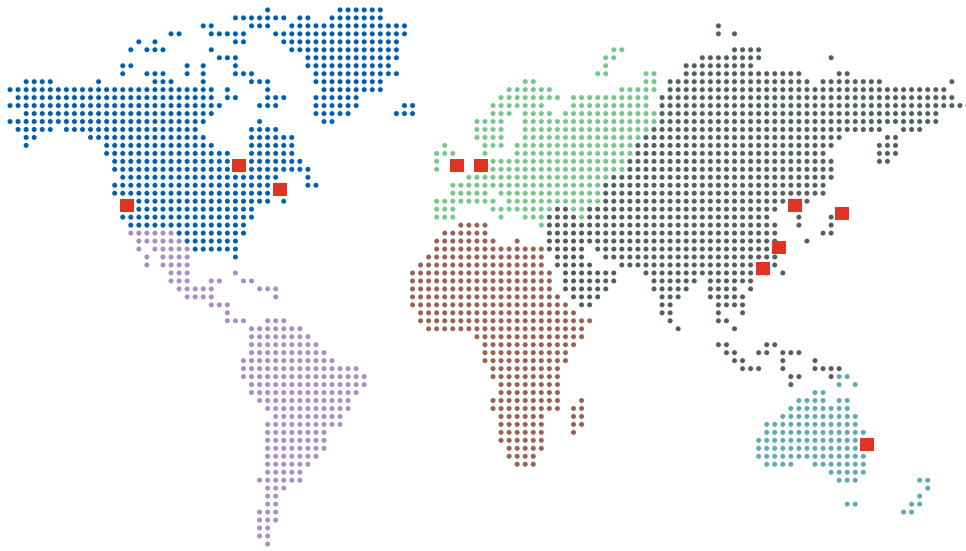


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What's a Fixed Income Investor to Do?

The past thirty years, which witnessed interest rates falling from double digits to near zero, have been generous to bond investors. But now, with interest rates at all-time lows, institutional and individual investors face a dilemma.

Many institutional investors have found a solution in corporate loans, an asset class that possesses a number of attractive attributes suited to the current investment climate. Loans are made to companies rated below investment grade (investment grade loans are vastly different). Loans are senior secured debt instruments that sit at the top of a corporate issuer's capital structure. They are senior to the unsecured or subordinated bonds, and, of course, to the preferred stock and equity. In other words, within a representative company's capital structure, loans have the most secure and dependable income stream of any corporate security, debt or equity. Equally important, loans are floating-rate, with coupons set at a spread above the LIBOR rate. So a few years from now, when fixed-rate bonds experience mark downs as interest rates rise, floating-rate loans' market value will remain unaffected, and their economic value will actually increase as the quarterly interest coupon (the spread plus the LIBOR base rate) rises along with market rates.

"These are really challenging times for large institutional fund managers. They have long term annual return targets of 7.5 to 8%, yet equity has gone nowhere for ten years with lots of volatility and traditional bond yields are at historic lows," said Blackstone/GSO's Senior Managing Director, Dan Smith, in explaining why more fixed income investors are turning to "outside the box" strategies, like investments in senior secured loans.

This reflects the recognition by many investment professionals of a shift in the fundamental risk/reward balance of various traditional fixed income instruments. "Fundamentals of corporations continue to improve compared to government

public debt. Consequently, corporate credit, including senior bank loans, offers compelling risk adjusted returns compared to traditional fixed income investments," said KKR's Co-Head of Leveraged Credit, Erik Falk.

As shown in Exhibit 1, over the past decade corporate leverage has decreased by about one-third while US government leverage has almost doubled. At the same time, corporate loan credit spreads have risen significantly above long term averages as US Treasury "risk free" rates approach all-time lows. In short, loan investors are being paid more to take decreasing corporate risk, while government bond buyers are being paid less to take steadily increasing sovereign risk. (see chart below)

"Loans are the most defensive of the 'core' asset classes, with qualities you don't get in any other investment," said Angelo, Gordon's Bruce Martin, Portfolio Manager/Head of Leveraged Loan and High Yield. These qualities – senior secured position in the capital structure and floating rates – were enough to appeal to many investors earlier this year, when all-in loan yields to likely maturity averaged around 6-7%. Now, because of the late summer/early fall downdraft that pulled loan prices down along with other asset classes, the yields available to loan investors approach 8%. This is attracting the attention of portfolio managers and investment consultants more than ever. But Martin and other loan market professionals are emphasizing to their clients that beyond the unique advantages loans have at this particular point in the economic cycle, they should actually play an integral and permanent role in every institutional investor's core holdings throughout the cycle. "Part of everyone's portfolio should be floating rate," Martin said.

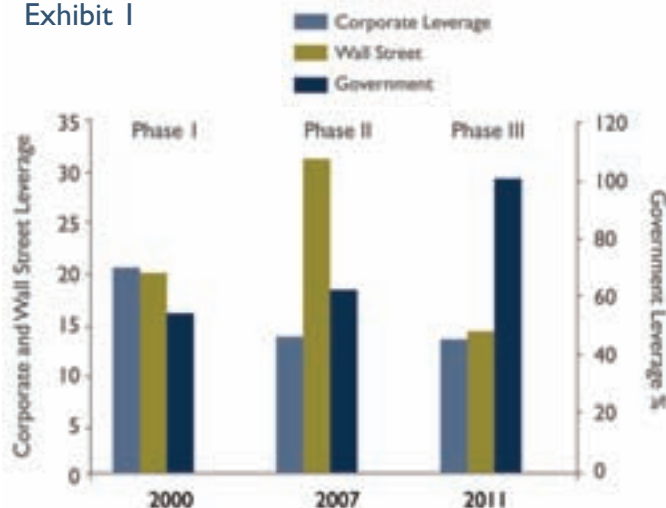
Recent History of the Loan Market

In the recent past, corporate loans were routinely referred to as "bank loans" for one simple reason: they were loans made by banks to their corporate clients. Banks not only made these loans, but they held them to maturity.

In the 1990s, big US banks realized they could no longer count on other banks – especially Japanese and other foreign banks – to buy and hold the loans that they needed to make to their major corporate customers. In order to continue financing mergers and acquisitions as well as the organic growth of their businesses, banks were forced to market these loans to institutional investors.

But loans didn't fit neatly into either of the two "core" asset classes into which most institutional investors divided their portfolios: stocks and bonds. So loans had to compete for the smaller slice of the portfolio called "alternative investments." This is the catch-all category that includes venture capital, hedge funds, commodities, private equity, timber, real estate and other non-traditional investments. While loans have little in common with these other types of investments aside from a shared dissimilarity to stocks and bonds, these investment classes all seek to outperform equities,

Exhibit I



Source: IMF, WEO, Factset, S&P

S&P/LSTA Leveraged Loan Index: Annual Return



typically with less risk and/or lower volatility. With a nice, dependable return averaging about 5% over time, loans were perceived as a bit too sedate and not equity-like enough to compete for space in the alternative investment category.

Fortunately, investment bankers found that if they took loans and added leverage, they could create an equity-like investment (CLO Equity) that competed well with other alternative asset classes. They also created attractive CLO liabilities (mostly investment grade rated) to compete with bond investments. Thus were born collateralized loan obligations (CLOs), which were a spin-off of collateralized (high yield) bond obligations (CBOs) that had been introduced a few years earlier. By adding 6 or 8, and eventually even as much as 10 or 12 turns of leverage to a loan portfolio yielding 5 or 6%, bankers could provide the CLO's equity investors a return in the mid-teens or higher. As it turned out, loans' security, stability and lower credit losses made them more durable candidates for securitization than high yield bonds, a reality that explains why CLOs have performed so much better through periods of credit unrest than have CBOs.

Other investors, especially hedge funds and proprietary trading desks, also found ways to leverage their investments in loans in order to convert the return, to something closer to an equity earnings level. Unlike most CLOs, which are closed vehicles whose viability depends on the cash flows from their underlying assets irrespective of their market values, the leverage of most hedge funds and proprietary trading desks was based on margin loans or credit default swaps that had to be marked to market regularly.

The high volume of loans bought by leveraged investors during the 2000 to 2007 period put a healthy floor under loan demand, but it also made the market more vulnerable to a downturn if those leveraged buyers were required to liquidate their holdings quickly in order to meet margin calls. When this did in fact occur in 2008, the loan market (see chart above) suffered a 29% loss, with the average healthy loan dropping in price to about 60 cents on the dollar. Fortunately, for buy-and-hold investors, loans rebounded to earn 52% in 2009, and another 10% the following year, so those who sat tight through the crisis made about 6% annually for the 2008 to 2010 period, despite some of the highest default rates in history. Many opportunistic buyers, who realized

that loans' precipitous price decline had little to do with their underlying performance or credit quality, initiated or increased their loan holdings in late 2008 and early 2009 and earned outstanding returns.

Ironically, despite its volatility in 2008 to 2009, what many institutional investors value most about the loan asset class is its resilience. "The market is more stable now because more of the capital in the market is more stable. Mark-to-market financing, large underwritten inventories at banks, proprietary trading desks and liquid hedge funds have been replaced by unlevered and term financed institutional and retail funds," said KKR's Falk, commenting on the entrance of many more traditional, unlevered investors into the loan market.

This does not mean volatility is gone from the loan market. Indeed, many investment professionals point out that volatility in markets is something they are accustomed to managing. But they prefer market volatility that is transparent and understandable, like the impact of retail fund outflows last August, rather than the more opaque volatility caused by the unwinding of privately leveraged positions. That today's higher returns are achievable without leverage may help to eliminate some sources of more opaque volatility, offering potential loan investors reassurance that they are considerably less likely to be caught off guard the way many were in previous years. "Institutional buyers now realize they don't have to leverage their loan holdings to earn an attractive return," said Angelo, Gordon's Martin.

One question always at the back of investors' minds is whether 2008 could happen again. Jonathan DeSimone, Managing Director at Sankaty Advisors for one is convinced that 2008 was an anomaly. "There are several critical differences in today's markets," he explained. "The buyer base is much more stable. Most participants are long-only institutions, and CLOs play an increasingly small role as their reinvestment periods come to an end. CLOs issuance today is a mere fraction of the volume of issuance we saw in the years leading up to the crisis. Banks have also undergone dramatic changes, with proprietary trading desks having largely exited the loan space. Finally, in 2008, banks had \$300 billion of committed deals they needed to syndicate off their balance sheets, a phenomenon we're unlikely to see again." ■

Positioning Loans in Your Portfolio

The past decade's experience and widely reported "New Normal" equity prospects, along with increased downside risks for bond investors at current interest rate levels, raise questions about the adequacy of many traditional allocation models. The chart below, "The Pincer Movement", depicts how reduced return expectations for both traditional stock and bond asset classes are driving investors into corporate credit, primarily in the form of secured loans and high yield bonds. (see chart below)

Parsing the components of "fixed income"

For the past 30 years, fixed income managers have successfully focused their attention almost exclusively on bonds and ignored the other sub-sets of the fixed income world, such as loans. With interest rates on a downward trajectory since the 1980s, managers of bond portfolios have essentially had the wind at their backs for most of the past thirty years. Investors could collect their coupon payments on a regular basis and also enjoy frequent capital gains as well.

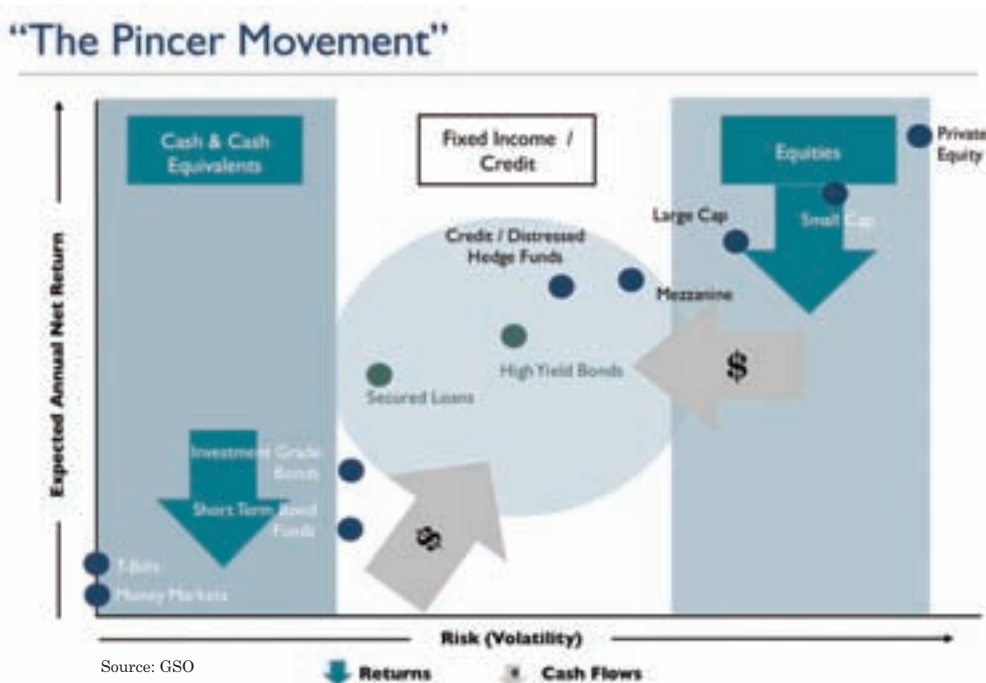
In this sort of falling rate environment, fixed income investors easily lost sight of what they are being paid for. Obviously investors are paid to take risks. Usually the more risk one takes, the greater the returns at least in theory and over the long term. In the fixed income market, an investor assumes both credit and interest rate risk, although the relative amount of each varies considerably from one instrument to another. In a long dated US Treasury bond, for example,

the risk is almost entirely related to interest rates, since the chance of not receiving par value at maturity is virtually nil. In investment grade corporate bonds, investors are paid fixed returns which are often quoted as spreads above equivalent-term Treasury bonds. These spreads are typically less than the underlying Treasury bond rate, which means investors are being paid less to take the credit risk of the issuer than they are for taking the interest rate risk on the issue. The 2.05% in the example on page 10 is not purely interest rate risk, but also inflation risk. This is due to the fact that the value of future payments may be eroded by inflation.

In simple terms, one can approximate what an investor is being paid to take credit risk on any fixed rate instrument by subtracting the credit risk-free rate, which generally is the rate on the Treasury bond of that same maturity, from the yield on fixed rate investments under consideration.

Bonds, unlike equities, are a "zero sum game" in that the only long-term income generated comes from the coupon on the instrument. Obviously an individual bondholder can generate a capital gain by selling an existing bond that has a higher coupon than the current market yield, but then the investor is simply monetizing the present value of the future "excess" yield they would gain over time were they to hold it to maturity. Likewise, an investor can sell at a loss a bond with a lower coupon than the current market yield, but here again the investor would merely be recognizing currently the negative differential in yield that they would otherwise incur

continued on page 8



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continued from page 6

gradually were they to hold the bond to maturity. But, however it is recognized, the coupon on the bond – whether it is above or below the current market yield – is the only return component of the instrument.

Today's investment grade bond buyers can look forward to a return of about 3.25 % for taking a 10 year risk on a single-A corporate credit. That increases to about 4.5% if they increase it to a 20-year risk, of which 75 basis points of the 1.25% additional coupon compensates for interest rate risk. In other words, a single-A corporate bond investor gets paid 1.2% for taking a 10 year credit risk and an additional 50 basis points for the extra 10 years.

To a fixed income manager traditionally focused on high-grade bonds, these numbers are sobering and may not even generate any "real" return after accounting for inflation. Obviously each investor must review its own strategy to determine whether a return below 3% adequately compensates them for taking a 20-year interest rate risk, or whether a return well below 2% is sufficient remuneration for a 20-year credit risk.

Given this reality, and the need for many pensions and other institutional investors to meet targets in the 7 to 8% range, it is no wonder many consultants and portfolio managers have moved more aggressively into the high yield bond and loan markets. Although high yield bonds and loans differ in some fundamental ways, there is one key similarity: they both represent essentially credit bets, as opposed to the interest rate bets that are the primary risk components of both Treasury and investment grade bond investments. So as institutional investors shift emphasis from the government/high grade world to the high yield/loan world, they are changing significantly the nature of the risk they are taking in their fixed income portfolios. Fortunately, as we shall discuss, high yield and loan investors get paid much more in today's market environment for taking credit risk than they do for taking interest rate risk, so instruments em-

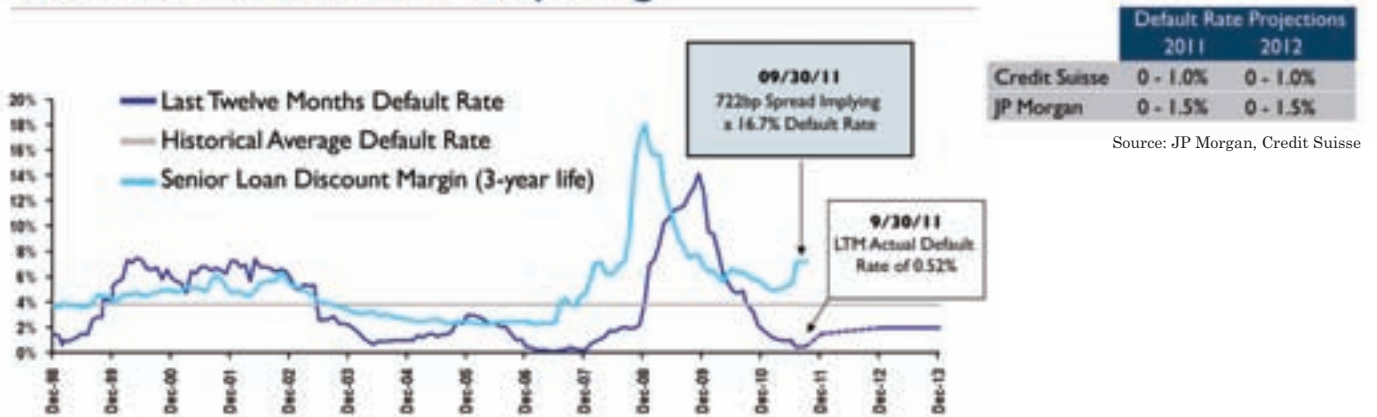
phasizing credit risk – if managed prudently and professionally – currently represent a potentially better way to meet one's investment targets.

A critical consideration for loan investors is the estimated future level of actual credit defaults versus the default level implied in the pricing of the loans themselves. In other words, the level of credit losses (defaults, taking into account an assumed recovery rate) investors will actually experience versus the level of losses they are being paid to take. At the moment, the ratio between the two is very much in an investor's favor. The graph below shows that loans were recently priced at a level implying a 7% annual default rate, while actual default projections are in the 1.5 to 2% range. That means an additional premium return of about 5% is available to investors if current default estimates prove accurate.

Comparing loans and bonds

High yield bonds and corporate loans are both debt instruments issued by companies that are rated below investment grade (double-B-plus and lower). A key difference is that loans are most often secured by the borrowers' assets as well as by protective covenants that are incorporated into the loan documents, whereas high yield bonds are almost always unsecured and sometimes even explicitly subordinated to other debt. As a result of the additional protections, loans tend to default slightly less often than bonds, since companies will often go to great lengths to keep paying the lenders even if they can't keep up payments to unsecured and subordinated creditors who are further down the capital structure. Consequently, when companies do default or go into bankruptcy, loan investors typically collect 60 to 70% of their principal, versus 25 to 40% for unsecured or subordinated creditors. This means that loan investors give up substantially less of the gross earnings on their portfolios to credit loss than high yield bond investors.

Current Spreads Imply Higher Future Default Rates Than the Market is Projecting



The level of recoveries after default can make a significant difference to the default adjusted returns for a loan or bond investor. “Two instruments, a loan and a bond, may have the same gross yield,” explained Sankaty Advisors’ Managing Director, Jonathan DeSimone, “but at the long-term average default rate of 4%, bonds have historically experienced nearly twice the losses of leveraged loans.” As indicated on the graph, although market spreads are only about 50 basis points apart, after adjusting for the difference in historic average credit losses, the net spread on the average loan is 66 basis points higher than that of the bond. (see chart below)

The other critical difference is because they are fixed rate, high yield bonds contain duration risk, or the embedded “bet” that interest rates will either remain flat or fall. If interest rates rise meaningfully, the bonds’ market values are likely to fall as a result of the duration. Loans, by contrast, are floating rate, with a fixed spread above a LIBOR base rate (usually 3-month LIBOR, which is reset every 90 days). As a result, loans have a very short duration and therefore the market value of the loan is not contingent on the direction of interest rates. Instead, the amount of the coupon increases as rates go up and decreases as rates fall. In sum, purchasing a high yield bond is essentially a bet that rates will go down, and purchasing a floating rate loan is a bet that rates will increase.

The comparison of bonds and loans includes a number of qualitative factors difficult to value explicitly. Chief among these are call protection, which prevents an issuer from prepaying its bond or loan prior to some specified date without paying a penalty or “make whole” to the investor. Without such protection, the bond issuer could pay off the debt and refinance at a lower rate whenever interest rates drop. But when rates moved up, the investor would be stuck earning a below-market rate until the bond matured. That would make

the interest rate bet, which is integral to a high-yield bond, unattractive and one-sided.

The floating-rate loan market has traditionally taken a more relaxed view of call protection and prepayment risk, since interest rates constantly re-adjust to market levels, removing much of the incentive for loan issuers to refinance to get lower rates in a declining rate environment. With its roots in a commercial bank lending culture, the loan market was traditionally more focused on protecting itself against the risk of not being paid by borrowers with deteriorating credit than it was with the risk of being paid prematurely by borrowers whose credit was improving.

As a result, loans usually have covenants and other protective features that give the investors the right either to accelerate payment or to increase pricing midway through the deal should the issuer’s credit deteriorate. Offsetting that is the risk that some issuers whose credit improves over the course of a term loan may choose to prepay and refinance at a lower spread over LIBOR. Loan agreements may anticipate this by incorporating “pricing grids” that call for the rising and lowering of interest rate spreads based on the improvement or deterioration of the issuer’s credit rating. Buying senior loans at a discount from par is another way for investors to build in some protection against loan prepayment.

Given the greater credit risk and historically higher credit losses assumed by high yield bond investors, one would expect them to be compensated more highly than better secured loan investors. While this has normally been the case, current data tells a different story:

If we take a typical high yield bond yielding 8.5%, after subtracting out the 1.5% that the investor could make for investing in a “risk-free” government bond, we see that investors are paid 7% for taking the additional credit risk of the issuer. “According to data provided by Barclays, high yield bond returns in any given year over the past 20 years

continued on page 10

Default Adjusted Spreads

Leveraged Loans			High-Yield Bonds		
Average Default Rate:	Average Recovery:	Implied Loss	Average Default Rate:	Average Recovery:	Implied Loss
4.0%	66%	34%	4.3%	41%	59%
Current Loan Spread	Default Adjustment ⁽¹⁾	Default Adjusted Spread	Current Bond Spread	Default Adjustment ⁽¹⁾	Default Adjusted Spread
L+683	(137)	L+546	T+732	(252)	T+480

Source: JPMorgan, S&P/LSTA. Loan spreads assume 3-year refinance as of 11/4/2011.

(1) Default adjustment for bonds assumes long-term average default rate of 4.3% and recovery of 41.35 since 1982.

Default adjustment for 1st lien loans assumes 4.0% average default rate since 1998 and 65.8 recovery average since 1990. All per JPMorgan Default Monitor.

continued from page 9

have never been within 200 basis point of their average coupon,” explained Angelo, Gordon’s Portfolio Manager/Head of Leveraged Loan and High-Yield, Bruce Martin. “This is because they either get clobbered or boosted by risk free rates moving up or down, or they get clobbered or boosted by credit risk rising or falling... it is a feast or famine market beholden to variables well beyond a credit analyst’s control.”

That 1.5% yield on 7-year Treasury bonds may seem like slight compensation for a 7-year interest rate bet, especially given the cyclically low current interest rate level. But the 7% that remains is considerably more than the relatively meager 1.2% that, as we see below, holders of 10-year investment grade bonds are being paid to take credit risk. In fact, it is almost 6 times as much, which may be appropriate given that empirical data shows that non-investment grade companies default considerably more frequently – on the order of 5 to 10 times as much, depending on credit rating – as investment grade companies.

Attractive as that gross return on credit risk may seem, compared to what investment grade bonds pay, it is somewhat less than what loan investors currently receive. Obviously this is counter-intuitive, since one would expect the riskier high yield bonds to compensate the credit risk-taking investor more than the relatively safer senior secured loans. As the table shows, leveraged loans currently provide all-in yields of 7.6%, when taking into account the spread, the minimum LIBOR floor included in virtually all new loans issued today, and the original issue discount. And because essentially none of that spread has to be allocated to an interest rate bet, since there is essentially none in a floating rate loan, the entire 7.6% yield is compensation for taking credit risk. “You’re not giving up anything to get the better credit posi-

tion,” is how KKR’s Co-Head of Leveraged Credit, Erik Falk describes the “win-win” situation in which loan investors now find themselves.

Importantly, with the inclusion of LIBOR floors and discounts to par, cash on cash returns on loans rival those of comparably rated bonds. And loans have upside from rising rates, whereas bonds have none at this point in the cycle when rates are near zero.

Of course, as pointed out earlier, that 60 basis points differential – 7.6% for loans minus 7% for bonds – actually understates the loan asset’s current advantage. Because loans are senior and secured, whereas bonds are unsecured (often even subordinated), loans suffer less than one-half the credit losses as bonds, on average, when issuers default. Off-setting this somewhat, as mentioned above, is the call protection bonds provide that loans generally do not.

The facts are:

- (1) Loans currently pay investors more than bonds for taking what is actually less credit risk.
- (2) Loans provide a hedge against rising rates at a time of historically low interest rates.

The combination of these realities makes a powerful argument for re-allocating at least a portion of an investor’s fixed income commitment to the floating-rate loan asset class.

Loans’ high yields are attracting considerable attention among institutional investors and their consultants. “We are describing this to many of our clients who are traditional high yield bond buyers as a unique opportunity to move higher in the corporate capital structure without sacrificing yield,” Blackstone/GSO’s Senior Managing Director, Dan Smith said. ■

Interest Rate Risk vs. Credit Risk

	10 Year Single-A Corporate	20 Year Single-A Corporate	7 Year High Yield Bond	3 Mo LIBOR Floating Leveraged Loan
Instrument Yield	3.25%	4.50%	8.50%	7.60%
Benchmark Yield	2.05%	2.80%	1.50%	0.00%
Differential*	1.20%	1.70%	7.00%	7.60%

* what investor is paid for credit risk

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Loan Management Through the Cycle

While the current interest in floating rate loans is understandable, many investment consultants and portfolio managers struggle to decide whether loans should occupy a permanent position in their clients' portfolios. Should loans be the debt instrument of choice only when interest rates are historically low or their returns unusually high or do loans merit consideration as a core portfolio holding at all times?

"Loans should be part of every investor's portfolio" said Sankaty's Managing Director, Jonathan DeSimone. "Their position in the capital structure and lien on assets provides good downside protection while their floating rate nature provides upside to economic growth and higher interest rates. Most investors have had 2 to 5% allocations to high yield bonds for a long time without a similar allocation to loans despite the fact that the corporate loan market is nearly as big."

A strategy for all seasons

"Okay, you've convinced me," an investor may say. "I know part of my portfolio should be invested in loans, especially at a time like this when interest rates are so low. But how much should I allocate to loans? And what are the signals that would trigger a change in my allocation?"

These are the questions that institutional investors are now asking their portfolio managers and investment consultants. They are seeking guidance in allocating between high yield bonds and loans, not just in the current environment, but also through cycles.

"In the past, most investors didn't really have a choice in fixed income," said Sankaty's DeSimone. "It was all bonds, and you lived with the fact that you had a built-in bias to-

ward betting on falling interest rates. Now with loans as an established asset class, investors have the option of choosing to invest in credit without having to bet on interest rates as well."

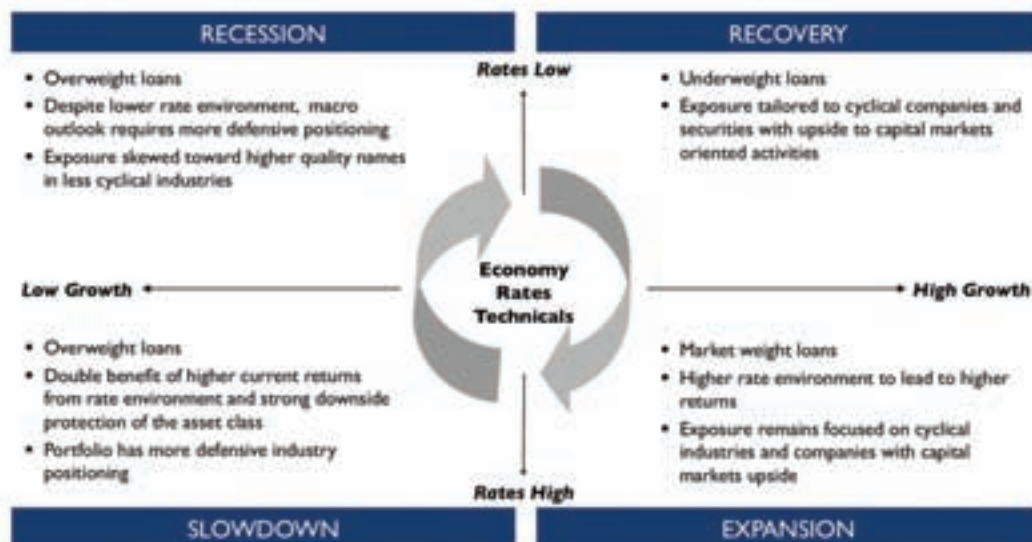
One place to start building an allocation model would be to assess one's view on interest rates. Bonds incorporate a bet that interest rates will remain the same or go down, while loans include a bet that rates will remain the same or go up.

At the same time, such an allocation model should also consider the relative return on credit risk from each asset class at that point in time. As we saw earlier, it is important to strip out the portion of the high yield bond return that represents payment for taking interest rate risk in order to see what bond holders are actually being paid for taking credit risk. Once that is done, the "credit risk return" on the bonds can be compared with the credit risk return on loans to see which pays investors more for assuming pure credit risk.

The chart below is a conceptual model of how investment strategists might analyze the decision to weight loans in a portfolio throughout the cycle.

But interest rate outlooks and credit spreads are not the whole story. Underlying an investment strategist's analysis – as well as their use of this model – must also be their macro-economic view. If, for example, the outlook for falling interest rates reflects an expected economic downturn with increased corporate defaults, a loan investor may decide the importance of staying senior and secured in the capital structure outweighs the advantage of shifting to fixed rate but unsecured bonds. At another point in the cycle, when strong economic growth is anticipated, high yield bonds may be ex-

Dynamic Asset Allocation



Source: Sankaty Advisors

pected to behave more like equity than other fixed rate debt and therefore warrant overweighting in spite of the drag of their fixed rate coupons.

Not an “either-or” proposition

This model is not meant to suggest that investors should be 100% invested in either loans or bonds at any one time. Rather it is intended to introduce a way of analyzing and integrating some of the key factors that might drive an investor’s decision about allocating a fixed income portfolio. Many investors and their consultants are only beginning to explore seriously the opportunity of having fixed income assets strategically split between high-yield bonds and floating rate loans. The step beyond that is to develop the analytical tools required to manage that split dynamically as market conditions and economic outlooks change.

This will involve a long-term, serious commitment to loans as a core asset class, according to Sankaty’s DeSimone. “We would expect investors to maintain core holdings of both high yield bonds and loans, and to move between the two as their interest rate views and credit expectations evolve through various cycles,” he said.

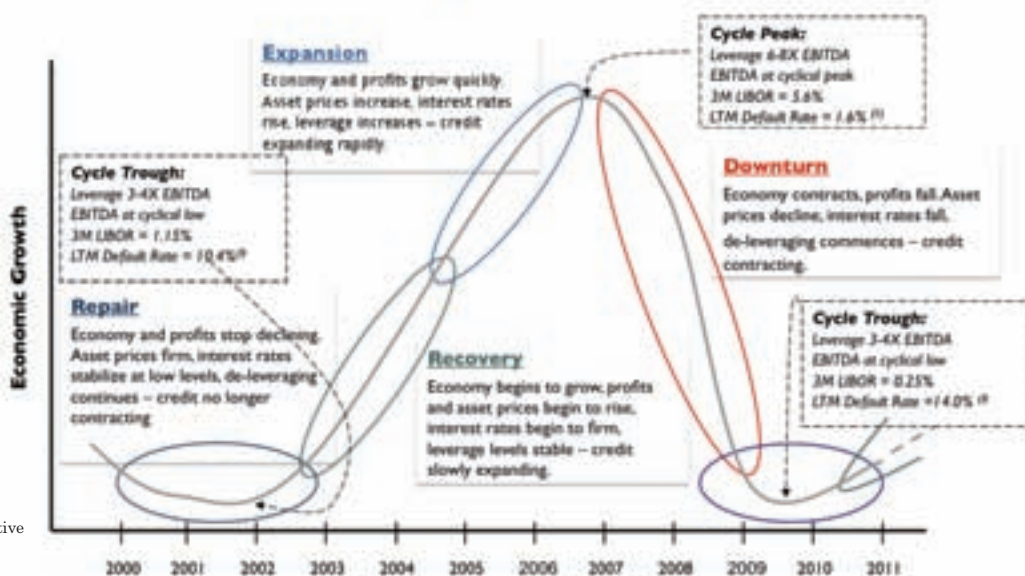
But for any investor seeking to initiate or expand a position in loan assets, this is a particularly opportune time, given current market conditions and interest rate levels. “The best time to invest in loans is after a downturn,” said Blackstone/GSO’s Senior Managing Director, Dan Smith. “Returns are higher, credit risks are lower and receding, companies are de-leveraging and the economy is improving, we have current and real information as to how the company performs in a challenging environment and simply put it’s a ‘lender’s market,’” he added.

The chart below displays graphically how the credit cycle goes through its downturn/repair/recovery/expansion phases. During the “repair” phase, which is where we currently still are following the crash of 2008, loan investors

need higher returns and more conservatively structured transactions in order to be lured back into the markets. Those who enter at these times, based on past experience, are well rewarded once the “recovery” phase eventually gains momentum, as underlying spreads narrow, original issue and secondary market discounts begin to shrink, and default rates drop. ■

One place to start building an allocation model would be to assess one's view on interest rates. Bonds incorporate a bet that interest rates will remain the same or go down, while loans include a bet that rates will remain the same or go up.

The Current Credit Cycle



(1) Moody's speculative grade default rate
Source: GSO

Loan Myth-Busters

Like any new idea in finance or other fields, the loan asset class has had to prove itself both in the marketplace and in the court of public opinion. We would like to address a few of the more common challenges and objections here:

(1) Isn't all high yield debt the same? Aren't loans just as risky as junk bonds?

Actually no, there is a world of difference between senior secured loans and the unsecured and often legally subordinated debt that is issued in the form of high yield bonds. Loans are secured by collateral, generally all the physical and tangible assets of the borrower, so in the event of a default, loan investors get paid first and have priority access to the assets that generate cash flow. High yield bond holders get paid out of whatever assets, if any, are left over after the senior lenders are repaid. Loans also have what are called restrictive covenants in the loan contracts. These are provisions that limit the actions of corporate management with respect to how much additional debt they can take on, or how much the borrower's operations can deteriorate before the lenders can take remedial action. These covenants, by allowing secured lenders to take action while the company is still in a healthy, albeit weakened condition, can often forestall more serious trouble and prevent default. Bondholders, by contrast, are often helpless to do anything but sit idly by and watch as a company slides downhill. As a result of these features – covenants and collateral security – loans typically recover at a 60 to 70% rate in the event of default, whereas bondholders, depending on whether they are subordinated or merely unsecured, typically are repaid between 25 and 40%. This translates into credit losses for loan investors that are generally only about one-half the losses suffered by high yield bond investors.

(2) Isn't the loan market highly volatile? Didn't loans plunge in value in 2008?

Loan prices did fall substantially in 2008, with the S&P/LSTA leveraged Loan Index falling 29%, and then climbing back up by 52% the following year, with a further 10% return in 2010, for a net annual return of 6% for a patient buy-and-hold investor that continued to hold through the crisis. Other major asset classes – stocks, investment grade, government and high yield bonds, not to mention many commodities and other assets – had similarly volatile price fluctuations. But unlike many other assets, in the case of loans the underlying cash flows that support the loans did not fluctuate much, and the annual principal loss rate due to defaults for loans during the worst period of the crash never reached as high as 2% per year. This explains why buy-and-hold investors experienced no unusual loss of income and securitized vehicles (collateralized loan obligations or CLOs)

that invested in corporate loans have been among the steadiest and most dependable performers in the structured finance world

(3) Is there enough liquidity to support the loan market throughout the cycle?

In size, the loan market now totals \$1.22 trillion, which means it is slightly larger than the high yield bond market (which totals \$1.1 trillion). During even the most illiquid periods of the 2008 crash, bids were always available on major loans, albeit at significantly reduced market prices. Loans came back more quickly than bonds during the first leg of the market rebound, as investors focused on the most senior instruments to the best companies. During that period, loans were as “liquid” (or illiquid) as bonds, as measured by the low market prices at the time for both healthy loans and bonds.

There are over 20 dedicated closed-end loan funds, about 80 traditional open-end loan mutual funds, and hundreds of high yield, limited duration and multi-sector debt funds that routinely buy loans. Several loan ETFs have been started or are close to launch. Transparent pricing data, quotes and loan indices are available from multiple dealers and services.

(4) Loans are only good to own when rates are rising.

Interest rates are only part of the story when it comes to owning loans. Being senior in the capital structure and secured by collateral is a powerful reason for choosing to own loans throughout the cycle, even when rates are expected to drop. Decreasing rates can be a sign of economic weakening, so the fixed rate high yield bond that goes up in value because of the falling interest rates may also take more credit losses because of its junior position in the capital structure. A sophisticated asset allocation strategy will consider and balance the advantages of both corporate loans and high yield bonds throughout the macroeconomic cycle and will shift weightings accordingly.

(5) Loans are an “alternative” investment

Loans are as mainstream as high yield bonds. Indeed, they should be considered complementary to high yield bonds, as discussed earlier, with the decision whether to overweight one or the other driven by one's view of (1) the interest rate outlook, (2) the relative advantage/disadvantage of being senior and secured or junior and more equity-like given the economic outlook, and (3) how relatively well one is compensated for taking the credit risk of either instrument once the interest-rate bet component of the yield is removed. Investors, who incorporate loans into their core fixed-income portfolio as an equal partner with high yield bonds, will likely find over time that their risk-adjusted returns in fixed income will increase. ■



A trusted partner for investment success

Sankaty Advisors LLC, the credit investment arm of Bain Capital, is a global leader in high-yield fixed income and leveraged finance. Founded in 1998, today Sankaty Advisors oversees \$12.4B of investor capital across a variety of traditional and alternative credit strategies including high-yield bonds, leveraged loans, distressed debt, private mezzanine capital, structured credit and equity. Through our extensive industry experience and flexible approach, we assess every level of a company's capital structure to pick the most attractive security and can provide customized capital solutions for companies with unique financing needs.

The key factors in our success include our world class team of 86 investment professionals, highly analytical investment approach, flexible capital and strong alignment of interest with our partners. This strong alignment is created by the fact that Sankaty Advisors is 100% employee owned and makes substantial employee co-investments in each of our funds.



Since 1995, The LSTA has been the leading advocate of the senior secured loan asset class

The Loan Syndications and Trading Association promotes a fair, orderly, efficient and growing corporate loan market and provides leadership in advancing and balancing the interests of all market participants.



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