Senior Loans

Senior Loans Attractively Priced Relative to High Yield

In light of the improving financial conditions in Europe, the increasing confidence in the U.S. economy, and the growing recognition that short-term interest rates are likely to remain effectively near zero percent well into 2014, investors have allocated more than $14 billion into high yield bonds so far in 2012.[1] The increased appetite for higher yielding corporate paper has led to a 1.08% decline in the yield of the JP Morgan Domestic High Yield Index, from 8.14% at the beginning of the year to 7.06% at the end of February. Growing demand for lower rated credit has also supported prices in the senior loan market, but that rally has been muted in comparison. Loan funds have experienced $200 million in outflows during the same time period. In fact, the yield of the Credit Suisse Leveraged Loan Index only declined by 0.52% during the same period to 6.60%.

This is not just a 2012 phenomenon. The yield advantage high yield bonds have over senior loans has been contracting since 2008, from a cyclical high of 5.00% to currently just north of 0.40%. This tighter spread between high yield bond yields and senior loan yields exists despite the fact that unlike senior loans, high yield bonds are not secured by collateral and have a junior position to loans in a company's capital structure. This narrow level, which is approaching historical lows, implies that while high yield bonds are still attractive on an absolute basis, senior loans may be the better value. (See Chart 1)

Joseph Welsh, CFA
Head of High Yield Corporate Debt Team, Senior Vice President and Portfolio Manager

CHART 1

Senior Loans May Be a Better Value

High Yield Bond–Senior Loan Yield Differential (1/31/95–2/29/12)

Source of chart data: Bloomberg, JPM Research, CS Research (loan yield is calculated by adding the discount margin to maturity to 3-Month LIBOR). Indices: JPM Domestic High Yield Index & CS Leveraged Loan Index, as of 2/29/12. Indices are unmanaged and cannot be purchased directly by investors. Index performance does not reflect fees or expenses and is shown for illustrative purposes only and does not predict or depict the performance of any particular investment. **Past performance does not guarantee future results.**

In support of the case for senior loans, it may be worthwhile to revisit other important reasons they may merit a long-term allocation in a diversified portfolio.

Higher income potential

One of the most important reasons to be in senior loans is yield potential. While interest rates have been kept artificially low by the Fed, it is difficult for investors to be excited about a 2.00% yield on the 10-year Treasury. Senior loans continue to have a sizable yield advantage over Treasuries as well as other domestic fixed income sectors. (See Chart 2)

Lower interest rate risk

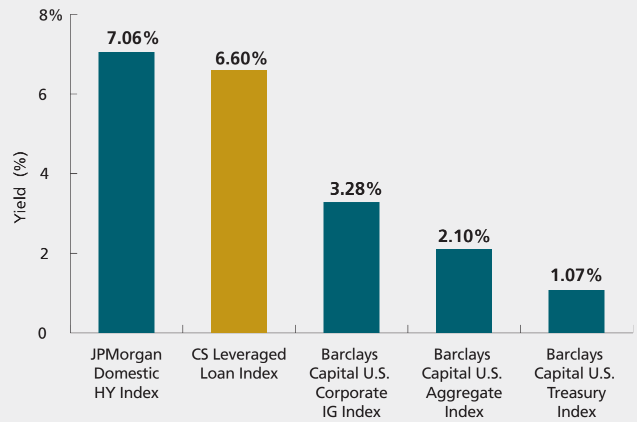
Although the Fed might leave short-term rates anchored for the foreseeable future, this does not necessarily mean that U.S. Treasury rates cannot rise. Take the fourth quarter of 2010, for example, when the 10-year U.S. Treasury yield increased approximately 1.00%; or more recently (October 3rd through October 27th) when the rate increased 0.64% from 1.76% to 2.40%. While their coupons did not float higher during these periods, senior loans' low relative interest rate risk or durations (a function of their coupons resetting periodically—whether higher or not) did contribute to their relative outperformance versus other fixed income sectors with longer durations. (See Chart 3)

Healthy corporate sector may keep default rates low

The fundamentals for many below-investment-grade companies remain sound. Many have taken conservative measures to shore up their balance sheets and fund their longer term operations. Some of these have included overall deleveraging, building up cash balances, and pushing out their debt maturities towards the latter part of this decade. Taken in aggregate with stronger profitability resulting from an improving economy, the outlook appears positive for debt serviceability and low defaults.

CHART 2

Senior Loans May Offer Sizeable Yield Advantages
Yields as of 2/29/12



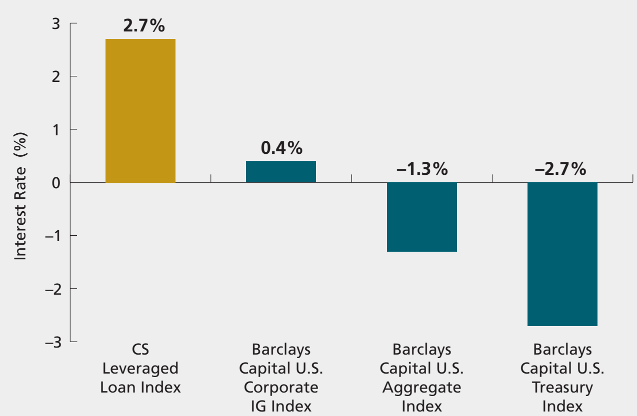
Source of chart data: Barclays Capital Research, JPMorgan Research, CS Research, as of 2/29/12.

The yields illustrated are yield-to-worst with the exception of the Credit Suisse Leveraged Loan Index, whose yield is calculated by adding the discount margin to maturity to 3-Month LIBOR.

The JPMorgan Domestic High Yield Index is an index composed of non-investment-grade corporate bonds. The Credit Suisse Leveraged Loan Index is an unmanaged index that tracks the performance of senior floating rate loans. The Barclays Capital U.S. Corporate Investment Grade Index is a widely used indicator of the U.S. investment-grade corporate bond market performance. The Barclays Capital U.S. Aggregate Index covers the USD-denominated, investment-grade, fixed rate, taxable bond market of SEC-registered securities. The index includes bonds from the U.S. Treasury, government-related, corporate, MBS (agency fixed rate and hybrid ARM passthroughs), ABS and CMBS sectors. The Barclays Capital U.S. Treasury Index includes public obligations of the U.S. Treasury with a remaining maturity of one year or more. Indices are unmanaged and cannot be purchased directly by investors. Index performance is shown for illustrative purposes only and does not predict or depict the performance of any particular investment. **Past performance does not guarantee future results.**

CHART 3

Senior Loans May Outperform When Treasury Rates Rise
Sector Total Returns from 10/3/11 to 10/27/11



Durations	**0.25**	**6.94**	**4.94**	**5.77**

Source of chart data: Barclays Capital Research, CS Research, as of 10/27/12.
Duration is a measure of interest rate risk. The longer the duration, the greater the expected volatility as rates change. The Credit Suisse Leveraged Loan Index is an unmanaged index that tracks the performance of senior floating rate loans. The Barclays Capital U.S. Corporate Investment Grade Index is a widely used indicator of the U.S. investment-grade corporate bond market performance. The Barclays Capital U.S. Aggregate Index covers the USD-denominated, investment-grade, fixed rate, taxable bond market of SEC-registered securities. The index includes bonds from the U.S. Treasury, government-related, corporate, MBS (agency fixed rate and hybrid ARM passthroughs),ABS and CMBS sectors. The Barclays Capital U.S. Treasury Index includes public obligations of the U.S. Treasury with a remaining maturity of one year or more. Indices are unmanaged and cannot be purchased directly by investors. Index performance does not reflect fees or expenses, is shown for illustrative purposes only and does not predict or depict the performance of any particular investment. **Past performance does not guarantee future results.**

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1. Source of data: ICI, 2/29/12.

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Senior loans are typically lower rated (more at risk of default) and may be illiquid investments (which may not have a ready market). Fixed income investing entails credit risks and interest rate risks. When interest rates rise, bond prices generally fall, and the Fund's share prices can fall. Below-investment-grade ("high yield" or "junk") bonds are more at risk of default and are subject to liquidity risk.

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