The Case for Bank Loans: Opportunity for the Long-Term Strategic Investor

As has been well documented, many financial assets, some more fundamentally impaired than others, have declined precipitously in value as a result of the systematic, and at times forced, deleveraging set in motion by the sub-prime mortgage debacle.

Bank loans have not been immune to this.

Buyers of bank loans who played a critical role in the growth of this asset class from a fledgling $100 billion market in 2000 to today's $600 billion market have been marginalized, as the CLO arbitrage disappeared and opportunistic, tactical allocations from hedge funds dried up with their financing.

Poor technicals, combined with deteriorating, yet still solid, fundamentals have contributed to an unprecedented decline in prices, as stunning for its speed as for its magnitude.

What has resulted is an opportunity for investors with long-term, stable capital to make a strategic allocation to bank loans and take advantage of capital appreciation potential never before seen.

There will be bumps along the road as investors adjust to the multitude of economic and regulatory challenges that lie ahead. Furthermore, achieving a semblance of near-term stability is dependent upon a sizable class of non-traditional buyers, enticed by new levels of absolute return, finding the will to step into a murky trading environment.

Therefore, tactical buyers looking for short-term gains are wise to remain on the sideline.

In this paper, we will lay out the case for bank loans for patient capital looking for an income-producing investment, with attractive capital appreciation potential and structural characteristics that should help protect them from the default risk likely to characterize the market in the near term.

Historically Low Prices Skew the Return Profile in Favor of Principal Return

Bank loan investors had long grown accustom to buying bank loans at or near PAR, receiving a periodic floating rate coupon and receiving PAR back no later, and often sooner, than the stated maturity of the loan.

Owing to their near-zero interest rate duration and callability at the discretion of rational economic agents (i.e. CFOs), bank loans rarely traded much above PAR, thereby limiting their capital appreciation potential.

A review of historical performance however, serves as an important reminder that principal return at times can be a valuable component of bank loan total returns. Using the Credit Suisse Leveraged Loan Index (the "Index") as a proxy for the bank loan market, we examined the proportion of its monthly total return that was attributable to principal and interest return in different pricing environments.

As you can see in the table below, when the Index price was above its historical median (~$97) and principal return was positive, interest return was clearly dominant, accounting for almost 80% of the total return. Bank loan investors new to the asset class since 2004 have only ever known this return profile.

On the other hand, when the Index was below its historical median and principal return was positive, interest return, while still important, is no longer dominant, as the return from principal and income return were roughly equal.

Composition of Total Return

Positive Monthly Principal Return

Index Price			Occurrences			% Total Return From:	
vs. Median	Low	High	Total	Positive Total Return	Negative Total Return	Principal	Interest
Above	$96.82	$100.11	53	53	0	22.49%	77.51%
Below	$86.94	$96.70	42	42	0	48.88%	51.12%

Source: Credit Suisse, Credit Suisse Leveraged Loan Index, October 2008

How effectively interest return cushions bank loan investors when principal return is negative has long been a primary source of its appeal To illustrate this effectiveness, we looked at how many times interest return "covered" principal return when principal return was negative, also in different pricing environments.

As the data in the following table indicates, when the Index produced negative principal return and its price was above median, its interest return was more than 25 times the principal return, swamping the effect of the negative principal return and enabling the Index to provide positive total returns in all but one of those months.

When the Index dollar price was below $97, on average the interest return covered about 3 times the principal loss. This still healthy cushion enabled the Index to provide positive total returns more than half of the time despite the headwind of negative principal return.

Principal Loss "Coverage"

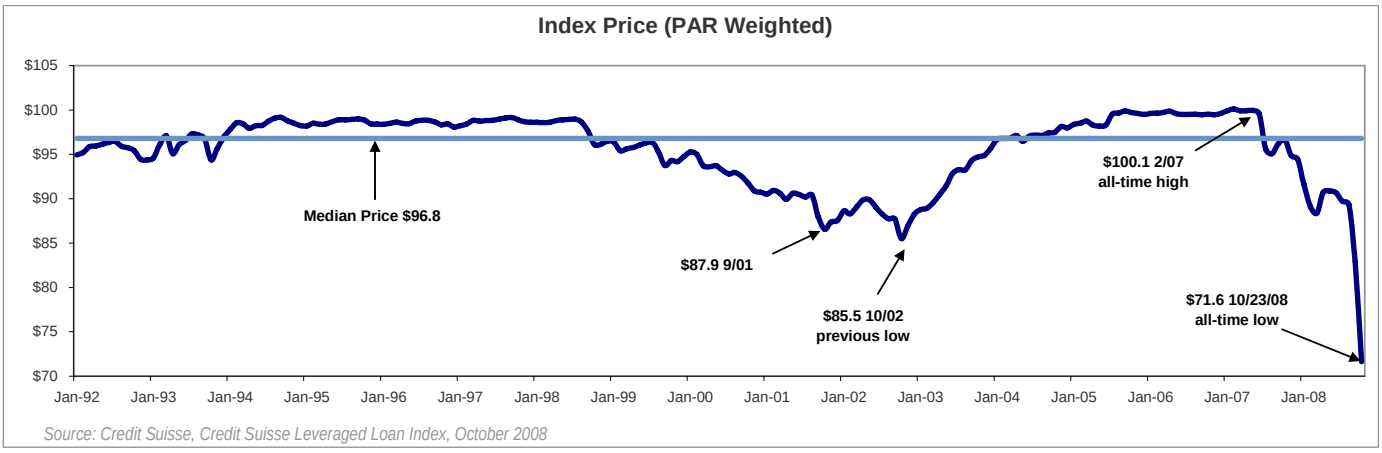
Negative Monthly Principal Return

Index Price			Occurrences			
vs. Median	Low	High	Total	Positive Total Return	Negative Total Return	Multiple of Principal Covered by Interest
Above	$96.80	$99.95	48	47	1	25.65
Below	$82.91	$96.75	58	31	27	3.10

Source: Credit Suisse, Credit Suisse Leveraged Loan Index, October 2008

As of 10/23/08 the Index dollar price was $71.64, providing investors an unprecedented discount to PAR that, absent defaults, we expect will be returned to them at some point at or before the final maturity of the loan. As we contemplate the potential total return for bank loans going forward, history reminds us how much the prevailing pricing environment affects the composition of that return.

In light of the historically low cost of admission to this asset class (see the price graph below), we expect the composition of returns to favor principal return to a degree equal to, if not greater, than previously observed. At the same time, we take great comfort in the consistent generation of interest return that we expect will continue to provide a cushion against further price deterioration.



Source: Credit Suisse, Credit Suisse Leveraged Loan Index, October 2008

When Should Investors Expect to Receive PAR?

In light of this discount, it is important to recognize the powerful effect the timing of its repayment has on the return profile of a callable asset class like bank loans.

Recall the primary reason any security trades at a discount to PAR: because it offers a coupon that is below that which is available in the market for a security with similar risk characteristics.

The ideal scenario for any investor paying a discount to PAR for a loan is having it prepay as quickly as possible. In that case, one receives their original investment plus the accretion of the discount to PAR, which is re-investable in a loan that pays the higher market coupon rate.

From the issuer's perspective, the exact opposite scenario is the ideal. Issuers will prefer to stay current on all required debt service, take advantage of the below market borrowing rate as long as possible and pay off the principal as far in the future as they are contractually permitted.

Historically, the average payback period for bank loans has been about 18-24 months, far shorter than their typical seven-year final maturity. Along with minimal scheduled amortization (~ 1-5% per annum), issuers generally exercised their option to prepay their borrowing for reasons that included cheaper refinancing opportunities or a corporate finance transaction that facilitated the retirement of the debt.

Since investors and issuers approach indifference on prepayment timing as loan dollar prices approach PAR, the importance of this issue increases as dollar prices decrease. Clearly, today's historically lowest dollar price has elevated the importance of this issue to its highest level ever.

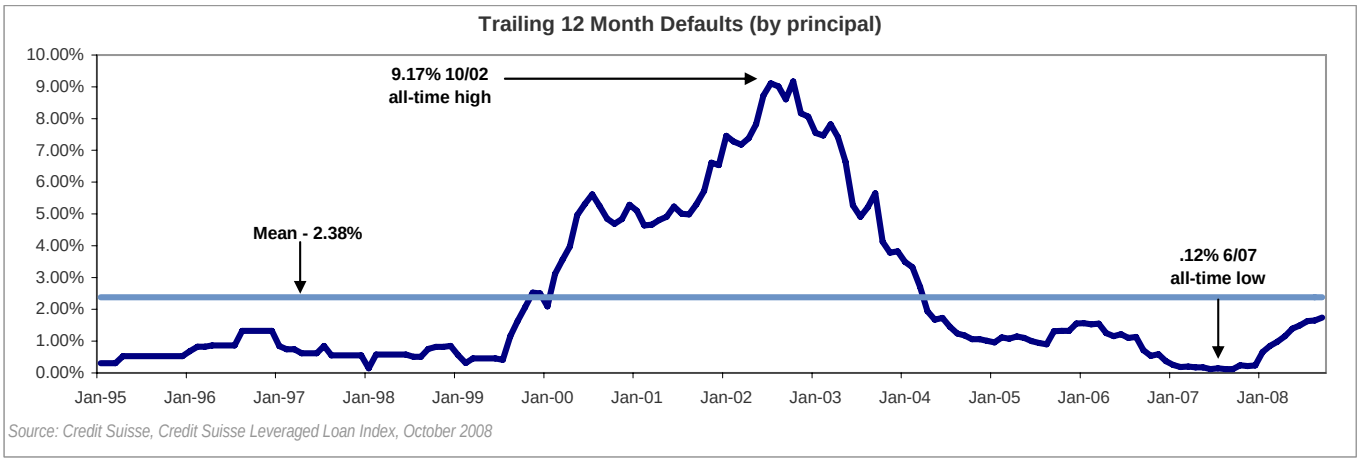
Given the attractive cost of their outstanding debt, borrowers have no incentive to prepay their outstanding loans. With the credit market open only to the highest quality borrowers, and intermittently so at that, and borrowing costs sky-high, it seems that refinancing opportunities will be limited for the near future. At the same time, a lack of available financing and a murky economic outlook will dampen the merger and acquisition activity that could spur the retirement of debt.

Therefore, any investor contemplating an investment in bank loans should expect to receive their discount repayment at or near the final maturity of the loan, which for the broad market we estimate to be close to five years, resulting in a very back-end loaded potential return profile.

How Much of That PAR Should Investors Expect to Receive?

Regardless of the environment, default and recovery expectations are critical to the evaluation of any credit risky asset. Since bank loans are borrowings by non-investment grade companies, expectations of the probability of repayment are even more important.

While this most recent decrease in bank loan prices has not been without defaults, they have definitely lagged, having only recently begun to pick-up and approach the long-term historical averages (see the graph below).



Given the current economic environment and the widely held belief that consumer spending has not fully reflected the decline in Main Street America's two largest stores of wealth, their homes and investment portfolios, defaults are certain to increase from today's levels.

Different from the last credit cycle, there does not appear to be an entire non-investment grade sector susceptible to suffer massive defaults (i.e. telecommunications), nor do we expect the market to be beset with fraud and malfeasance (i.e. Enron, Worldcom). These factors give us some comfort.

However, the sector under the most strain in the investment grade market, bank and finance, affects all markets and threatens to exact a heavy toll on all segments of the economy by spreading its misery through a restriction of credit.

We expect the up-tick in defaults to continue and anticipate a worst-case scenario in excess of history to play out if the current policy decisions of the U.S. Treasury and Federal Reserve are unable to arrest the speed with which the economy is deteriorating.

For purposes of evaluating the long-term return prospects of bank loans, it is instructive to consider the peak in defaults of the previous cycle as a starting point. The highest Index default rate by principal amount of any 12-month period since 1995 was 9.17% for the 12-months ending 10/2002.

It is conceivable that defaults may approach, if not surpass, that experience at some point in the next couple of years as bank loan borrowers feel the full weight of the global economic downturn.

Of course, expectations for recoveries are also critical. Once again using history as our guide, loans have recovered approximately 70% buoyed by their structural superiority and priority pay position relative to other non-investment grade sectors. Many have argued that along with higher default rates, the prudent investor should also consider a decrease in the recovery rate. We are in complete agreement with that.

What gives us comfort about recoveries even if defaults increase is the principal downside cushion today's low dollar prices provides. One must remember that recoveries are a percentage of PAR values, not acquisition costs, so current deeply discounted prices greatly reduce the potential loss of invested principal if a loan defaults.

In an extreme example for illustrative purposes only, a portfolio of loans acquired at $70 that incurs a 100% incident of default with a 70% recovery, would suffer no loss of invested principal and have a total return that would approximate the interest income generated prior to the default.

Whether recovery is 60%, 50%, or even 40%, no one, even among the most seasoned bank loan experts can be sure. What is certain is that prudence dictates a conservative stance so that any asset allocation decision reflects proper downside risk management.

Scenario Analysis

Now that we have walked through the key considerations when contemplating a strategic allocation to bank loans, we will combine our various assumptions for principal repayments, defaults, and recoveries to illustrate the return potential for the asset class. We calculated the Internal Rate Return (IRR) using the 10/23/08 fixing of the Index for various combinations of relevant variables.

The base repayment assumption considers a scenario where the return of any discount is fully back-end loaded to five years. This is a sub-optimal outcome for the investor, but given the extreme valuations still allows for attractive long-term returns for an investor able to stomach some potential volatility along the way.

We show a range of repayment periods to illustrate the upside potential associated with a return to more historically normal credit environments in which the return of principal is more consistent with history than the five year assumption discussed previously.

LIBOR, the floating reference rate for most bank loan coupons, is held constant at zero such that all IRRs are expressed as "LIBOR +". In doing so, we avoid the potential distortion associated with extrapolating today's LIBOR for the life of the investment.

Having said this, we expect LIBOR will be a positive value at all times, therefore all IRRs in our analyses will understate the "all-in" expected results.

The "Mean Defaults" scenario assumes the average twelve-month trailing defaults by principal amount of 2.38% per annum and a recovery rate of 60%. We also increased this default assumption by one (4.90%), two (7.41%), and three (9.93%) standard deviations (one s.d equals to 2.52%) to illustrate the potential downside risk associated with increased default experience.

A more stressful scenario is the "1-Year Peak Defaults" scenario and assumes the peak twelve-month trailing defaults by principal amount of 9.17% per annum and a more onerous recovery of 50%. We also increased this peak default experience by one (11.68%), two (14.2%), and three (16.72%) standard deviations.

These assumptions are notably draconian when you consider that 9.17% is the peak one-year experience since 1995 and loan recovery rates have historically been about 70%.

The results of our scenario analyses are summarized in the accompanying table.

Without knowing each investor's unique investment parameters and return requirements, it is difficult to assess whether these potential IRRs will be viewed favorably. However, we are encouraged that in all of our scenarios, even our most severe (~17% p/a defaults with 50% recovery), all IRRs are comfortably positive relative to LIBOR and many approach returns that would have historically satisfied the return requirements of most equity investors.

Internal Rate of Return Scenario Analysis - Constant Defaults and Recoveries*

Default Rate (per annum)	Scenario Description	Recovery Rate	Payback (Yrs)			
			2.0	3.0	4.0	5.0
2.38%	Mean	60.00%	20.74%	14.37%	11.32%	9.53%
4.90%	Mean +1 s.d.	60.00%	19.72%	13.47%	10.47%	8.72%
7.41%	Mean +2 s.d.	60.00%	18.71%	12.57%	9.64%	7.92%
9.93%	Mean +3 s.d.	60.00%	17.70%	11.68%	8.81%	7.13%
9.17%	1-Year Peak	50.00%	16.81%	10.78%	7.90%	6.22%
11.68%	1-Year Peak +1 s.d.	50.00%	15.48%	9.57%	6.76%	5.11%
14.20%	1-Year Peak +2 s.d.	50.00%	14.14%	8.37%	5.62%	4.02%
16.72%	1-Year Peak +3 s.d.	50.00%	12.80%	7.16%	4.48%	2.93%

Because static default and recovery assumptions over a holding period are not as flexible as we would like, we present an additional scenario analysis that accounts for our expectation of how bank loan defaults and recoveries will respond to the credit cycle as it plays out. Each of the vectors (V1, V2, V3) represents increasingly dire assumptions of defaults and recoveries.

The results of this analysis are summarized in the accompanying table.

Once again, you will notice that even in our most extreme scenario (V3), where defaults go immediately to the all-time peak and continue to accelerate and recoveries are cut to less than 50% of historical averages, the return profile exhibits tremendous resilience as evidence by the 3.88% return assuming a 5-year payback.

Internal Rate of Return Scenario Analysis - Default and Recovery Vectors*

Default Rate (per annum)	Scenario Description	Recovery Rate	Payback (Yrs)			
			2.0	3.0	4.0	5.0
3/6/9/6/3 %	V1	70/60/50/60/70%	20.01%	12.77%	9.88%	8.47%
6/9/12/9/6 %	V2	60/50/40/50/60%	18.07%	10.66%	7.83%	6.54%
9/12/15/12/9 %	V3	50/40/30/40/50%	15.36%	7.80%	5.02%	3.88%

**Source: NYLIM, October 2008*

1. *The returns are estimates given a set of assumptions and are for discussion purposes only*
2. *Purchase Price ($71.64) and Portfolio Spread (+276) assumptions are based on CS Leveraged Loan Index as of 10/23/08*
3. *Returns assume the remaining portfolio is paid off at par at the end of the payback period*
4. *Defaults occur at the end of each year, with immediate realized recoveries*
5. *Recoveries from defaults are assumed not to be reinvested, but are returned immediately to the investor and are factored into the IRRs*
6. *LIBOR is held constant at 0% throughout the payback period*

Expected returns are statistical estimates of hypothetical average returns of economic asset classes, derived from statistical models. Actual returns are likely to vary from expected returns. Expected return models apply statistical methods and a series of fixed assumptions to derive estimates of hypothetical average asset class performance. Reasonable people may disagree about the appropriate statistical model and fixed assumptions. These models have limitations, as the assumptions may not be consensus views, or the model may not be updated to reflect current economic or market conditions. Accordingly, these models should not be relied upon to make predictions of actual future account performance. NYLIM has no obligation to provide recipients of these materials with updates or changes to such data.

We have attempted to be thoughtful and conservative in constructing the assumptions that affect the output of the analyses and encourage you to review the scenarios while considering where our opinions diverge.

With this in mind, our expectation is that we are more likely to be accused of painting a picture that will be more severe than what plays out. This is consistent with a fixed income philosophy that pays special attention to the potential downside risks of any investment we contemplate. Fortunately, the current pricing environment has presented investors with a rare opportunity in which the return profile remains attractive even when accounting for that downside.

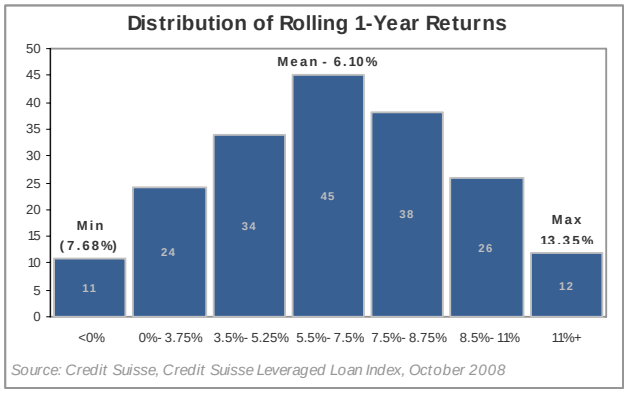
What If You Are Too Early?

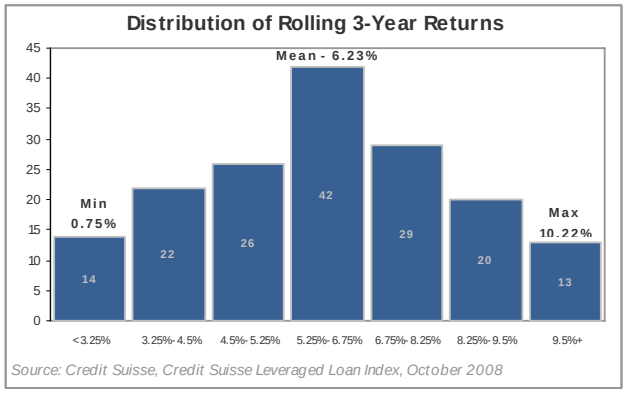
Times of extreme volatility affect investors differently based upon their objectives and length of their holding period. In our view, those willing to absorb the potential for short-term negative price action will be handsomely rewarded over a long holding period and should be much less concerned about picking the bottom of this or any market.

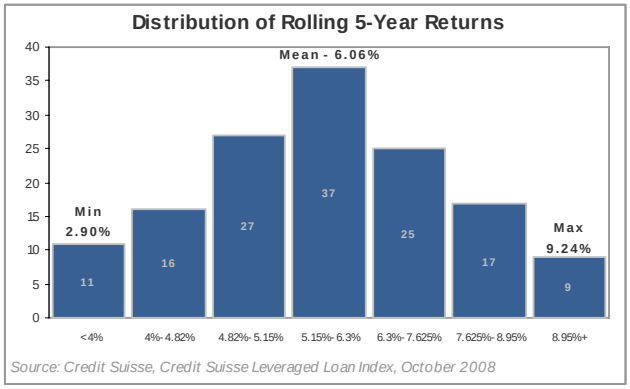
However, we are still conscious of the fact that being early hurts, no matter who you are.

To address those concerns we calculated the rolling monthly returns for every one, three and five year period for the Index since inception. The distributions of returns tell a familiar story about the power of a long-term holding period, one that is entirely consistent with our view about the potential returns in bank loans. The histograms are below.

Each period has an average return of about 6%, but the range and distribution of those returns greatly diminishes as the holding period lengthens. We expect a similar scenario to unfold in the future giving comfort to investors who can weather the potential near-term volatility that may accompany this market on its way to a longer-term recovery.







Past performance is no guarantee of future results, which will vary.

Another way we considered the cost of being early was by re-running our vector scenario analysis, while holding the default and recovery vector constant and varying the purchase price from today's level.

The results are in the accompanying table.

Timing the bottom of any market is an elusive goal, one that investors commonly fail to achieve. In the last twelve months, a number of investors who tried to take advantage of perceived uncommon value were margin-called out of business under a wave of selling pressure.

While we are leery of declaring, "this time will be different", it is clear to us that an entry point near the long-term recovery experience of this asset class is "different" enough. Moreover, if you are wrong and too early, we believe long-term unlevered investors will find that the returns achievable (6.54%) at today's dollar price ($71.64) will mitigate the disappointment associated with leaving return on the table.

Internal Rate of Return Scenario Analysis - Opportunity Cost of Being Early*

Default Rate (per annum)	Scenario Description	Recovery Rate	Purchase Price	Payback (Yrs) 2.0	3.0	4.0	5.0
6/9/12/9/6 %	V2	60/50/40/50/60%	**$71.64**	18.07%	10.66%	7.83%	6.54%
6/9/12/9/6 %	V2	60/50/40/50/60%	**$66.64**	22.60%	13.60%	10.08%	8.40%
6/9/12/9/6 %	V2	60/50/40/50/60%	**$61.64**	27.68%	16.87%	12.56%	10.45%
6/9/12/9/6 %	V2	60/50/40/50/60%	**$56.64**	33.44%	20.54%	15.35%	12.75%

**Source: NYLIM, October 2008*

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Conclusion

Over the course of time, the capital markets have demonstrated a tendency to overshoot, at different points pricing in overly optimistic or overly pessimistic expectations.

Rather than falling prey to the momentum trade at times like this, we continue to advocate a rigorous scenario analysis that pays particular attention to the potential downside associated with any investment decision.

After careful consideration of the relevant variables that will effect the return potential of an investment in bank loans, we feel the current market environment is presenting investors with an opportunity to invest at a time when long term valuations are significantly dislocated from current trading values.

The path to these returns has the potential to be volatile, necessitating investors to make a commitment to this allocation that is perhaps longer than they normally would be accustomed to making. However, our belief is that a stable, long-term capital commitment to bank loans will be compensated amply for its exposure to potential near-term volatility.

We realize that our analysis is dependent on a number of variables that are unknown and unknowable. Therefore, our conclusions may, and should, be open to discussion. However, we believe that it is incumbent upon all prudent investors to (re)consider an allocation to bank loans within a framework that incorporates the elements described above and based upon today's unprecedented market conditions.

For more information please contact Institutional Sales at 877.394.4800 or institutional@nylim.com

Credit Suisse Leveraged Loan Index is designed to mirror the investable universe of the U.S. dollar denominated Senior Loan market. LIBOR stands for London Interbank Offered Rate. It is the rate of interest at which banks offer to lend money to one another in the wholesale money markets in London for one month. Standard Deviation is a measure of the dispersion of a set of data from its mean.