SENIOR LOANS:

An Overlooked Source of Income and Potential Total Return

MARKET COMMENTARY

JUNE 2016

REGARDLESS OF ONE'S VIEW ON INTEREST RATES, senior secured U.S. corporate loans (also commonly referred to as "senior loans" or "floating rate loans"), such as those found in senior loan mutual funds, remain a compelling relative value for those looking to own risk assets. After two years of retail mutual fund outflows, senior loans trade at a material discount to par, yet fundamentals remain strong. Senior loans may be an important part of an asset allocation strategy when positioning for a slow-growth economy with the potential for rising rates.

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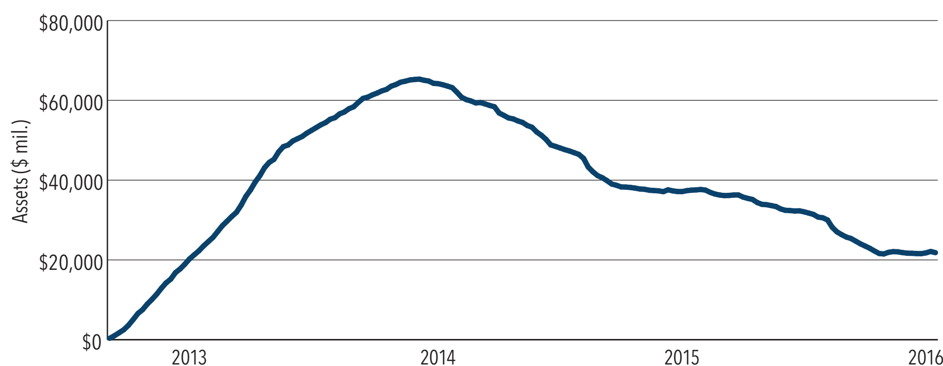
Senior Loans: The Most Unpopular Kid in the School of Retail Advisors

Retail financial advisors have historically had a fickle relationship with senior loan mutual funds and the senior loans they invest in: one day they can't get enough, and the next day they are running for the exits – sometimes without much reason. Between January 2011 and May 2014, retail investors poured over $60 billion into senior loan mutual funds in anticipation of Federal Reserve (Fed) rate hikes that never materialized. Over the following 24 months, between June 2014 and May 2016, they pulled $40 billion back out (during which time the Fed finally raised rates).

Senior Loan Cumulative Retail Fund Flows (February 1, 2013 – May 18, 2016)



Data source: EPFR Global, 2/1/13 – 5/18/16.

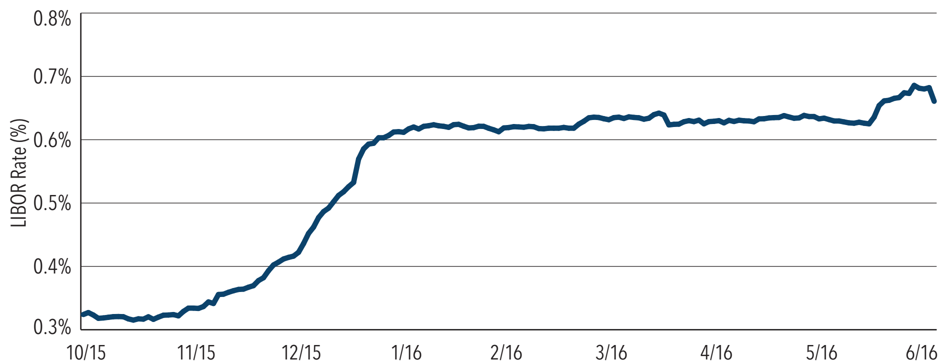
SENIOR LOAN ASSETS have seen a large increase and a large decrease as investors reacted to fears that never materialized.

Worries over rising rates have ebbed and flowed but have remained largely in the background since the beginning of the taper tantrum in the spring of 2013. Low U.S. interest rates have been held in check partly by weakness in economies outside of the United States, while U.S. growth remains slow but positive.

NOT FDIC INSURED NO BANK GUARANTEE MAY LOSE VALUE

Investors have recently focused on a falling 10-year Treasury rate. However, short term rates have quietly ticked higher. One place we've seen this is the short-term U.S. LIBOR market, where the 90-day rate has more than doubled since late 2014. This benchmark rate is extremely important for senior loan investors as the majority of U.S. corporate loans "float" above this 90-day U.S. LIBOR base rate.

3 Month LIBOR Rate (October 1, 2015 – June 6, 2016)



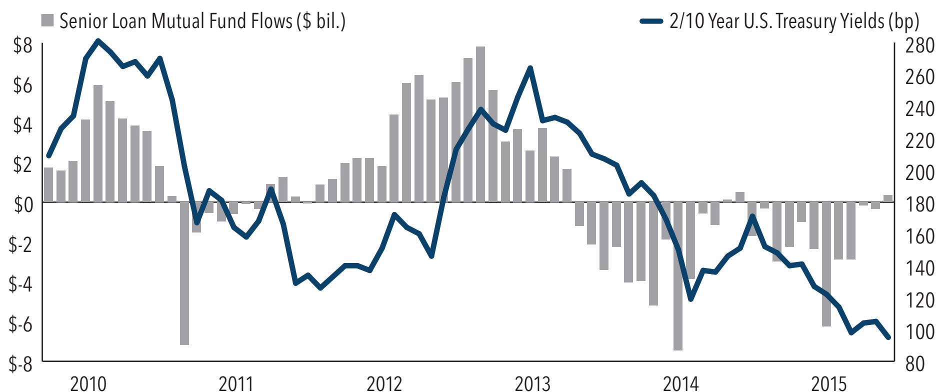
Data source: Bloomberg, 10/1/15 – 6/6/16. **Past performance is no guarantee of future results.**

THE POTENTIAL FOR RISING RATES EXISTS and short-term U.S. LIBOR rates have already started to increase.

Retail Demand for Senior Loans Has Been All About Interest Rates

Retail demand for senior loans remains heavily tied to the perceived threat of interest rate risk. This is best observed by looking at the steepness of the yield curve, or the spread between the 2-year treasury yield and the 10-year treasury yield, commonly referred to as the "2/10 spread". Historically, as this spread moves wider and the yield curve steepens, the senior loan asset class (via senior loan mutual funds) has seen inflows. During the last eighteen months, as the spread has narrowed and the yield curve has flattened, money has flowed out of senior loan funds. Recently flows have been mixed as the rhetoric on rates has shifted from "sooner" to "longer".

Senior Loan Mutual Fund Flows vs. 2/10 Year U.S. Treasury Yields (September 1, 2010 – May 31, 2016)



Data source: JPMorgan and Lipper FMI, 9/1/10 – 5/31/16. **Past performance is no guarantee of future results.**

DEMAND FOR SENIOR LOANS has been heavily tied to the perceived threat of interest rate risk.

Senior Loans Before and During a Rising Rate Environment

While many investors try to "time the market" with regard to interest rate increases, senior loans have historically performed well not only during rate increases, but also before rate increases.

Senior Loan Performance Before and During Rising Rate Periods

Returns BEFORE			DURING Periods					
Beginning of Rasing Rate Period	Senior Loan Annualized Returns for Prior 12 Months	Senior Loan Annualized Returns for Prior 24 Months	Rising Rate Period	Change in Fed Funds Rate	Senior Loans	Investment Grade Bonds	High Yield Bonds	U.S. Treasuries
2/1/94	12.2%	9.6%	2/1/94 - 2/28/95	+ 3.00%	9.6%	-0.7%	1.3%	-0.7%
6/1/99	4.3%	6.1%	6/1/99 - 5/31/00	+ 1.75%	3.9%	-0.4%	-3.1%	3.0%
6/1/04	8.3%	6.0%	6/1/04 - 6/30/06	+ 4.25%	5.9%	3.1%	8.1%	2.8%
Average	**8.3%**	**7.2%**	**Average**	**+3.00%**	**6.5%**	**0.7%**	**2.1%**	**1.7%**

Data source: Bloomberg, Credit Suisse, U.S. Federal Reserve. **Past performance is no guarantee of future results.** Total returns for a period of less than one year are cumulative. **Senior Loans:** Credit Suisse Leveraged Loan Index; **Investment Grade Corporate Bonds:** Barclays U.S. Corporate Investment Grade Index; **High Yield Bonds:** BofA ML High Yield Master II Index; **U.S. Treasuries:** Barclays U.S. Treasury Index. Different indices and economic periods will produce different results. Indices are unmanaged and unavailable for direct investment. All investments carry a certain degree of risk, including possible loss of principal, and there is no assurance that an investment will provide positive performance over any period of time. See Glossary for index definitions.

SENIOR LOANS historically have provided attractive returns in anticipation of rates rising and have outperformed during rising rate periods.

Retail Ouflows Have Created Value

The focus on the floating rate aspect of senior loans has led to many retail investors redeeming from their senior loan mutual funds. Amid this lack of demand, senior loans currently trade at a material discount to par. This is unusual given the U.S. economic backdrop, which remains supportive of credit fundamentals and senior loans.

Historical Average Price of Senior Loans (January 31, 1992 – May 31, 2016)

Data source: Credit Suisse, 1/31/92 – 5/31/16. Data shown is for the Credit Suisse Leveraged Loan Index.

RECENT DISLOCATIONS in loan prices offers both an opportunity for income and total return.

As a result of the current discount on senior loans, the spread has recently implied a default rate that has failed to materialize. As a result, investors owning loans have been overcompensated for the risk they are assuming - a good thing for investors.

Senior Loan Default Rate, Implied vs. Actual (December 1, 1998 - May 31, 2016)

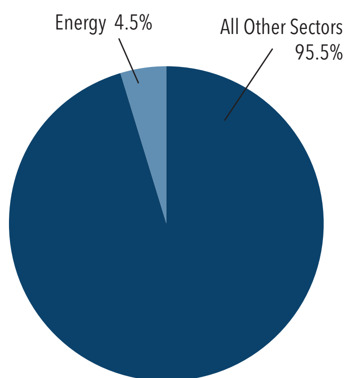
Data source: JP Morgan, 12/1/98 – 5/31/16. Data represents the Credit Suisse Leveraged Loan Index trailing 12-month default rate, implied and actual. **Past performance is no guarantee of future results** Different indices and economic periods will produce different results. Indices are unmanaged and unavailable for direct investment. All investments carry a certain degree of risk, including possible loss of principal, and there is no assurance that an investment will provide positive performance over any period of time.

THE MARKET IS PRICING IN HIGHER DEFAULTS, but actual cases are low, creating a compelling risk/reward profile for senior loans.

Fundamentals Remain Strong

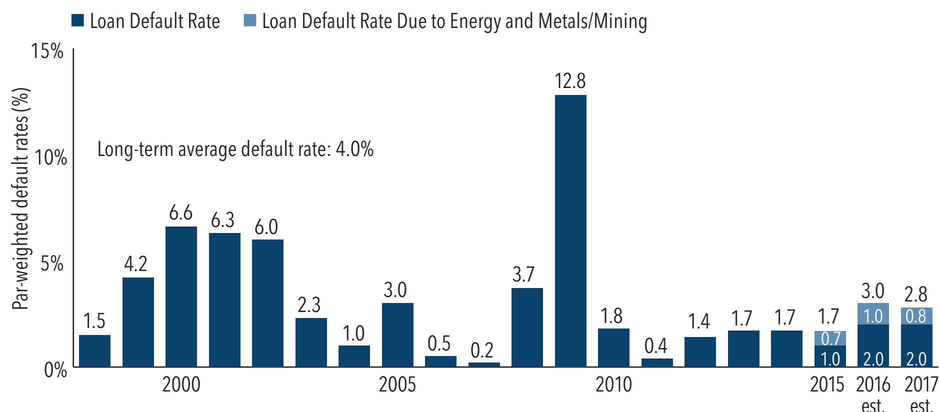
Credit fundamentals within the loan asset class appear intact. The asset class has little commodity exposure and default forecasts remain quite low for the next one to two years.

Energy Exposure (As of April 29, 2016)



Data source: Credit Suisse, as of 4/29/16. Allocations are for the Credit Suisse Leveraged Loan Index.

Default Forecast (1998 - 2017est.)



Data source: JP Morgan, 1998 - 2015 are actual. 2016 - 2017 are estimates. Default rate is for the Credit Suisse Leveraged Loan Index. Different indices and economic periods will produce different results. Indices are unmanaged and unavailable for direct investment. All investments carry a certain degree of risk, including possible loss of principal, and there is no assurance that an investment will provide positive performance over any period of time.

Conclusion

Senior loans may provide solutions for investors looking for income and total return, regardless of their view on Fed policy or long-term interest rates. In a rising rate environment, senior loans may provide additional benefits. The critical risk for loans is U.S. economic activity, which currently appears to be relatively stable and supportive of credit fundamentals and the senior loan asset class. While senior loans may not be appropriate for everyone, the lack of favor among retail investors has created opportunities for those willing to look a little deeper than the floating rate coupon.

For more information, please contact your financial advisor or visit nuveen.com.

GLOSSARY

A **basis point** is one one-hundredth of one percentage point, or 0.01%. For example, 25 basis points equals 0.25%.

Discount is the amount (stated in dollars or a percent) by which the selling or purchase price of a security is less than its face amount. Also the amount by which the market price of a closed-end fund is less than the fund's Net Asset Value.

Par value is the face value of a bond or stock as printed on the certificate. Bonds generally have a par value of $1,000.

The **Barclays Municipal Index** covers the USD denominated long-term tax-exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds, and prerefunded bonds.

The **Barclays U.S. Aggregate Bond Index** represents securities that are SEC-registered, taxable and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities and asset-backed securities. These major sectors are subdivided into more specific indices that are calculated and reported on a regular basis.

The **Barclays U.S. Corporate Investment Grade Index** is a broad based benchmark that measures the investment grade, fixed-rate, taxable, corporate bond market.

The **Barclays U.S. Treasury Index** includes public obligations of the U.S. Treasury. Treasury bills are excluded by the maturity constraint but are part of a separate Short Treasury Index. In addition, certain special issues, such as state and local government series bonds (SLGs), as well as U.S. Treasury TIPS, are excluded. STRIPS are excluded from the index because their inclusion would result in double counting.

The **Barclays U.S. Treasury Bellwethers 10 Yr. Index** is a universe of Treasury bonds, and used as a benchmark against the market for long-term maturity fixed-income securities. The index assumes reinvestment of all distributions and interest payments.

The **BofA Merrill Lynch High Yield Master II Index** tracks the performance of U.S. Dollar-denominated below investment grade corporate debt publicly issued in the U.S. domestic market.

The **Credit Suisse Leveraged Loan Index** is designed to mirror the investable universe of the U.S. dollar-denominated leveraged loan market. Loans are added to the index if they qualify according to the following criteria: The highest Moody's/S&P ratings are Ba1/BBB+, only funded term loans are included, and the tenor must be at least one year.

The **MSCI EAFE Index** (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. & Canada. The MSCI EAFE Index consists of the following 22 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom.

The **S&P 500® Index** measures the performance of large capitalization U.S. stocks. The S&P 500® is a market weighted index of 500® stocks that are traded on the NYSE, AMEX and NASDAQ.

RISKS AND OTHER IMPORTANT CONSIDERATIONS

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Debt or fixed income securities are subject to market risk, credit risk, interest rate risk, call risk, derivatives risk, dollar roll transaction risk and income risk. As interest rates rise, bond prices fall. The value of the portfolio will fluctuate based on the value of the underlying securities. There are special risks associated with investments in high yield bonds, hedging activities and the potential use of leverage.

Below investment grade or high yield debt securities are subject to liquidity risk and heightened credit risk. Preferred securities are subordinated to bonds and other debt instruments in a company's capital structure and therefore are subject to greater credit risk. Foreign investments involve additional risks, including currency fluctuation, political and economic instability, lack of liquidity and differing legal and accounting standards. Asset-backed and mortgage-backed securities are subject to additional risks such as prepayment risk, liquidity risk, default risk and adverse economic developments.

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GPE-YSRLNS-0616P 17042-INV-Y-05/17