LOOMIS | SAYLES

INFO SHEET

DECEMBER 31 2018

Loomis on Loans

A quarterly look at data and topics in the syndicated loan market

PERFORMANCE HIGHLIGHTS

As market sentiment turned towards risk-off this quarter, bank loan prices declined and overpowered coupon returns. BB-rated loans underperformed B-rated loans due to unusual selling pressures on higher quality loans.

	Q4 2018	1-YEAR
S&P/LSTA "All" Leveraged Loan Index	-3.45%	0.44%
S&P BB Index	-3.50%	-0.42%
S&P B Index	-3.29%	0.86%

Source: S&P Capital IQ, as of 12/31/18.

MARKET STATISTICS

Prices dropped and spreads widened as investors redeemed from the bank loan market during the quarter.

	PRICE	12-MONTH CHANGE	SPREAD
S&P/LSTA "All" Leveraged Loan Index	93.84	-4.3%	L+334
S&P BB Index	95.29	-4.7%	L+259
S&P B Index	94.62	-4.3%	L+369

Source: S&P Capital IQ, as of 12/31/18.

Concentrating on Covenants: Labels Are Not Enough

The investment world is complicated, and sometimes we try to simplify those complications by summarizing investment categories with snappy labels. Those labels may implicitly assign misleading character to those investment classes, but the labels often stick because it is human nature to simplify. However, we think investors may be making a mistake when they make decisions about investment classes based on labels alone.

A prime example of the power of labels is "junk bonds." For a category that has returned 6.6% a year since 1997, with volatility of 8.7%, the unfavorable implication seems unfair. "Equities," by contrast, sound very fair, and yet history shows them to be far riskier than "junk bonds". (See graph below for a sense of relative volatility.)

Trailing 12-month Returns

	LOANS	HIGH YIELD	EQUITIES
Total Annualized Return	4.78%	6.57%	7.70%
Total Annualized Volatility	5.70%	8.72%	14.96%
Return/Risk	83.92%	75.27%	51.49%

Source: Bloomberg and S&P Capital IQ from 1/1/1997 – 12/31/2018. Indexes include the S&P/LSTA Leveraged Loan Index, the ICE BofAML US High Yield Index and the S&P 500 Index.

John Bell, VP
Portfolio Manager

Michael Klawitter, VP, CFA
Portfolio Manager

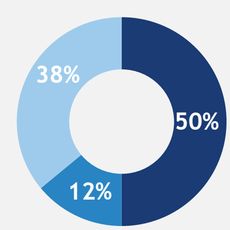
Heather Young, VP, CFA
Strategist

Christos Maniatis, VP
Senior Portfolio & CLO Analyst

Cheryl Stober, VP
Product Manager
cstober@loomissayles.com

TECHNICAL TOPICS

Investor Share of Institutional Leveraged Loan Outstanding (as of December 31, 2018)**



- Size of the BL market is $1.1T
- Grew by 20.1% in 2018
- Support from $129B of CLO issuance despite $3.1B of fund outflows

**Universe of 1,269 US CLOs.*
***S&P/LSTA Leveraged Loan Index outstanding as of 12/31/2018.*
Source: S&P Capital IQ LCD and Thomson Reuters LPC as of 12/31/2018.
Source of Graph: Thomson Reuters LPC.

FOCUS ON FUNDAMENTALS

We have a positive outlook on corporate fundamentals. Loans in our portfolios average historically robust interest coverage, and leverage has been largely stable in 2018.

ISSUER STATISTICS	VALUE
Average Total Leverage	5.1X
Average Interest Coverage	4.3X
Average Enterprise Value	$5.1B

Source: Loomis Sayles as of 12/31/18.

CONCENTRATING ON COVENANTS CONTINUED

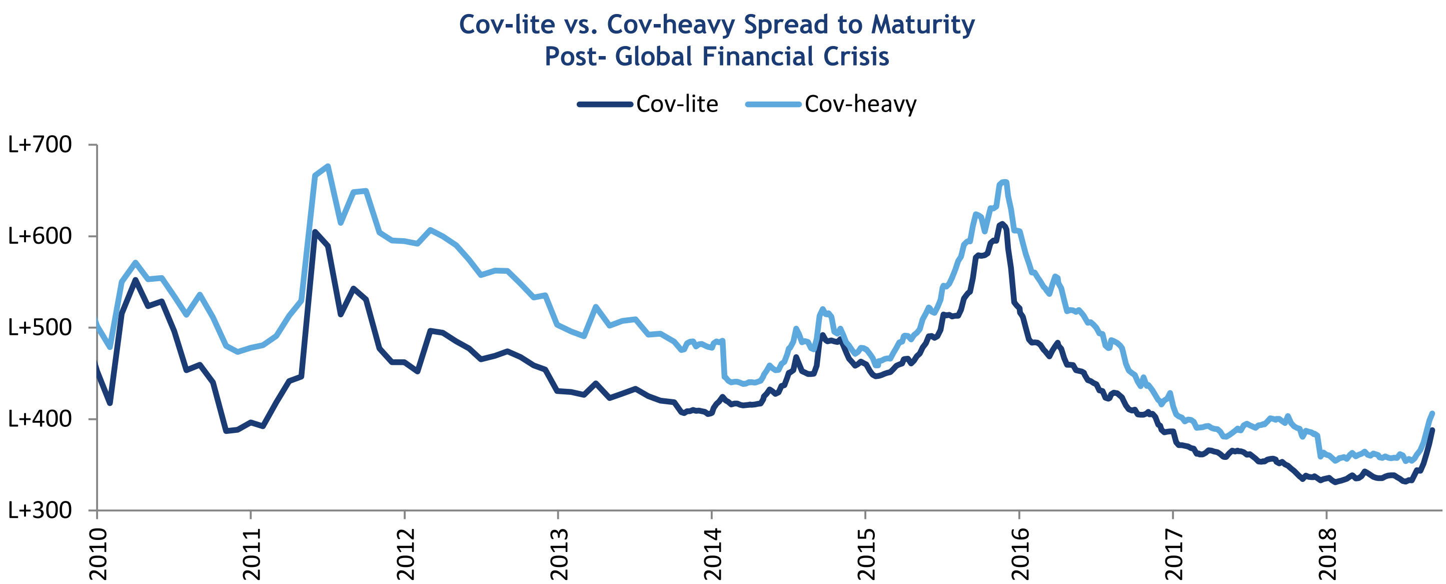
LABELS ARE NOT ENOUGH

This leads us to "cov-lite" loans, a topic we know very well. The implication of the label "cov-lite" is that lenders lack the discipline to grant good loans, and that will lead to some inevitable bad outcome for the asset class. In both our experience and judgment, neither implication is correct.

"Cov-lite" technically means that a loan lacks a maintenance financial covenant (e.g., leverage cannot exceed 4 times), although some writers seem to conflate the term with overall covenant quality. Before the 2008 recession, cov-lite loans were predicted by some to lead to worse recoveries in the event of default. Subsequent studies showed that did not occur. That is because there is simply no reason for cov-lite to drive lower recoveries. Recoveries reflect the market environment at the time of default and the fundamentals of the credit during default, neither of which correlates at all with the historical presence of a covenant. Nor is there any reason to think bankers will throw companies into bankruptcy faster if there is a covenant and thereby improve their recovery. Regardless of whether a loan is cov-lite or cov-heavy, bankers and markets will take each case on its own and try to figure out the best way to maximize value over time. Cov-lite gives borrowers a greater chance to avoid the costs and reputational damage of bankruptcy and thereby preserve equity value below the loans. That would be a win-win for lenders, if successful. We'd be happy to have a financial covenant in order to get a fee for waiving a violation, but that is likely to be of limited value on a portfolio basis if credit is granted judiciously.

Beyond cov-lite as a label, there are of course better and worse covenant packages over every credit cycle, and there are covenants Loomis cares a lot about. It is part of our job to discriminate against credits with covenants that we do think could increase default potential and lower recovery potential. A maintenance financial covenant, however, is not on that list (with cov-lite at 80% of the market, we are not alone in reaching that conclusion)^. We focus on cash flows and firm value and recovery probability among many other factors in granting credit. In fact, the market has spoken on the importance of cov-lite in more ways than just market acceptance. Cov-heavy loans consistently carry a higher spread than cov-lite loans, suggesting greater risk of default despite the existence of a maintenance covenant.

The next time you read "cov-lite" as if it is a meaningful criticism of the syndicated loan market's health and rationality, we hope you will look beyond the label.



Source: S&P Capital IQ from 3/31/10 to 12/31/18.

^ *S&P Capital IQ as of 12/31/18*

LIBOR is going away by 2021. Questions? Concerns? Set up a call with us to hear more.

Past market performance is no guarantee of future results. MALR022895-0919

DISCLOSURE

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