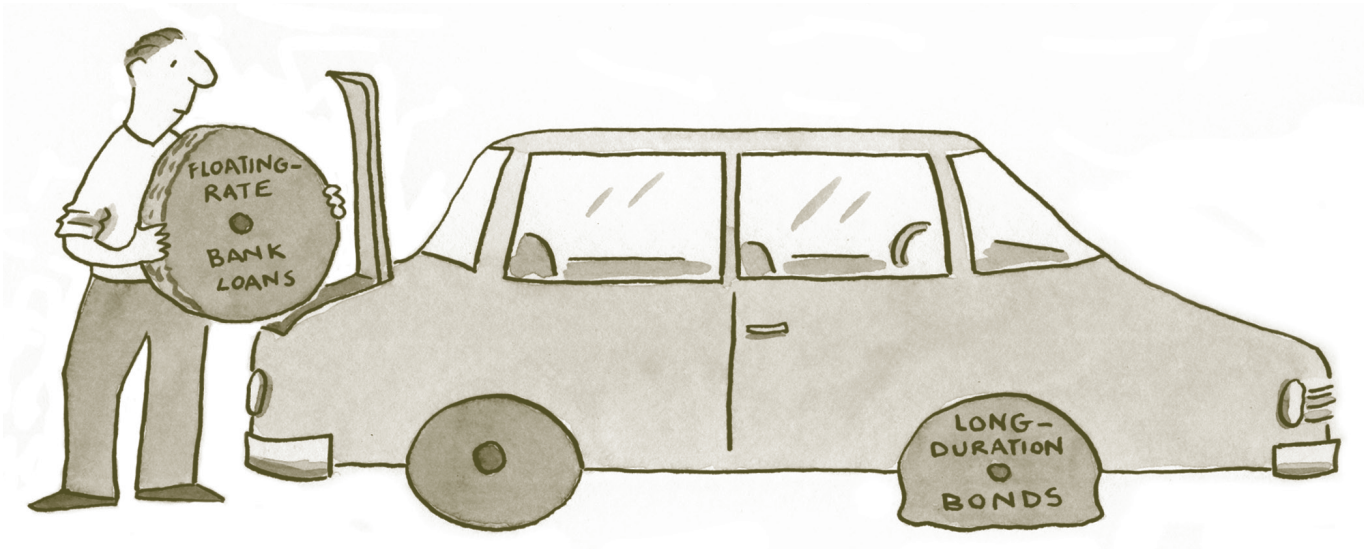

Floating-rate Bank Loans

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With the post-crisis economic recovery beginning to show signs of self-sustainment, the bond market appears to be at an inflection point. As Exhibit 7 illustrates, the United States has experienced a secular decline in interest rates for the last 30 years. Declining interest rates are a boost for bondholders – as interest rates go down, bond prices go up (see Exhibit 8 for a quick tutorial on bond math) »

EXHIBIT 7 10-YEAR U.S. TREASURY YIELD

Source: Bloomberg

At the depths of the recent financial crisis, the Federal Reserve and market forces brought interest rates down to all-time lows, and we are now in a situation where interest rates cannot go meaningfully lower.

No one knows when, by how much, or how quickly interest rates will rise, but there is little room for them to fall further from here. With the tailwind of falling interest rates gone, fixed income investors face increasing challenges to preserve principal and generate sufficient income, all without taking on undue risk. The floating-rate bank loan market has been on the periphery for many years, but it is now taking on a much more significant role in many investors' portfolios to help meet their goals.

Floating-rate bank loans are loans, typically below investment grade, that are made by banks to corporate borrowers. Corporations that use bank loans range in size and industry from relatively small operations to large household names, and they undertake these loans for a variety of reasons, including financing an acquisition or refinancing their capital structure. The loans are typically the most senior position in a borrower's capital structure, secured by specific assets as collateral. After originating the loan, the financial institution then sells it off in pieces to investors. Typical bank loan investors include banks, hedge funds, mutual funds, and collateralized loan obligations.

One of the most important features of bank loans is their floating rates. Unlike normal bonds that pay a fixed coupon, bank loans pay a fixed spread over the London Interbank Offered Rate (LIBOR). LIBOR is a widely recognized, market-driven rate that fluctuates every day. Bank loans' coupon resets every 30 to 90 days, so as LIBOR changes, so does the interest the loan pays. For example, if a bank loan is issued at LIBOR plus 4%, and LIBOR is at 2%, then the loan will pay 6%. But if 30 days later, LIBOR has gone up to 3%, the loan will now pay 7%.

EXHIBIT 8 A SIMPLIFIED EXAMPLE OF THE EFFECT OF CHANGES IN INTEREST RATES ON BOND PRICES

We buy a bond that promises to pay $100 at maturity and pays a coupon of $5 per year, or in other words 5%. If the market interest rate is 5%, that bond's price will be $100. Now let's say the market interest rate goes down to 4%. In this new 4% interest rate environment, a new bond can be issued and will only have to pay a coupon of $4. Assuming our bond and this newly issued bond are of equal quality and maturity, one would prefer our bond that pays a $5 coupon over the new bond that pays a $4 coupon. Thus, after the decline in market interest rates, our original bond will experience an increase in price. By the same token, were interest rates to increase from 5% to 6%, a new bond issued with a $6 coupon would be preferable to our $5 coupon bond, so the price of our bond would go down.

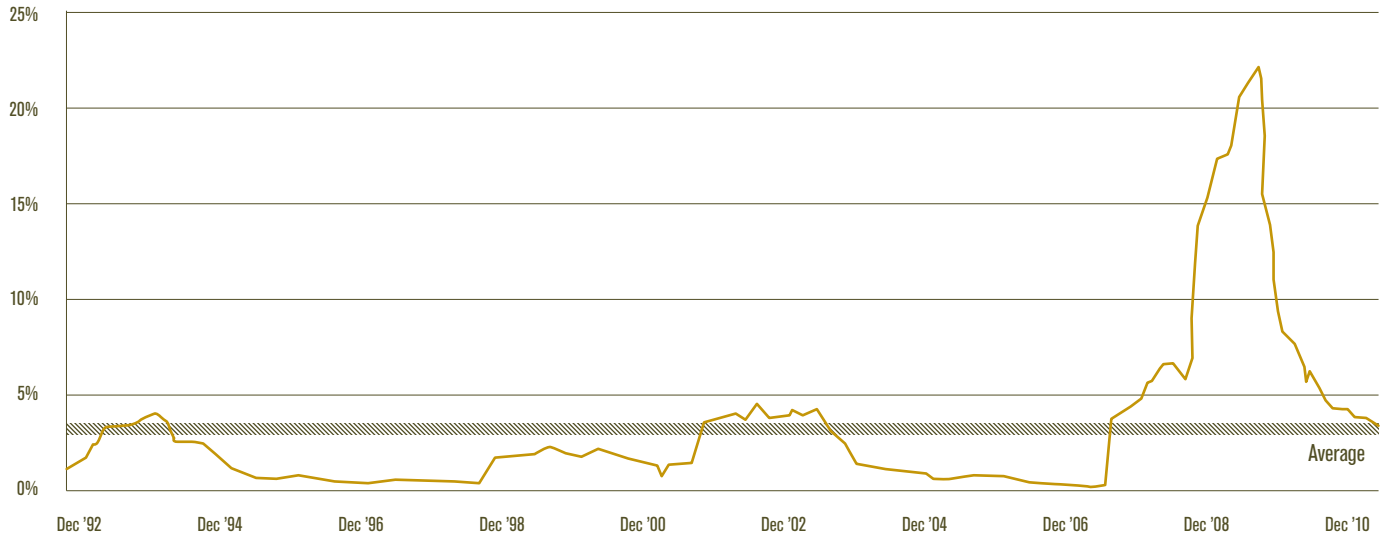
Until the summer of 2007, bank loans enjoyed an exceptionally stable market – a market some might even call boring. Default rates averaged about 4%, and recoveries from those defaults were high at 70%,[1] due to loans' high position in the capital structure and because they were typically secured by hard assets. As demonstrated in Exhibit 9, even during periods of market instability such as 1994 and 2001, the 12-month volatility of bank loan returns, a common measure of risk, was never higher than 5%. By comparison, during the same period, the S&P 500 standard deviation averaged 12% and went as high as 23%.[2]

The bank loan market peaked in February 2007, when the average price of a loan hit more than 100 cents on the dollar. Then in July of 2007, at the very beginning of the financial crisis, bank loans began to plummet. By December 2008, the average loan price was all the way down to $0.62, a decline of 38% from the top.

Some of this decline was due to fundamental factors, the natural reaction of the market recognizing a peak and beginning to anticipate a recession, and thus, higher default rates for bank loans. But much of the decline was attributable to technical issues. At that time, hedge funds were large holders of bank loans, and most levered their holdings many times in an attempt to enhance performance. When loan prices started falling and hedge funds showed negative returns, they faced redemptions and were forced to sell their holdings at low prices. This put extra pressure on prices, causing a vicious cycle. Meanwhile, the market dried up for companies looking to secure bank loan financing – no one was willing to lend, and no new deals were getting done.

In 2009, during the depths of the recession, the default rate for bank loans reached 11%, more than double the rate in the bear market of 2001-03. However, bank loan prices fell significantly below any measure justified by fundamentals. »

EXHIBIT 9 ROLLING 12-MONTH VOLATILITY, CREDIT SUISSE LEVERAGED LOAN INDEX



Source: Zephyr

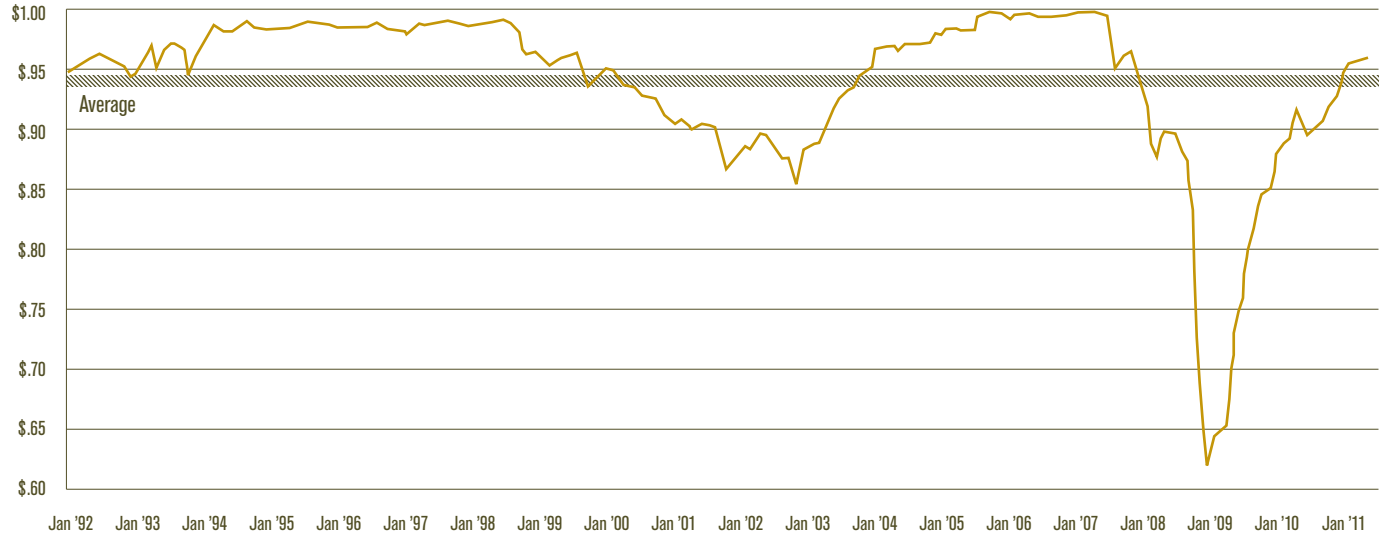
At that point, opportunistic investors began stepping in, and, as Exhibit 10 illustrates, bank loans rapidly rebounded from the bottom. By April 2011, they were back to trading at a more normal $0.96, a 54% increase from the bottom. During this time, the lending market opened back up, allowing companies to secure bank loan financing once again.

In hindsight, the pendulum clearly swung from irrational exuberance in 2006-07 to panic in 2008-09. Today, it appears to be settled at a fairly healthy state in between: Good companies are able to secure lending at fair pricing, more mediocre companies can get loans provided the terms of the deal are strict, and the market is not making loose loans to bad companies.

From an investment perspective, with loans now priced near 100 cents on the dollar, there is not a lot of room for prices to go much higher, another couple percent at most. But because many companies have extended the maturity of their loans years into the future and the economy is growing, albeit at a relatively slow pace, defaults are expected to be low for the foreseeable future, justifying loans' relatively high price. The main investment case for bank loans today is therefore their floating rates. As previously stated, there is little room for interest rates to fall further from here. No one knows when, by how much, or how quickly they will rise, but when they do, bank loans should be direct beneficiaries.

To be sure, regardless of the market environment, RMB's overarching principles of managing fixed income hold true: Wealth preservation comes first, with income generation a secondary goal. But with a changing interest rate backdrop, new methods are now essential to meet those two needs. A cautious approach is still required, particularly when investing in bank loans. But when allocated appropriately, floating-rate bank loans have a place in many investor portfolios. ■

EXHIBIT 10 AVERAGE PRICE, CREDIT SUISSE LEVERAGED LOAD INDEX



Source: Bloomberg

1. Eaton Vance: Floating-rate Loans: Why This "Anti-Bond" Asset Class May Be More Compelling Than Ever; April 2010
2. Zephyr Style Advisor