Senior Floating Rate Loans: An In-depth Overview
The Basics

What Are We Talking About Anyway?: Senior Floating Rate Loans Defined

Senior floating rate loans, often referred to as leveraged loans, are loans made by banks or other financial institutions to non-investment grade corporations looking to finance acquisitions, leveraged buyouts, and recapitalizations, or for general corporate purposes. Their name originates from two of their inherent features. The senior comes from the fact they take a senior position on a company’s capital structure, meaning that they must be paid before the majority of the borrower’s liabilities. The floating rate comes from the way the loans’ interest rates are calculated. The interest payment floats based on movements of its benchmark interest rate, typically the London Interbank Offered Rate (LIBOR). The loan’s yield is set at a certain rate above LIBOR. The difference between these two rates is called the spread. As LIBOR moves up, the loan’s yield follows suit. The resetting of the loan’s interest rate generally occurs every 90 days.

More recently, the majority of new loans that have come to market offer a LIBOR floor. A LIBOR floor represents the minimum LIBOR level that will be associated with the coupon for that particular loan. The average LIBOR floor currently in the market is approximately 125 basis points and slightly over 60% of the loan market (by par amount) has a LIBOR floor. As a result, loans with LIBOR floors offer their investors the LIBOR floor plus any associated spread as their coupons. LIBOR floors have become much more common in the loan market to compensate investors in this environment of extremely low short-term interest rates.

Leveraged Loans, Fixed-Income and Money Market Securities, and CDs.
What’s the Difference?: Investments Compared

Fixed-Income Securities Versus Senior Floating Rate Loans

Although senior floating rate loans — and the funds that invest in them — are often placed in the same category as fixed-income securities, the two are fundamentally different. As their name suggests, the income portion (yield) of fixed-income securities is fixed. The income portion of leveraged loans, however, is determined according to a floating rate. In the subsequent pages, we will address some of the benefits leveraged loans have over fixed-income securities.

Money Market Funds Versus Senior Floating Rate Loan Funds

Money market funds typically have a stable share price, so their net asset value (NAV) does not fluctuate. Therefore, it is very likely, though not guaranteed, that investors will receive their original investment when selling fund shares. The NAV of a senior floating rate loan fund, on the other hand, fluctuates and may lose value. Despite the risk of losing the original investment, leveraged loan funds provide the potential for capital appreciation, a benefit not available with money market funds.

Certificates of Deposit Versus Senior Floating Rate Loans and Senior Floating Rate Loan Funds

Senior floating rate loans differ from certificates of deposit (CDs) based on how their yields are determined. Banks set CD yields according to current prevailing interest rates. These yields are typically slightly above or below the Federal Funds Rate set by the Federal Open Market Committee (FOMC) of the Federal Reserve. Once issued, a CD’s yield is typically fixed, regardless of interest-rate movements.

An important difference between senior floating rate loan funds and CDs is liquidity. When investors purchase CDs, they agree to lend money to a bank for a specified time period. If investors need to withdraw money from the CD before its due date, a pre-determined penalty is assessed. In recent years, shares in some senior floating rate loan funds became redeemable on a daily basis, providing investors with the liquidity not available in CDs.

Lastly, CDs issued by FDIC-member banks are insured, so all or part of their original value are protected. It is important to remember, however, that FDIC insurance covers only $100,000 per depositor, per insured bank. Money market and senior floating rate funds do not carry such insurance.
Move to the Front of the Line:
Capital Structure

Senior floating rate loans are usually the most senior debt that companies carry. Therefore, in the event of default, senior floating rate loans are paid before other outstanding loans or bonds. Figure 1 illustrates a company’s typical capital structure.

In addition, the loans are usually secured, so they are backed by the borrower’s assets. If a borrower defaults on the loan, the lender can take possession of the assets that the borrower promised as collateral. In this case, the principal, or a portion thereof, can be paid by repossession and liquidation of the collateral.

What Is in a Rating?:
Credit Quality

A company’s credit quality is rated primarily by three agencies: Moody’s Investors Service, Standard & Poor’s Rating Services and Fitch Ratings. These agencies assess a company’s creditworthiness and issue a rating, which corresponds to a particular grade and risk level. These ratings are derived from the analysis of a variety of financial, industry, market and economic data. Each rating agency uses its own rating symbols, as shown in Figure 2.

The higher a company’s credit rating, the higher its credit worthiness and an agency’s belief that the company is to pay interest and principal on debt they would issue. In general, higher-rated companies pay a lower interest rate. Senior floating rate loans are usually issued by companies with a below investment-grade rating.

My How You’ve Grow n: The Evolution of the Senior Floating Rate Loan Market

For much of the early life of the leveraged loan market, loans were priced and valued internally by each firm selling them. Thus, pricing inconsistencies arose, which made it difficult for these loans to be easily bought and sold. This situation was accepted at the time, as the asset class was not heavily traded.

Over the years, the market has grown into a full-fledged asset class, into which many new issuers and investors have entered. In fact, as shown in Figure 3, the total size of the U.S. Institutional leveraged loan market increased significantly since 1993. In addition, new issuance has grown dramatically from 1993 to 2007, rising from $2 billion in 1993 to $426 billion in 2007. Simply put, the number and size of new loan issuance continued...
to increase during the time frame and expanded the market significantly. After a few years of diminished new issues, institutional leveraged loan issuance has bounced back in 2012, but still remains well below the levels seen in 2007.

The growth of the senior floating rate loan market led to the need for standard settlement and operational procedures, market practices and consistent pricing. In 1995, the Loan Syndications and Trading Association (LSTA) was formed to address those issues. Among other things, the LSTA provides the market with consistent mark-to-market pricing. The standards established make it easier to buy and sell loans in the secondary market.

The Risks

LIBOR Floors

The ability of bank loans to provide higher levels of income in an environment of extremely low short-term interest rates is due to LIBOR floors. The average LIBOR floor is approximately 125 basis points, while the actual LIBOR rate at the end 30 November 2012 was 31 basis points. Slightly more than 60% of the loans in the market currently have a LIBOR. However, it is important to note these same loans will not experience additional yield increases when rates actually do rise. The coupon will remain the same until the actual LIBOR rate exceeds the LIBOR floor of the loan. In a simple example where a bank loan has a coupon of 4.5%, LIBOR is at 31 basis points, and the loan has a LIBOR floor of 125 basis points, an upward move in rates will not translate into an increase in yield until LIBOR moves higher than the 125 basis point LIBOR floor.

What Goes Up Must Come Down: Interest Rate Risk

No investment is without some type of risk, and senior floating rate loans are no exception. One risk associated with these loans is the risk that interest rates will fall. While investors in senior floating rate loans are guaranteed to receive a definite spread over LIBOR, there is always the chance that LIBOR will fall even further. If this occurs, the yield on the outstanding loan will fall. As shown in Figure 4, the largest decrease from one year to the next was 2.95 percent (2000 to 2001), and the smallest decrease was 0.05 percent (1998 to 1999).

What’s in a Rating Again?: Credit Quality Revisited

As previously mentioned, senior floating rate loans are usually issued by companies that have a below-investment-grade rating. Therefore, the debt of these companies carries a higher default risk. Despite that fact, with the exception of a few years, default rates in the leveraged loan market have been low over the past 15 years, as shown in Figure 5. Investors in senior floating rate loans must remember that they can lose some or all of their original investment in the loan.

Are These NAVs Moving?: Fluctuating NAVs

The net asset value of senior floating rate loan funds fluctuates. What factors contribute to a decrease in a fund’s NAV? One has to do with default and recovery rates. If a borrower defaults on a loan, the fund that holds the loan can liquidate the assets promised as collateral for that loan. While possible, it is not guaranteed that these assets, when sold, will bring in enough money to cover the outstanding balance of a loan. In this instance, the fund would lose the difference between the outstanding balance and the amount brought in from the sale of assets, its NAV suffering as a result.

1 www.lsta.org
Another cause of decreased NAVs stems from dealings in the secondary loan market. After purchasing a loan, a fund may decide to sell it because holding it is no longer in its best interest. The value of the loan may have decreased since it was purchased and would therefore be sold at a loss in the secondary market. Again, this loss would impact a fund’s NAV.

I’ll Take That Money Now: Liquidity

The secondary market for senior floating rate loans was not very liquid in its early days, making it difficult for loans to be sold. Thus, funds that held senior floating rate loans were not able to offer their investors the level of liquidity they desired. Fund investors were only able to cash in a portion of their investments at the NAV, through periodic tender offers, which were typically made quarterly. This was not ideal since investors usually could not collect the money they needed for a considerable amount of time. As a result, some funds decided to offer their shareholders daily liquidity, by investing a portion of their assets in more liquid and sometimes riskier assets, such as high-yield bonds and short-term securities.

Today, the secondary market for leveraged loans is by far more liquid. Due to the increased liquidity in the secondary market, many funds are able to offer their investors daily liquidity without investing in riskier asset classes. Thus, many fund investors now have the benefit of daily liquidity without the added risk.

Leveraged Loan Funds, Money Market Funds, or CDs?: The Loans Are Not An Alternative To Other Investments

Money market funds and CDs have their place in an investor’s portfolio, and senior floating rate loan funds should complement these investments, not be used as an alternative to them. Individual money market securities and CDs may be insured by the FDIC, offering investors some degree of protection. Please note that although most money market funds are not FDIC insured, they offer investors the security of a stable NAV, generally providing the return of their original investments. Upon maturity, FDIC-insured CDs return their principal plus a fixed-rate of income.

The Benefits

What Goes Down Must Come Up: Interest Rate Sensitivity

One major benefit of senior floating rate loan funds is their sensitivity to interest rates. If interest rates increase, the yield on the loans that a fund holds will also increase. Since the yield is pegged to benchmark interest rate, it will be higher than that interest rate regardless of the increased amount. Therefore, in this scenario, the fund will always earn a higher yield on its underlying loans than the loans’ benchmark interest rate.

Senior floating rate loan fund investors need not be as concerned about rising interest rates as they would with a fixed-income investment. Fixed-income investments, to which leveraged loan funds are most often compared, suffer when interest rates increase. When interest rates rise, the value of an existing bond declines.

Money market fund and CD yields are related to interest rates but are not necessarily determined by them. The rates on money market funds will likely increase when rates rise, but the move is by no means definite or swift. CD rates are fixed and do not change regardless of interest rate changes.
The difference in interest rate sensitivity between senior floating rate loan funds and fixed-income investments, CDs and money market funds can make loan funds an important tool for diversifying a portfolio containing these other investments.

**I Don’t See the Resemblance, Are These Investments Related?: Correlation**

An investment that has a low to negative correlation to another asset class (.5 to -1) behaves differently than that asset class under the same market conditions. Their correlation indicates whether they will move in tandem in response to some change in the market, such as the increase of interest rates.

As shown in Figure 6, senior floating rate loans have a low or negative correlation to many different equity and fixed-income securities, making them an excellent diversifier for an investor’s overall portfolio. Thus, senior floating rate loan funds usually have a low to negative correlation to fixed-income funds.

![Figure 6: Total Return Correlation of Various Asset Classes to Senior Floating Rate Loans (1994 - 2012)](image)

It is extremely important for investors to hold investments in their portfolio that have a low correlation to one another. If all of the holdings in an investor’s portfolio are highly correlated, they would all behave similarly based on some event in the economy. In a well-diversified portfolio — one in which some holdings are not highly correlated to others — a market move may hurt some investments, but not all. In effect, a well-diversified portfolio cushions a portfolio from a hard fall.

**Rising Rates and Floating Loans: Higher Current Income Potential**

Senior floating rate loans have the potential to produce higher current income, compared to most other income-producing investment strategies, should interest rates go up. Since the yield on these loans float with changes in interest rates, they have the potential to increase, raising the level of income that senior floating rate funds garner from their holdings. This benefit is not available with fixed-income securities and CDs, whose yields do not change. Although money market fund yields can change, the change may not be swift or large. As for equity investments that pay dividends — not all do — they do not typically pay a dividend as high as the yield on senior floating rate loans. Therefore, investors in senior floating rate loan funds have the potential to earn a higher current income than investors in CDs and fixed-income, money market and equity funds.
So What Else Should I Know?: Other Benefits of Senior Floating Rate Loans

Senior floating rate loans may not carry as much credit-rate risk as some fixed-income securities, such as high-yield bonds, because the loans are senior and secured. Despite having a lower credit rating than many fixed-income investments, being higher up on the borrower’s capital structure offers the loans some protection in the event of bankruptcy. Consequently, these loans can have recovery rates (the amount recovered once bankruptcy or default procedures are initiated) that are higher than high-yield bonds (Figure 7). In addition, most leveraged loans carry restrictive covenants that limit the borrower from leveraging themselves further.

Another benefit that these loans offer is their historically lower volatility as compared to some other asset classes. As shown in Figure 8, senior floating rate loans have historically been less volatile than other popular asset classes and have shown a return greater than some asset classes.

**Figure 7: Institutional Leveraged Loan vs. High-Yield Bond Recovery Rates**

<table>
<thead>
<tr>
<th>Year</th>
<th>Institutional Leveraged Loan Average</th>
<th>High-Yield Bond Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995-2012</td>
<td>66.12%</td>
<td>43.79%</td>
</tr>
</tbody>
</table>

Institutional includes TL-b, TL-c, TL-d, delayed-draw and other tranches generally held by institutional investors.

Source: Credit Suisse as of December 31, 2012.

**Figure 8: Risk/Reward Characteristics of Various Assets (1994 - 2012)**


Diversification does not insure against market loss. See Endnotes for index definitions.
What Does It All Mean?: Senior Floating Rate Loans and Funds

Senior floating rate loans comprise an exciting, relatively young asset class that is growing in both size and importance. As mentioned earlier, its features are distinctly different from those that are characteristic of other asset classes. These features include potentially higher current income and low correlation compared to other investments, reduced interest-rate sensitivity, strong historical performance, attractive risk/reward profile and the potential for capital appreciation.

Through senior floating rate loan funds, investors may benefit from the features inherent in senior floating rate loans. Of course, as with all investments, the funds do have their risks, and investors should carefully consider them before investing.

Past performance is not indicative of future results.

Senior floating rate funds are not money market funds and may not be suitable to all investors. Their NAVs will fluctuate and may lose value. Investment in these loans involves certain risks, including among others: risks of nonpayment of principal and interest; collateral impairment; non-diversification and borrower industry concentration; and lack of full liquidity. High yield debt instruments carry a greater default risk, may be more volatile, less liquid, more difficult to value and more susceptible to adverse economic conditions or investor perceptions than other debt instruments.

In Figures 6 and 8: **Emerging market bonds** are represented by the JP Morgan Emerging Market Bond Index (an unmanaged market capitalization-weighted index of U.S. dollar-denominated Brady bonds, Eurobonds, traded loans, and local market debt instruments issued by emerging markets’ sovereign and quasi-sovereign entities). **International large-cap stocks** are represented by the MSCI EAFE Index ([Europe, Australasia, Far East] a free float-adjusted market capitalization index that is designed to measure developed market equity performance, excluding the U.S. & Canada). **U.S. large-cap stocks** are represented by the S&P 500 Index (Standard & Poor's 500 Composite Stock Price Index; a widely recognized, unmanaged index of common stock prices). **Senior floating rate bonds** are represented by the Credit Suisse Leveraged Loan Index (a representative index of tradable, senior secured, U.S. dollar denominated non-investment grade loans). **U.S. investment-grade bonds** are represented by the Barclays Capital U.S. Aggregate Bond Index (Comprised of government securities, mortgage-backed securities, asset-backed securities and corporate securities to simulate the universe of bonds in the market. The maturity of the bonds in the index is over one year). **U.S. Treasury bills** are represented by on the run three month Treasury bills as reported by Bloomberg (except in Figure 6 where the U.S. Treasury 30 day rate is used). Indices are not managed and an investor cannot invest directly into an index.

In Figure 6, high yield bonds are represented by the Credit Suisse High Yield Index (an unmanaged index designed to mirror high yield debt securities). In Figure 8, high-yield bonds are represented by the Barclays Capital High Yield Corporate Index.

**Investors should carefully consider a Fund's investment objectives, risks, charges and expenses before investing. The prospectus, containing this and other important information, can be obtained from your financial adviser, the SunAmerica Sales Desk at 800-858-8850, ext. 6003, or at www.safunds.com. Read the prospectus carefully before investing.**

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