



# A Synopsis of the Bank Loan Market

HOTCHKIS AND WILEY CAPITAL MANAGEMENT

High Yield Newsletter 2Q 2011

*"The more it changes, the more it's the same thing"*  
Jean-Baptiste Alphonse Karr (1808-1890) – French journalist/novelist

## Introduction

The 10-year Treasury yield has been below 4% for more than two and a half years—it recently dipped below 3%. In response to these chronically low rates, investors have been on the hunt for elevated yields. Consequently, both high yield bond and bank loan (aka "leveraged loan") mutual funds have experienced considerable asset inflows. According to Morningstar®, high yield bond mutual funds experienced \$15 billion in net inflows for the year ended March 31, 2011. Bank loan mutual funds experienced \$27 billion in net inflows over the same period, including nearly \$15 billion in the first quarter of 2011 alone.

Given the increased popularity of bank loan mutual funds, we have received numerous questions about the market's prospects and thought it would be the perfect subject for our newsletter. Over the past decade, the bank loan market has evolved considerably—it has, in many ways, converged with the more seasoned high yield bond market. In this newsletter, we will describe the similarities and nuances of the high yield bond market and the bank loan market using the following blueprint:

- I. Market Structure
- II. Market Evolution
- III. Risk
- IV. Performance

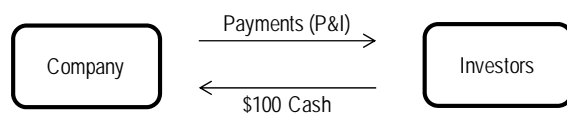
## I. Market Structure

### Payment Structure

The basic structure of fixed income markets is quite simple, but financial innovation over time has translated into structures/nuances that can be highly complex. To the extent possible, we will sidestep intricacies that may convolute our basic message—we want to keep this simple.

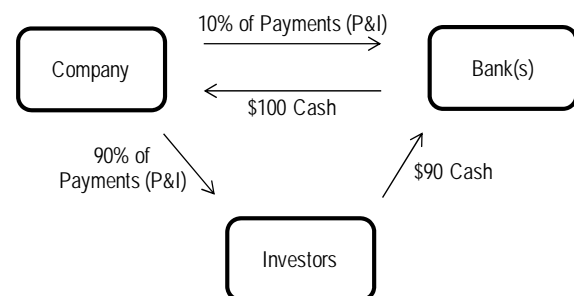
The basic structure of a high yield bond is very straightforward. A company borrows cash from investors. In return, investors receive fixed interest and principal payments from the company. The investors' capital is fully exposed to the risk that the company fails to make interest payments or repay the principal.

\$100 High Yield Bond: Sample Structure (simplified)



The basic structure of a bank loan is only slightly more complex because we now introduce an intermediary (the bank). A company borrows cash from a bank (or a syndicate of banks). In return, the bank receives interest and principal payments from the company. To diversify its risk, however, the bank sells a portion of its exposure to non-bank investors<sup>1</sup>. The bank receives cash from these investors, and in return, gives up a percentage of the payments it receives from the company.

\$100 Bank Loan: Sample Structure (simplified)



In the above example, the bank has \$10 at risk (\$100 loan minus the \$90 it received from investors) and receives 10% of the principal and interest payments—in finance jargon, this portion of the loan that the bank retains is typically referred to as "Term A Loan". Investors have \$90 at risk and receive 90% of the principal and interest payments—in finance jargon, this portion of the loan that the bank sells to investors is typically referred to as "Term B Loan". The only difference is who owns the loan—seniority, covenants, maturity, etc. are identical.

### Coupons

Bank loans almost always pay a floating coupon while high yield bonds almost always pay a fixed coupon. The coupon rate for bank loans is typically expressed as a spread over LIBOR while the coupon rate for high yield bonds is expressed as a fixed percentage.

### Maturity

Bank loans are typically issued at five- and seven-year maturities and are generally callable at par from day one. High yield bonds are typically issued at eight- and ten-year maturities and are *not* callable until halfway between its issue date and its maturity date.

<sup>1</sup>This process also involves important nuances that are largely beyond the scope of this paper. Most importantly is whether the allocation to investors is classified as "participation", in which case the investor acquires voting rights, or "assignment", in which case the bank retains the voting rights.

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This is an important dynamic that high yield investors refer to as call protection. When a company's credit improves, bank loan investors are often forced to sell the loan back to the company—at the company's behest. In this same scenario, high yield bonds' call protection precludes investors from being forced to sell the bond back to the company—instead, the bond's price appreciates. As a result, many investors view high yield bonds as better total return vehicles and bank loans as better “carry” or short-term vehicles.

## Seniority

Typically, bank loans are senior to high yield bonds in the capital structure of a company that has issued both types of debt. Bank loans often contain a first lien claim on assets whereas high yield bonds often contain an unsecured claim on assets. Over time, this has translated into higher recovery rates for bank loans in default situations. Note that we said “often” and not “always”—we tend to seek high yield bonds that are senior and secured with collateral. This provides us with the support of a senior secured credit while maintaining the total return potential of a high yield bond.

## Covenants

Bank loans generally possess extensive covenant packages, including maintenance tests that are conducted regularly (usually quarterly). These maintenance tests limit management's capital allocation decisions to prevent actions that would be deemed unfavorable to bank loan investors. Covenant packages for high yield bond issuers are generally less onerous and seldom include maintenance tests. In times of economic stress, maintenance covenants can be tripped, forcing the company to negotiate with the banks. This often serves as an effective early warning system for credit erosion.

## Trading

High yield bond trades typically settle three days after initiated (t+3). Due to the onerous and non-standardized documentation process, bank loan trades typically settle ten days after initiated (t+10). Investors with short-term or unknown liquidity requirements would be wise to avoid relying solely on bank loan investments to provide needed liquidity.

High yield bonds commonly trade in increments of \$1 million in total face value (an allotment of 1,000 bonds each with a par value of \$1,000), but can be traded in smaller increments fairly easily. Price negotiation can become challenging, but trades of under \$1 million are quite common. Bank loans do not possess this fungible quality, and trade in \$1 million increments almost exclusively. Accordingly, focusing on bank loans exclusively requires considerable scale to diversify portfolios effectively.

## Market Structure—key takeaways:

- ✓ Bank loans pay floating coupons
- ✓ Bank loans are shorter maturity and callable immediately—they do not provide call protection
- ✓ Bank loans are senior in the capital structure
- ✓ Bank loans have more stringent covenant packages
- ✓ Bank loans can be more difficult to trade

## II. Market Evolution

The high yield market is fairly established, dating back about 30 years. For investors who consider the high yield market young, the bank loan market should be viewed as in its infancy. While the bank loan market dates back nearly 20 years, its configuration is very different today than in the early 1990s. This dramatic evolution poses challenges when assessing the bank loan market's history.

## Breadth

Of the major index providers that track both the high yield market and the bank loan market, we find that Credit Suisse offers relevant and robust data. In addition to a high yield index, it has an all-encompassing bank loan index designed to mirror all investable bank loans denominated in US dollars (the Credit Suisse Leveraged Loan Index). A more commonly used benchmark is a subset of this index, which Credit Suisse labels “institutional” (the Credit Suisse *Institutional* Leveraged Loan Index). This sub-index begins with the broad index and then eliminates loans with any of the following conditions:

- Term A Loans (retained by the bank, as described)
- Loans priced at \$90 or below
- Loans rated CC or below by the rating agencies

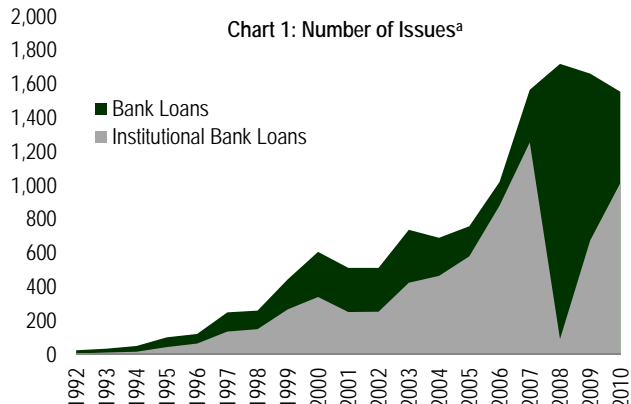
The benefit of using the institutional index is that it more closely resembles the criteria of a non-bank investor, particularly by removing the Term A Loans. A potential problem with the institutional index, however, is that its exclusion criteria can result in abrupt changes to the index in extreme environments. As an example, see Chart 1 which displays the number of issues in these two indices going back to their inception in 1992.



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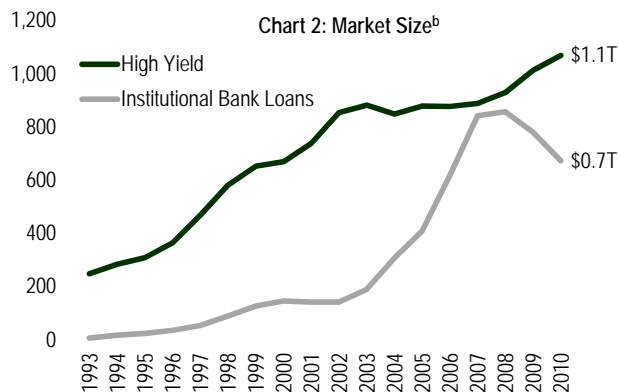
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When the credit crisis of 2008 began, most bank loans fell below \$90 exempting them from the institutional index—though institutional investors were certainly exposed to this event. When possible, we will show both indices to foster perspective. Due to the private nature of the bank loan asset class, however, public data are limited. If not explicitly stated, assume we are referring to the institutional index from here forward. Regardless, the number of issues in the bank loan market has grown tremendously, particularly since the late 1990s.

## Size

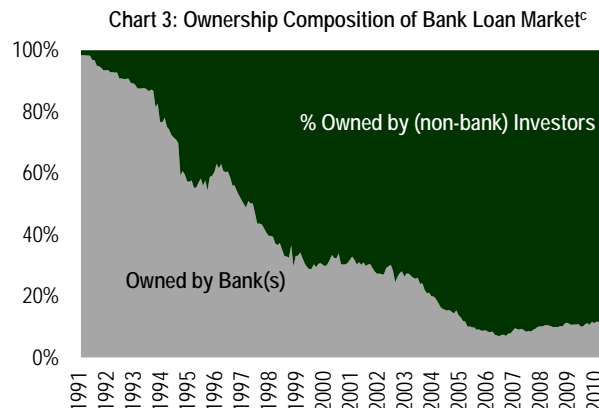
As depicted in Chart 2, the high yield market and the bank loan market have grown precipitously. The bank loan market, however, remained rather insignificant until the 2003-2007 credit explosion. This growth was buoyed by massive demand for collateralized loan obligations (“CLOs”) and other credit derivatives, which have since become infamous. The loan market has actually shrunk a bit over the past couple of years because many companies have swapped their bank debt (floating rate) for high yield bonds (fixed rate) due to persistently low interest rates. Refinancing has been exceptionally robust over the past few years.



## Ownership Composition

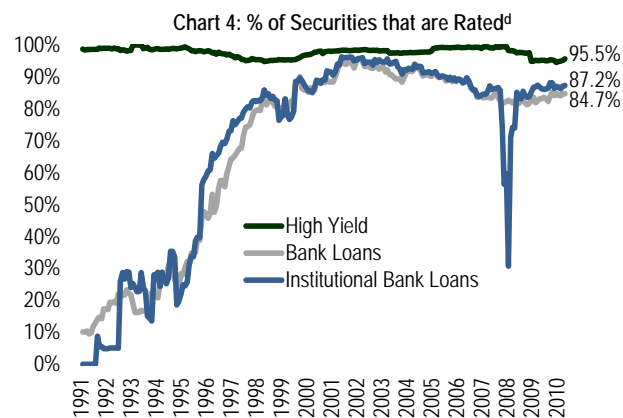
As logic would have it, bank loans were actually owned by banks when this market began. Financial engineers would have

no part of this logic, of course, as the powers that drive the fickle world of finance took hold. Chart 3 highlights this dynamic as the percentage of bank loans owned by banks has dwindled through time. Note that this is represented by the broad index and not the institutional index because the latter excludes the portion retained by banks.



## Rating Agency Coverage

The rating agencies are normally the last ones to join the party. They are uninvited, of course, but once they arrive they seem to invigorate the party rather than dissipate it. They misguidedly increased investors’ confidence in the safety of bank loans, and inadvertently contributed to the market’s explosive growth. As shown in Chart 4, rating agency coverage increased tremendously in the late 1990s and has remained reasonably steady since—though its ratings coverage is less robust than the high yield market’s coverage.



## Market Evolution—key takeaways:

- ✓ The bank loan market has grown tremendously over the past decade
- ✓ Ownership has shifted from banks to non-bank investors
- ✓ Rating agencies have covered most of the market for over a decade

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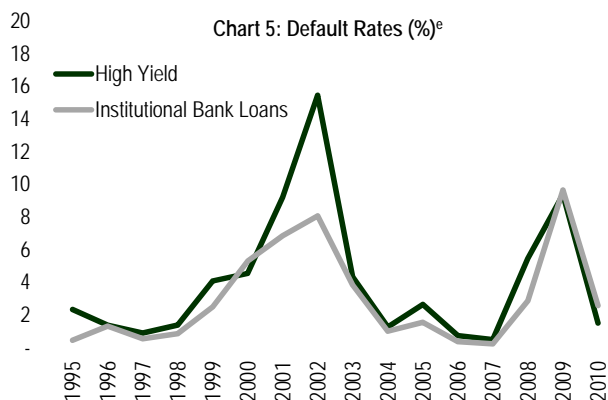
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### III. Risk

Typically, bank loans are senior to high yield bonds in a company's capital structure. Consequently, bank loans have less credit risk than high yield bonds for a company engaged in both types of borrowing. This does not necessarily mean, however, that high yield bonds are riskier than bank loans. The bank loan of a company with excessive leverage and poor asset coverage is riskier than the high yield bond of a different company with less leverage and strong asset coverage. While we believe investors should assess risk on a case-by-case basis, we'll show some aggregate information to help provide some perspective.

### Default Rates

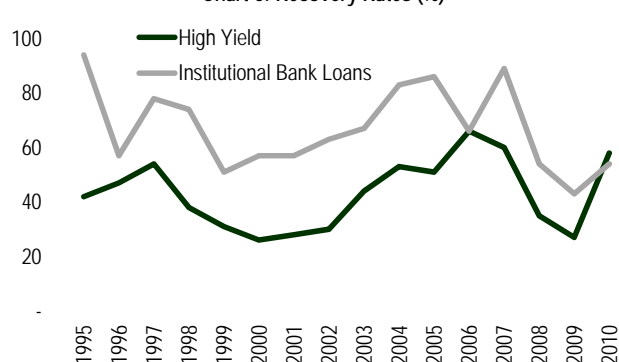
As shown in Chart 5, the default rates of the high yield bond market and the bank loan market generally moved in tandem (correlation of about 0.90). In most instances, the default rate in the high yield market exceeded that of bank loans by a small degree. The notable exception was 2001-2002 when the default rate for both markets increased dramatically—less so for bank loans, which at the time totaled less than \$150 billion in total assets.



### Recovery Rates

In the event of default, fixed income investors are rarely left with nothing because they have legal claims on the firm's assets. The recovery rate is the amount, as a percentage of par value, that creditors receive in a default. As shown in Chart 6, the recovery rate in the bank loan market has exceeded the recovery rate in the high yield market. This makes sense because bank loan investors generally have the most senior claim on a company's assets, as discussed earlier. This appears to have converged recently, however, with recovery rates in the bank loan market falling below recovery rates in the high yield market for the first year on record. This is largely due to the abundance of over-levered LBO transactions in 2006-2007 as well as the exceedingly low default rates currently.

Chart 6: Recovery Rates (%)<sup>f</sup>



### Maturity Schedule

As a bond or loan's maturity date approaches, the company/debtor has three basic options: 1) repay, 2) refinance or 3) default. Often times refinancing is the preferable option. If the company is unable to refinance, then it might be forced to take the third option—default. Needless to say, this is normally a bad outcome for investors. It is important, therefore, to be cognizant of the market's (or portfolio's) maturity profile to assess refinancing needs/risks. Chart 7 illustrates the overall market's maturity schedule. Robust refinancing in recent years has extended maturities and resulted in few bonds/loans coming due in the next couple of years—the menacing maturity cliff has transformed into a manageable gradient.

Chart 7: Credits Maturing by Year (\$billions par)<sup>g</sup> as of 3/31/11



### Liquidity

Due to the private nature of the bank loan market and its dramatic evolution, a comprehensive historical synopsis of its liquidity characteristics is an impossible endeavor. Nevertheless, we can confidently state that the bank loan market is less liquid than the high yield market by a considerable margin. Over the past five years, average quarterly trading volume for the bank loan market has been about \$100 billion versus \$400 billion for the high yield bond market. This represents a substantial improvement from the bank loan market's early days, however, and is another characteristic of the bank loan market that appears to be converging with the high yield market.

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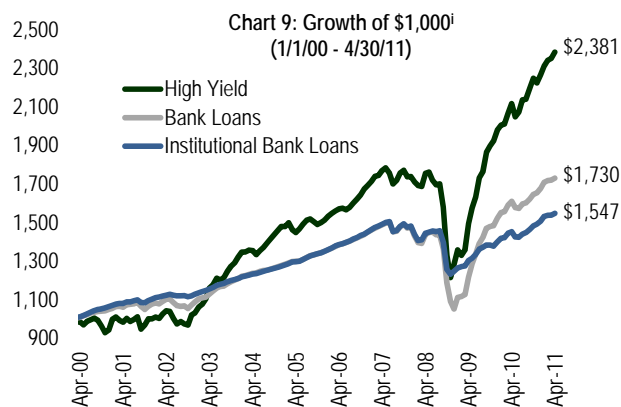
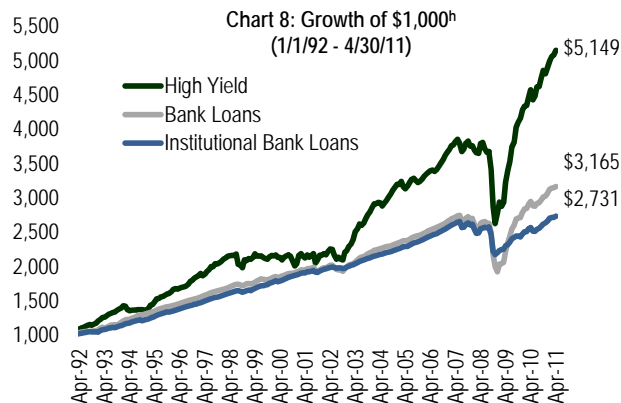
## Risk—key takeaways:

- ✓ Default rates in the bank loan market have been slightly lower than the high yield market
- ✓ Recovery rates in the bank loan market have been higher than the high yield market—but this has converged
- ✓ The maturity profile of a portfolio is an important consideration in assessing refinancing risk
- ✓ The bank loan market is less liquid than the high yield market

## IV. Performance

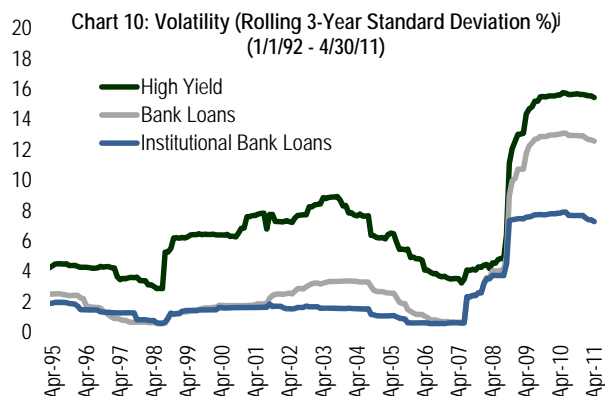
### Returns

The high yield market has outperformed the institutional bank loan market in 12 of the 19 years since the latter's inception in 1992. If we exclude the 1990s, before the bank loan market began to expand/evolve, the high yield market outperformed the institutional bank loan market in 7 of 11 years. Charts 8 and 9 below show the hypothetical growth of \$1,000 invested in these markets over these two periods. As a reminder, the *institutional* leveraged loan index excludes Term A Loans (loans retained by the banks), loans trading at less than \$90, and loans rated CC or below by the rating agencies.



### Volatility

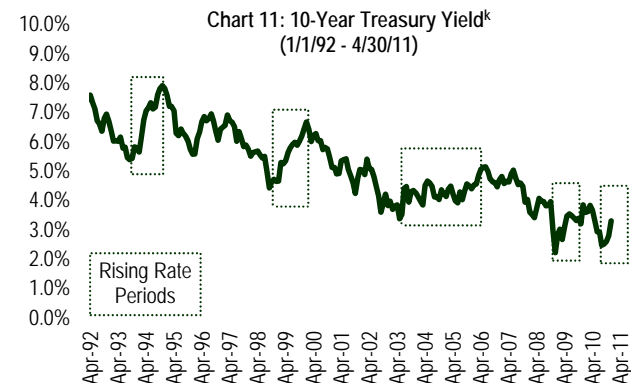
What stands out in Charts 8 and 9, besides the outperformance of high yield bonds, is the consistency of returns in the bank loan market prior to 2007. We explored this a bit further, as shown in Chart 10. As depicted in the chart, the high yield market experienced an increase in volatility over the past few years—not a surprise given the severity of the recession and the strength of the ensuing recovery. While the increase in volatility of the high yield market is striking, it pales in comparison to the increase in the bank loan market, which increased more than tenfold from extraordinarily low levels.



We believe the low volatility level exhibited by the bank loan market prior to the mid-2000s is deceiving. The explanation is the market's poor liquidity prior to the last five years, which we discussed earlier. Illiquid assets are marked-to-market less frequently, which creates the illusion of stability. We believe the recent past better represents bank loans' true volatility.

### Rising Interest Rates

Finally, we thought it would be interesting to compare the two asset classes in periods of rising interest rates. Because bank loans are floating rate securities, a reasonable investor should expect them to perform well when rates rise—especially compared to Treasuries and other high grade debt. As it turns out, bank loans have performed well in rising rate environments. They have not, however, performed as well as high yield bonds.



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Chart 11 highlights five different periods since 1992 when interest rates increased. Both high yield bonds and bank loans had positive returns in each of these five periods, with high yield outperforming in three of the five.

## Average Return During Rising Rate Periods (1/1/92 - 4/30/11)<sup>1</sup>

High Yield Bonds	13.9%
Bank Loans	11.2%
Institutional Bank Loans	7.6%
10 Year Treasury	-2.3%

### Performance—key takeaways:

- ✓ Bank loans have underperformed high yield bonds over time
- ✓ Bank loans have performed well in periods of rising interest rates, but not as well as high yield bonds
- ✓ Bank loan returns have been less volatile than high yield bonds, but its volatility has increased considerably

### Wrap-Up

The bank loan market has some interesting prospects, but it is a less established market than its 20-year history suggests. Over the past decade, the bank loan market has evolved in a manner that has made it increasingly similar to the high yield market. We have no doubt there are interesting investment opportunities within the bank loan market, but we do not see any obvious advantages to a bank loan only strategy relative to a high yield bond strategy. While the bank loan and high yield markets are similar in many respects, the high yield market is more established, more liquid, and has exhibited greater total return potential. We believe bank loans can serve as an effective complement to high yield bonds, but would not serve as an effective substitute.

Mark Hudoff, Portfolio Manager  
Ray Kennedy, Portfolio Manager  
Ryan Thomes, Portfolio Analyst

You should consider the Fund's investment objectives, risks, and charges and expenses carefully before you invest. This and other important information is contained in the Fund's summary prospectus and prospectus, which can be obtained by calling 1.800.796.5606 or visiting our website at [www.hwcm.com](http://www.hwcm.com). Read carefully before you invest.

All investments contain risk and may lose value. Investments in debt securities typically decrease in value when interest rates rise. This risk is usually greater for longer-term debt securities. Investment by the fund in lower-rated and non-rated securities presents a greater risk of loss to principal and interest than higher-rated securities. The Fund may invest in derivative securities, which derive their performance from the performance of an underlying asset, index, interest rate or currency exchange rate. Derivatives can be volatile and involve various types and degrees of risks. Depending on the characteristics of the particular derivative, it could become illiquid. Investment in Asset Backed and Mortgage Backed Securities include additional risks that investors should be aware of such as credit risk, prepayment risk, possible illiquidity and default, as well as increased susceptibility to adverse economic developments. The Fund may invest in foreign as well as emerging markets which involve greater volatility and political, economic and currency risks and differences in accounting methods.

All references to the High Yield market based on the Credit Suisse High Yield Index; Bank Loans based on Credit Suisse Leveraged Loan Index; Institutional Bank Loans based on the Credit Suisse Institutional Leveraged Loan Index; and 10-Year Treasury based on Barclays Capital US 10-Year Treasury Bellwether Index.

Chart data sources: a-j, l – Credit Suisse, Hotchkis and Wiley. k – Bloomberg, Credit Suisse, Hotchkis and Wiley

*Credit Suisse High Yield Index*: Represents all corporate bonds rated below BBB- (or equivalent; including non-rated) by the major ratings agencies. *Barclays Capital US 10-Year Treasury Bellwether Index*: Represents an investment in 10-Year on-the-run Treasury bonds. *Correlation*: Statistical measure of the degree to which the movements of two variables (stock/option/convertible prices or returns) are related. *LIBOR* = London Interbank Offered Rate. *LBO* = Leveraged buyout.

*Standard Deviation*: Statistical measure of the historical volatility of a mutual fund or portfolio, usually computed using 36 monthly returns.

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