



# Investment Perspective

## Bank Loans



**Gregory Stoeckle**  
Managing Director

Invesco Senior Secured Management, Inc.  
1166 Avenue of the Americas  
New York, NY 10036  
212 278 9208

## Bank Loan Themes 2010 "An Income-Producing Inflation Hedge"

Bank Loan investors enjoyed nothing short of an epic year in 2009. This statement is best evidenced by returns of 50.14% on the S&P/LSTA Leveraged Loan Index and 43.62% on the Credit Suisse Leveraged Loan Index,<sup>1</sup> through the close of business on December 18, 2009, which represented the year's last full week of trading. **As we have discussed in prior commentaries these returns were driven by a recovery from 2008's technical collapse and significant improvement in the fundamental environment which has once again fueled investor appetite for risk based credit assets.** Rather than revisiting the details of 2009 we refer investors to our prior commentaries and will instead focus on the outlook and themes for 2010. While there is no way that 2010 can match the returns of 2009, bank loans remain a compelling story for three reasons:

1. Income Producing Inflation Hedge:  $YTM^2 = LIBOR^3 + 748 \text{ bp}$
2. Still Trading Cheap to Historic Levels:  $Price^4 = \$.867$
3. Relative Value to Other Credit Products:  $Swaps^5 = T + 831 \text{ bp}$

Each of these concepts is discussed in more detail below along with risks to our thesis.

1. Contact Invesco's Bank Loan team for a discussion of index comparisons, methodologies and limitations.
2. Based on the S&P/LSTA Leveraged Loan Index and a 4 year maturity.
3. LIBOR or (London Interbank Offered Rate) is a floating base rate of interest that resets on a 30, 60 or 90 day basis. For purposes of this commentary we use the 90 day rate which is the defacto standard for bank loans.
4. Based on the S&P/LSTA Leveraged Loan Index.
5. Floating to Fixed Swap vs 4 Year Treasuries.

All Data as of December 2009, unless otherwise stated. Source: Invesco, unless otherwise stated. All references to Invesco refer to Invesco Senior Secured Management, Inc.

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## Income producing inflation hedge

With the average price of the S&P/LSTA Index at \$.867 the bank loan market trades to an all-in four year annualized yield to maturity of LIBOR + 748 bp. At today's LIBOR rates this equates to a 7.7% annual yield but this does not take into account the forward LIBOR curve. Recall that the LIBOR component of bank loan interest payments is reset when the contracts roll – typically between 30 and 90 days – so investors should benefit from any future increases in interest rates with little or no corresponding price exposure. This is one of the unique features of the bank loan asset class and provides investors with a hedge against rising interest rates/inflation. Although there is much debate about the timing and extent of future interest rate action by the FED there is general agreement that rates must eventually move in an upward direction. The interest rate outlook is best reflected in the forward LIBOR curve and if we apply this to the bank loans, the expected annual yield for the asset class jumps to 10.31%.

Bank Loan Income Components <sup>1</sup>		U.S. 3-Month Forward Rate <sup>1</sup>	
Current Income	Contribution		
(LIBOR + Credit Spread) / Price	3.86%		
Capital Appreciation			
((Par - Cost) / Avg. Maturity) / Price	3.87%		
<b>Total Return</b>	<b>LIBOR + 748 bps</b>		

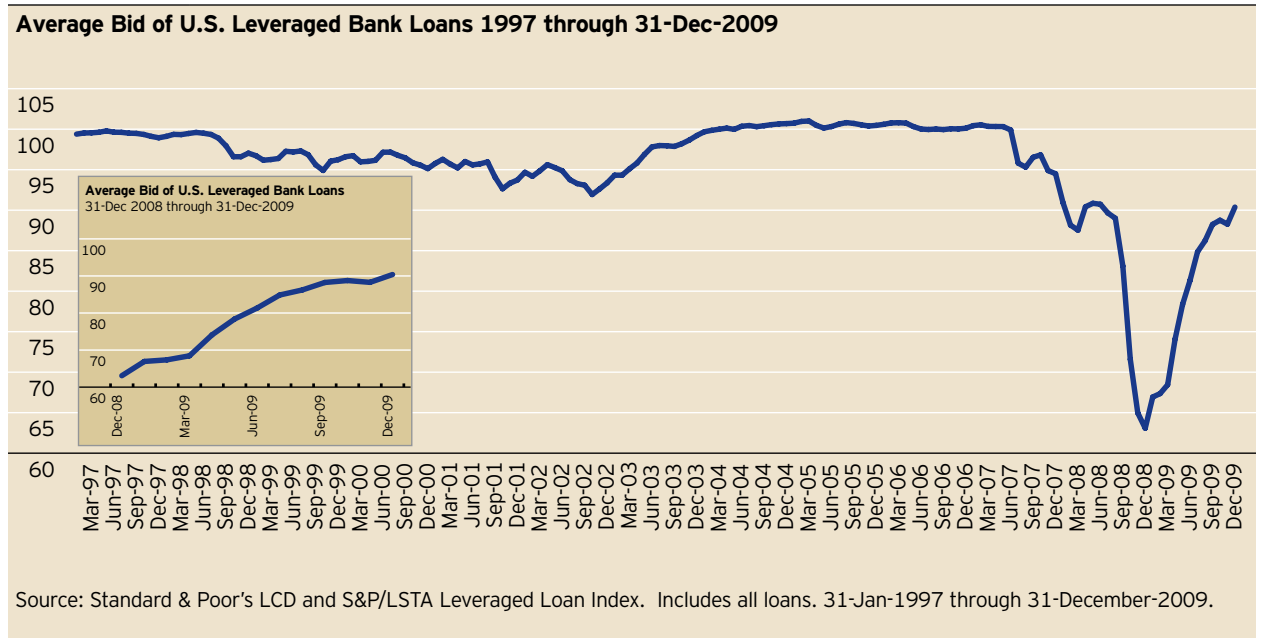
Impact of Forward LIBOR on Current Income <sup>1</sup>			
Date	Forward LIBOR	Credit Spread	Current Income
12/23/2009	0.25%	3.10%	3.87%
03/23/2010	0.38%	3.10%	4.01%
06/23/2010	0.62%	3.10%	4.29%
09/23/2010	0.94%	3.10%	4.67%
12/23/2010	1.30%	3.10%	5.08%
03/23/2011	1.66%	3.10%	5.50%
06/23/2011	2.02%	3.10%	5.91%
09/23/2011	2.36%	3.10%	6.30%
12/23/2011	2.69%	3.10%	6.68%
03/23/2012	2.98%	3.10%	7.02%
06/25/2012	3.26%	3.10%	7.35%
09/24/2012	3.52%	3.10%	7.64%
12/24/2012	3.75%	3.10%	7.91%
03/25/2013	3.82%	3.10%	7.99%
06/24/2013	4.05%	3.10%	8.26%
09/23/2013	4.28%	3.10%	8.52%
12/23/2013	4.26%	3.10%	8.50%

1. Source: Bloomberg.

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## Still trading cheap to historical levels

While loan prices have made a significant recovery from all time lows set in December of 2008, the market has yet to return to its historical trading range at or near par. With market technicals now a positive factor and credit fundamentals improving on stabilized corporate earnings, the return of positive GDP growth and, the re-opening of capital markets, we expect loan prices will continue moving back toward historical norms as 2010 progresses.



The case for an accelerated pull to par in 2010 is further strengthened by vastly improved credit performance and visibility on the market. This is best evidenced in declining corporate default rates which started out in the first quarter of 2009 at an annualized rate of 19.5% and have since steadily declined to an annualized rate of 7.6% in the fourth quarter. Most market participants believe that the current credit cycle was "front-end loaded" and that an improving corporate earnings outlook along with renewed access to the capital markets will drive the default rate below 5% in 2010. This means that credit losses should have less of an impact on returns in 2010 and underscores that the market remains cheap relative to historic norms. Using the S&P/LSTA Performing Index as a proxy for the market, today's gross yields are 240 bp wider than historical averages. If we risk adjust this excess yield to account for prospective credit losses there is still a solid 190 bp pick-up to historical levels:

<b>S&amp;P/LSTA Performing Loan Index*</b>				
Date	Price	YTM	Credit Losses	Net Yield
12-18-09	\$.892	L + 653 bp	Forecast 150 bp	L + 503 bp
Jan '97 to Dec '09	\$.953	L + 413 bp	90 bp	L + 322 bp

\* Note that we use the Performing Index as a Proxy for the market as this data set reaches back to 1997. The broader index which is more widely quoted and the basis for all other current figures in this commentary only reaches back to 2006. Source: Bloomberg.

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## Relative value to other credit products

The risk return of Bank Loans coupled with a floating base rate that helps to hedge inflation risk creates a compelling relative value story when compared to other corporate asset classes. This story becomes even more commanding against the backdrop of an improving credit environment where risk assets would typically outperform. In short, Bank Loans will see positive current income gains on any future interest rate increases and minimal price exposure since LIBOR adjusts up and risk based credit spreads are usually inversely correlated to rate movements.

	Yield	Swapped Yield	Yield At Forward LIBOR
5 Year Treasuries	2.27%		
10 Year Treasuries	3.33%		
I.G. Credit	4.67%		
H.Y. Bonds	9.06%		
Bank Loans	L + 7.48%	T + 8.31%	10.31%

Source: Bloomberg/Invesco as of 12-18-09

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## Are bank loans too good to be true?

2009's returns were propelled by a reversal of the market's unprecedented technical collapse following the Lehman bankruptcy in the fall of 2008 and a realization that fundamental risk was heavily over-sold on uncertainty about the direction of the economy/financial markets. With market visibility steadily improving throughout 2009 it appears that both technicals and fundamentals are well in-hand as we head into 2010. There are several key themes that support our view on visibility, what we believe is a manageable risk profile for the market and, ultimately an expectation for positive returns.

### ■ Technicals:

- \$50 billion or 8.3% contraction of market supply during 2009<sup>1</sup>
- New investors continue to emerge as 2009 market performance garnered the attention of a wide range of institutional investors. There appears to be an increased willingness of investors to look at bank loans both opportunistically and as an alternative to traditional fixed income allocations.
- TRS (Total Return Swap) desks are ramping up again and providing leveraged investors with funding well below L + 200 bp (positive arbitrage). This is likely to create new demand albeit we acknowledge that de-leveraging had been a major source of volatility in 2008.
- Headlines are speculating on the return of the CLO in 2010. Performance across the CLO space has indeed materially improved and we are aware of new issue discussions at both the arranger and investor level. Based on this we expect some, albeit modest, new issue in 2010.

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<sup>1</sup> Source: Standard & Poor's Leveraged Commentary & Data, as of December, 2009.

■ **Fundamentals:**

- Risk of a double-dip recession seems to be waning albeit there are lingering concerns around housing, employment and, the health of second tier/regional financial institutions which are important to the middle market. While any of these could stall a broad economic recovery we see corporate earnings performance having hit bottom in Q3 2009.

<b>Sequential U.S. GDP Growth</b>		<b>Sequential Performance for Large Public Loan Issuers</b>		
			<b>Revenue</b>	<b>EBITDA</b>
Q4 '08	-5.4%	Q4 '08	-6.47%	-14.63%
Q1 '09	-6.4%	Q1 '09	-6.53%	-3.72%
Q2 '09	-1.0%	Q2 '09	5.04%	16.91%
Q3 '09	2.2%	Q3 '09	5.12%	9.99%
Source: Bloomberg		Source: Bloomberg		

To conclude, we believe that visibility on bank loan market performance should continue to improve into 2010. Taking this in tandem with both absolute and relative return profiles and the added benefit of an inflation hedge tied to a floating base interest rate warrants a pure-play allocation into the bank loan asset class.

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