



Zak Summerscale, Managing Director



Zak heads up loans and high yield for Babson Capital Europe and chairs the Babson Capital Europe Credit Committee. He joined Babson Capital in March 2001 from New Flag Asset Management (New Flag) where he was Portfolio Manager for a European high yield fund.

The fund was short-listed by

Global Investor Magazine for Investment Excellence in High Yield for 2000. Prior to New Flag, Zak worked for the United Bank of Kuwait (UBK). He joined UBK as a Distressed Debt Analyst, rising to Senior Portfolio Manager in charge of both the US and European high yield funds. He qualified as an ACA with Ernst & Young in 1996 and has served on the board of the Loan Markets Association (LMA). He holds a B.A. (Hons) in Economics from Durham University.

Michael Freno, Managing Director



Michael Freno is a member of the firm's High Yield Investments Group and a member of the Global Loan Oversight Committee for the

Global Loan Fund and Global Senior Secured Bond Fund. In addition to his role as a portfolio manager and member of the group's Bank Loan Investment Committee, Michael is the Head of Loan Total Return Funds. He has 12 years industry experience. Prior to joining Babson Capital Management in 2005, Michael was a research analyst for Mangan & McColl Partners, LLC, where he focused on equity and credit analysis for the firm's special situations and distressed investments. Prior to that, Michael was a Manager at PricewaterhouseCoopers. He holds a B.A. from Furman University and an M.B.A from the Wake Forest Babcock School of Business.

FINDING RELATIVE VALUE IN GLOBAL LOANS

Mike Freno and Zak Summerscale are members of the Global Loan Oversight Committee for Babson Capital's Global Loan Fund. The Global Loan Fund seeks to maximize total return through capital gains and current income while preserving principal. The portfolio managers pursue an active strategy by investing in a diversified portfolio of senior secured loans across issuers in the U.S. and European markets.

Babson Capital is one of the largest global loan managers with investment teams located in the U.S. as well as Europe. How do you assess relative value between U.S. and European loans?

Mike: One of our core strengths is that we do have strong loan investment teams in the U.S. as well as in Europe with over 45 investment professionals in the U.S. and 26 in Europe. Our investment process starts with a bottom-up, fundamental approach to each investment opportunity. Our investment ideas are sourced in local markets and analyzed by the respective U.S. or European analyst. Local knowledge is important due to the variety of legal, regulatory and geopolitical environments that we invest in. Our local investment committees will then review and approve or disapprove investment recommendations. We as portfolio managers build upon our best ideas in each market to develop a portfolio based on the best global relative value, in addition to taking macroeconomic factors into account.

Zak: Also, we have a portfolio oversight component that requires Mike and I to constantly review the portfolio with a focus on issuer and industry concentrations in the U.S. and Europe and any changes to our near-term market outlook. It really is an active portfolio management process that enables us to capture the best investment ideas in both locales with a disciplined, consistent approach.

How does the attractiveness of the U.S. and European loan markets compare?

Mike: Loan markets are still regional and the resulting inefficiencies in the markets can create opportunities for investors that have a global presence. For example, from 2000 to 2004, U.S. loans were more attractive as they offered an average of 103 bps in excess spread for similar leverage and default levels. Between 2004 and 2008, the spread differential dropped to 34 bps, but U.S. loans were still more attractive as European loans were more levered. In 2008, the opportunity set changed as the spread differential swung in favor of the European loan market. Currently, there are appealing investment opportunities in the European secondary market whereas in the U.S., the new issue market appears attractive with LIBOR floors and higher spreads. Importantly, our global platform allows us to benefit from local knowledge and selecting from a larger universe of investment opportunities.

For Investment Professionals Only



Can you give an example of a relative-value trading opportunity?

Zak: Sure. There was a recent opportunity to invest in the European loan of a European telecommunications provider that issued both European and U.S. term loans. At issuance, the U.S. loan had a spread of 350 bps compared to 375 bps for the European loan. However, during September 2010, the U.S. loan was priced at 97.5 whilst the European loan traded at 93.75 in the secondary market, which meant that the European loan had an effective spread almost 40% higher than the U.S. loan. Both loans have since moved close to par, so this buying opportunity no longer exists. Remember, we are talking about the same company – same collateral, same credit risk – with its U.S. and European loans trading at different prices due to inefficiencies in the global market. Not many asset classes still present such global relative value trading opportunities.

“...having an experienced team, again with the local knowledge to understand the degree of risk in various jurisdictions, is crucial to effectively pricing the risk and to establishing both security value and remedies to potential covenant breaches or default.”

–Zak

It seems the nuances between the U.S. and European loan markets would present quite a challenge for a U.S.-only domiciled loan manager to invest in Europe. Would you shed some light on the similarities and differences between the two markets?

Mike: While the structure of the deals is generally similar in terms of covenant packages, liens on collateral, etc., the investing environment can be quite different. The U.S. loan market is larger, with a market cap around \$620 billion compared to the European market at approximately €160 billion (\$225 billion)¹. In terms of deals, about half of U.S. deals are LBO related while in Europe, this percentage is much higher. The U.S. market is more liquid overall, with a more developed secondary market.

Zak: The European market is also more fragmented than the U.S. in the sense that the jurisdiction of issuers can be disparate. Looking at it from a geographic perspective, Northern European countries tend to be more creditor friendly with more stringent bankruptcy codes that favor debt holders. On the other hand, Southern and Central Europe are usually not as debt holder friendly. We have seen cases in some countries where companies are sold off at deep discounts just because the buyer guarantees the continued employment of the company's employees or a judge makes a ruling that is adverse to debt holders. At times, the market does not price in the divergence in bankruptcy risk. Within the broader North/South regions, there are further nuances between countries. So, having an experienced team, again with the local knowledge to understand the degree of risk in various jurisdictions, is crucial to effectively pricing the risk and to establishing both security value and remedies to potential covenant breaches or default.

1. Source: Credit Suisse Leveraged Loan Index (U.S.) and Credit Suisse Western European Leveraged Loan Index as of 6/23/11.



How has the loan investor base changed? Do you see CLOs regaining their dominant bid in the market or will there be a “new equilibrium”?

Mike: The CLO market in the U.S. is still in a state of flux as new regulations are still being discussed and the rules of engagement are not yet clear. CLO demand, which was approximately 2/3 of the market in 2002 has declined to about 1/3 of the market in 1Q11 and the run off continues as the 5-7 year reinvestment cycle that accompanied the peak CLO issuance between 2005-2007 leaves a void to attract new capital. However, there has been a sea change in how institutional and retail investors view the loan market. Retail money has been flowing into loan investments along with institutional capital. Some investors worry that this might lead to an “over-heating” of the loan market, but we believe that this capital inflow, while providing new sources of demand, does not even replace the funding gap left by CLOs.

Zak: Active loan buyers in Europe used to be banks and CLOs; institutional investors preferred to buy highly rated paper in structured vehicles rather than invest directly in loans. Like the U.S., direct loan investments in Europe now receive far greater attention from pension funds and consultants alike. High yield loans are viewed as a relatively new asset class in Europe even though they have been around for years. Investors are dedicating more time to understanding the asset class and sizeable allocations continue to be made. The retail market is slightly different here in Europe in that access to the loan market through retail investment vehicles, that can be marketed on a Europe wide basis, such as UCITS, is limited, keeping loans accessible almost exclusively by institutional investors.

“ Like the U.S., direct loan investments in Europe now receive far greater attention from pension funds and consultants alike. ”

–Zak

How do institutional and retail investors access the loan market?

Mike: Institutional access is pretty much the same in both regions. Smaller institutional clients access loans through commingled funds and mutual funds, and our larger clients invest through segregated or separate accounts which are set up exclusively for them utilizing customized investment guidelines. These separate accounts may or may not be levered. Retail investment conduits, as mentioned previously, differ somewhat. In the U.S., retail clients can invest through open-end or closed-end funds while European retail investors are generally only permitted to buy shares in closed-end loan funds. As Zak mentioned previously, the retail market in Europe is slightly different.

Zak: To add to that, our global platform allows our investors to be currency agnostic. Considering bank loans, we generally do not find much “cross-pollination investment” exists in Europe and the U.S. For example, U.S. investors who buy U.S. loans do not tend to invest in European bank loans and vice versa, perhaps due to the lack of options available. Our global platform offers investors the ability to gain loan exposure in different currencies as investors can denominate their investments in U.S. dollars, Euros, Pound Sterling or Australian dollars. Furthermore, in terms of AUM, we are a top five loan manager in both Europe and the U.S.



What are some of the risks of investing in loans and how do you mitigate these risks for investors?

Mike: Much like other fixed income asset classes, loans are exposed to credit risk which may, in extreme cases, result in default. However, the overall recovery rate is much higher for loans than high yield bonds because loans typically have stronger covenants, better collateral security and rank senior to bonds in the capital structure. As a global loan manager, there is really no substitute for fundamental analysis and having a deep, experienced investment team to help us navigate through the universe of issuers to build a portfolio. As such, picking the right manager is of paramount importance for an investor.

Zak: Another risk investors should be mindful of is refinancing risk. Unlike bonds, which are typically governed by call protection, loans are generally callable at par at any time. In an environment of spread compression, there is an increased likelihood that higher spread, vintage loans will be called and refinanced at lower spreads. This helps issuing companies by lowering their cost of capital; however, it hinders investors by exposing them to the risk of reinvesting in lower yielding instruments. A high volume of refinancing can erode a portfolio's yield and hence lower its return. It should be noted that we have undergone a tremendous refinancing wave recently, so this risk may not be as prevalent unless you expect further credit spread compression. We are of the mind-set that spreads will remain generally at current levels. As Mike said, we are a large global loan manager and our broad platform offers investors more options to diversify.

“ ...there is really no substitute for fundamental analysis and having a deep, experienced investment team to help us navigate through the universe of issuers to build a portfolio. ”

–Mike

Some investors seem to have the view that loans are more of a tactical allocation than a core allocation, i.e. due to their floating rate nature, loans are only going to perform well when interest rates are rising. Would you agree with that assessment?

Zak: We believe an allocation to loans should be part of a core holding of any fixed income portfolio. By their very nature, loans have unique characteristics that provide a portfolio with attributes that are difficult to replicate with other asset classes. While the floating rate nature of loans and low correlation to other asset classes allows loans to enhance the risk/return profile of a portfolio during a rising rate environment, it can be more than merely a tactical allocation or interest rate hedge. As the correlation between loans and other fixed income asset classes has been fairly low over the last 20 years, the diversification and de-risking impact of loans makes it a good long term or core portfolio allocation as well.

“...even if the global economy is stuck in a low growth mode, most loans should perform well.”

–Mike

What is your outlook for the global loan market?

Mike: We believe the global loan market remains attractive. There has been a significant pipeline of new issuance at lower leverage multiples and higher spreads than we have seen in the past that offer better returns and higher equity capitalization than older vintage deals. In addition, the loan maturity wall and technical backdrop supports a sustainable opportunity that we would expect to keep spread levels wider than average. Company earnings continue to be strong and even if the global economy is stuck in a low growth mode, most loans should perform well. We expect default rates to remain low over the next six to 12 months.

Zak: This asset class has compelling risk-return dynamics with good cash flow and low volatility and should continue to attract investors, both institutional as well as retail. The average price of loans, especially in Europe, should allow for further upside given the current rate of M&A and refinancing activity whilst the running yield continues to improve through the addition of primary market transactions. In fact, with pricing differentials on primary deals becoming more common, there is an opportunity for good credit pickers to generate excess returns.



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Babson Capital Management LLC

manages \$134.5 billion* for a broad range of global institutional investors. We are also the lead investment advisor to our parent, the Massachusetts Mutual Life Insurance Co. (MassMutual). We are known for our global reach, our disciplined, repeatable investment processes, and an enviable depth and breadth of capabilities in fixed income, equities, alternatives, structured product and commercial real estate. But we are distinguished by our passion, evident in the long-term relationships we have built with our clients based on transparency and trust and a dedication to providing value.

* As of March 31, 2011. Assets include Babson Capital Management LLC and its subsidiaries

Babson Capital Europe Limited

is one of the largest European sub-investment grade credit fund managers, with €6.5 billion* in assets under management. Our core focus is sub-investment grade credit, in particular senior secured loans, mezzanine loans and leveraged buyout related high yield bonds. We believe our strength lies in rigorous credit analysis, staffed by an experienced team of professionals. Our innovative thinking and ability to recognise opportunities is applied across all areas of our organisation. And our team's long experience in the market has allowed us to establish strong relationships with our clients, the major arranging banks and private equity sponsors.

* As of March 31, 2011.

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