AIG Investments®

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LEVERAGED LOANS

HIGHER-RETURN OPPORTUNITIES—EVEN IN TURBULENT MARKETS

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Think of leveraged loans as the "misunderstood" asset class.

Although often thought of as a type of fixed income vehicle because they tend to be grouped together with yield-generating investments, they actually belong in a completely different category.

By definition, leveraged loans are not fixed income investments; the income portion "floats" based on LIBOR.

But even more importantly, these investments do not carry as much credit-rate and interest-rate risk as fixed income. Historically, leveraged loans have been a relatively stable class, as the price typically doesn't fluctuate significantly.

While the subprime crisis did have a negative ripple effect on leveraged loans through collateralized loan obligations (CLOs), the impact is believed to be temporary. Leveraged loan portfolios do not usually invest in mortgages—subprime or otherwise.

Leveraged Loans and CLOs

Historically, holders of CLOs were major investors in the leveraged loan asset class, representing up to 60% of the demand in the market. Many CLO holders were also invested in other asset-backed vehicles (SIV) that were directly exposed to mortgages.

With the onset of the mortgage crisis, these CLO/SIV investors suffered significant losses, and so they put a hold on current investment activities while they determined their next moves.

As the capital typically available for CLOs dried up, the demand for the leveraged loan asset class declined as well. This meant a technical reversal—or a reversal of the supply/demand balance that had existed—for a market where supply had been increasing exponentially in recent years.

As supply was now too large for a market with limited demand, the banks and financial firms issuing leveraged loans were forced to make concessions to get already-negotiated deals completed. So new loans entering the market were priced with wider spreads and increased yields over previous ones.

To make these aging leveraged loans as appealing as the newer transactions, issuers decreased the market price of the still-outstanding loans significantly.

Today, as spreads in the market have widened, yields on leveraged loans have continued to increase. In addition, the selling price of many of the loans has decreased significantly.

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While a weaker economy could lead to an increase in defaults of leveraged loans, these defaults are already priced into the market. As a result, leveraged loans represent a highly advantageous investment in the current environment.

Recent Leveraged Loan Market History

Balancing Market Supply and Demand

The leveraged loan market has been growing at a healthy pace for more than 10 years, increasing in size by more than 40 times since 1996 and nearly fivefold in the last five years alone. The rate of new issues contributed to the growth of the market, which grew from US $220 billion in 1997 to US $535 billion in 2007.[1]

Not surprisingly, for the past decade, while supply in the leveraged loan market grew steadily, so too did the demand.

In 1993, there were only 14 manager groups supplying the leveraged loan market. But by 2007 that number had jumped to 307.[2]

Leveraged loan investment vehicles also created corresponding demand, with just 67 vehicles in 1997. Ten years later in 2007 that number had ballooned to 807.[3]

With such extraordinary growth in the market, issuers were arranging deals at will, and those deals were being purchased

1, 2 Standard & Poor's Leveraged Commentary & Data (LCD)
3 Standard & Poor's LCD. Includes investor groups that either participated in three or more loans or made $10 million of commitments

by investors as quickly as they could be introduced. It was inevitable then that if demand dried up, many issuers would be left hanging.

In fact, 2007 ended with a massive pipeline of hung leveraged loan deals that had been underwritten by financial institutions and banks, but never distributed. Among those deals were those of casino giant Harrah's and major U.S. automaker Chrysler.

Clearing Hung Deals

Because of aggressive discounting, as well as the cancellation of some deals, many of these hung deals have now been completed. In fact, from the fall of 2007 to April of 2008 the approximate dollar value of hung deals in the market decreased by more than 60%, from US $250 billion to US $90 billion.[4]

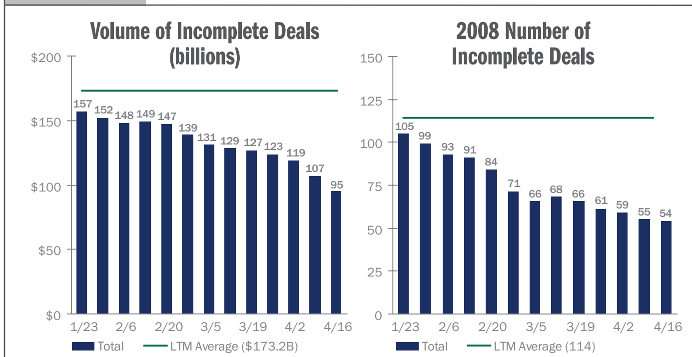
Moving Ahead With the Forward Pipeline

This positive market dynamic also affected the forward pipeline—deals that were announced, but never launched. Issuers became hesitant to announce deals because of the weakness of the market.

Now, a majority of these deals are finally being launched, making way for a renewed wave of new issuance.

At the end of January 2008, 105 deals valued at approximately US $157 billion were still up in the air, as seen in **Figure 1.** But just four months later, after discounting and higher yields, these numbers were reduced to 54 deals valued at approximately US $95 billion.[5]

FIGURE 1 **The Leveraged Loan Market is Normalizing**



Source: Standard & Poor's LCD, S&P LSTA Index

Default Rates

Of course, default rates must also be considered. These are rising from their historically low pre-subprime-crisis levels.

In fact, S&P's issuer-based default rate has reached a 20-month high of 2.58 as of June 30, 2008; considerably up from just 0.26% in December 2007.

Attractive Opportunities Created

Defaults Already Priced In

As noted earlier, while increasing default rates cannot really be considered an opportunity, it is important to note that default rates are already priced into the market. In fact, the market is currently pricing in a higher default rate than what we anticipated.

According to S&P, implied default rates are currently between 20% and 22%. By comparison, default rates from 2000 to 2003—the last slowdown and recovery period—were around 6%. With such a high, and unlikely-to-be-met, default rate priced in, valuations in the market have become extremely attractive.

By the end of the year, defaults could rise to 4% or 5%, which would be above the historical average of 3%. However, this would still be below the historical high of more than 7.5%.

In addition, due to the high yields currently available in the market, a portfolio of loans could conceivably withstand 20% defaults and still have positive returns, as long as the average recovery stays at its current average of 70%.[6]

Wider Spreads and Discounted Prices

Many leveraged loans are now selling below par. This situation differs from other instances of investments selling at a discount, because the current decrease in loan prices doesn't mean that the loans aren't a good credit risk. Instead, this reflects the technical imbalance in the market.

For example, a loan that can be fully expected to repay at par may have to lower its price to 88% of par in order to compete with the current yields of new issues to market.

While recent leveraged loan market activity has temporarily increased volatility and decreased value, it has also created tremendous buying opportunities. As a result, the asset class is now seeing some of the highest spreads in its history.

The spreads on leveraged loans are the yield above LIBOR, and this is what determines their coupon.

In June 2003, spreads on B+/B new issues were approximately 320 basis points above LIBOR, or L+320. When factoring in the small price discount of 7.5 basis points available at the time, the all-in new-issue spreads—spreads including price discount—were 327.50 basis points over LIBOR.

By June 2008, spreads alone had reached L+352. In addition, the average price discount had jumped to a staggering 176 basis points, which brought all-in new issue spreads to more than L+528.

The average three-month LIBOR rate in June 2003 was 1.12%, so an average loan would have offered a yield of 4.39%. With

4, 5 AIG Estimates
6 Credit Suisse

an average three-month LIBOR rate of 2.77% in June 2008, that loan would now pay a yield of 8.05%.[7]

In the secondary market, where AIG Investments does the majority of its investing, the widening of spreads has been similar, and even higher yields are available.

For example, in June 2003, spreads on B and BB loans in the secondary market, including price discount, were approximately L+369. But by June 2008, these spreads had jumped to L+585.

Again, with an average three-month LIBOR of 2.77% in June 2008, this spread level would equate to a yield of 8.62%.

Clearly, whether talking about the primary or secondary market, wider spreads and discounted purchase prices are offering investors extremely attractive yields in leveraged loans.

Repayments Add Value

Because of current market price discounts, repayment rates also have the potential to create return upside in the market. An increased repayment rate also increases the annual return for a leveraged loan investment.

This is especially true when dealing with a loan selling at a discount, as a higher repayment rate would lead an investor to collect his or her price appreciation (par price minus the discount purchase price) sooner.

This benefits the investor because of the time value of money; a dollar today is worth more than a dollar five years from now.

Stronger Market Makeup

It is important to note that there is a major difference between the market during the last downturn and the current market.

The current market is made up of different sectors than the market in 2001. In 2001, telecom was the largest sector in the market—by more than double the percentage of the next closest sector.

As many investors remember, Telecom was the riskiest sector during the last downturn and also had the lowest recovery rates of all the sectors.

Currently, the riskiest sectors are considered Homebuilding and Financials. However, unlike 2001, in 2007 Homebuilding and Financials did not make up large percentages of the leveraged loan market. In fact, Homebuilding accounted for less than 5% and Financials less than 2%.[8]

If these sectors are indeed the riskiest and likely to have the lowest recovery rates, it bodes well that the market is well diversified. As a result, the leveraged loan market may not be at as much of a risk as it was during the last economic downturn.

Normalizing Conditions Mean Potential

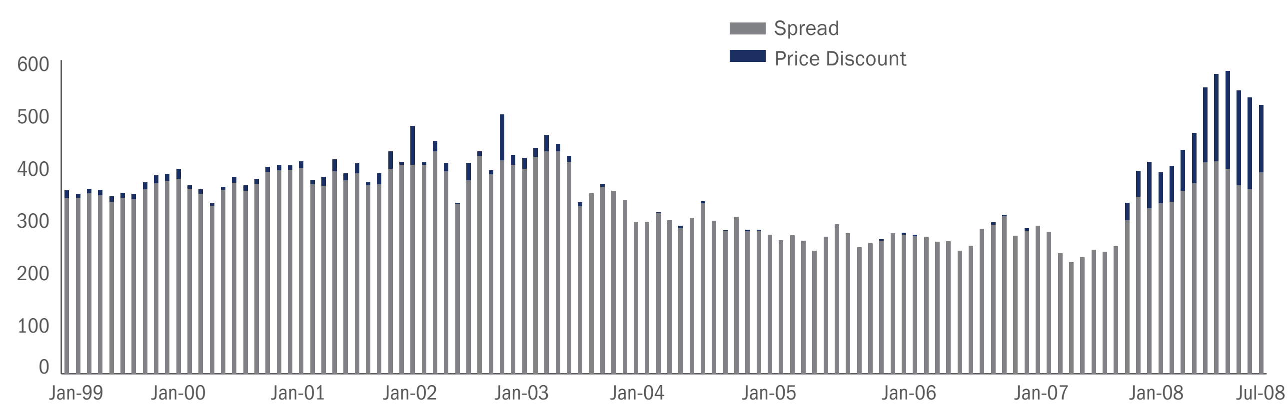
What does all of this mean for leveraged loan investors? The supply demand imbalance has meant that yields had to increase, and sale prices had to decrease, in order to get deals done. And this combination created great buying opportunities in the market.

Essentially, leveraged loan investors are currently being handsomely rewarded for the same risk level that was only fairly compensated last year. And although defaults are rising, they are already priced in, so even if the default rate rises, investors should wind up with a handsome return—higher than this asset class' typical return.

The Bottom Line

Once the market stabilizes further, leveraged loan yields will also normalize, and the opportunity will have passed. We believe that now is an advantageous time to earn much higher returns from leveraged loans than they typically generate.

FIGURE 2 **Spreads are Widening While Discounts Increase**



Source: Standard & Poor's LCD. Average all-in new-issue first-lien spread of B+/B institutional loans assumes upfront fee is amortized evenly over a three-year assumed life; upfront fee includes original issue discount as of 10/5/06. LCD began using corporate credit ratings by S&P and corporate family ratings by Moody's for rated spread and rated upfront fee calculations.

7 Spreads: Standard & Poor's LCD. LIBOR - British Banker's Association
8 Lehman Brothers

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