

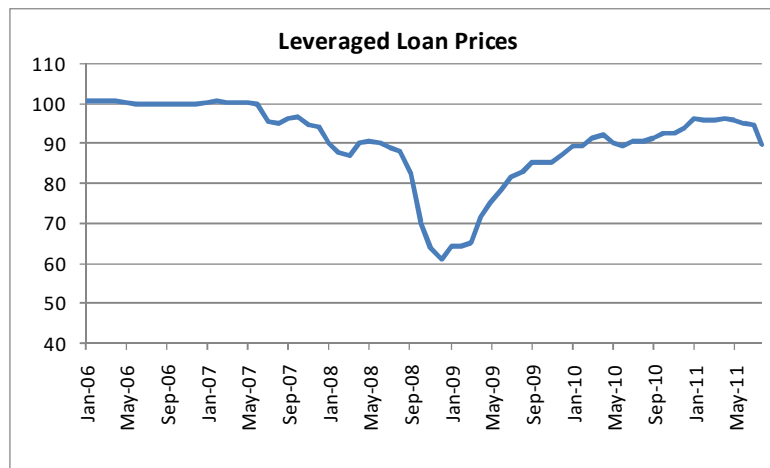


BACKGROUND

August proved to be a challenging month for investors on a confluence of negative news around the world including a slowing in U.S. economic growth, a U.S. debt rating downgrade, and an escalating debt crisis in Europe. The result was a bout of investor risk aversion, and spike in volatility, not seen since the U.S. financial crisis in late 2008/early 2009. Risk assets were sold in favor of the safety of Treasuries, gold and safe haven currencies such as Yen and the Swiss Franc. For August, U.S. Treasuries returned 2.8%, long duration Treasuries surged 8.8%, as the yield curve flattened, and most investment grade bond segments did reasonably well too, albeit lagging Treasuries, on interest rate declines. Meanwhile, risk assets such as equities and speculative grade credit sold off as measured by the S&P 500 (-5.4%), MSCI EAFE (-9.0%), BC Corporate High Yield (-4.0%) and S&P/LSTA Performing Loans (-4.4%) as investors headed for the exits.

INVESTMENT THESIS

The dramatic decline in risk asset prices presents an opportunity to potentially profit from a rebound in their value. Currently the average dollar price in the bank loan (also known as leveraged loan) market is well below par at 90. We believe at this level, the segment has become a better value as fundamentals remain good, making this a potentially good entry point for investors seeking an asset class that should perform well as interest rates rise sometime in the future.



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Clearbrook Perspectives

The Case for Bank Loans

While prices could decline further, the market dynamics that drove bank loan prices to a severely depressed level of 62 in early 2009 including rapid deleveraging, the shutdown of the Collateralized Loan Obligation (CLO) market, excessive exposure on bank underwriter balance sheets, a dramatic spike in defaults, and a collapse in LIBOR rates, do not exist today. Recent downward price pressure has been the result of increased investor risk aversion and strong mutual fund outflows following a period of robust inflows over the last year in anticipation of a rise in interest rates.

THE CASE FOR BANK LOANS

We believe the case for bank loan investment is compelling, barring a protracted recession in the U.S. and a spike in default rates. We believe fundamentals in the bank loan market continue to be good with recent price declines the result of investor risk aversion and mutual fund outflows. This is the type of market dynamic that generally makes for a good entry point for longer term investors. Further, consider that this is a short duration category of asset whose price will appreciate toward par, barring default. With default rates at very low levels, refinance activity robust and credit markets functioning well, we believe most issuers will be able to meet their obligations.

Our view is also based on the following:

New Issuance

During the first half of 2011, bank loan new issuance totaled about \$180 billion, already surpassing the low level of issuance for full year 2010. However, the majority of proceeds have been used to refinance existing debt so there has not been a great deal of net new supply. Further, issuers have pushed out maturities alleviating a lot of the concern over the impending “wall of maturities” coming due over the next few years as a result of a high level of past issuance, particularly in 2006 and 2007.

Short Average Life Floating Rate Assets

Bank loans are callable by the issuer at any time and typically have an average life of 3-4 years. For a relatively short maturity security, we believe current prices and yields are attractive. The short maturity profile of this sub-asset class has resulted in a lower level of historical price volatility, which is appealing. The coupon on leveraged loans is based on a spread over LIBOR, which is currently 0.33%, with spread ranges of 300-475 bps. Over the last several years, LIBOR floor features have become more prevalent with about 42% of the index containing loan structures with LIBOR floors. The new structure is designed to keep the LIBOR base rate at a minimum level, which can negate some of the floating rate characteristics inherent in the securities. However, the rise in new issuance and underwriting competition has caused the LIBOR floor to be greatly reduced from approximately 2.5% to 1.5%. Given that future rate increases may very well exceed 150 bps, upside appreciation potential continues to exist.

Senior Secured Structures

Bank loans are senior in an issuer’s capital structure and are often secured by most or all of the company’s assets. In addition, recovery rates are better in the event of a default than an issuer’s bonds. According to Credit Suisse Leveraged Finance Research, bank loans have historically experienced default recovery rates of 70% versus 44% for high yield bonds. Currently, default rates are low and hovering at approximately 1%, with only a moderate increase expected in the next few years.

Clearbrook Perspectives

The Case for Bank Loans

Attractive Relative Value

At an average price of 90, assuming a 3-year average life, the segment has a yield spread of approximately LIBOR plus 770 bps which compares favorably to unsecured high yield debt yielding 8.68% on average with an option-adjusted spread of 708 bps, and unsecured high grade corporate bonds yielding 3.68% with an option adjusted spread of 206 bps.

CONCLUDING THOUGHTS

While we do not expect interest rates to increase in the near term, we do not believe the economy will contract meaningfully either. We anticipate slow economic growth, which is not particularly good for stocks, but is a fairly good environment for corporate credit, as long as credit markets are functioning normally and there is credit availability. For corporate issuers, a low level of rates is also a plus.

As is always the case with credit, a disciplined credit evaluation process, strong system of risk management, and careful monitoring of market developments and issuer financial condition improves the probability of success.

About The Author

MaryAnn DiMaggio is a Managing Director and Head of Global Fixed Income Research at Clearbrook.

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