Bank loans are justifiably earning the attention of individual as well as traditional institutional investors. Their appeal lies in the fact that while generally made to below-investment grade borrowers, bank loans are secured debt instruments, senior to corporate high yield bonds in the capital structure and pay a floating rate cash coupon. As a result, bank loans have the potential to provide diversification, downside mitigation and lower volatility relative to unsecured debt. Additionally, their floating rate coupon means they can benefit in a rising rate environment and can help to mitigate inflation risk. In this article, we take a closer look at the characteristics of bank loans and why we believe they represent an attractive risk/reward proposition.

Market Overview

Bank loans (also known as leveraged loans) are loans made to businesses with generally below investment grade credit ratings. They are typically senior instruments, secured by the debtor’s assets, and rank first in priority of payment in the capital structure, ahead of unsecured debt (Exhibit 1). As a result of their senior secured status, bank loans have historically had lower default rates, higher recovery rates and lower volatility relative to corporate high yield bonds.

EXHIBIT 1: SAMPLE CAPITAL STRUCTURE

<table>
<thead>
<tr>
<th>Percentage of Capitalization</th>
<th>Senior Secured Loan</th>
<th>High-Yield Bonds and/or Subordinated Mezzanine Debt</th>
<th>Preferred Equity</th>
<th>Common Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>First Loss</td>
<td>30-50%</td>
<td>20-30%</td>
<td>20-40%</td>
<td>30-50%</td>
</tr>
</tbody>
</table>

Source: Credit Suisse.

1 The chart is hypothetical and shown for illustrative purposes only.
Bank loans typically pay a cash coupon that resets in accordance with changes in short-term interest rates, primarily LIBOR. This floating rate coupon mitigates the risk of rising interest rates. A standard bank loan coupon is LIBOR (“L”) plus a spread expressed in basis points, for example: L+325 or LIBOR plus 3.25%. Given the current historically low levels of LIBOR, new issuances of bank loans have a LIBOR floor that often ranges from 100–200 basis points.

Exhibit 2 compares and contrasts the attributes of bank loans relative to other asset classes. As noted, bank loans generally offer security and a comprehensive covenant package. These covenant packages generally include incurrence covenants and financial maintenance covenants. With incurrence covenants, specified criteria must be met in order for the borrower to engage in certain conduct such as incurring additional debt. With financial maintenance covenants certain financial ratios must be complied with on a regular basis. Loans lacking financial maintenance covenants are referred to as “cov lite” loans. While financial covenants are important, they should not be considered determinative of the quality of any loan’s overall terms, other covenants and collateral package. In saying this we are not discounting the benefits of financial maintenance covenants, but acknowledging that such covenants are but one factor out of many in evaluating the attractiveness of an investment.

The top right chart shows market statistics from the Credit Suisse Leveraged Loan Index as of September 30, 2011. The current pricing of the bank loan market presents favorable risk/reward characteristics as part of a diversified portfolio when considered together with the interest-rate risk mitigation and downside mitigation properties of the market. Please note that bank loans typically possess limited call protection, if any. Accordingly, it is unusual for a loan to trade substantially above par.

Exhibit 3: A Return to Normalized LIBOR Levels Would Boost Bank Loans

As the chart below indicates, LIBOR is currently at extremely low levels. Over the last 26 years LIBOR has averaged 4.62% with a high of 10.31% (2/28/1989) and a low of 0.24% (6/30/2011). Accordingly, the return potential of the bank loan market could be augmented by a return of LIBOR to more normalized levels (Exhibit 3).
The bank loan trading market is a large liquid market comparable in size to the high yield bond market. Prior to the recent financial crisis, highly levered investors such as collateralized loan obligations (CLOs) and hedge funds were prominent market participants. These over-leveraged vehicles were generally obliged to de-lever during the financial crisis. This de-levering was often accomplished through the hurried disposition of portfolios thereby creating poor market technicals and significantly contributing to the uncharacteristic market volatility and dramatic mark-to-market price fluctuations experienced during the financial crisis. Today, the bank loan market has considerably less explicit leverage and strong technicals, driven by the increasing presence of traditional unlevered institutional investors and the diminished prominence of highly leveraged investors.

Investor Appeal

In an environment where inflation could be on the horizon, it is not surprising that many investors are turning to bank loans to mitigate the risk of rising interest rates. During the month of August the average loan price dropped approximately 4 points from approximately $95 to approximately $91. This material discount offers the potential for enhanced returns through prepayments at par as loans typically pay down ahead of scheduled payments. In addition, as previously noted, bank loans offer other attractive attributes such as enhanced portfolio diversification, collateral that provides downside mitigation relative to unsecured debt, seniority within the capital structure, lower volatility relative to high yield bonds, strong fundamentals and an attractive risk/reward proposition (Exhibit 4).

### How J.P. Morgan Asset Management Invests in Bank Loans

We have an experienced team that has been managing leveraged loans in dedicated accounts and in our broad high yield strategies since 2000. As of September 30, 2011, we manage approximately $1.24 billion in dedicated leveraged loans and $3.87 billion in leveraged loans including our broad high yield strategies.

At J.P. Morgan Asset Management, we utilize fundamental research to build a diversified portfolio of leveraged loans through both the primary and secondary bank loan market. Our investment strategy is to take specific, targeted credit risk when our analysis indicates a favorable risk/reward opportunity, while building a core of improving credits. Our assessment of risk/reward is derived from our analysis of the underlying fundamentals and circumstances of each issuer as well as the specific properties of each loan, including covenants, collateral and placement in the capital structure.

Portfolios are constructed utilizing the fundamental research conducted by 11 industry-aligned credit analysts that focus solely on the leveraged credit market, and bottom-up security selection that focuses on issuers with strong fundamentals that present an attractive risk/reward proposition. When making investment decisions, the portfolio managers will use the philosophy and fundamental analysis that the team has developed managing leveraged credit strategies for more than 23 years.
The manager seeks to achieve the stated objectives. There can be no guarantees those objectives will be met. Past performance is not indicative of comparable future results.

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Credit Risk is the risk that issuers and counterparties will not make payments on securities and investment held by the portfolio. Such default could result in losses to an investment in the portfolio. In addition, the credit quality of securities held by a portfolio may be lowered if an issuer’s financial condition changes. Lower credit quality may lead to greater volatility in the price of a security. Lower credit quality also may affect liquidity and make it difficult for the portfolio to sell the security. The portfolio may invest in securities that are rated in the lowest investment grade category. Such securities are considered to have speculative characteristics similar to high yield securities, and issuers of such securities are more vulnerable to changes in economic conditions than issuers of higher grade securities.

High Yield Securities Risk: One of the Fund’s main investment strategies is to invest in high yield, high risk securities (also known as junk bonds) which are considered to be speculative. These investments may be issued by companies which are highly leveraged, less creditworthy or financially distressed. Although these investments generally provide a higher yield than higher-rated debt securities, the high degree of risk involved in these investments can result in substantial or total losses. These securities are subject to greater risk of loss, greater sensitivity to interest rate and economic changes, valuation difficulties, and a potential lack of a secondary or public market for securities. The market price of these securities can change suddenly and unexpectedly. As a result, the Fund is intended for investors who are able and willing to assume a high degree of risk.

Leverage: Certain of the Fund’s investments may be leveraged, which may adversely affect income earned by the Fund or may result in a loss of principal. The use of leverage creates an opportunity for increased net income, but at the same time involves a high degree of financial risk and may increase the exposure of the Fund or its investments to factors such as rising interest rates, downturns in the economy or deterioration in the condition of the investment collateral. The Fund may be unable to secure attractive financing as market fluctuations may significantly decrease the availability and increase the cost of leverage. Principal and interest payments on any leverage will be payable regardless of whether the Fund has sufficient cash available. Senior lenders would be entitled to a preferred cash flow prior to the Fund's entitlement to payment on its investment.

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