

Manager Commentary December 2009

Financial market gains slowed in the fourth quarter from their torrid pace earlier in the year, but most asset classes continued to post strong performance, as the spectacular worldwide rally continued. The recovery has been remarkable in many ways given the widespread damage in 4Q08, the challenges facing the global economy and financial system entering 2009 and the rock-bottom sentiment. Evidence of economic improvement, declining risk premiums and massive liquidity injections have combined to drive asset prices up significantly from their lows earlier this year. US non-investment grade credit has been among the best performers, with leveraged loans and high yield bonds posting staggering all-time high returns of 44.87% and 54.22%, respectively, as measured by the Credit Suisse indices.

	<u>4Q09</u>	<u>2009</u>	<u>2008</u>
Credit Suisse Leveraged Loan Index	3.65%	44.87%	-28.75%
Credit Suisse High Yield Index	6.24%	54.22%	-26.17%
Merrill Lynch Investment Grade Index	1.22%	19.76%	-6.82%
S&P 500 Index	6.04%	26.46%	-37.00%
MSCI World	4.18%	30.79%	-40.33%

Source: Credit Suisse, Bank of America/Merrill Lynch and Bloomberg.

In the leveraged loan market, the themes of our past several commentaries continue. Loan prices continued to rise during the quarter reflecting further positive fundamental and technical factors. Fundamentally, continued evidence of economic recovery resulted in further declines in required risk premiums and therefore continued spread tightening. This has been supported by corporate earnings that have generally exceeded very low expectations, leading investors to conclude that credit statistics are poised to improve and the default cycle is close to its peak, both of which traditionally augur a favorable environment for non-investment grade credit investment returns. Technical factors have also been supportive. According to Lipper FMI (AMG), retail inflows into bank loan mutual funds totaled \$0.7 billion in the fourth quarter and an impressive \$3.4 billion for 2009. We believe additional institutional investment and a portion of the hefty \$3.9 billion of third quarter and \$20.6 billion of 2009 inflows into high yield mutual funds have also flowed into the loan market. An absence of new loan issuance, combined with substantial prepayments, amortization and refinancing via a very strong high yield bond market, have resulted in strong secondary bids as cash inflows and prepayments are redeployed into a shrinking loan market. LCD estimates the institutional term loan universe contracted by \$65 billion, or 10.9%, in 2009. These positive technical factors appear likely to continue.

While many of our predictions proved correct, our expectations that individual credit selection and a high quality bias would be critical in 2009 were not. Leveraged loan returns in 2009 were predominantly beta driven, as the riskiest companies and sectors outperformed, and by a very significant margin, relative to stronger credits. Just as the difficult conditions in 2007 and 2008 exposed the substantial risk inherent in careless or aggressively positioned portfolios, the inverse occurred in 2009. The explosive returns and straight line trajectory (with no meaningful pull-backs) disguised the significant risk inherent in more speculative portfolios and on the surface masked the risk-adjusted alpha generated by more prudent and conservatively positioned managers.

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CCC and B rated loans returned 7.80% and 3.48%, respectively, during the fourth quarter as compared to 1.36% for BB and 0.96% for split BBB/BB loans. For all of 2009, CCC and B rated loans posted staggering returns of 79.10% and 56.46%, respectively, as compared to 31.15% for BB and 20.83% for split BBB/BB loans. By sector, those industries that are most economically sensitive and were facing the greatest challenges coming into 2009 performed the best, including Broadcasting, Retail and Automotive, while more stable sectors like Food and Drug, Utilities, Cable and Healthcare underperformed. The biggest surprise was the Automotive sector, which entered the year facing a significantly depressed production rate, constrained consumer credit, the bankruptcies of GM and Chrysler, and financial difficulties across the supplier and dealer base, but was still able to post an 83.04% return despite the significant challenges that remain.

Credit Suisse Leveraged Loan Returns

	<u>4Q09</u>	<u>2009</u>	<u>2008</u>	<u>Sector</u>	<u>4Q09</u>	<u>2009</u>	<u>2008</u>
Split BBB/BB	0.96%	20.83%	-13.71%	Chemicals	14.68%	43.22%	-31.09%
BB	1.36%	31.15%	-21.98%	Broadcasting	10.32%	89.58%	-45.23%
Split BB/B	2.44%	45.49%	-30.36%	Aerospace	7.41%	47.59%	-29.71%
B	3.48%	56.46%	-34.53%	Manufacturing	7.22%	29.37%	-23.84%
Split B	4.75%	53.48%	-42.12%	Metals/Minerals	6.66%	46.37%	-28.22%
CCC/Split CCC	7.80%	79.10%	-51.06%	Housing	6.46%	52.07%	-40.44%
CS LL Index	3.65%	44.87%	-28.75%	Land Transportation	6.19%	42.46%	-32.75%
				Automotive	6.08%	83.04%	-46.59%
				Diversified Media	6.02%	54.51%	-40.10%
				Retail	5.63%	68.28%	-38.20%
				Energy	5.53%	40.52%	-25.61%
				Financial	5.48%	46.52%	-29.40%
				Consumer Durables	5.19%	47.15%	-37.89%
				Information Technology	4.97%	58.82%	-32.54%
				Gaming/Leisure	4.51%	51.42%	-39.34%
				Consumer Non-Durables	4.49%	40.29%	-24.12%
				Forest Products/Containers	2.45%	34.21%	-20.35%
				Service	2.04%	49.10%	-27.79%
				Shipping	1.79%	12.57%	-27.14%
				Telecommunications	1.30%	42.92%	-28.07%
				Food/Tobacco	1.03%	27.47%	-15.53%
				Healthcare	0.92%	28.84%	-16.48%
				Wireless Communications	0.66%	32.49%	1.15%
				Food and Drug	0.37%	40.93%	-24.15%
				Utilities	0.17%	29.04%	-21.17%
				Cable/Wireless Video	0.03%	36.12%	-19.10%
				CS LL Index	3.65%	44.87%	-28.75%

Source: Credit Suisse and Stanfield Capital Partners.

Macroeconomic Outlook

Economic data now solidly confirm that the economy is in recovery, and we are much more confident in the outlook. The pace of job loss has slowed considerably, industrial production has sustained a broad-based expansion, and consumer spending has improved, with broad-based advances in both goods and services. While still weighed down by weak labor market conditions and prior declines in household net worth, consumer confidence has turned upward and surveys of business conditions, sentiment and capital spending plans point to further advances in factory output and a modest rise in business spending going forward. Real GDP rose in the third and fourth quarters in almost all major developed and emerging economies, and in the few countries where output declined, the pace of contraction moderated substantially.

The unprecedented government response to the crisis has been extremely effective. TARP and the stress tests have triggered renewed confidence in the banking system and have enabled banks to raise substantial amounts of equity from the private sector and, with the help of a steep yield curve, rebuild their capital ratios. Massive monetary and fiscal stimulus has successfully reversed the sharp drop in confidence and sentiment and has led to tangible improvement in the underlying real economy.

The future direction looks solidly upward, but we continue expect a more moderate recovery than historical norms. We do not believe the economy is strong enough yet to generate a self-sustaining recovery without government support. In particular, the government needs to continue to support job creation, bank lending (to consumers and small businesses), and housing finance, and maintain accommodative monetary conditions until the economy is self-sustaining.

Third quarter GDP of 2.2% was even lower than our below consensus estimate of 2.5-3%. However, with some of the inventory re-build we expected in the third quarter now likely to appear in the fourth quarter, and a broader set of data confirming the economic recovery, we are raising our estimate for the fourth quarter to 3-3.5% (from 2-2.5%) resulting in GDP growth of -0.5% for 2009. In 2010, we expect growth to be modest in the first half but gain strength as the year progresses resulting in 2.5%-3% for the year.

As we discussed last quarter, we believe several notable factors unique to this recession are likely to persist and constrain GDP by at least 1% per annum for the next several years. We therefore expect growth to remain below trend for some time. First, despite historically low interest rates, we remain skeptical that credit availability will return as in past recoveries given the crisis and weakening of the financial system. This is particularly the case for consumer and small business credit. Consumers represent almost 70% of the US economy and small businesses are typically the driver of job creation in economic recoveries. Second, even as low cost consumer credit becomes available, we doubt it will have the traditional growth impact as households remain constrained due to lingering high unemployment, elevated household debt levels and reduced household wealth. Third, massive deficits and the required government borrowing have negative implications on interest rates, tax burden and the dollar. Fourth, increased uncertainty from greater government involvement, bureaucracy and political influences are likely to distort market signals, rates of return and the efficient flow of capital.

Given our expectations for modest economic growth, we don't expect the Fed to raise rates until late 2010. In the initial phase to reduce monetary accommodation, quantitative easing will end, liquidity will be removed from the system as the new Fed and Treasury programs gradually expire, and the Fed will begin to intentionally drain excess reserves through the use of reverse repurchase agreements (using their large inventory of Treasuries and MBS) and term deposits, before finally raising the Fed funds rate and the interest rate paid on excess reserves in late 2010. Long term rates will begin to rise as quantitative easing ends, economic growth accelerates and inflation concerns and government deficits achieve greater prominence.

Given the severity of the recession and financial crisis, its global reach and our expectations for a more constrained economic recovery, we believe there are likely to be some periods of uncertainty and ambiguous data over the next six to twelve months which will cause some price volatility in the equity and credit markets. Whether perception or reality, it seems likely that at some point after an inventory-led uptick, concerns about a stalling recovery or "double dip" will cause financial markets to retrace some of their gains. We are also in the confusing period where stronger than expected economic data, which should intuitively be good for equities and corporate credit, instead trigger concerns of earlier monetary tightening and markets trade off. In the case of leveraged loans, we expect any correction to be less than 5% on average.

The financial markets remain somewhat fragile and vulnerable to shocks to investor confidence. For example, a large default, sovereign credit concerns (Dubai, Greece, etc.), and state and local budgetary pressures (and their impact on the municipal bond market) could have a disproportionate effect beyond their quantifiable tangible impact if they derail investor sentiment. We are also concerned about the deteriorating conditions in the commercial real estate sector and the impact of losses on bank capital, credit availability, investor confidence and the ripples to other securitization markets, given the contagion caused by subprime. Overall, we believe the risks of these events and their potential impact on the recovery are declining, but we continue to monitor them closely.

Default and Recovery Rates

The challenging economy and credit markets have had their expected impact on leveraged loan default rates and recoveries. The trailing twelve month default rate reached all-time record highs of 8.25% of issuers and 10.81% of principal outstanding in November 2009, according to LCD. As we expected, the peak of the default cycle looks to have occurred in late 2009. The pace of defaults is slowing and the default rate is falling, with the trailing twelve month default rate declining to 8.07% of issuers and 9.61% of principal outstanding at the end of 2009.

The crisis in the fourth quarter of 2008 was sharp and sudden, and many of the resulting defaults were difficult to foresee. Now, after twelve months of very difficult conditions, the depth of the downturn is known, companies have impressively shed excess capacity, cut costs and reduced inventories, and the outlook has turned positive. Those companies that have survived are better positioned for the upturn, and the laggards and

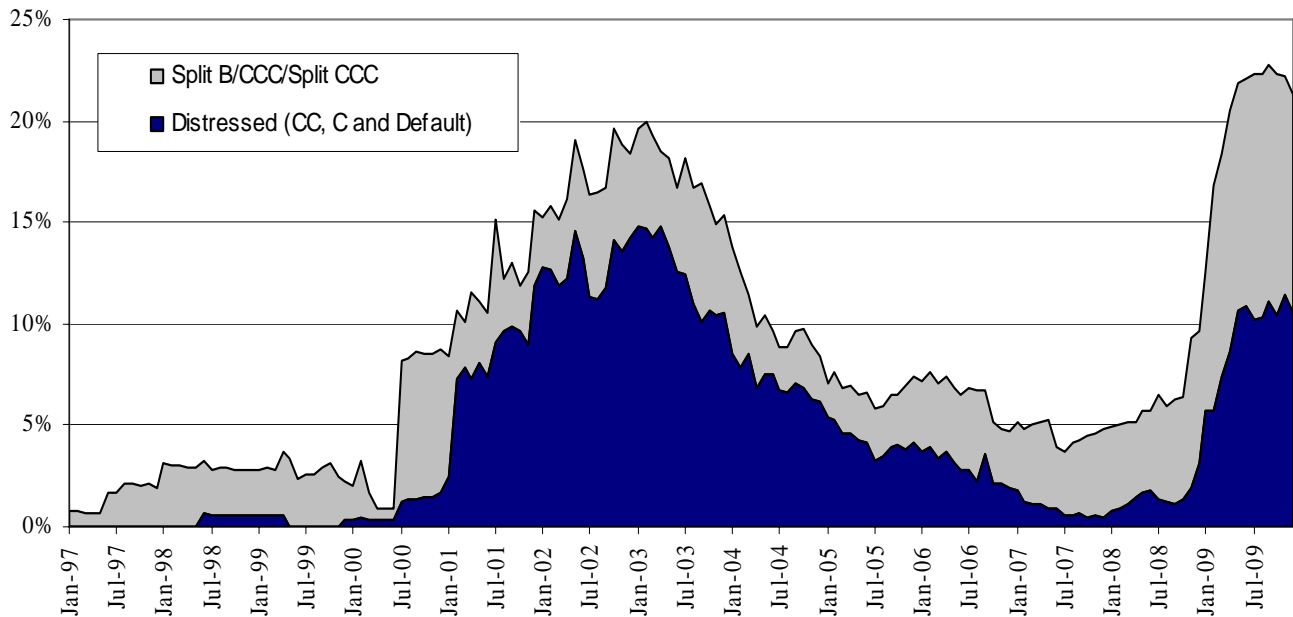
problem credits are much easier to spot. Economic improvement, stronger financial markets, enhanced liquidity and company cost reduction have reduced the likelihood of default, and we expect the default rate to continue to decline over the next several years to 4-5% in 2010 and 3-4% in 2011 (issuer and principal should be similar going forward). Seasoned, active managers should be able to significantly outperform the default rate of the broader market, and we point to Stanfield's own 2009 default rate of less than 1.5% as evidence.

As we previously discussed, we expected that the very low 30-40% senior secured recoveries early in the cycle (measured at the time of default) would eventually revert to closer to historical norms over time. Abundant distressed capital, improving outlooks and fewer new distressed opportunities have significantly improved recoveries and the availability of rescue and exit financing. In fact, recent recoveries have been 70-80% and we expect this improvement to continue. Ultimate recoveries will not be known for several years, but should be much higher than current market levels as the economy and financial markets strengthen. We continue to expect recovery rates to average around 60-70% through the current credit cycle, with recoveries from future defaults significantly higher. Periods with declining default rates and rising recoveries have traditionally been very positive for loan returns and we expect further improvement in the credit cycle to be a powerful tailwind for loan returns over the next few years.

Rating Agency Downgrades

Rating agency downgrades have been overwhelming, causing additional stress for CLOs. In particular, the significant rise in the number of companies downgraded to Caa1/CCC+ or below caused further erosion of overcollateralization ratios. The rising supply of Caa1/CCC+ or lower credits in a market with no natural buyers caused these loans to trade very poorly earlier in the year, although prices recovered considerably throughout the year as distressed investors deployed their capital. We estimate Caa1/CCC+ or lower rated credits peaked at 22.8% of the leveraged loan market in September 2009. This exceeded the estimated 18% during the tech/telecom difficulties of 2002. However, the pace of downgrades began to slow in the second quarter, and now appear to be offset by a greater number of upgrades. We expect the number of Caa1/CCC+ or lower credits will continue to gradually decline over time as the economy and company credit statistics strengthen.

CCC and Below Rated Assets % of Credit Suisse Leveraged Loan Index (Par Weight)



Source: Credit Suisse and Stanfield Capital Partners.

Refinancing Cliff/CLOs

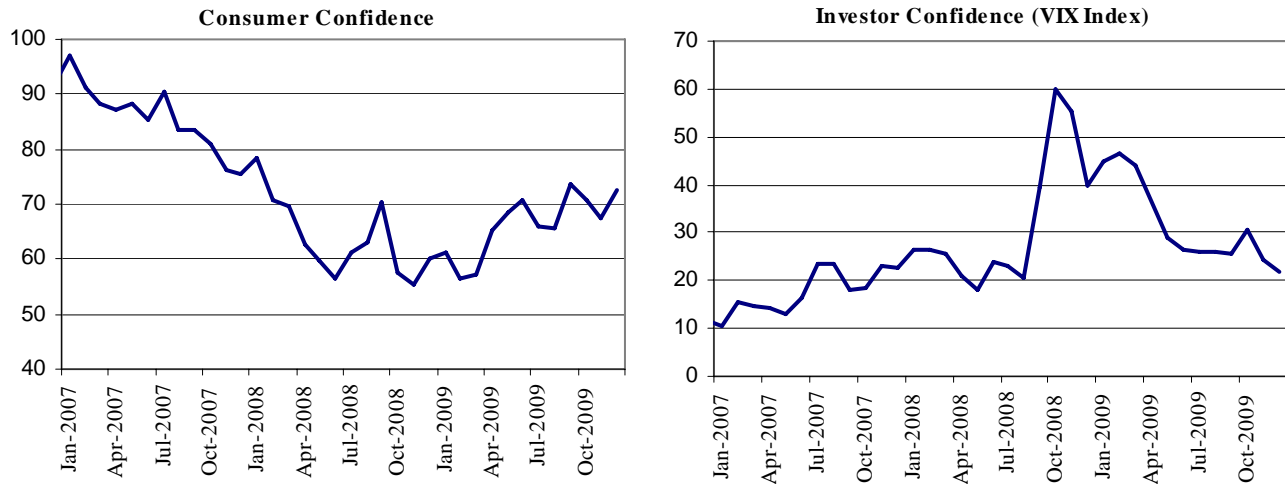
The capital markets have already begun to address the substantial 2013-2014 maturities in an impressive fashion, through pay downs, bond refinancings and amend/extends. According to LCD, issuers completed \$59 billion of amend/extends in just over the past 3 quarters in addition to \$85 billion of repayments in 2009. Continued extensions and prepayments from cash flow, bond financings, M&A and equity issuance should allow the market to alleviate the refinancing cliff. The loan market remains small compared to other fixed income classes. With greater familiarity and understanding of the loan asset class, we believe pension funds and insurance companies will increase their exposure to loans. Combined with renewed bank, institutional and retail mutual fund demand, we believe there will be sufficient new capital available to refinance the remaining maturities when due.

Factors that would conspire to cause a significant amount of CLO portfolios to be liquidated at once are highly unlikely. Most will gradually run-off. We also believe new CLO issuance will return, albeit at a much lower 4-5x leverage. As with many financial products, CLO leverage, terms and quality of manager were driven to excess. Still, hindsight will show that most deals weathered the “100 year flood” fairly well and largely worked as designed. Levered portfolios of loans through TRS or CLOs are likely to again provide an attractive means for investors to achieve higher rates of return and on a better risk-adjusted basis than many other alternatives.

Outlook

We have incessantly stated that confidence is the key to the capital markets and economic growth. The powerful shift in sentiment over the past nine months marks an important turning point for the global economy. Just as eroding confidence triggered the financial crisis and a sharp decline in the real economy, the dramatic improvement in consumer and investor confidence over the past several quarters is a powerful force to drive continued recovery and growth. The combination of improving confidence and massive monetary and fiscal stimulus has re-opened the capital markets and has driven impressive improvement in the tangible real economy. Economic data continue to confirm this recovery, and bolster the “positive feedback loop”, as improvements in the economy, sentiment and financial markets reinforce one another in an upward spiral.

Both Consumer and Investor Confidence are Improving



Source: Bloomberg and Stanfield Capital Partners. Reuters/University of Michigan Consumer Sentiment Index and CBOE implied volatility of S&P 500 index options (VIX).

While there are likely to be some periods of uncertainty and ambiguous data over the next six to twelve months which will cause some price volatility in the equity and credit markets, the future direction looks solidly upward. However we believe there are a number of challenges and notable factors that will persist and cause economic growth to be below trend for the next several years. These factors have important implications for investment returns and strategy going forward. In an environment of low economic growth and low corporate profit growth, we believe high rates of return will be difficult to achieve without taking on a disproportionate amount of risk. Higher return assets like equities and high yield bonds will have much greater associated risk than they have had in the past as investors will have to “reach” for much riskier companies to get higher growth. Lastly, low risk assets like government bonds or government-guaranteed assets will have very low or negative real rates of return, due to their current low yields, rising interest rates, growing government deficits and potential inflationary pressures in the future. Rising interest rates will similarly undermine investment grade bond returns.

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In our expected slow growth environment, we believe stable, income producing assets will outperform, especially on a risk-adjusted basis. We believe non-investment grade loans are well positioned and will offer investors an attractive risk-adjusted return on investment over the next several years.

Excluding 4Q08, non-investment grade loans have fairly consistently generated 5-8% annual returns with low volatility. Returns have typically been higher than normal for several years following recession. Current spreads of 400-800bp imply above normal returns, and when supplemented with continued capital appreciation from fundamental spread tightening, positive credit events and favorable technical factors, loans appear poised for very healthy returns. We believe loans could generate 6-10% annual returns over the next few years, which is particularly attractive on a risk-adjusted basis. Even greater returns are achievable through more aggressive strategies, or with leverage from TRS and potential new CLO issuance.

We believe the arguments in favor of leveraged loan investments at this point in the credit and economic cycle are much more compelling than the reasons against, especially when viewed against other investment alternatives. Please see our recently published *Stanfield Perspectives* entitled “*Why Loans? Why Now?*” for a detailed discussion of the favorable outlook for loans. It is available on our web site, www.stanfieldcp.com.

It is unlikely that investors can benefit as easily as in 2009 by buying riskier credits or the market overall. Credit selection should matter again in 2010 and beyond. Going forward, we continue to believe BB-rated credits offer the best risk-adjusted returns. However, after spending the past three years de-risking our portfolios, with the stronger economy and outlook, we are now gradually and opportunistically scaling back our defensive portfolio positioning to selectively capture higher return opportunities. There are a number of B-rated companies with strong competitive positions, attractive relative value and a catalyst for significant capital appreciation. We believe they are unappreciated and undervalued by the market and should trade up over time as the merits of their businesses become more evident and their credit statistics and outlook improve. With significant recent cost reduction initiatives, these companies are likely to post impressive earnings and cash flow growth in the near term, even with modest revenue growth. The new issue market also continues to present a number of high quality credits with attractive spreads and LIBOR floors. In the meantime, we believe our portfolios are well positioned to withstand any further volatility, and with roughly 20% of our portfolios consisting of loans with LIBOR floors, we expect to benefit from the higher current income these loans provide.

Stanfield Capital Partners LLC is an SEC-registered investment advisor founded in 1998, with a core focus on non-investment grade loans and related credit-based strategies. Stanfield's Managing Partners structured one of the first independently managed loan portfolios in 1990 and have one of the longest institutional track records in the non-investment grade loan business, with an average of 25 years of experience managing loans and high yield bonds through many different economic cycles. Stanfield's investment, risk and operations platform and active portfolio management style are uniquely suited to generate superior risk-adjusted return performance across a broad variety of credit investment products and market environments. Stanfield had approximately \$5.2 billion in assets under management as of December 31, 2009.

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