

Why Loans? Why Now?

Non-investment grade loans staged a spectacular rally in 2009, with the Credit Suisse Leveraged Loan Index up a remarkable 44.9%. On the heels of such a strong performance, it is natural to question whether the loan market is overvalued and what returns can be reasonably expected over the next few years. We believe the outlook for loans continues to be very positive.

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.

Reasons FOR Loans

- **Attractive yields without spread tightening**

Secondary and new issue spreads (DM3s) of 400-500bp for BB and 600-800bp for B rated loans and 2% average LIBOR over the next few years imply healthy loan market yields of 6-7% for BB and 8-10% for B rated loans, absent any spread tightening. Skillful, active managers should be able to add incremental return from credit selection and net capital gain.

- **Spreads still at historically high levels**

Despite the 2009 rally, spreads remain well above historical norms. In fact, BB and B spreads are still at levels similar to the peak of the 2002 credit crunch. Continued fundamental improvement in the economy, financial markets and credit quality should provide meaningful additional loan market return as spreads tighten further.

Reasons AGAINST Loans

- **Better returns elsewhere**

Simplistically, if the economic recovery is underway, then higher rates of return can be achieved by moving further out on the risk spectrum. For some investors, leveraged loan returns of 6-10% are just not interesting enough. However, despite the recovery, many challenges and uncertainties remain. We believe several notable factors will persist and cause economic growth to be below trend for the next several years, and thus high rates of return will be difficult to achieve without taking on a disproportionate amount of risk. Further, stocks, fixed income and MBS are all negatively impacted by rising interest rates. We believe stable, income producing assets will outperform, especially on a risk-adjusted basis. Through TRS and the potential return of CLOs, higher rates of return are achievable in the loan market.

- **Missed the move**

Given the almost 45% return in loans last year, some investors believe there isn't much return left. But spreads remain at historically high levels and even without further tightening loan returns are attractive. Other asset classes have had greater moves off the trough. For example, the S&P 500 is up 66.7% from its trough.

Reasons FOR Loans

- **Positive credit events will continue**

The economics of holding existing loans will improve with more amendments and amend/extends. Prepayments will remain high and offer substantial capital appreciation to holders of discount assets. Companies and equity sponsors are highly focused on improving and extending their balance sheets. Bond issuance, IPOs, asset sales and M&A will continue to be positive credit events and drive prepayments.

- **Favorable technical flows will drive further spread tightening**

While we expect more diverse and attractive new issue as M&A activity increases, on net, we expect term loan principal outstanding in the loan market to decline again in 2010. The technical imbalance of continued inflows and prepayments into a shrinking loan market should drive further price appreciation. Investors who allocate early are likely to benefit.

- **Default risk declining and recoveries improving**

Economic improvement, liquidity and company cost reduction have reduced the likelihood of default. Abundant distressed capital, improving outlook and fewer new opportunities are improving recoveries and the availability of rescue and exit financing. The back-side of the default cycle is traditionally a very good time to invest in non-investment grade loans.

- **Rising LIBOR**

The rising LIBOR component will provide an additional source of return. The forward curve is predicting a 3 month LIBOR of 2% by mid-2011 and 3% by early 2012. Many newly issued loans have LIBOR floors of 2-3%, which provide incremental return until LIBOR rises.

Reasons AGAINST Loans

- **Worries about a repeat of 4Q08**

The loan price declines in 4Q08 were an aberration caused by a severe liquidity contraction and financial crisis. While the declines were surprising given loans' historical stability, they remained much less severe than for other asset classes. If an investor is selecting investments based on a desire to avoid 4Q08-type price declines, we know of no other asset besides Treasuries and investment grade corporates that can achieve that objective. That strategy seems destined for minimal or even negative real returns.

- **Double-dip recession**

While we do not believe the economy has reached self-sustainability yet, we are growing more confident that we will not see a double-dip given the tremendous improvement in confidence, abundant liquidity and stimulus, and the resolve of governments around the world to create jobs and support dysfunctional markets and industries. If there is a double-dip, we see equities, high yield and MBS as more vulnerable than loans. We also expect a less dire impact on leveraged loan issuers given the cost reduction, debt repayment and liquidity enhancement efforts of the past two years.

- **Refinancing cliff/end of 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. These actions will continue, along with M&A and equity issuance, and should allow the market to alleviate the refinancing cliff. 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, as hindsight will show that most deals weathered the "100 year flood" fairly well and largely worked as designed.

Reasons FOR Loans

• **Rising long-term interest rates**

Due to a combination of the end of quantitative easing, accelerating economic growth, deficit financing/crowding out, and rising inflation concerns, interest rates are poised to rise. Rising interest rates will cause investors to flee fixed income and seek floating rate assets. This is likely to result in low or negative real returns and spur an exit out of fixed rate and into floating rate assets. Rising rates typically drive P/E compression and are also negative for equities and MBS. The inflow of capital into the floating rate loan market should drive loan prices higher.

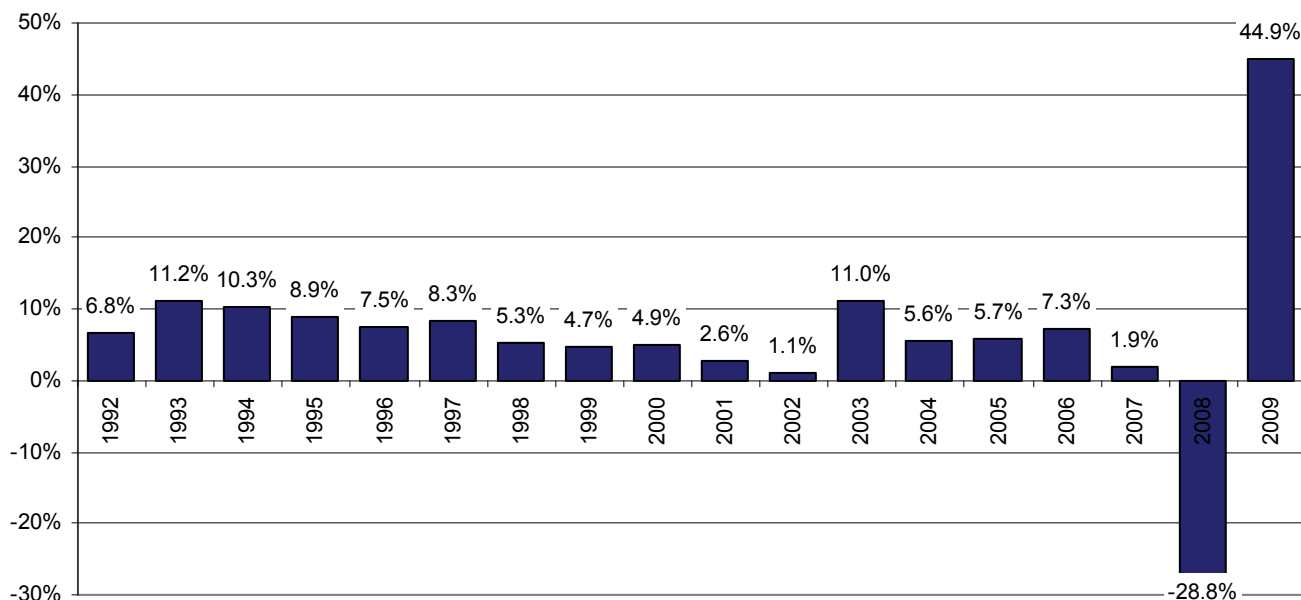
Reasons AGAINST Loans

Reasons FOR Leveraged Loans

Attractive yields without spread tightening

Excluding 4Q08, non-investment grade loans have fairly consistently generated 5-8% annual returns with low volatility, as shown below. Returns have typically been higher than normal for several years following recession. Secondary and new issue spreads (discount margin measured over 3 years, or DM3s) of 400-500bp for BB and 600-800bp for B rated loans and an average LIBOR of 2% over the next few years imply healthy loan market yields of 6-7% for BB and 8-10% for B rated loans, absent any spread tightening. Skillful, active managers should be able to add incremental return from credit selection and capital appreciation.

Credit Suisse Leveraged Loan Index Annual Return

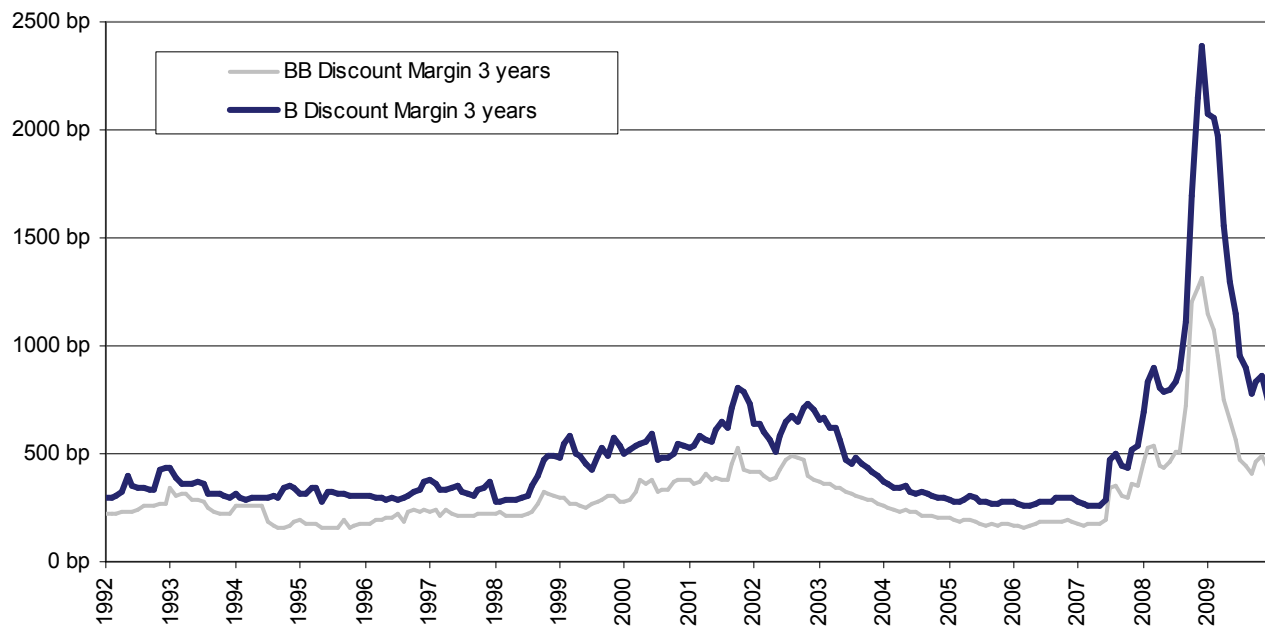


Source: Credit Suisse and Stanfield Capital Partners.

Spreads still at historically high levels

Despite the 2009 rally, spreads remain well above historical norms. In fact, BB and B spreads are still at levels similar to the peak of the 2002 credit crunch. Continued improvement in the economy, financial markets and credit quality should drive at least a reversion to the mean, providing meaningful additional loan market return as spreads tighten further. If spreads tighten by 200bp over the next few years, that implies roughly 1-2% per annum of additional yield from capital appreciation.

Credit Suisse Leveraged Loan Index Spread



Source: Credit Suisse and Stanfield Capital Partners. Discount margin over 3 years.

Positive credit events will continue

The economics of holding existing loans will improve with more amendments and amend/extends, which provide increased spread and amendment fees. Prepayments will remain high and offer substantial capital appreciation to holders of discount assets. Companies and equity sponsors are highly focused on cash generation and improving and extending their balance sheets. We expect company free cash flow to improve and be used primarily for debt repayment. While high yield bond spreads also remain wide, absolute coupon levels are low relative to historical norms and interest rates are likely to rise. Companies will continue to take advantage of a strong high yield market to issue bonds to repay bank debt, extend maturities and secure long term “covenant lite” capital at attractive rates.

Stronger financial markets will drive a return of M&A activity, asset sales, and even IPOs, providing a further source of positive credit events and prepayments. The environment that tends to spur M&A activity is one with a combination of slow growth, improved visibility, and low interest rates, such as we face today. In addition, while financial sponsor equity investments are underwater in a large number of 2006 and 2007 LBOs, an IPO may actually be the most efficient way for a portfolio company to delever. Immediate dilution

may be offset by enhanced financial flexibility, earnings improvement and multiple expansion over time, and a public listing can be the first step in facilitating an exit. An IPO can also provide the sponsor more flexibility in selling the company than loading it up with fixed rate, non-callable bonds. The aftermath of the last LBO boom/bust/recession cycle in the late 1980s spawned a massive amount of new public equity issuance in the early 1990s as companies “re-equitized” their balance sheets. We expect public equity issuance by non-investment grade companies to be surprisingly high over the next few years. Loan prices should benefit from prepayments and stronger balance sheets.

Favorable technical flows will drive further spread tightening

An absence of new loan issuance, combined with substantial prepayments, amortization and refinancing via a very strong high yield bond market, have resulted in 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 we expect more diverse and attractive new issue as M&A activity increases, on net, we expect term loan principal outstanding in the loan market to decline again in 2010. The technical imbalance of continued inflows and prepayments into a shrinking loan market should drive further price appreciation. Investors who allocate early are likely to benefit. Established managers with superior access to investment opportunities, strong credit selection and price discipline should be able to keep their clients well invested.

Default risk declining and recoveries improving

The challenging economy and credit markets have had their expected impact on leveraged loan default rates and recoveries, with the trailing twelve month default rate reaching all-time record highs of 8.25% of issuers and 10.81% of principal outstanding in November 2009, according to LCD. However, 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.

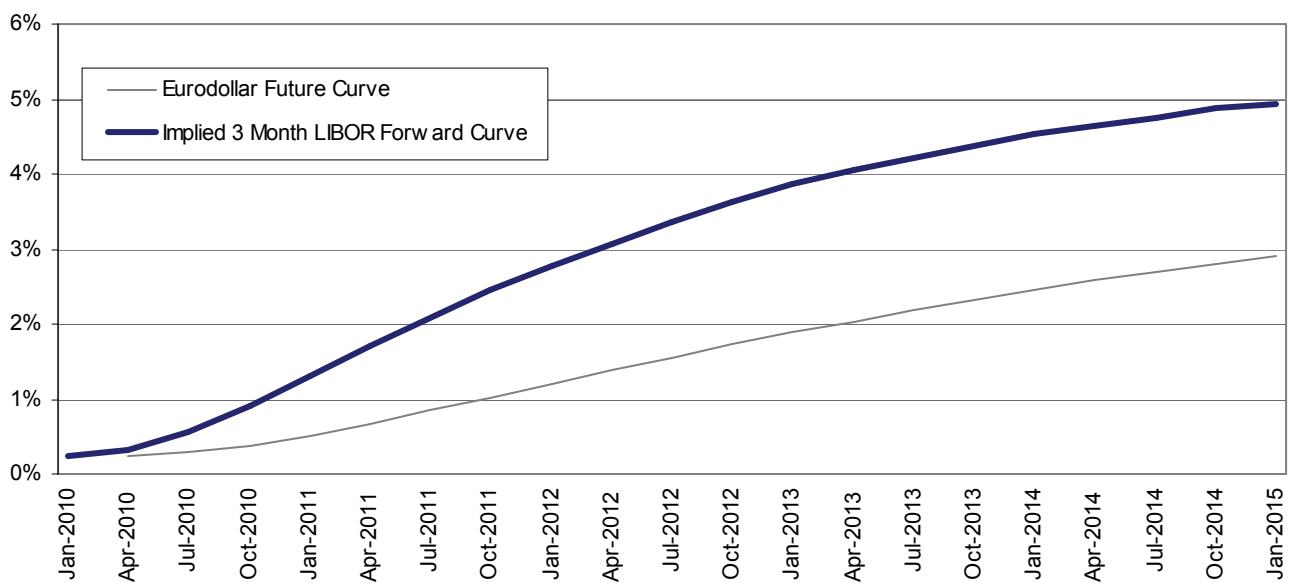
The crisis in the fourth quarter of 2008 was sharp and sudden, and many of the resulting defaults were difficult to foresee. Now, after twelve months of very difficult conditions, the depth of the downturn is known, companies have impressively shed excess capacity, cut costs and reduced inventories, 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.

Rising LIBOR

LIBOR will rise, and therefore the LIBOR component will provide an additional source of return to leveraged loans. The forward curve is predicting a 3 month LIBOR of 2% by mid-2011 and 3% by early 2012. Many newly issued loans have LIBOR floors of 2-3%, which provide incremental return until LIBOR rises.

3 Month Implied LIBOR Forward Curve



Source: Bloomberg and Stanfield Capital Partners.

Rising long-term interest rates

Due to a combination of the end of quantitative easing, accelerating economic growth, deficit financing/crowding out, and rising inflation concerns, interest rates are poised to rise. Rising interest rates will cause investors to flee fixed income and seek floating rate assets like leveraged loans. The inflow of capital into the floating rate loan market should drive loan prices higher, and with LIBOR rising, should result in enhanced loan market returns, in contrast to fixed income assets which are likely to experience low or negative real rates of return. Treasuries and high grade corporates look particularly vulnerable, but rising rates are also negative for stocks and MBS as well. Even as the improving economy drives higher earnings, rising interest rates typically cause P/E multiples to compress, which offsets much of the earnings growth benefit. Rising rates are also negative for MBS given their negative convexity, as the extension of their expected weighted average lives further compounds the price impact from rising rates.

Reasons AGAINST Leveraged Loans

Better returns elsewhere

Simplistically, if the economic recovery is underway, then higher rates of return can be achieved by moving further out on the risk spectrum. For some investors, leveraged loan returns of 6-10% are just not interesting enough. However, despite the recovery, many challenges and uncertainties remain, and are likely to constrain GDP by at least 1% per annum for the next several years.

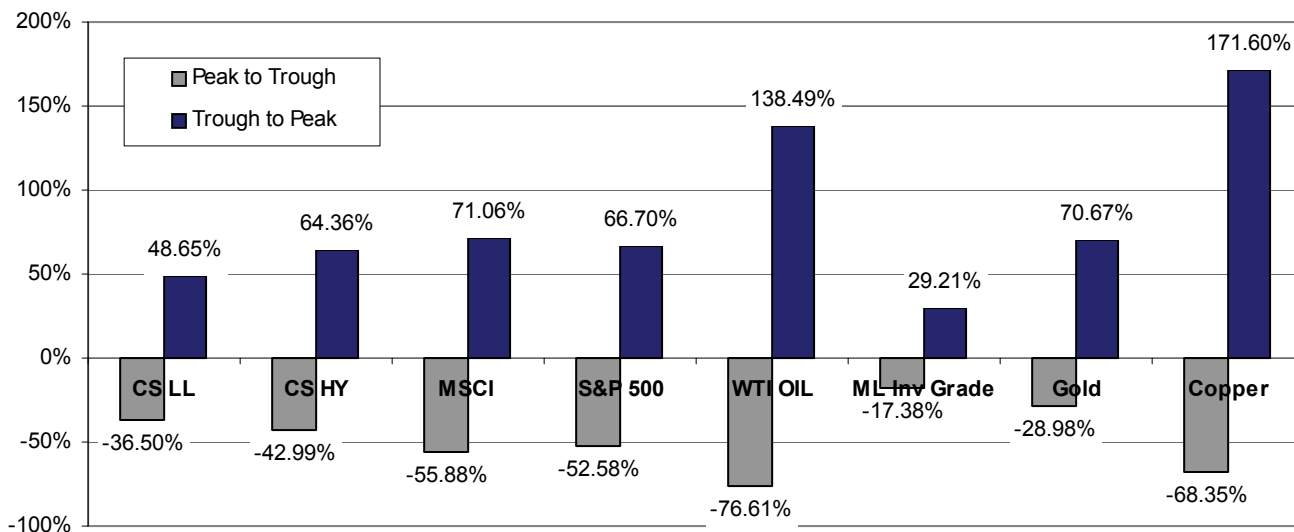
First, despite historically low interest rates, we remain skeptical that credit availability will return as in past recoveries given the crisis and weakening of the financial system. This is particularly the case for consumer and small business credit. Consumers represent almost 70% of the US economy 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.

We believe these factors will persist and cause economic growth to be below trend for the next several years. Thus, high rates of return will be difficult to achieve without taking on a disproportionate amount of risk. Further, stocks, fixed income and MBS are all negatively impacted by rising interest rates. We believe stable, income producing assets will outperform, especially on a risk-adjusted basis, and non-investment grade loans are well positioned. Through TRS and the potential return of CLOs, higher rates of return are achievable in the loan market for those investors with high return thresholds, and on a better risk-adjusted basis than many other alternatives.

Missed the move

Given the almost 45% return in loans last year, some investors believe there isn't much return left, especially when the return is compared other assets like stocks which increased less in 2009 (the S&P 500 returned 26.46% in 2009). However, the calendar year return distorts the loan move relative to other assets since the trough in loan prices occurred roughly at the beginning of the year, while for stocks it occurred in March. Other asset classes have had much greater price moves off trough levels as shown below.

Asset Price Change 2007 – 2009



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

Further, we would argue that a significant portion of the rebound in loans was an undoing of excessive declines in 2008. That an entire market could trade 10-20 points below historical recoveries, like the Credit Suisse Leveraged Loan index did in December 2008 when it reached an average price of 62, is a situation that never should have occurred on a fundamental basis. It seems at least two-thirds of the 2009 returns should be attributed to a reversal of the 4Q08 liquidity driven forced selling, with the remainder reflecting improved fundamentals. But even after 2009's spectacular performance, spreads remain at historically high levels. Current spreads imply greater than 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 over the next few years.

Worries about a repeat of 4Q08

The loan price declines in 4Q08 were an aberration caused by a severe liquidity contraction and financial crisis. While the declines were surprising given loans' historical stability, they remained much less severe than for other asset classes. If an investor is selecting investments based on a desire to avoid 4Q08-type price declines, we know of no other asset besides Treasuries and investment grade corporates that can achieve that objective. That strategy seems destined for minimal or even negative real returns.

Double-dip

While we do not believe the economy has reached self-sustainability yet, we are growing more confident that we will not see a double-dip given the tremendous improvement in confidence, abundant liquidity and stimulus, and the resolve of governments around the world to create jobs and support dysfunctional markets and industries. If there is a double-dip, we see equities, high yield and MBS as more vulnerable than loans. We also expect a less dire impact on leveraged loan issuers given the cost reduction, debt repayment and liquidity enhancement efforts of the past two years.

Refinancing cliff/end of 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.

Investment Strategy

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 have 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. In a year encompassing the deepest global recession since WWII and the bankruptcy of General Motors, Chrysler and numerous auto dealers and suppliers, CCC-rated credits and automotive credits returned an astronomical 79.1% and 83.0%, respectively. Going forward, it is unlikely that investors can benefit as easily 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. Depending upon investors' objectives, we recommend supplementing a mostly BB-rated portfolio with selected lower-rated B and CCC companies with strong competitive positions, attractive relative value and a catalyst for significant capital appreciation. There are a number of credits we believe are unappreciated and undervalued by the market that 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 many high quality credits with attractive spreads and LIBOR floors. Seasoned, active managers like Stanfield, with longevity, superior credit selection, deep and long-standing relationships with underwriters and dealers, and premier access to investment opportunities should be able to generate significant alpha in addition to impressive beta for their loan investors. Stanfield can develop an investment strategy and portfolio uniquely customized to meet your specific investment objectives and risk/reward criteria. We welcome the opportunity to further discuss the attractiveness of the loan market with you. Please contact us with any questions or comments.

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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