



2011 Informational Report Series of Common Client Questions and Investor Education

Senior Secured Floating Rate Loans Asset Class Potential Alternative to Fixed Rate Bonds

Fixed Rate Bonds Continue to be at High Risk

In February, 10-year Treasuries (the benchmark for most bonds) continued to have losses. Most analysts expect the slow increase in rates to continue, with resulting falling of bond values.

On 3/1 the 10-year Treasury stood at 3.4%. The historical average yield since 1953 is over 6%. The Republicans are attacking the budget estimates because - these only increases Treasury rates to 5.4% in 10 years and there is a risk the rate could increase. J.P. Morgan "Market Insights" 12/31/2010, reported that a 1% rate increase would result in the following bond losses: 10-year Treasury -8.54%, 30-year's -16.6%, average corporate bond -6.53%.

Senior Secured Floating Rate Loans

Potential Benefit of Floating-Rate Loans during Rising-Rate Environments

Table with 5 columns: Time period, 10/93-10/94, 1/99-1/00, 5/03-5/04, 6/05-6/06. Rows include One-year rise in interest rates, Floating-rate loan returns, and Intermediate-term bond returns.

Source: Morningstar Inc. Past performance is historical and does not guarantee future results. Asset class representation: Floating-rate loans, Credit Suisse Leveraged Loan Index; intermediate-term bonds, Barclays Capital 5-7 Year US Aggregate Index, which with average maturities of five to seven years. Data is for illustrative purposes and does not represent any specific investment. Index returns do not reflect fees or expenses. It is not possible to invest directly in an index. Performance over other time periods might not be as favorable.

Senior = If defaults on loan, investors have highest priority to be repaid ahead of all other debt, all bonds, all unsecured creditors and of course ahead of all shareholders.

Secured = Secured by assets which in case of default can be sold to pay loan: often includes cash, inventory, accounts receivable, key equipment, computer systems, real estate and any other assets.

Often loans have covenants whereby certain financial ratios must be maintained or loan can be "called" before company gets in serious financial trouble. Loans are made at a percentage of the value of the assets used as collateral so there is often "over collateralization" required to secure the loan.

Floating = Interest rate "floats" with a base usually 90 day Libor (i.e., "London InterBank Offered Rate" a global standard base for many interest rates, especially commercial loans.) If interest rates move higher, an interest rate reset may lead to potentially higher returns vs. traditional fixed rate bonds which lose value with higher rates.

Most loans have an interest rate of Libor + a spread of maybe 4-6% and a "floor" of, for example, 2%. Today

that means an interest rate for example of 6-8%, since Libor is still near historic lows (under 0.4%), so the "floor" is being used plus the spread. This is hypothetical and does not represent any specific investment.

In 2007 before central banks forced rates down, Libor averaged about 5%. It peaked at over 11% in 1989. Once Libor exceeds the floor the rate would go up. Even with Libor not above most loan floors, the S&P/LSTA Loan index was up 2.6% for the first two months of 2011 and up 10.1% in 2010.

Loans - Packaged for investors into various pieces and sold to institutional investors, insurance companies, hedge funds and mutual funds. There is an active secondary market where loans can be bought and sold to provide liquidity.

These loans are often referred to as "leveraged loans" since assets of the company are "leveraged" by debt. Loans are sometimes used to finance acquisitions of other companies using the assets as collateral. Sometimes they are called "bank loans," since they used to be done primarily by banks, but today they are also originated by investment firms.

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Trade interest rate risk for default risk

Default risk is managed by small amounts (often \$1 million blocks) in many loans, diversified by industry. I can discuss why I recommend certain choices vs. others based on risk taken and historical track records.

From 2001-2009, which included the tech bubble crash and the worst recession since the Depression, the average default rate on floating-rate loans (average of all, without any company selection) was only 3.63%. This compares to the default rate on "high yield" unsecured bonds of 7.12%. Source Moody's. Experienced active managers can have default rates lower than such overall averages.

If a loan defaulted even in the Deep Recession, in the 4Q08-2Q10 cycle the recovery rate was 77.8%, very close to the recovery rates in the 2001-2002 recession cycle (77.9%). (Source Moody's) Combine the historic low default rate, the high recovery rate if in default and a widely diversified portfolio, the risk has been very low even in the worst business cycles.

"Carry Trade" Additional Gain Potential

In some investments the manager may use leverage (I never recommend over 50%) by borrowing just as an example, say at Libor +2.5% matched to loans yielding Libor +4.5%. That would result in a "Carry Trade" of 2% additional return on the loan.

History of steady returns

Returns to loan investors have been mostly stable, and consistent since the S&P/LSTA Leveraged Loan Index began in 1997. (Investors cannot directly invest in indices.)

The worldwide liquidity crisis in 2008 affected the loan market as it did other markets, driving loan-market returns down by 30% in 2008 and back up by 52% in 2009. Patient "buy-and-hold" investors who held their loan portfolios through the crisis would have earned a net return of about 8% over the two years, despite the resulting recession and some of the highest default levels ever recorded.

In 2010, the index returned about 10%, as the credit environment improved and loan default rates fell to below 2%. This was with no significant increase in Libor, but based on interest and gains due to improving economics based on prices in the secondary market.

The loan market's performance through the most challenging credit environment since the 1930s has confirmed to many observers and investors the durability of senior, secured loan assets from a credit perspective. It has also contributed to growing interest by institutional investors in senior secured loans as a mainstream asset class — one that deserves a permanent position in a fixed-income allocation whether it be an individual, pension fund, endowment or other long-term portfolio — rather than

just a position as an alternative or opportunistic investment. Source: Pension and Investments "A Case For Senior Secured Loans" 2/2011

The development of the floating-rate loan market

While commercial banks have done these loans for hundreds of years, the non-bank floating-rate loan market started in the 1970's, dominated by emerging market government borrowers. In the 1980's it was used for mergers and acquisitions. Since the 1990's it has been a prime method of general corporate funding.

Starting in 2010 with banks doing very little lending, these loans became one of the few alternatives for "recession tested" strong private companies willing to pay high rates for secured financing. Public companies which have access to the public bond and equity markets also use these loans, but at usually lower interest rates than for private companies with more limited access to capital.

In 1996 Standard and Poor's began rating corporate floating rate loans. Prior to 1996 the secondary market was limited since valuation was difficult. In 1999 the Loan Syndications and Trading Association (LSTA) licensed Loan Pricing Corp. to run the "mark-to-market" service, based on dealer quotes. In 2000 the SEC mandated that floating rate loan managers begin pricing securities based on actual mark-to-market values which brought pricing transparency to the loans.

Example of Burger King Buyout

3G Capital used about \$2 billion of floating rate loans as part of its \$4 billion buyout of Burger King in September 2010. The loans were secured by all of Burger King's domestic U.S. assets and two-thirds of the stock in its foreign subsidiaries. The loan bears interest at Libor +4.5% with a floor of 1.75% for a total coupon of 6.25%. It sold at 99% of par, resulting in a yield of 6.63% - which could increase if Libor exceeds the 1.75% floor.

Past performance does not assure future results. There is no assurance that objectives will be met. Loan investments are subject to interest-rate and credit risks. Floating rate loans tend to be rated below-investment grade and may be more vulnerable to economic or business changes than issuers with investment-grade credit.

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