Market Insight

ING MARKET PERSPECTIVES

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Senior Loan Investing in a Low-Interest-Rate Regime

Historically, investors have sought senior loans as hedges against rising interest rates, a benefit these investments have provided through their floating base rates and ultrashort durations. With the Federal Reserve holding the federal funds rate near zero and promising to keep it there until 2013, however, investors may be wondering whether floating-rate senior loans still offer attractive benefits.

We believe they can. Even in today's low-rate environment, investors are seeking senior loan investment opportunities for the securities' high absolute yields, senior positions in issuers' capital structures and claim on the issuers' assets, and diversification potential.

Bond-Like Yields With Lower Loss Risk and Virtually no Duration Risk

Senior loans and high yield bonds are types of non-investment grade corporate debt. High yield bond coupon payments compensate investors for duration risk, since the interest rate is locked in for the life of the bond, and for credit risk, because the borrower is below investment grade and the bond is not backed by collateral.

Compensation for duration risk on a bond can be estimated based off of the yield on riskless bonds such as U.S. Treasuries. Seven-year U.S. Treasury notes were yielding about 1.5% as of early December 2011. Since the credit risk on such securities is considered zero, we can attribute the entire 1.5% to seven-year duration risk. Thus, we can assume a high yield bond with a seven-year maturity would be compensated 1.5% for duration risk. Since the full yield for such a bond was 8.5% as of early December 2011, we suppose that the remaining 7% was attributable to credit risk.

It would seem that a subordinated, unsecured bond should be paid more than a senior loan due to the "higher risk, higher reward" rule. During early December, however, full yields for senior loans stood at 7.6%. Since duration risk on senior loans is virtually zero, this finding implied that the yield attributable to credit risk on senior, secured loan investments was 60 basis points (bps) higher than that for an unsecured bond of the same average credit quality. Factoring in certain assumptions about average historical loss upon default shifts the comparison further in favor of senior loans.

Duration Risk vs. Credit Risk: High Yield Bonds and Floating-Rate Notes

Yields	7-Year U.S. T-Note	7-Year High Yield Bond	Floating Rate Senior Loan
Credit Risk Component	0.0%	7.0%	7.6%
Duration Risk Component	1.5%	1.5%	0.0%
Full Yield	1.5%	8.5%	7.6%
Average Default Loss[1]	0.0%	3.3%	1.5%

Source: Loan Syndications and Trading Association, Credit Suiss

[1] This analysis assumes a 0% default rate for U.S. Treasury bonds. Average default loss assumptions for high yield bonds and loans are based on the Credit Suisse 3rd Quarter 2011 High Yield and Leveraged Loan Default Review. Data are from January 1, 2000, through September 30, 2011.

The 7.6% yield on senior loans has increased recently due to nominal spreads that are wider than historical averages, LIBOR floors and the capital gain potential generated by the current price discount from par. These benefits are offset, to some degree, by low base rates (i.e., three-month LIBOR). Currently, many senior loans pay above-market base rates through the implementation of LIBOR floor provisions. These

floors impose a minimum base rate that must be paid by senior loan borrowers. Lenders are currently benefitting from an average floor of 151 bps and can expect higher income as three-month LIBOR surpasses the floor and returns to its historical average (2.8% from 2000 to present).

Current Returns Similar to High Yield Bonds, Without the Risks of a Subordinated, Unsecured Position

Senior loans typically hold the highest position within a borrower's capital structure and are secured by a lien on the company's underlying collateral. High yield bonds, in contrast, are generally subordinated and unsecured. As a result, senior loans generally have lower default and higher recovery rates than high yield bonds. While high yield bonds have historically been rewarded for this increased risk through higher spreads, recent risk-adjusted yields (as noted earlier) may be tilting in favor of senior loans.

In addition, senior secured loans feature contractual protections called maintenance covenants that require the issuer to uphold standards of financial health; e.g., minimum operating cash flow, maximum debt leverage and minimum interest coverage ratios. These covenants typically require mandatory paydowns to senior lenders upon certain events, such as the issuance of additional stock or the sale of significant company assets. Maintenance covenants serve as an early warning system for lenders. If borrowers violate these covenants, lenders may take actions ranging from increasing the nominal spread on the loan to calling the loan and requiring its immediate repayment in full. Covenants are in place for more than 80% of the S&P/LSTA Leveraged Loan Index and almost all new loans issued in 2011.

Historical Three-Month LIBOR and LIBOR Floors
January 1, 2000, through December 31, 2011

Source: Bloomberg, ING Investment Management

Senior Loans Offer Significant Diversification Benefits

Floating-rate senior loans offer features that can add value to an asset allocation strategy: high current income, security through a lien on borrowers' assets and lower relative volatility. These traits can be even more compelling when paired with the fixed income stream of high yield bonds. Adding senior loans to a fixed income portfolio can hedge against rising interest rates and lower the volatility of returns within a portfolio while maintaining an attractive return profile, as shown in the figure below. The orange line in the graph below depicts the same period without the effects of the 2008–09 global financial crisis, further illustrating the low volatility that can be achieved by combining the two asset classes in normal market conditions.

As you can see, combining senior loans with high yield bonds can significantly reduce portfolio volatility, even during extreme market conditions.

Outlook and Opportunities

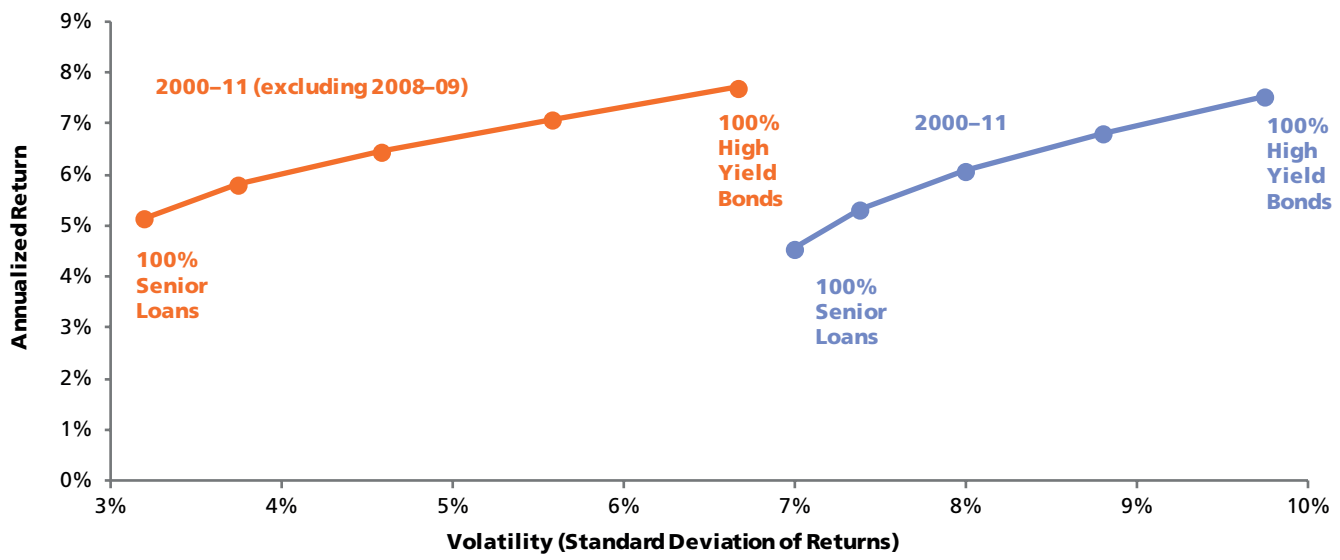
With the U.S. economy growing moderately at best and Europe's future still uncertain, most equity and fixed income assets remain highly volatile. One notable exception has been senior loans, which — despite the current low-interest-rate regime — have generated attractive risk-adjusted returns and continued to capture market share.

We cited what we believe are the main reasons for the continued interest in senior loans:

- High absolute and risk-adjusted yields
- Collateral-backing and priority in the capital structure
- Diversification potential

Even under current conditions in which an interest rate hedge is not needed, these benefits retain their power. In our view, investors perceive correctly that senior loans can add value at any stage of the business cycle — including the conditions expected between 2012 and 2013. ■

Efficient Frontier: Senior Loans vs. High Yield Bonds
January 1, 2000, through December 31, 2011



Source: Bloomberg, ING Investment Management

Trajectory of U.S. Government Debt Remains Ominous Unless Deficit-Reduction Efforts Succeed

Source: Congressional Budget Office

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