



Investment Insights

Bank Loans



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Bank Loans Within the Broader Market

The Bank Loan asset class

Bank Loans are privately arranged corporate debt instruments that take their name from the older days of commercial banking when “banks” originated and held “loans” for corporate borrowers. As the banking landscape changed in the 1990s, the industry moved to an originate and distribute model whereby the corporate loans formerly held on bank balance sheets were syndicated to a much broader institutional investor base. Today the U.S. market place for bank loans is roughly \$1.5 trillion in size, making this a significant component of the capital markets. Our discussion and investment thesis will focus on the “institutional” segment of the market, which is a \$500 billion sub-set comprised of the most attractively priced fully-funded loans. Issuance in this segment of the market is transactional and typically revolves around M&A, LBO and Recapitalization activity and results in the underlying issuer taking on a “non-investment grade” ratings profile similar to a High Yield bond issuer. The similarities to High Yield bonds end at the rating profile, however, and this is where Bank Loans become much more interesting - especially in the current environment:

	Bank Loans	High Yield Bonds
Seniority	First Priority	Second Priority
Security	Secured by all assets	Unsecured
Term	6-8 Years	7 - 10 Years
Call Protection	Freely Callable	Call Protected
Interest Rates	Floating	Fixed Rate

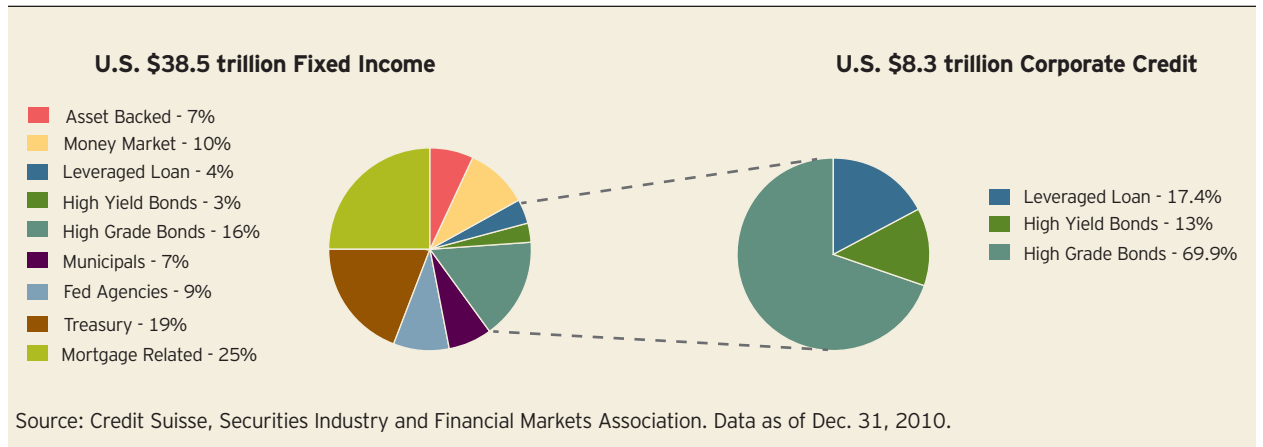
The institutional segment of the Bank Loan market currently includes over 800 issuers in a diverse group of industries, with the largest being health care at 9.6%. The issues themselves are also very diverse and include both mid-cap and large-cap companies.

Data as of December 31, 2010, unless otherwise stated. Past performance is not a guarantee of future results.

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Bank loans within fixed income

Bank Loans are most often included as part of the broader fixed income market and occupy a meaningful percentage of overall corporate debt issuance at 17%.¹ In truth, Bank Loans are more of a hybrid since the floating rate LIBOR component of Bank Loan interest payments strips away traditional yield curve or duration risk, making the investment more of a pure play credit decision. In fact, since the LIBOR base rate is reset every 90 days, current interest income on a bank loan portfolio will increase on any upward change in short term rates. Even at the credit level there are structural features, such as collateral and covenants, which cause Bank Loans to differ from bonds. These differences compensate for the non-investment grade risk profile of most Bank Loans and provide a meaningful layer of protection against credit losses. This is best evidenced in a comparison between the historical recovery rates on defaulted Bank Loan issues (80.7%) versus High Yield Bond issues (40.3%).¹



Because of the differences noted above, Bank Loans are often viewed as a stand-alone allocation within fixed income portfolio strategies. In addition to historically delivering comparatively high levels of current income with limited duration risk, the unique attributes of Bank Loans also translate into a profile that is largely uncorrelated with other asset classes. This is attractive in terms of portfolio diversification and is another reason that Bank Loans are viewed as a stand-alone allocation.

	5-year Treasury	10-year Treasury	LB Aggregate Bond Index	JPMorgan JULI High-Grade Index	JPMorgan Global HY Index	S&P 500	Wilshire 5000	Russell 2000	JPMorgan EMBI - Global Composite	Dow Jones World EM Stock Index	Gold	U.S. Inflation
10-year Treasury	0.94											
Aggregate Bond Index	0.85	0.90										
Investment-grade Index	0.59	0.67	0.88									
JP Morgan Global HY Index	-0.25	-0.18	0.17	0.46								
S&P 500	-0.26	-0.20	0.01	0.21	0.60							
Wilshire 5000	-0.28	-0.22	-0.01	0.20	0.62	0.99						
Russell 2000	-0.32	-0.26	-0.06	0.14	0.62	0.80	0.87					
JPMorgan EMBI - Global Composite	0.05	0.12	0.31	0.46	0.58	0.57	0.58	0.54				
Dow Jones World EM Stock Index	-0.28	-0.24	-0.04	0.19	0.62	0.73	0.75	0.70	0.68			
Gold	0.20	0.21	0.25	0.24	0.13	-0.01	0.02	0.09	0.29	0.21		
U.S.'s Inflation	-0.17	-0.21	-0.16	-0.15	0.13	0.03	0.04	0.04	0.05	0.05	0.06	
Leveraged Loans	-0.38	-0.36	-0.04	0.23	0.80	0.41	0.42	0.43	0.29	0.41	0.02	0.33

Notes: Fifteen years ended Jan. 31, 2011. Bank Loans = Leveraged Loans.
Sources: JPMorgan; S&P/LCD.

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1. Source: Credit Suisse. Data as of 12/31/10.

Loan market liquidity

Although Bank Loans are a private, non-exchange traded asset class, growth in market size and expansion in the number of market participants has fostered an active and liquid secondary trading market. This market is well-defined by standardized trading practices, depth of market makers and increased transparency created by two well recognized third party pricing services: Markit Partners and Reuters/LPC. As secondary liquidity has expanded, there is now a robust market environment that allows for active portfolio management and the ability to deliver more flexible/liquid product structures to investors.

The evolution of liquidity and trading statistics

While the syndicated bank loan market and secondary trading dates back to the 1980's, two of the more significant developments that fostered liquidity were the standardization of trade practices in the U.S. loan market by the industry's trade association, the LSTA, and the launch of the LPC mark-to-market pricing service in 1999. The LSTA represents over 300 market participants including all major broker/dealers and the vast majority of large institutional investors, with a mission to "promote a fair, orderly, efficient and growing corporate loan market and provide leadership in advancing and balancing the interests of all market participants." In addition to establishing standard settlement practices of T+7 for par trades, the organization has added better transparency and efficiency to the market. Trading in bank loans started the millennium by first breaking \$100 billion in secondary volume in 2000. That volume doubled by 2005 to \$200 billion and now registers annual volumes of \$400 to \$500 billion. In addition to the dollar volumes traded, the number of bank loans that trade has increased sharply. The latest statistics published by the LSTA show that approximately 80% of the loan facilities within the S&P/LSTA Index trade on a quarterly basis and approximately 70% traded greater than five times.¹ We expect these levels to continue given the healthy two-way flow that market participants have experienced.

Attractiveness of the asset class in 2011

The Bank Loan market turned in a strong 2010 performance, with gains on the S&P/LSTA Loan Index running at 10.13% at the end of the year. This was propelled by strong credit performance, demand for yield bearing risk assets and investor recognition that Bank Loans have minimal exposure to the yield curve since a portion of Bank Loan interest payments float on a 90 day basis with LIBOR. These themes, along with a robust new issue market that features spreads very close to all-time wides, carry forward into 2011 and set the stage for what we believe should be another year of strong performance. A price entry point of \$0.956 (price at which the index closed in 2010) offers some upside potential relative to both fundamentals and historical levels, but we believe the majority of 2011 returns should ultimately be driven by current coupon income, which averages 4.75%² across the market. All of this combined with the fact that Bank Loans have minimal duration risk, have drawn investor's attention and allocations to the asset class. This theme is discussed further below.

Current income

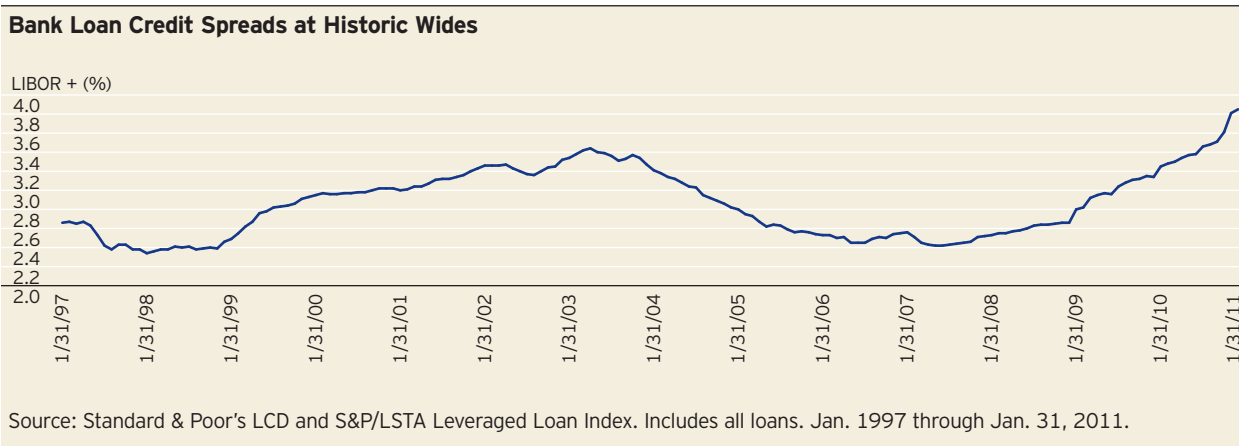
A robust new issue market totaling \$150 billion in 2010 and an active pace of amendments came with very favorable economics for the Bank Loan investor. The prototypical deal during Q4 was issued at LIBOR + 4.5% and a \$0.985 price with a LIBOR Floor³ of 1.5%. This puts current income of new deals at 6.0% and has helped to raise the nominal spread on the S&P/LSTA Index to an all time high of 3.85% at year end.

1. Source: LSTA trade study as of 3/31/10.

2. Source: Standard & Poor's LCD. Data as of 12/31/10.

3. LIBOR Floor: Issuer pays a minimum rate of LIBOR versus the actual 90-day LIBOR. A form of yield protection in a low interest rate environment.

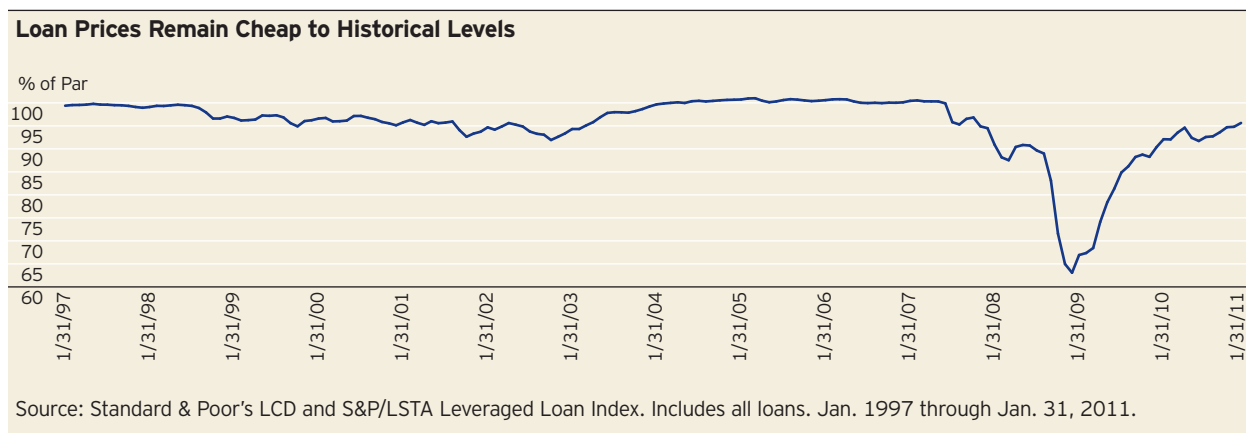
Past performance is not a guarantee of future results.



At an average spread of L+385bp and with roughly 30% of the market carrying a LIBOR floor at 175bp, the market is producing an average current coupon income of 4.75%.¹ Our discussions with the principal broker-dealers point to the continuance of a strong new issue calendar in 2011, as PE firms resume LBO activity and existing issuers tap the markets for refinancing/maturity extensions and recaps. On balance, this should be positive for the economics of the overall market, as the new deals are expected to carry similar terms to what we saw in Q4 2010 and further skew returns toward current income.

Cheap entry price

While the market rallied on technicals and improving fundamentals in 2010, the S&P/LSTA Leveraged Loan Index still closed the year below par at \$0.956. As indicated in the chart below, this remains cheap to historical levels after backing out 2008 and the "Lehman Effect." We focus on pre-2008 trading ranges, as we believe that heavily margined investment vehicles that were forced sellers during the Lehman crisis have been purged from the market, and that the market's buyer base has reverted back to "real money" accounts and unleveraged buyers. Moving forward into 2011, we see relatively stable technicals and thus expect price movement to be driven by fundamentals and pre-payments. Our argument for both is outlined below, with an estimated net result of 200 to 250 basis points of potential upside and price capture in 2011.



Prepayments

Prepayments ran at about 20% in 2010 resulting in roughly 200 bps of realized gain for the year on the S&P/LSTA Leveraged Loan Index. We expect a similar level of prepayment activity during 2011, driven by both "normal course" debt amortization and refinancing activity attached to maturity extensions and/or other corporate actions. Assuming our expectations are correct, a 20% pre-payment rate should produce 88 basis points of realized gains for the year: $20\% \times (\text{Par} - .956) = 88$ basis points.

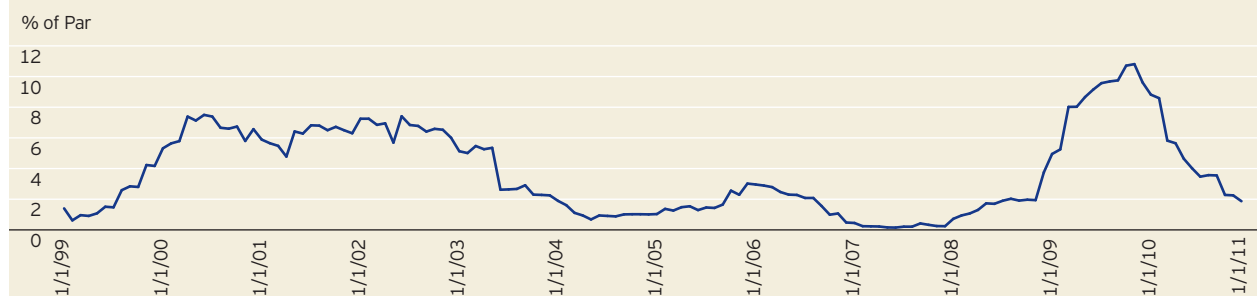
1. Source: Standard & Poor's LCD. Data as of 12/31/10.

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Credit fundamentals

Underlying credit fundamentals saw steady improvement throughout 2010, and we entered 2011 against a backdrop of successive corporate earnings gains, positive GDP growth and declining default rates. The year ended with a trailing 12-month default rate of 1.87%, which is a post Lehman bankruptcy low and a number below historical norms. Applying average historical loss rates of \$0.30 for defaulted bank loan issues, this translated into real credit losses of 56 basis points for the year.

Lagging 12-month Default Rate below Historical Norms by Dollar Amount



Source: Standard & Poor's LCD. Data as of Dec.31, 2010.

Earnings outlook

Looking ahead to 2011 we expect positive earnings momentum and a 2.5% to 3.0% GDP growth rate to sustain a benign default environment. The table on the right supports this idea by highlighting five straight quarters of year-over-year EBITDA growth for the universe of publicly filing bank loan issuers.

As a result, consensus forecasts are pegging 2011 defaults at 2.0% to 2.5%; therefore, if we apply a \$.30 loss rate to this, total credit losses should be inside of 75 bps. The math here suggests that the market is over-compensating for forecasted losses and thus we see the potential for upward price movement as indicated in the table below.

	U.S. GDP Growth	Average YOY EBITDA Growth of Public Bank Loan Issuers*	QE Default Rate	Annualized Quarterly Default Rate
1Q09	-6.4%	-17.80%	8.02%	19.54%
2Q09	-0.7%	-15.20%	9.15%	8.70%
3Q09	2.2%	9.69%	9.75%	4.76%
4Q09	5.6%	15.36%	9.61%	7.61%
1Q10	2.7%	9.43%	5.82%	3.35%
2Q10	1.7%	12.10%	4.02%	0.90%
3Q10	2.5%	25.60%	3.55%	2.66%
4Q10**	2.8%	NA	1.87%	0.61%

Source: S&P, LCD, Bureau of Economic Analysis.
 * S&P/LSTA Index issuers with public filings.
 ** Estimate GDP growth, default rate based on October/November data (most recent data available).

	Spread	Price	Yield to Maturity	Less Expected Loss Based on Default Forecasts	Risk Adjusted Yield to Maturity
12/31/2010	LIBOR + 3.85%	\$0.956	LIBOR + 5.57%	0.75%	LIBOR + 4.82%
Historical ¹	LIBOR + 2.86%	\$0.978	LIBOR + 3.31%	1.08%	LIBOR + 2.23%
				Excess Credit Spread	2.59%

Note: Includes LIBOR floors.
 Source: Standard and Poor's LCD, Invesco. Data as of Dec. 31, 2010.

Even assuming a healthy margin for error on the default forecast, it appears that there is significant upward price capture available in 2011.

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1. Historical spread, price and yield reflect pre-credit crisis average from 1/31/1997 to 12/28/2007. Historical default forecast reflects average default rate 1998-2010.

Interest rate optionality and limited duration risk

Bank Loans deliver yield without exposing investors to the long end of the interest rate curve. This is due to the LIBOR component of Bank Loan interest payments which resets, on average, every 90 days. This reset mechanism not only minimizes price risk, but it also allows investors to positively participate in any future rate increases at the short end of the curve. An example of the potential for positive rate participation is outlined below, based on the effects of the forward LIBOR. Finally, to further evidence stable price behavior in a volatile market, we show secondary prices of the Bank Loan market vs 10 Year treasuries during December 2010 when rate markets widened out.

Bank Loan Prices vs. 10-Year Treasury Prices December 2010



Source: S&P/LSTA Leveraged Loan Index, Bloomberg. Data as of December 31, 2010.

Bank Loan Income Components		Impact of Forward LIBOR On Current Income			
Current Income	Contribution				
(LIBOR + Credit Spread)/Price	4.80%	Date	Forward LIBOR	Benefit of LIBOR Floor	Current Interest Income
Capital Appreciation		02/01/2011	0.30%	0.43%	4.58%
((Par-Cost)/Avg Maturity)/Price	1.07%	05/03/2011	0.37%	0.43%	4.65%
Total Return	LIBOR + 557 bps	08/01/2011	0.45%	0.43%	4.73%
Source: Invesco.		11/01/2011	0.58%	0.43%	4.86%
		02/01/2012	0.76%	0.43%	5.04%
		05/01/2012	1.00%	0.43%	5.28%
		08/01/2012	1.28%	0.43%	5.56%
		11/01/2012	1.57%	0.43%	5.85%
		Note: Includes impact of LIBOR floors. Source: Bloomberg as of Dec. 31, 2010.			

These favorable interest rate and correlation attributes, along with the market's reversion back to pre-Lehman price behavior, has set the stage for a very favorable risk/return profile vs. other asset classes. J.P. Morgan recently highlighted this in their December 17, 2010 Credit Strategy Weekly Update.

Risk-Adjusted Returns for Various Assets over the Past 12 Months			
	Annualized Return (%)	Volatility (%)	Risk/Return
Leveraged Loans	11.99	4.81	2.49
JPMorgan Global High Yield Index	16.34	6.95	2.35
JP Morgan JULI High Grade Index	8.96	4.18	2.14
5-Year Treasuries	6.64	4.89	1.36
Russell 2000	26.99	24.28	1.11
10-Year Treasuries	7.30	8.75	0.83
S&P 500	9.94	18.38	0.54
Source: J.P. Morgan.			

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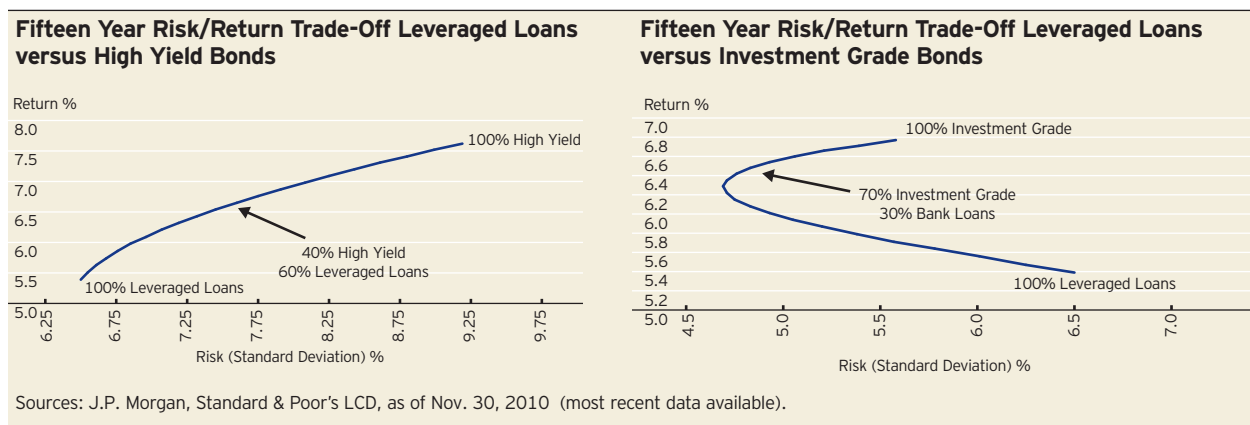
The value discussion around Bank Loans can also be demonstrated by looking at a table of both absolute and relative yields for several of the major fixed income asset classes.

	Yield to Maturity	Spread to Worst	At Forward LIBOR	Duration (yrs)
5 Year Treasuries	1.93%			4.75
10 Year Treasuries	3.32%			8.45
Barclays U.S. Aggregate Bond Index	2.97%	T+.54%		4.99
JP Morgan High Yield Index	7.54%	T+5.60%		4.75
S&P LSTA Index	L+5.57		6.88%	60 days

Source: Bloomberg, S&P/LCD. As of Dec. 31, 2010.

Conclusion

We conclude our thoughts for 2011 by restating our core themes: current income, good credit performance, a cheap price entry point and limited duration risk. These factors should remain in favor as investors continue to search for yield in a low interest rate environment and consider bank loans as part of an allocation strategy. Floating rate loans can reduce interest rate risk, while offering a compelling current income. To that end, we offer two final charts demonstrating how bank loans can be added to a fixed income portfolio (either investment grade or high yield) to enhance the risk/return trade-off and move a portfolio up on the efficient frontier.



How investors can access the market

Institutional investors can access the bank loan market through a variety of investment strategies: unleveraged funds, moderately leveraged funds (2x-5x), and highly leveraged funds (10x-12x). All can be delivered in either a co-mingled format (unit trust, LP) or via a separate account. Unleveraged funds offer the lowest risk/return potential, but are the most liquid and flexible. The typical investment objective is benchmarked to an index such as the Credit Suisse Leveraged Loan Index or S&P/LSTA Index. Moderately leveraged strategies offer moderate risk/return potential, but are less liquid. The investment objective is to generate an enhanced level of current income by arbitraging the cost of borrowing (now LIBOR + 115) against the overall portfolio yield. In addition to having more limited liquidity than an unleveraged fund, this strategy carries more volatility and margin risk, as leverage is attained via a prime brokerage type arrangement known as TRS (Total Return Swap) financing. Highly leveraged funds provide the highest risk/return potential and most commonly take the form of a Collateralized Loan Obligation or CLO. Unlike the moderately leveraged strategies, the highly leveraged strategies, are typically term financed and do not bear "margin" risk. However, investors in highly leveraged term financed funds are typically locked-up for a minimum of 3 years and thus have limited liquidity in their investment.

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