

Leveraged Loans: A Source of Yield in a Low Rate Environment

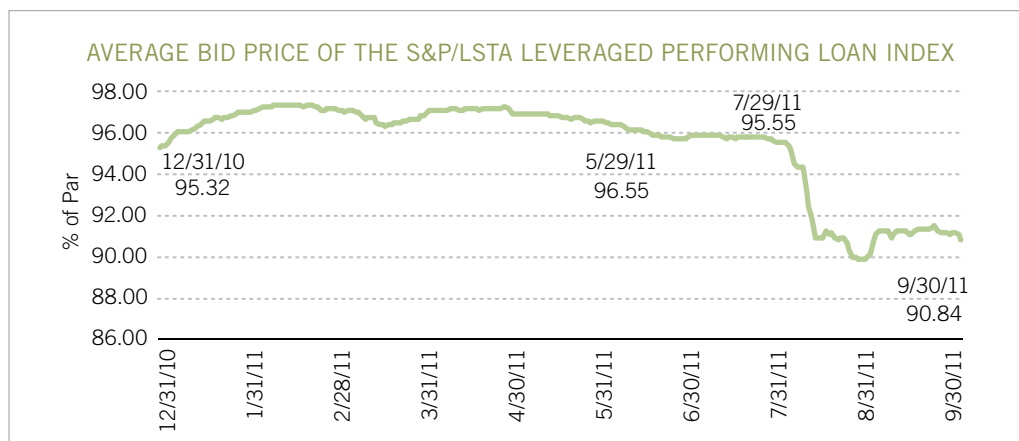
Entering 2011, the prospects for leveraged loans appeared favorable. U.S. economic growth seemed to be on the mend, and investors sought leveraged loans for protection from any subsequent increase in inflation and interest rates. However, macroeconomic and sovereign debt concerns that materialized during the second quarter changed investors' outlook for economic growth. Markets were rattled, and leveraged loans were not immune from the turbulence. This article highlights some causes of the recent volatility, and discusses the merits of leveraged loans as a core portfolio allocation based on loan characteristics and current valuations.

A global flight to quality

During the past several months, investors have retreated from nearly every category of riskier assets. Global markets plunged as the eurozone debt crisis spread to Italy and Spain. The contentious U.S. debt-ceiling debate also sent shockwaves worldwide. Though a potential default was avoided shortly before the August 2 deadline, the sell-off accelerated days later when Standard & Poor's downgraded the U.S. credit rating for the first time in history. Fears of a global recession soon intensified when the Federal Reserve (Fed) redefined its monetary policy outlook, announcing in August that "economic conditions are likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013."

The prospects of a slower growth and, more importantly, low interest-rate environment through mid-2013 caused leveraged loan prices to fall as risk was repriced and investors no longer valued the floating-rate option of loans after the Fed's announcement (see Exhibit 1, below). By early August,

EXHIBIT 1: The average leveraged loan bid price remained above 95 throughout 2011 before falling sharply in August.



Source: S&P/LSTA Leveraged Performing Loan Index, as of Sept. 30, 2011. The S&P/LSTA Leveraged Loan Index is an unmanaged index of the institutional leveraged loan market. Past performance is no guarantee of future results.



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Lisa Kasparian
Institutional Portfolio Manager

KEY TAKEAWAYS

- Volatility and uncertainty in the U.S. and the eurozone have driven down leveraged loan prices during the past few months, countermanding the market's strong performance in the first half of 2011.
- Despite the recent sell-off, the leveraged loan market still presents a compelling investment opportunity on a number of levels.
- Leveraged loan yields have risen sharply, which may prove attractive to investors in today's slow growth, low interest-rate environment.
- Capital appreciation potential, solid fundamentals, and higher recovery values further bolster the case for leveraged loans.

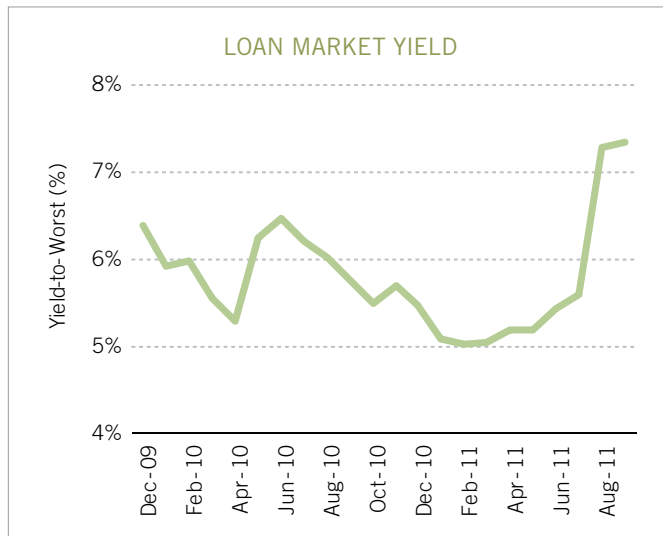
previously strong inflows into the loan asset class turned to outflows, which drove prices down further and erased year-to-date gains. Although the leveraged loan market bounced back modestly in September, the S&P/LSTA Leveraged Performing Loan Index was down 1.36% for the year as of September 30, 2011.¹

Today's value proposition

This backdrop raises questions about the prospects for leveraged loans, and whether or not investing in the asset class is still appropriate in a slow growth, low rate environment. In our view, the leveraged loan opportunity has become more compelling after the recent market sell-off, for the following reasons:

1. High absolute and relative yields: There's no doubt that recent volatility and investors' flight to quality has hindered the performance of leveraged loans. But finding yield in today's low rate environment has proven difficult. The loan market has repriced risk to reflect concerns about slowing demand, corporate profits, and increased risk of a global recession (see Exhibit 2, below).

EXHIBIT 2: Given the more challenging market backdrop, yields on leveraged loans have risen sharply during the past few months.



Source: Bloomberg, S&P Leveraged Commentary & Data, as of Sept. 30, 2011. Yield-to-worst is represented by the yield to four-year call. Past performance is no guarantee of future results.

With historically low absolute yields on higher-quality securities, investors may want to reconsider the relative value proposition that leveraged loans offer today. For many, the additional risk exposure may be well worth the reward as yields offered by bank loans today are considerably higher relative to Treasuries and investment-grade corporate bonds (see Exhibit 3, above right). As Exhibit 3 illustrates, the S&P/LSTA Performing Loan Index had an average price of 90.8% of par for a four-year yield calculated at roughly 7.3%. In comparison, five-year Treasuries yielded slightly less than 1% and investment-grade corporate

EXHIBIT 3: Leveraged loans have had a significant yield advantage over Treasuries and corporate bonds.²

	5-Year Treasuries	Performing Leveraged Loans	Investment-Grade Corporate Bonds
Average Price (% of Par)	100.23%	90.84%	108.63%
Estimated Life (years) [†]	4.78	4.00	6.41
Yield-to-Worst (%) [†]	0.95%	7.34%	3.95%

Source: Bloomberg, Standard & Poor's Leveraged Commentary & Data, as of Sept. 30, 2011. Data represented by the BofA Merrill Lynch U.S. Treasury Current 5 Year Index, the S&P/LSTA Leveraged Performing Loan Index and the BofA Merrill Lynch U.S. Corporate Index.³ Past performance is no guarantee of future results.

bonds yielded just shy of 4%. In other words, Treasuries yielded a little under 1% income per year over five years, investment-grade corporate bonds yielded slightly less than 4% per year over six years, and loans offered a 7.3% yield over four years (assuming no defaults).

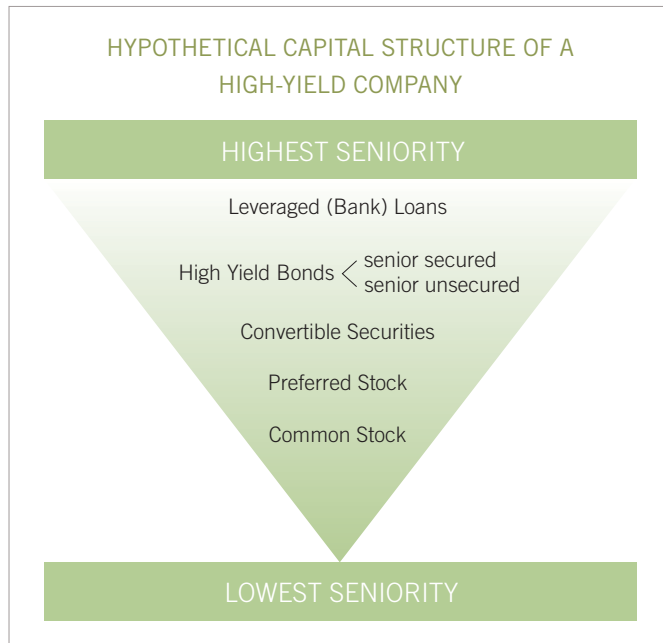
2. Solid corporate fundamentals: By most measures, loan issuer fundamentals appear healthy even when considering the risks in Europe and the mixed economic data in the U.S. and abroad. Earnings growth, while slowing, has remained positive and corporate balance sheets—a focus for below-investment-grade issuers since the 2008 debt crisis—are much healthier now than they were a few years ago, with reduced leverage, lower cost structures, and higher cash balances.

3. Potential for capital appreciation: With an average price of 90.8% of par, loans currently offer investors the opportunity for capital appreciation in addition to current income. Loans typically have structural covenants that direct the company to use excess cash flow to periodically pay down the loans. When this happens, the company pays off the loan at par, resulting in a natural “pull to par” over time and effectively shortening the life of the loan.

4. Low interest-rate sensitivity: While many bonds offer fixed-rate coupons, leveraged loan coupons have the ability to reset every 90 days based on changes in the reference rate (usually three-month LIBOR, the London Interbank Offered Rate). While the extended low-rate forecast makes this feature less relevant now, when rates do begin to rise, leveraged loans will be less sensitive to those interest-rate movements than traditional bonds with fixed-rate coupons whose prices fall when rates rise.

5. Higher recovery values: Through the end of September, the leveraged loan default rate was at a 45-month low, according to S&P Leveraged Commentary & Data. But if the economy falters and defaults tick higher, loan investors still have some protection from credit risk. Leveraged loans are usually the most

EXHIBIT 4: Leveraged loans have seniority in the corporate capital structure.



Source: FMRCo. For illustrative purposes only.

senior debt in a company's capital structure and are typically secured by assets of the issuing company. As a result, they have roughly 2.7 times higher recovery values than subordinated bonds with an average recovery of 80 cents on the dol-

lar.⁴ And since loans have a shorter average life than traditional bonds, investors might consider using them as a lower-risk proxy for short-duration exposure to high-yield companies.

Investment implications

The loan market is not without risks. Loans are made to below-investment-grade, highly credit-sensitive companies, and their prices can fluctuate quickly and considerably—which has certainly been demonstrated during the past few months.

Going forward, we expect volatility to remain elevated until there is greater clarity on the European sovereign debt crisis, the pace and method of its resolution, and any subsequent impact to the global economy. Thus, the market is likely to continue to trade on technicals and sentiment rather than on corporate fundamentals.

Despite the current market backdrop—and, in some ways, because of it—we believe leveraged loans offer a compelling investment opportunity. The market appears to be compensating investors for today's elevated levels of risk, with loans trading below par and yielding 7.3% despite the low rate environment. For investors with the appropriate risk appetite and who are looking for higher potential returns on capital, now may be a good entry point for loans.

Regardless of the prevailing state of the economy, investors can still take advantage of the distinctive characteristics of leveraged loans within a well-designed asset-allocation framework that seeks long-term, risk-efficient wealth accumulation.

Author

Lisa Kasparian
Institutional Portfolio Manager

Lisa Kasparian is an Institutional Portfolio Manager in Fidelity's Asset Management Division. In this role, Lisa is responsible for aligning the investment objectives and asset management opportunities within the intermediary and institutional investment marketplace with the ongoing management, innovation, development, and delivery of high-yield investment solutions provided by Fidelity's High Income Division.



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Investment decisions should be based on an individual's own goals, time horizon, and tolerance for risk.

Past performance is no guarantee of future results.

Investing involves risk, including risk of loss.

Diversification does not ensure a profit or guarantee against loss.

Investments in below-investment-grade-rated companies are highly credit-sensitive.

All indices are unmanaged. Performance of the indices includes reinvestment of dividends and interest income, unless otherwise noted, and is not illustrative of any particular investment. An investment cannot be made in any index.

In general, the bond market is volatile. Bonds entail interest rate risk (as interest rates rise, bond prices usually fall, and vice versa) and the risk of default. This effect is usually more pronounced for longer-term securities. Lower-quality bonds can be more volatile and have greater risk of default than higher-quality bonds. Foreign investments involve greater risks than U.S. investments, and can decline significantly in response to adverse issuer, political, regulatory, market, and economic risks. Any fixed-income security sold or redeemed prior to maturity may be subject to a substantial gain or loss.

Leveraged loans inherently have higher refinancing/repricing risk. Unlike other credit investments with non-call periods when the bonds cannot be redeemed, leveraged loans are callable at par at any time. As the broader market trades above the long-term average price and some loans trade at or above par, this callability presents an additional downside risk to loan investors.

[†] Estimated life is the expected duration remaining before a bond is called. Yield-to-worst is the lowest potential yield a bond can receive without the issuer actually defaulting.

¹ The S&P/LSTA Leveraged Loan Index is an unmanaged index of the institutional leveraged loan market.

² In addition to yield, different types of bonds may vary in their investment objectives, costs and expenses, liquidity, safety, interest-rate sensitivity, fluctuation of principal or return, and tax features, which should also be considered.

³ The BofA Merrill Lynch U.S. Treasury Current 5 Year Index is an unmanaged index of U.S. Treasury securities with final maturities of less than five years. The BofA Merrill Lynch U.S. Corporate Index is an unmanaged index comprised of U.S. dollar-denominated investment-grade corporate debt securities publicly issued in the U.S. domestic market with at least one-year remaining term to final maturity.

⁴ Moody's Investors Service, "Corporate Default and Recovery Rates, 1920-2010," February 2011. The data is from Moody's Ultimate Recovery Database, which includes robust, detailed information for over 4,500 loans and bonds from more than 950 U.S. corporate defaulters since 1987.

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