



Now is the Time for Senior Bank Loans

Dan Norman, Senior Vice President and Group Head of ING Senior Loan Group

The \$600 billion senior bank loan market presents an attractive investment opportunity for today's investors. Loans are trading near their historical low prices, while the

trailing 12 month default rate is currently at its historical average of 3%, well below its all time high of just over 8%. Newly issued senior bank loans are benefiting from better structures, stronger financial covenants and wider spreads, while existing loans are trading at discounts that provide attractive return potential. The fundamental story of senior bank loans remains valid. Senior bank loans are floating rate instruments that can provide a natural hedge against rising interest rates, and they are secured by the assets of the borrower, which has historically provided much better recovery rates in distressed and default situations.

In a one-on-one interview, Dan Norman, Senior Vice President and Group Head of the ING Investment Management Senior Loan Group, details the current state of the bank loan market, and why investors should add senior loans to their portfolios.

What are the attributes of the senior bank loan market?

Senior bank loans are loans made to non-investment grade companies. They are "senior secured," which means that they are senior to all other debt and they are secured by the assets of the company. They are also floating rate, not fixed rate. Consequently, senior bank loans have ultra-short interest rate duration, making them a natural hedge against fluctuations in short-term interest rates.

What are corporate borrowers using as collateral?

Looking at the capital structure of a corporate borrower, the most common question we get from institutional investors is: "What are the assets? What protection is there really?" Typically, the answer is that lenders receive a pledge of all the assets of the borrower, everything from cash and accounts receivable, inventory, plant and equipment, all the way to trademarks. These assets are pledged on a senior basis to the lenders. Other corporate debt such as bonds, convertible shares, preferred stock, and so on, are always subordinate to senior loans.

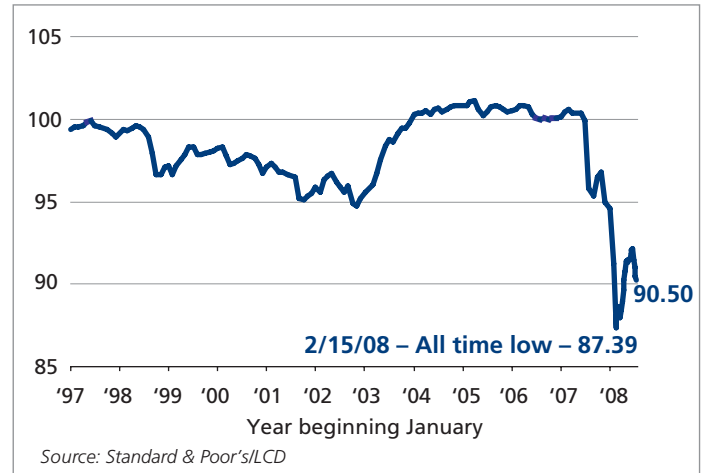
Because they are the first lien holders, secured lenders typically have a primary role in formulating the reorganization of a bankrupt borrower, and the senior lenders get paid first. This has a very positive impact on the recovery rates of senior bank loans compared to unsecured credit instruments. Historically, when a senior bank loan goes into default, there is about a 70% recovery rate. This is much better than the rate for unsecured bonds, for example, which have historically recovered only around 40%.

Why is now a good time to invest?

The dramatic changes in the senior bank loan market over the past year have brought us to a point where now is an extraordinary, and perhaps unprecedented, opportunity to invest in senior bank loans.

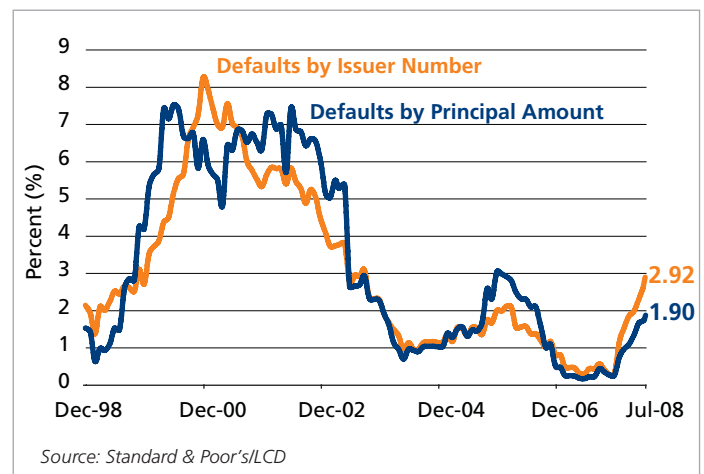
Number one, there is a significant opportunity for investors to benefit from the current low prices. Absent a default, senior bank loans pay off at par, so there is the potential to recapture today's price discounts over time as capital gains.

Average bid of senior bank loans* through August 1, 2008



Speaking of defaults, the trailing 12 month default rate in the Index on July 31 is right at its historical average and, more importantly, the current spate of defaults has been concentrated in smaller companies and weaker sectors that we avoid in our portfolios. While we see defaults continuing to occur over the rest of the year, and likely into 2009, we are confident that we are using the right strategy to minimize defaults in our portfolios.

Lagging 12 month default rate** through July 31, 2008



Number two, we are in a very low interest rate environment, a time when most investors expect interest rates to go up, and every pension plan manager wants to know "what's going to happen to interest rates?" I think it's just a matter of time before short-term rates rise. But unlike fixed-rate investments such as bonds, rising

interest rates can be good for senior bank loans. Because they are floating rate assets, the yields on the senior bank loans go up as market interest rates rise, while, absent any credit stress, their values remain essentially unaffected.

Number three, I think that nominal credit spreads are going to widen. An increase in credit spreads, coupled with an increase in market interest rates such as LIBOR, has the potential to significantly improve the returns on senior bank loans. And the good news is that bankers appear to have learned a very important lesson from the credit dislocation. Today's loan structures are significantly better than those of the past several years. So along with higher returns, we are getting better protection for our investments.

The ING Senior Loan approach

At ING, we are a pure bank loan investment manager. Over 98% of our portfolios will be invested in senior secured first lien bank loans. We only have about 1.5% in other categories, comprised of about 1% second lien loans and about 0.5% investment grade loans.

We focus on purchasing the best quality senior bank loans available, and we concentrate our investments in the largest and most liquid loans. As a result, our credit spreads are typically lower on average than the Index, by about 30 - 40 basis points, but we aim to out-perform the Index over a full credit cycle by avoiding defaults. That's exactly what we have done, even through the most recent bull market credit cycle.

In addition, our portfolios are highly diversified, with an average exposure to individual borrowers of less than 0.30%, and an average industry or sector exposure of around 2.70%. Using this strategy, we have been very successful in avoiding defaults in our portfolios. Our senior loan composite portfolios had no defaults at all in 2007 and only one default through the first half of 2008. Over that same period, I think there have been more than 20 defaults in the Index. Our one default was also very small in relationship to our portfolios. It constituted only 0.06% of the total assets of our composite.

Our primary competitive advantage is the size and experience of our team. We have one of the industry's largest teams dedicated to senior bank loans, with 15 team members with over 15 years of experience and seven team members with between 10 to 15 years of experience. Also, we manage loans strictly from the private

side of the market, meaning we have access to material non-public information about our borrowers. This gives us a decided edge over managers who attempt to manage senior bank loans from the public side as though they were high-yield bonds or equities.

Our 28 investment professionals are split into four investment teams in our Scottsdale, Arizona office, with each investment team primarily responsible for certain industries and sectors, and a European team located in London, England, which is responsible for sourcing European bank loans. In addition, the investment teams are supported by highly qualified trading, operations, analytics and legal personnel dedicated exclusively to this asset class.

Jeff Bakalar and I have been managing this team since 2000, and we are proud of the fact that we have had virtually no turnover in our portfolio management staff during that time. We manage a team that works very well together. We also manage through an investment committee, rather than an individual "star" manager, approach. We think this committee approach helps us avoid style drift and gives us the advantage of several experienced lenders when making investment decisions.

Finally, we believe that rigorous, ongoing monitoring of our investments is just as important as the initial investment decision. We track our loans everyday. Moreover, we are willing to take prompt, decisive action when necessary, including selling loans that we believe present an excessive risk.

Why has your outperformance been driven by avoiding defaults?

Defaults can really lower your returns. Remember, when a borrower defaults on a loan, the average recovery rate is around 70%. You also lose your interest on that amount until you get repaid. It takes a lot of earnings on other loans to make up that loss. So avoiding defaults is a key component of exceptional performance.

If you just look at index-level data and track this over a 10- or a 15- year period, our view is that a conservative style based on the avoidance of a 30% principal loss outperforms, which is fundamentally why we created our strategy back in 2000. We are proud to say that we have consistently had fewer defaults than the Index, often by a wide margin.

Do you have any concluding thoughts?

I have been involved with managing senior bank loans since 1995. I think today's environment, with the ability to buy high quality senior bank loans at a significant discount, coupled with an expectation of rising yields and more lender favorable loan structures, presents an exciting opportunity for institutional investors. Now is definitely a good time for them to learn about the benefits of senior bank loans and consider making an allocation.

* Excludes all loans trading at 70 cents on the dollar or less and facilities in default. Latest data available is August 1, 2008.

** Comprises all loans, including those not tracked in the LSTA/LPC mark-to-market service. Vast majority are institutional tranches. Issuer default rate is calculated as the number of defaults over the last twelve months divided by the number of issuers in the Index at the beginning of the period. Principal default rate is calculated as the amount defaulted over the last twelve months divided by the amount outstanding at the beginning of the period. Latest data available is July 31, 2008.