

Loomis on Loans

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

DEFAULT RATES AND LOSSES: THE BIG PICTURE CAN MISS A LOT

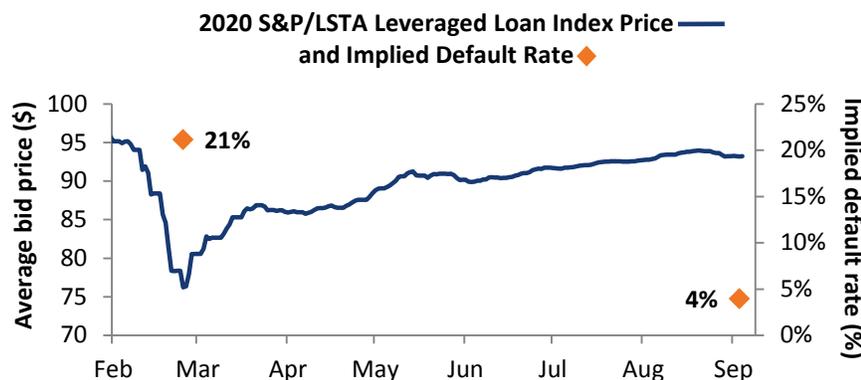
Strategy pieces making broad predictions of potential loan index defaults abound, especially in times of market tumult. However, those predictions can lack the perspective that only a manager close to their credits will have. At Loomis, we choose loans with the credit story at the forefront of our investment process. That informs our default loss modeling insights in ways that big-picture estimates do not.

We tackle default rate and potential loss modeling for our portfolios in three specific ways.

- Ratings-Based Model:** Assigns a default rate and recovery price, based on both historical observations of default and recovery patterns in recessions and downturns and on treatment by ratings agencies, to each credit by rating notch (e.g., B+, B, B-) in our portfolios.
- Portfolio-Based Model:** Takes average historical default assumptions and ticks them up or down based on the quality of our portfolio as determined by current market price rather than ratings. The result is a portfolio default model that assumes the lower-priced credits are at higher risk of default and the higher-priced credits are at lower risk, and calculates potential default loss in relationship to those market signals.
- At-Risk Credits Model:** Assigns a probability of default and estimated recovery price to each credit in our portfolios that is trading below 90 cents on the dollar and that we believe has some chance of defaulting. We then aggregate the default losses across all of those names to reach a potential default loss for our portfolio.

LOAN MARKET QUICK TAKE

S&P/LSTA Index	Q3 2020	YTD 2020	Price	3-Mo. Price Change	Nominal Spread
“All” Leveraged Loan Index	4.14%	-0.66%	93.18	3.68%	L+352
BB Index	2.68%	-1.94%	97.01	2.17%	L+260
B Index	4.33%	0.03%	95.73	3.55%	L+380



Implied Defaults Rate Decrease
 Since the end of March, the S&P/LSTA Leveraged Loan Index returned 14.2%, and its average bid price rose by 12.5%. With prices in a more normal historical range, the index’s implied default rate dropped from 21% to 4% between the end of March and the end of September.*

Source: LCD, an offering of S&P Global Market Intelligence; S&P/LSTA Leveraged Loan Index, as of 9/30/20.

* Implied default rates represent the return rate needed to equate the 3-year discounted spread at a given point in time to the long-term historical average default loss adjusted spread (adjusted for actual default losses over the next twelve months at a recovery rate of 70 cents on the dollar or an average of trailing twelve month default loss where actual next twelve month default losses are not yet known).



A deeper look at our default rate and potential loss modeling:

1. Ratings-Based Default Model

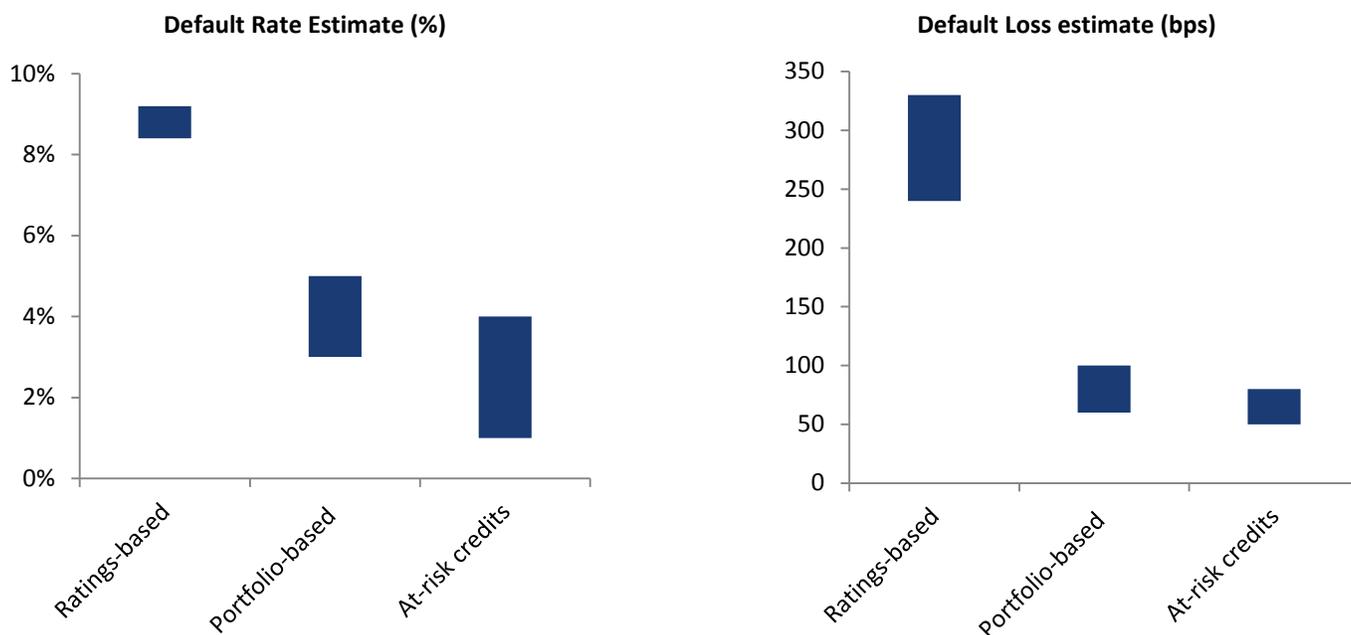
This model considers historical recessions and downturns to see what default and recovery patterns (% default rate and recovery prices) were in observed periods. From there, we analyze how ratings agencies treated downgrades and the subsequent default statistics. The ratings-based default model assigns a default rate and recovery price by rating notch (for example, B+, B, or B-) according to these historical observations. These assumptions are then applied, rating notch by notch, to the specific credits we have chosen within each notch in our portfolio. This is the least specific of our three targeted approaches and yields the most conservative (i.e., highest) default loss outcomes when markets reprice loans higher while ratings remain largely unchanged.

2. Portfolio-Based Model

This model takes average historical default assumptions and ticks them up or down based on the quality of our portfolio as determined by current market price rather than ratings. These default statistics are first applied to our portfolio constituents that are trading below what history indicates should be a solid recovery assumption, because we believe that the market is identifying the highest default-probability candidates for us. The remainder of our aggregate default assumption is spread across the rest of our portfolio. The result is a portfolio default model that assumes the lower-priced credits are at higher risk and the higher-priced credits are at lower risk, and calculates potential default loss in relationship to those market signals.

3. At-Risk Credits Model

The final and most credit-specific default model begins with a list of all loans currently trading below 90 cents on the dollar, the assumption being that the market is unlikely to grant default-prone loans such high prices. From there, the credits that we view as having no likely chance of default within one year are removed. The remaining names are then assigned odds of default and a ballpark recovery price (based on our credit work and any lender discussions and company news). We then aggregate the default losses across all of those names to reach a potential default loss for our portfolio.



Default rate and loss figures represent a range of outcomes that we believe realistic based on historical rating and price trends and our proprietary credit analysis, applied to our flexible portfolio strategy. We do NOT suggest that the midpoint of each range is the most likely outcome.

Past market performance is no guarantee of future results.



How do the results compare?

Method 1, the Ratings-Based Model, is the most generic and relies on historical results. Method 2, the Portfolio-Based Model, first accounts for what the market is telling us about each credit now, and then fills in general historical default assumptions afterward. Method 3, the At-Risk Credits Model, puts the credit work and current environment first, before considering today’s observed price (unless it is above 90). This method is meant to capitalize on what Loomis already knows, in real-time, about each credit we hold.

In a recent application of these three methods to an actively managed loan portfolio benchmarked against the S&P Leveraged Loan Index, our Portfolio-Based Model calculated a default rate range with a midpoint that was 54% percent lower than that of the Ratings-Based Model and a default loss range (in bps) with a midpoint that was 28% of the losses at the midpoint of the Ratings-Based Model. When we used the At-Risk Credits Model, the midpoint of the calculated default rate range was 72% lower than that of the Ratings-Based Model and has a default loss range (in bps) with a midpoint that was 23% of the losses at the midpoint of the Ratings-Based model.

We believe top-down models may not be the best indicators of likely default rates and losses for actively managed portfolios. Top-down models are starting points for conversation, but they are handicapped by arithmetic that calculates higher losses as prices increase faster than ratings, which conflicts with the message the market is sending. By implication, we believe the market reacts faster to changing default probabilities than the rating agencies can.

There is a famous saying in investing that prior returns do not predict future results. The same can be said about big-picture default rate and default loss models. Every period is different, especially this one! Big-picture models are better thought of as what-if models rather than forecasting tools, in our opinion. We use them in part to understand what our clients are reading and hearing, and in part to keep us skeptical of our At-Risk Credits Model. We use our models as tools to help inform us of the makeup of the existing portfolio and potential pockets of return-erosion -- and opportunity -- so we can enhance our investment management process through times of market turbulence.

John Bell, VP
Portfolio Manager

Heather Young, VP, CFA
Portfolio Manager

Emily Sweet, VP, CFA
Associate Product Manager

Michael Klawitter, VP, CFA
Portfolio Manager

Christos Maniatis, VP
Portfolio Manager (CLO)

Cheryl Stober, VP
Product Manager
cstober@loomissayles.com

Questions or concerns about the bank loan market? Email Cheryl Stober to learn more.

DISCLOSURE

KEY RISKS

Credit Risk, Issuer Risk, Interest Rate Risk, Liquidity Risk, Derivatives Risk, Leverage Risk, Counterparty Risk, Non- US Securities Risk, Prepayment Risk, Extension Risk and Management Risk.

Investing involves risk including possible loss of principal.

This quarterly report is provided for informational purposes only and should not be construed as investment advice. Any opinions or forecasts contained herein reflect the subjective judgments and assumptions of the authors only and do not necessarily reflect the views of Loomis, Sayles & Company, L.P. Investment recommendations may be inconsistent with these opinions. There can be no assurance that developments will transpire as forecasted and actual results will be different. Data and analysis does not represent the actual or expected future performance of any investment product. We believe the information, including that obtained from outside sources, to be correct, but we cannot guarantee its accuracy. The information is subject to change at any time without notice.

All indices are unmanaged and do not incur fees. You cannot invest directly in an index.

Past market performance is no guarantee of future results.

MALR026125-1030