portfolio construction

MARKETS SUMMIT

Tuesday 16 February 2010

Theme 2
Global debt markets

portfolio construction

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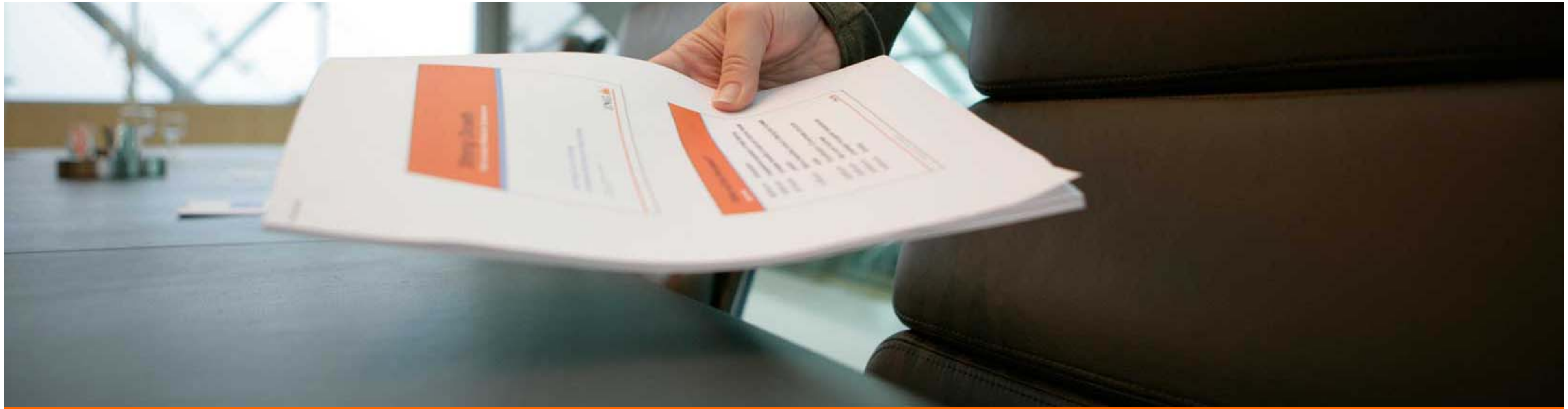

PortfolioConstruction Markets Summit 2010

Senior Loans Outlook

Dan Norman
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16 February 2010

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What are Senior Loans?

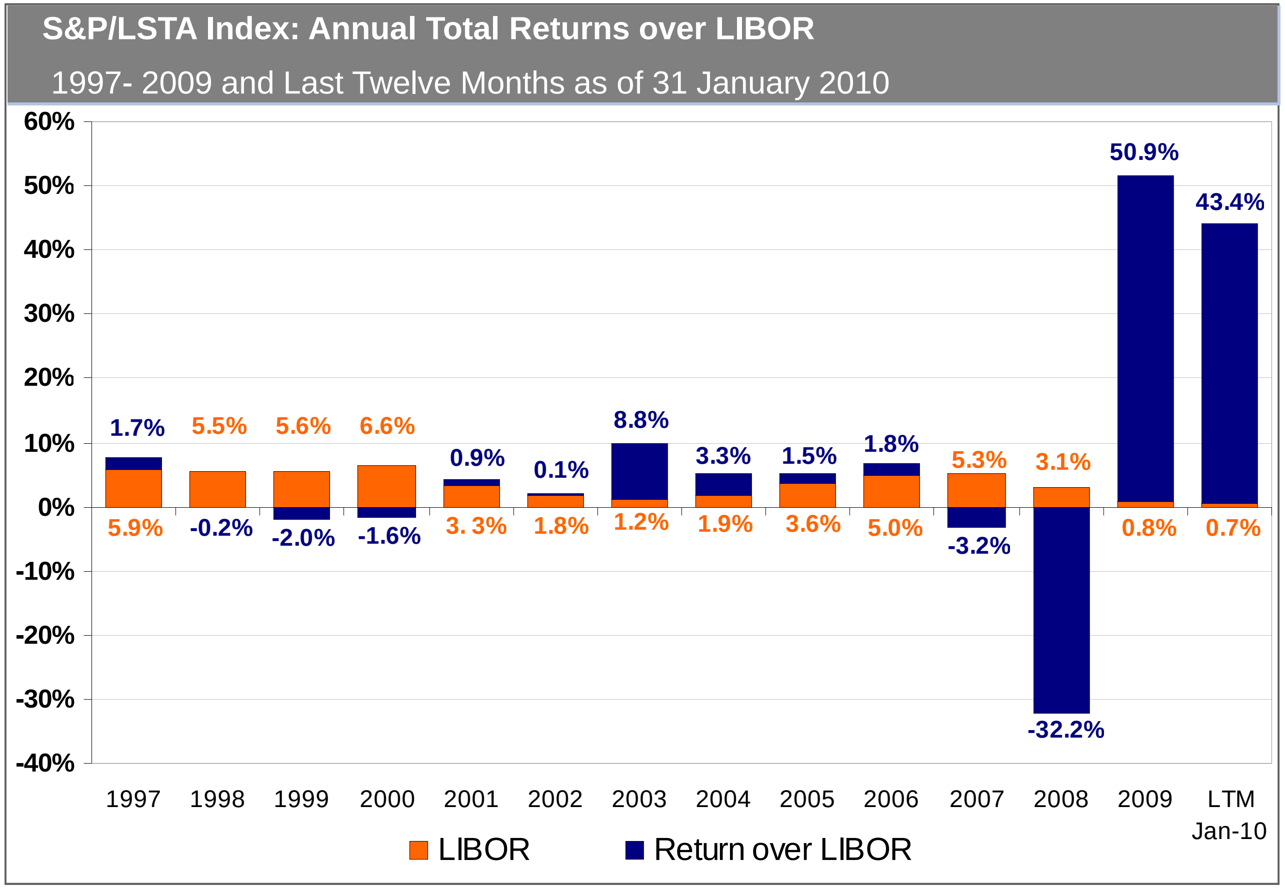
- ***Non-investment grade***
- ***A natural hedge against rising interest rates***
- ***Potential for high, risk-adjusted monthly income***
- ***Secured by collateral***

- **Extensions of credit made to non-investment corporations to:**
  - finance acquisitions
  - refinance existing debt
  - support business expansion
  - other general business purposes
- **Floating rate loans**
  - Interest paid on loans changes with interest rate movements
- **Large loans ranging from $50 million to over $10 billion**
  - Portions of the loan are syndicated to banks and institutional investors
  - Privately issued and traded
- **Secured by collateral**
  - Senior loans have first priority or senior lien on borrowed assets
  - Tends to have higher recoveries on defaulted loans than high yield bonds
- **Relatively illiquid when compared to public markets but growth of market has improved trading**

What Happened in 2009?

Surprise – the significant rebound in returns

- *Prior to 2008, returns have been consistently positive, a hallmark of the loan asset class*
- *Driven by unprecedented technical volatility, the Index had its first negative return year in 2008*
- *In 2009, returns rebounded significantly as technical stress diminished*
- *LIBOR is currently at historical lows*



Source: Standard and Poor's LCD and S&P/LSTA Leveraged Loan Index

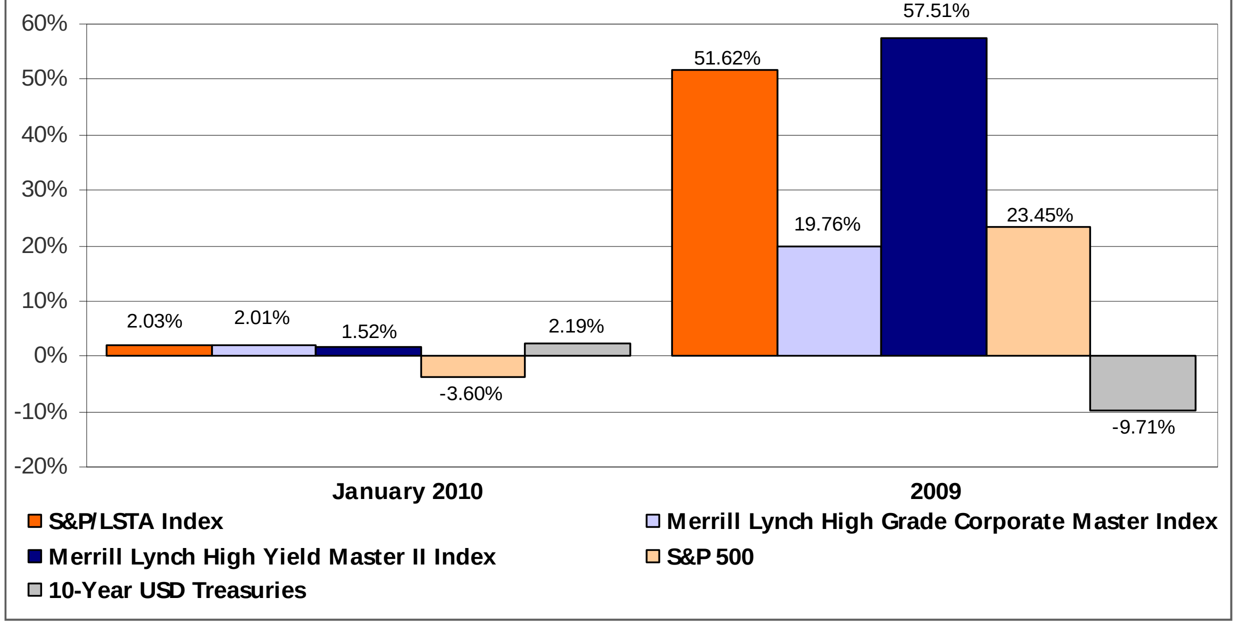
What Happened in 2009?

Theme 1 – Corporate credit outperformed many investor expectations

- ***Among major asset classes, only the 10-Year USD Treasuries posted a loss***
- ***Corporate credit experienced significant 2009 returns***

Relative Asset Class Performance

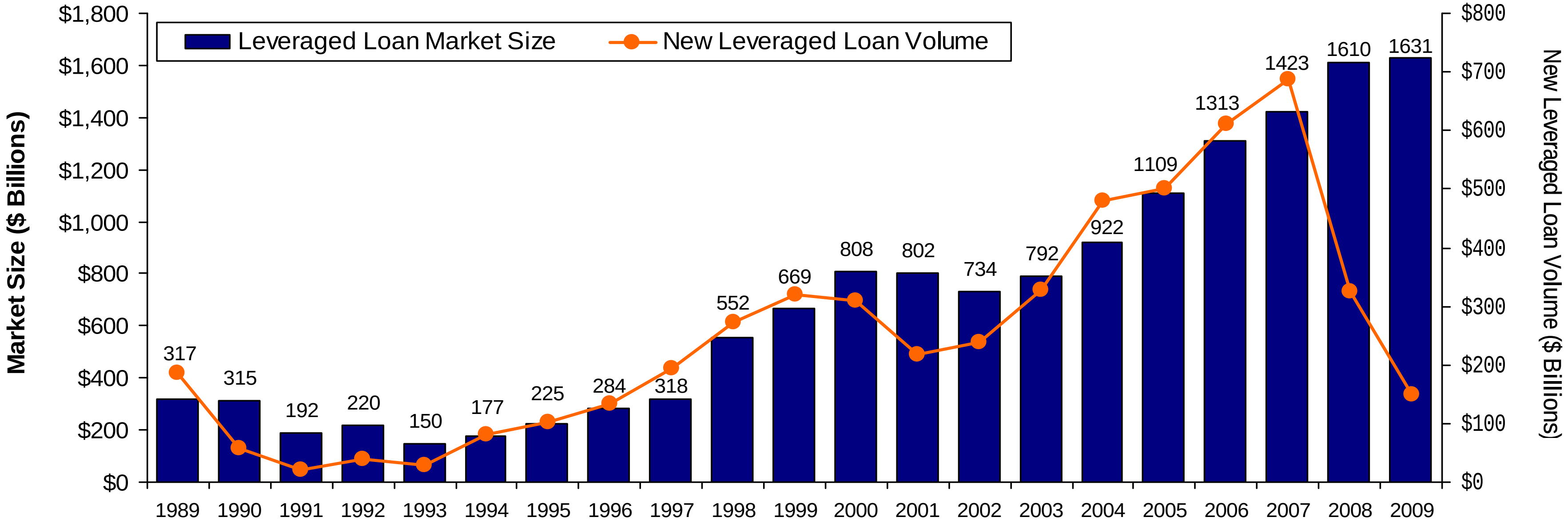
January 2010 and Full-Year 2009



What Happened in 2009?

Theme 2 – Leveraged Loan market continued to grow (but volumes down)

Historical Credit Suisse Leveraged Loan Index [1] Size and Volume
1989 - 2009



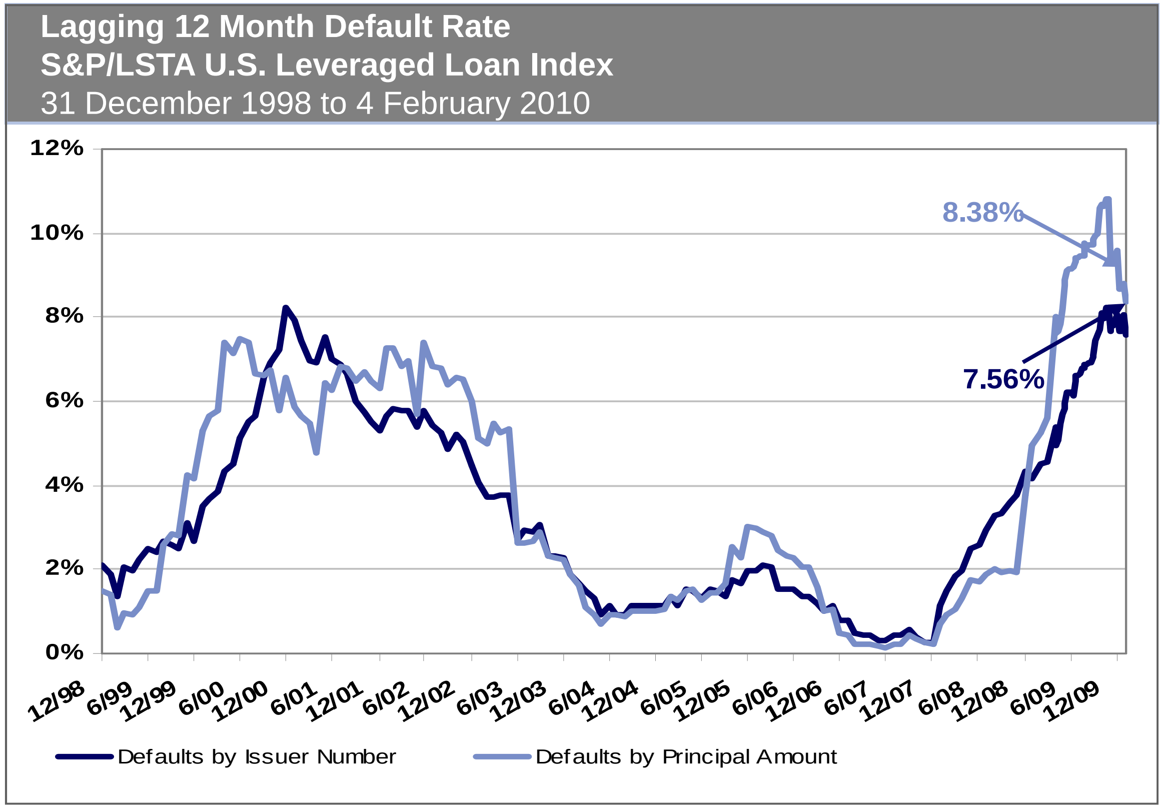
* As of 12/31/2009 Includes $US-denominated non-investment grade bank debt (revolvers, pro-rata and institutional term loans).

1 – The Credit Suisse Leveraged Loan Index is an unmanaged total return index that captures accrued interest, repayments, and market value changes. **Investors cannot invest directly in an index.**

Source: Credit Suisse

Key Lessons Learned

- ***The Index default rate by principal amount appears to have peaked in November 2009***
- ***Default risk remains elevated***
- ***Annualized rates have declined substantially from 1Q 2009 levels***



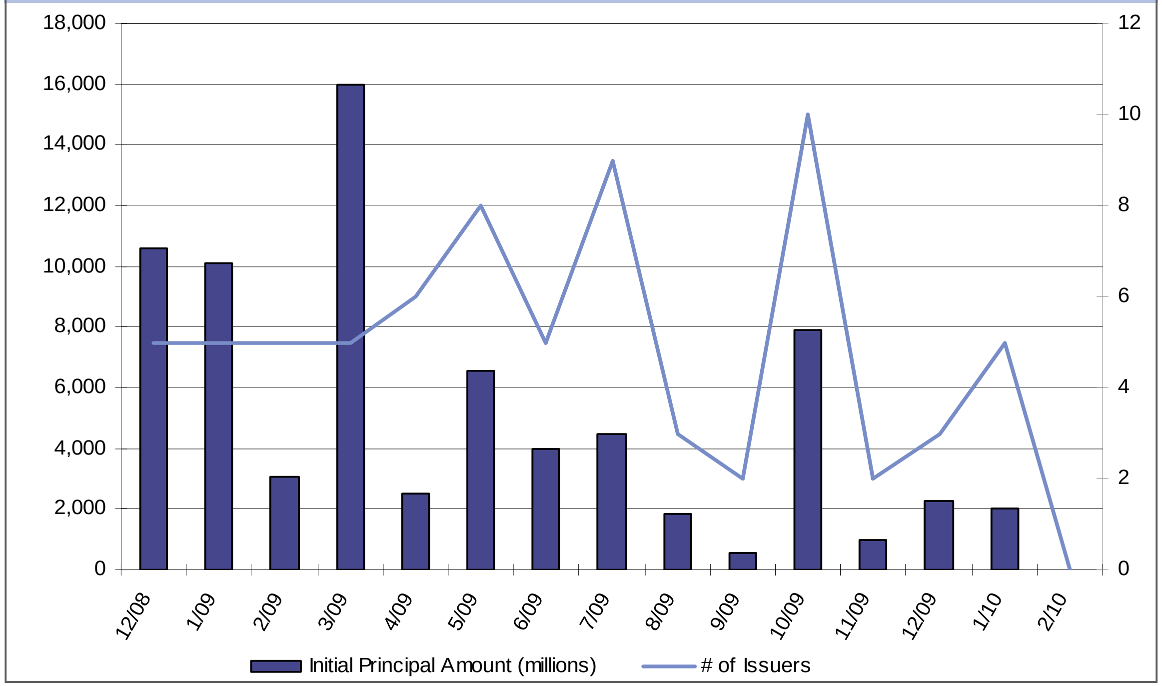
The S&P/LSTA Leveraged Loan Index is an unmanaged total return index that captures accrued interest, repayments, and market value changes. **Investors cannot invest directly in an index.** S&P/LSTA Index lagging twelve month default rate comprises all loans, including those not tracked in the LSTA/LPC mark-to-market service. Vast majority are institutional tranches. Issuer default rate is calculated as the number of defaults over the last twelve months divided by the number of issuers in the Index at the end of the prior period. Principal default rate is calculated as the amount defaulted over the last twelve months divided by the amount outstanding at the end of the prior period.

Source: Standard and Poor's LCD and S&P/LSTA Leveraged Loan Index

Key Lessons Learned

- ***The first large default in this cycle occurred in late December 2008***
- ***The top five Index defaults account for more than 50% of the total Index default rate by principal amount***
- ***Number and amount of defaults, month-over-month, has improved***

Monthly Default History
S&P/LSTA U.S. Leveraged Loan Index
December 2008 to 4 February 2010



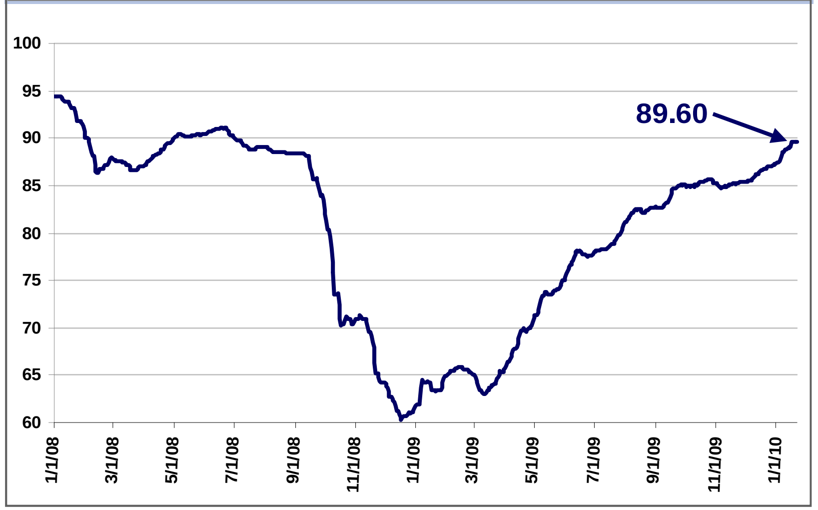
The S&P/LSTA Leveraged Loan Index is an unmanaged total return index that captures accrued interest, repayments, and market value changes. **Investors cannot invest directly in an index.** S&P/LSTA Index defaults shown are at initial principal amount, and do not include past pay downs.

Source: Standard and Poor's LCD and S&P/LSTA Leveraged Loan Index

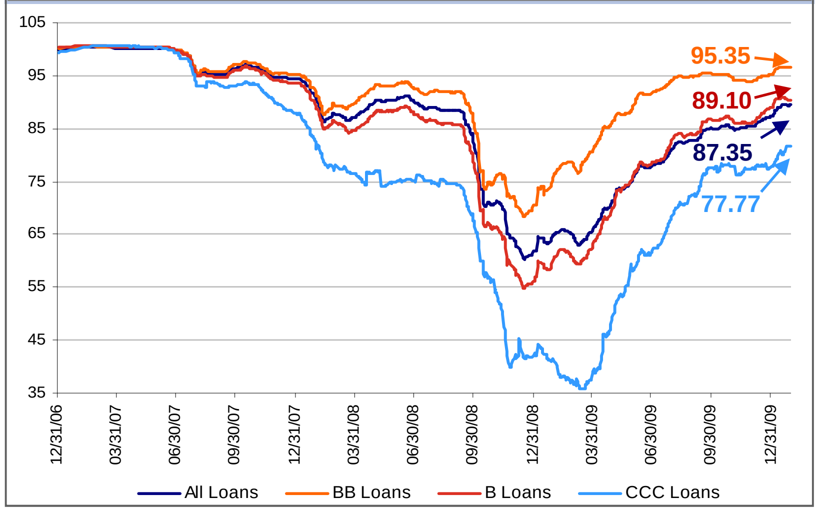
Where is the Senior Loan Market now?

S&P/LSTA Index Loan Price and Spread History

Average Bid of Leveraged Loans
1 January 2008 to 4 February 2010



Average Bid of Leveraged Loans by Rating
1 January 2007 to 31 January 2010

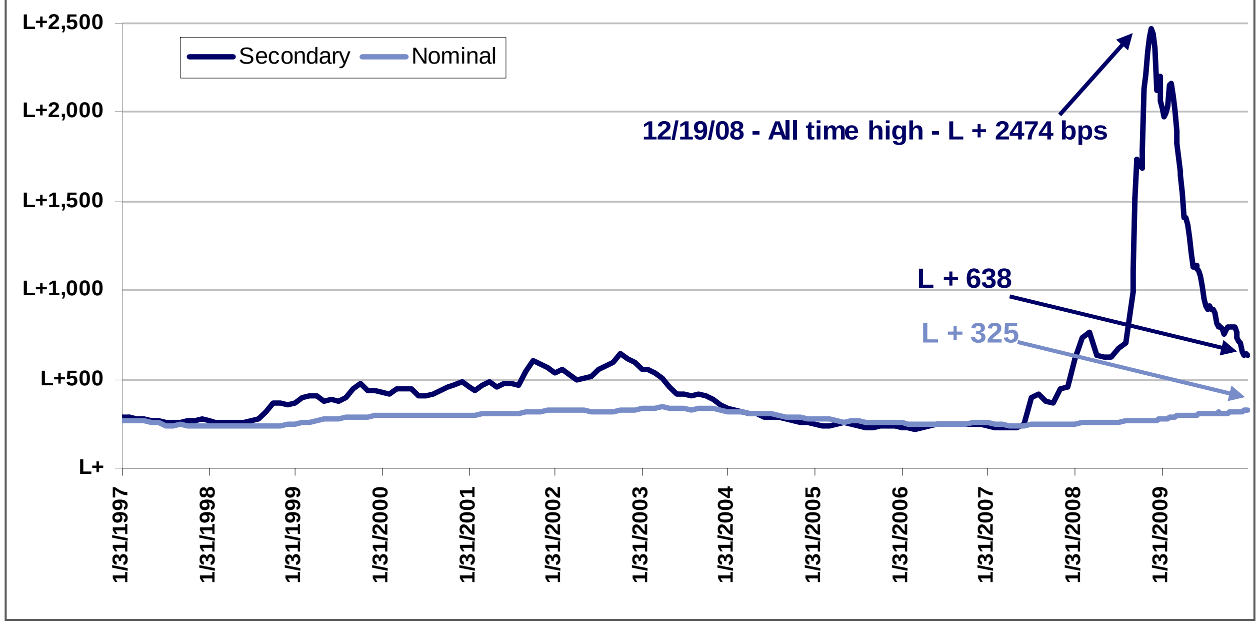


The S&P/LSTA Leveraged Loan Index is an unmanaged total return index that captures accrued interest, repayments, and market value changes. **Investors cannot invest directly in an index.** Source: Standard and Poor's LCD and S&P/LSTA Leveraged Loan Index

Where is the Senior Loan Market now?

- ***Nominal spreads are slowly rising due to technical and structural improvements***
- ***Secondary spreads continue to decline as loan prices near par***

Average Nominal and Secondary Spreads of Leveraged Loans
January 1997 to 29 January 2010



Nominal and secondary spread data excludes all facilities in default. For the three year call secondary spread chart, loan spreads are spreads to 18-month call if average bid is par or higher, 2 years if average bid is 98 but less than par and 3 years if the average bid is less than 98. The S&P/LSTA Leveraged Loan Index is an unmanaged total return index that captures accrued interest, repayments, and market value changes. **Investors cannot invest directly in an index.** Three year maturity assumption: (i) all loans pay off at par in 3 years, (ii) discount from par is amortized evenly over the 3 years as additional spread, and (iii) no other principal payments during the 3 years. Discounted spread is calculated are based on the current bid price, not on par.

Source: Standard and Poor's LCD and S&P/LSTA Leveraged Loan Index

Where is the Senior Loan Market now?

- ***Historically low correlation between loans and other asset classes***
- ***High-yield bonds have the closest correlation to loans***

Leveraged Loan Market Correlation to Other Asset Classes
January 1992 to December 2009

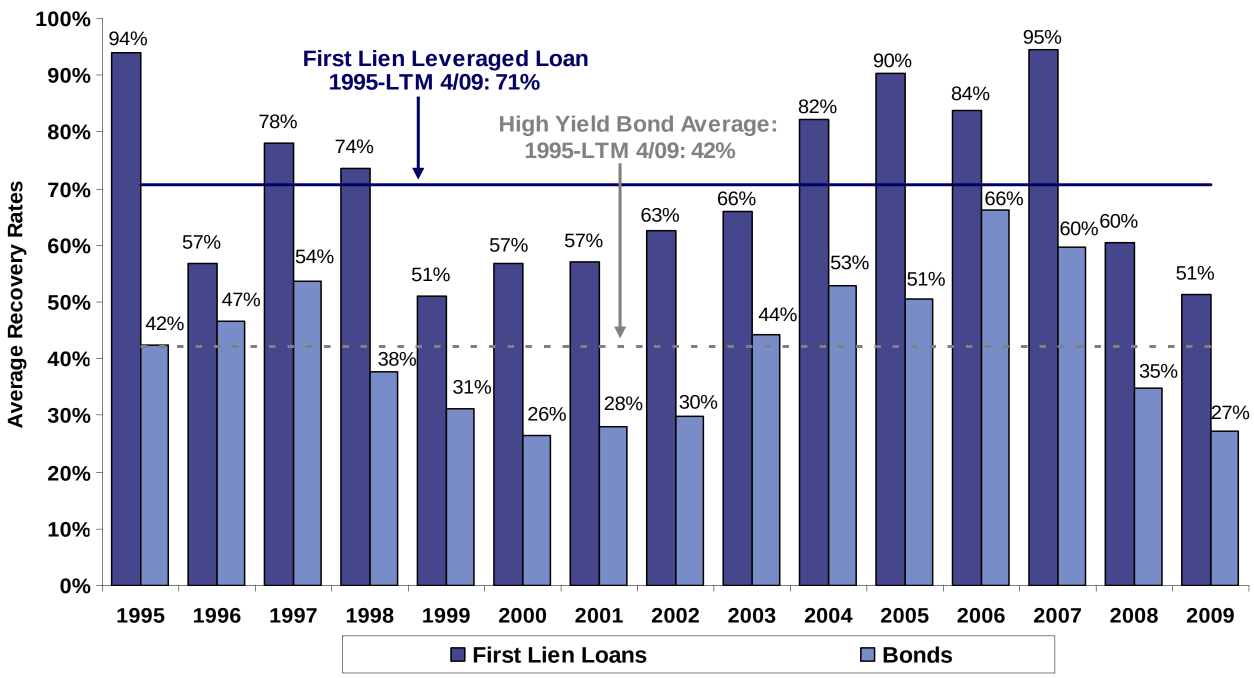
Credit Suisse High Yield Index	0.75
FTSE NAREIT All REITs	0.48
Dow Jones Wilshire 5000	0.41
MSCI Eafe	0.41
Russell 2000	0.41
Merrill Lynch ABS	0.39
Standard and Poor's 500	0.39
IA SBBI U.S. Inflation	0.34
Merrill Lynch U.S. Corporate	0.31
JPM Emerging Markets	0.22
Gold	0.05
U.S. 30 Day Tbill	-0.01
Lehman U.S. Agg Bond	-0.02
Merrill Lynch Mortgage	-0.11
Lehman U.S. Corporate Aaa	-0.12
U.S. Govt 10+ Years	-0.27
U.S. Govt 5-7 Years	-0.31

Source: Credit Suisse, Bloomberg, Ibboston Associates

Recovery Rates – Loans vs. Bonds

- ***First lien loan recovery rates continue to compare favorably to high yield bonds***
- ***Thus far in the cycle, first lien loan recoveries are lower than the historical average***
- ***Traditional recovery analysis ("headline recovery") tracks recovery <u>at time of default</u>***

1st Lien Loan vs. High Yield Bond Recovery Rates
1995 to 2009 (Data as of 31 December 2009)



Recovery Rate is measured at the time of default; determined by calculating the difference between 100% and the principal loss rate. The principal loss rate is the difference between the issue's price at default and par, divided by the issue price.

First Lien Loan Recovery Rate information is shown for institutional leveraged loan tranches within the Credit Suisse Leveraged Loan Index that could be sourced in the public domain with an initial issuance size greater than $25 million. The Credit Suisse Leveraged Loan Index is a total return index that tracks the current outstanding balance and spread over LIBOR for fully funded term loans in the Index. **Investors cannot invest directly in the Index.** Source: Credit Suisse

Outlook - Recoveries Scenario

Ultimate Recoveries – Loans vs. Bonds

- ***Ultimate recovery measures the value creditors realise at the resolution of a default event***
- ***Loan ultimate recoveries consistently exceed bond ultimate recoveries***
- ***Can still understate true ultimate or terminal recovery***

Average Corporate Debt Recovery Rates
Measured by Ultimate Recoveries
1987 to 2008 (Data as of 31 December 2008)

	Emergence Year			Default Year		
Lien Position	**2008**	**2007**	**1987-2008**	**2008**	**2007**	**1987-2008**
Loans	87.0%	96.6%	82.8%	61.2%	93.5%	82.8%
Bonds						
Sr. Secured	70.0%	85.5%	63.6%	51.1%	65.4%	63.6%
Sr. Unsecured	74.0%	60.0%	46.2%	76.8%	83.7%	46.2%
Sr. Subordinated	23.0%	62.9%	29.7%	9.3%[1]	55.4%	29.7%
Subordinated	--	0.0%	28.9%	--	0.0%	28.9%
Jr. Subordinated	0.0%	50.0%	16.0%	--	--	16.0%

[1] *There were only two sr. sub bond defaults in 2008.*

Ultimate recovery is the value that a creditor actually receives at the resolution of the default, usually at the time of emergence from bankruptcy. To calculate the ultimate recovery, each nominal recovery value at the time of emergence is discounted back to the last time interest was paid using the instrument's pre-petition coupon rate.

Loan Ultimate Recovery Rate information is obtained from the Moody's Ultimate Recovery Database, which includes over 3,500 loans and bonds from more than 700 U.S. corporate defaulters. Source: Moody's Investors Service

Outlook – Key Sign-posts

- ***Back to the basics***
- ***Successful fundamental credit selection will prevail***
- ***Clarity required for new regulation and government intervention***

- **Improved Visibility**
  - **The financial markets:** Still capital constrained; liquidity has improved; clarity required for government-sponsored programs and new regulations
  - **The senior loan market:** Downside technical pressure has abated. Going forward, volatility is likely to be based on fundamental credit performance
- **A long-term shift back to the basics**
  - Lower leverage
  - Wider spreads
  - Traditional covenant packages
  - Greater transparency
  - Strong equity sponsorship
- **Focus on strong credit culture, experienced underwriting and credit monitoring**
- **It is now all about the credit**
  - Economic outlook is improving; credit vigilance is paramount
  - Default avoidance and return of traditional pre-payment levels EQUALS attractive returns and out-performance

Outlook - Key Risks and Opportunities

- ***Above average total returns predicted by market analysts***
- ***Inflation hedge is an emerging theme***
- ***Macro risks remain***

Opportunities

- **Above average annual total returns**
  - High single-digit returns expected in 2010 and 2011 as loans recover back to "par"
  - Increasing nominal spreads
  - Declining default rates
  - Increasing recovery rates
- **Inflation "hedge"**
  - LIBOR is at both historic and cyclical lows
  - Average rate exposure ranges between 30 days and 60 days

Risks

- **Negative macro economic events**
- **Shifting government regulation**
  - Corporate loan issuance
  - Secondary market
  - Securitization
- **2012 – 2015 maturity cliffs**
  - Loans and high yield bonds
  - Current market activities sufficiently deal with the issue
  - Market disruption could create a new default cycle

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Outlook – Expected Outcomes

- ***Increasing credit spreads***
- ***Hedge against rising interest rates***
- ***Enhanced credit terms***
- ***Capital gain opportunity***

- **Attractive return opportunity for secured corporate risk**
  - Although prices are well above the lows, the opportunity remains attractive
- **Market technicals continue to favorably impact loan prices**
  - Stable to increasing demand, and little forced selling
- **Fundamental credit risks (defaults and recoveries) are still elevated, but manageable**
  - Annualized default rates have declined substantially
  - Portfolio positioning is key
- **Loans are expected to again outperform fixed rate instruments when rates start to rise**
  - A strategic, not just a tactical, investment
- **Historically attractive new issue loans**
  - Wider spreads
  - Lower leverage
  - Traditional lender-friendly structures

Source: Credit Suisse, Bloomberg, Ibboston Associates

IMPORTANT INFORMATION

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