CQS Strategy Perspectives

Global Loans

March 2016

Loans: An attractive asset class which exhibits strong relative value, with low volatility

Global senior secured loans ('Loans'[1]) offer compelling investment opportunities. We believe the asset class is attractive on a risk-adjusted basis, particularly in the current environment where capturing yield and managing interest rate duration risk are paramount.

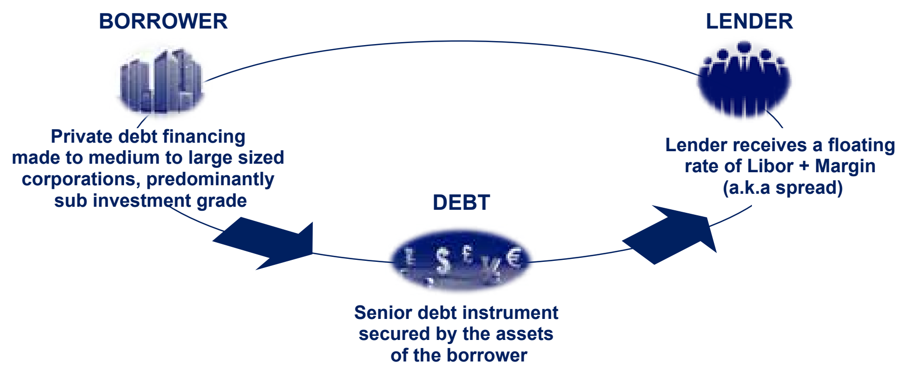
- Spreads on Loans are wide, at near historical highs
- Realised default rates remain benign
- Yields have dislocated from their credit fundamentals
- Loans offer a natural hedge against duration risk given their floating rate structure

> "TRADITIONAL INSTITUTIONAL INVESTORS HAVE INCREASINGLY RECOGNISED THE ATTRACTIVENESS OF THE ASSET CLASS

The Case for Global Secured Loans

We believe a global approach to investing in Loans provides institutional investors with flexibility to capture relative value, and facilitates reasonable diversification through careful credit selection. We believe that fundamental credit analysis is at the core of all credit investing and that an actively managed global loan mandate can generate excess returns with lower volatility compared with a static portfolio.

Figure 1: What are Loans?


BORROWER
Private debt financing made to medium to large sized corporations, predominantly sub investment grade
LENDER
Lender receives a floating rate of Libor + Margin (a.k.a spread)
DEBT
Senior debt instrument secured by the assets of the borrower

Bank Constraints Benefit Institutional Investors

The Loan market has traditionally been dominated by banks. Since the early 2000's institutional interest in Loans has been gradually increasing through the emergence of securitised vehicles (CLOs) and mutual funds (in the US). More recently, traditional institutional investors (such as pension and sovereign funds and insurance companies) have increasingly recognised the attractiveness of the asset class. Following the global financial crisis in 2008/9, increased regulation curtailed activity from traditional loan investors in Europe (primarily banks and CLOs) and this allowed institutional investors to benefit from more favourable spreads. We believe this trend is set to continue as banks continue to become increasingly capital and balance sheet constrained by regulation.

Source: [1]Loans in global senior secured loans which are typically syndicated bond loans, not peer-to-peer or direct loans.

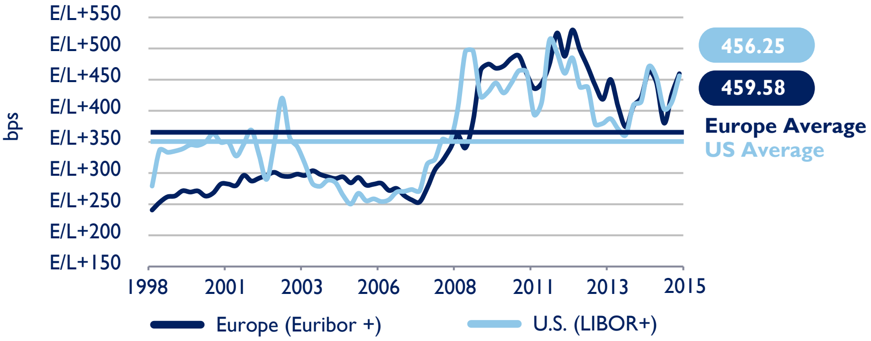
To put the global opportunity into context, the US loan market increased in size from $612bn in 2011 to $949bn as of 31 August 2015[2] and the European market has been stable at around €150bn[2] (although given the large number of private "club" deals, we believe that this understates the size of the market by approximately €25bn). This compares to a US and European high yield bond market of $1.3tn and €365bn, respectively.

> SPREADS ARE NEAR HISTORICAL HIGHS

Loan Spreads Remain Attractive in the US and Europe

Spreads on Loans currently stand at close to a post-crisis highs. With spreads in the region of €/L+550-600bps, we believe European and US Loans currently offer an attractive risk/return profile in both primary and secondary markets. Figure 2 illustrates this from a primary market's perspective showing spreads since 1998.

Figure 2: Primary Spreads Remain Attractive[3]

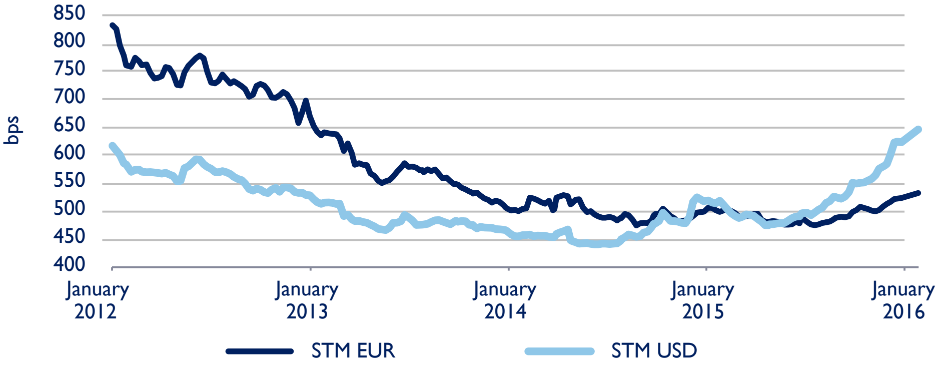


> THE TECHNICAL PICTURE HAS SHIFTED RELATIVE VALUE IN FAVOUR OF US LOANS

US Spreads at a Premium to Europe

Since early 2012, we have been a strong advocate of investing in European Loans, based on favourable technical factors and solid credit fundamentals. We now believe the technical picture has shifted relative value in favour of US Loans which have widened and are at a material premium to European Loans (as shown in Figure 3). This is further illustrated in cross-border transactions where dollar tranches are materially cheaper than euro tranches for the same borrower. In large part, this has been driven by technical factors and a perceived higher US exposure to the energy and commodities sector. US Loans' exposure to the energy and commodity sector is, however, modest at 2.6% of market value and materially less than that of US high yield at 11.7%.[4]

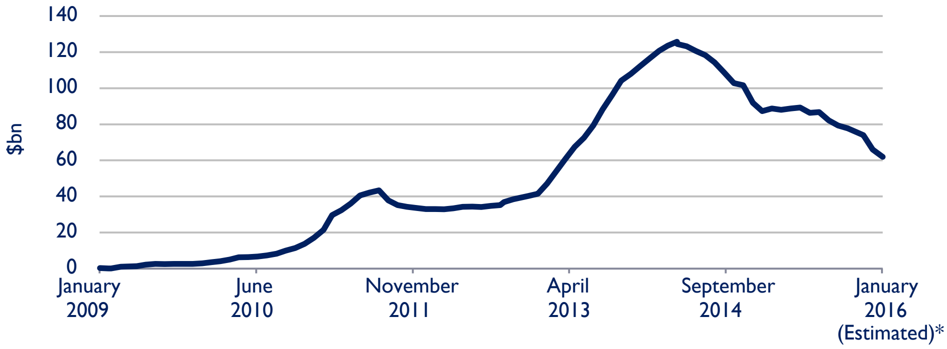
Figure 3: Secondary Spreads in US and Europe[5]



Source: [2]US Institutional Sub Investment Grade Secured Loan Market (Credit Suisse U.S. Leveraged Finance Projections Update 04 September 2015). [3]S&P Capital IQ - LCD Global Review – US/Europe, Q4 2015. 1Q08 WAIS for Europe includes exit financing facility for Delphi Corp., a cross-border transaction carrying a spread of 575. The 1Q08 WAIS excluding Delphi would be 308.3. [4]Credit Suisse LLI market Weightings 29 February 2016. [5]LCD Comps as at 29 January 2016 [6]S&P and LCD analysis as of 31 December 2015.

From 2009 to the middle of 2014, the US Loan market experienced material inflows from both retail mutual funds and CLOs. Cumulative inflow from Loan retail funds alone was more than $125bn[6]. Since mid-2014, however, retail flows have reversed as perceptions shifted regarding the timing and extent of the US Federal Reserve's Taper and perceptions of an interest rate hiking cycle.

Figure 4: US Retail Flows[7]

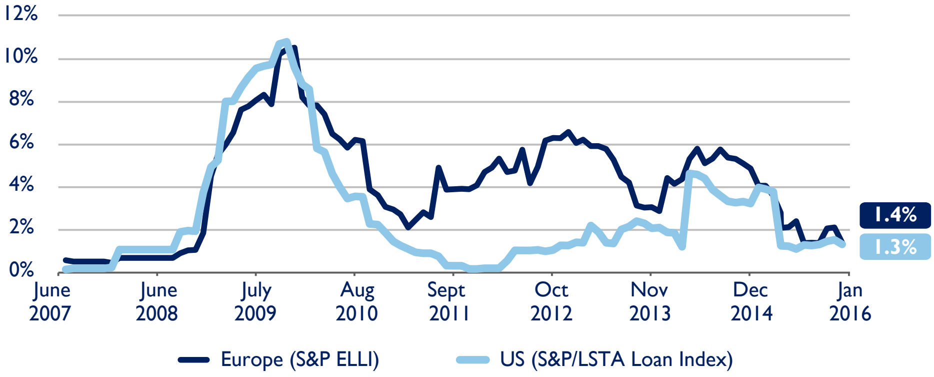


From its 2014 peak until January 2016, approximately $70bn has flowed out of US retail Loan funds. In contrast, the European Loan market has not experienced such volatility in retail flows because the UCITS Directive has a low limit on investment in Loans.

“ THE DEFAULT RATE IS NOT EXPECTED TO PICK UP SUBSTANTIALLY

As a result, the relationship between European and US loan spreads inversed over the last three years: US Loans spreads currently offer a 100bps premium over European Loans, while European Loans spread used to offer a more than 200bps premium three years ago (see Figure 3).

Figure 5: Lagging Twelve-Month Loan Default Rate Based on Principal Amount[8]



Realised Defaults Remain Benign

The default rate is not expected to pick up substantially. Acccording to Moody's, US default rates are expected to reach 4.4% by the end of 2016 and to remain near current levels of 3% in Europe.[9]

Source: [7]S&P and LCD as at 29 January 2016. *S&P and LCD estimated as at 29 January 2016. [8]S&P Capital IQ 29 January 2016 [9]Moody's High Yield Interest, 18 January, 2016. [9]Credit Suisse U.S. Leveraged Finance Projections Update 04 September 2015

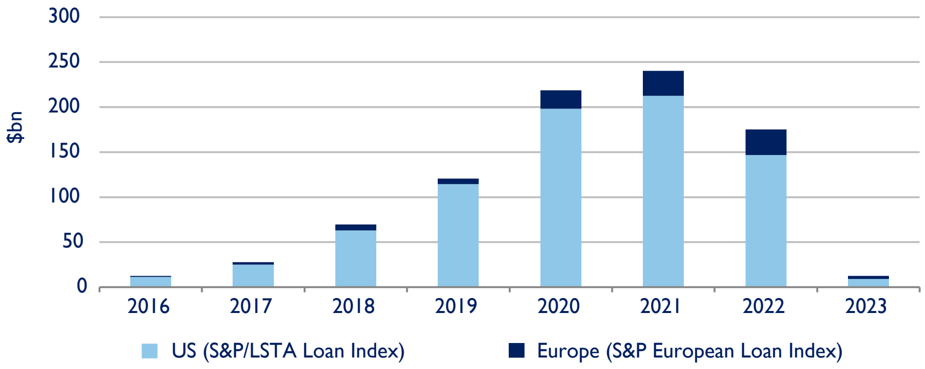
> “ THE IMPLIED DEFAULT RATE IS INCONSISTENT WITH UNDERLYING FUNDAMENTALS

This present level of relatively low default expectation can be partially explained by three main factors.

- The Loan market has a limited exposure to energy and other commodity-related sectors (c. 2.6% of US Loans[9] and quasi non-existent in Europe), which are expected to be the main source of increased defaults rates going forward.
- From a fundamental standpoint, interest cover (a metric used to assess companies' ability to service their debt) is currently at a historical peak, implying capital structures are more conservative and can allow for better absorption of future shocks, albeit we are cognisant of the low rate environment contributing to this stronger interest cover.
- Lastly, the maturity profile of outstanding Loans is manageable and partially mitigates against refinancing risk, as the next significant wall of maturities for Loans does not occur until 2019 (See Figure 6).

We therefore feel the implied expected default rate (and realised loss) is inconsistent with underlying credit fundamentals.

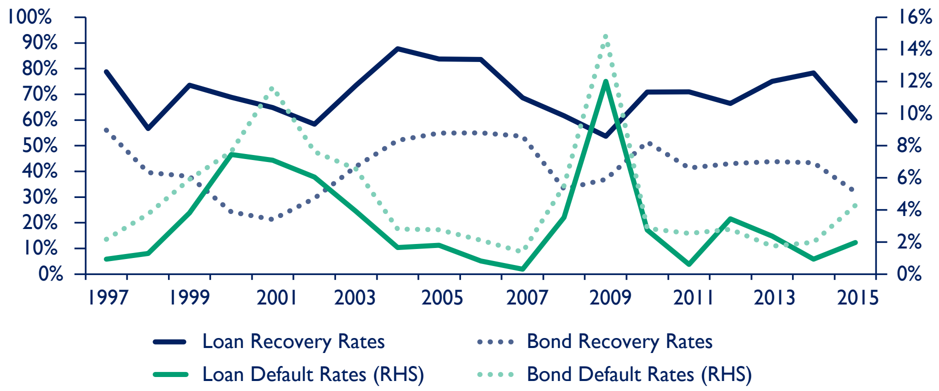
Figure 6: Global Senior Secured Loan Outstanding Maturity Profile[10]



In addition, recognising that wider macroeconomic conditions may potentially cause an unexpected increase in global default rates, there is a key mitigant from investing in Loans. As can be seen in Figure 7, while default and recovery rates have varied over time, Loans have exhibited lower default rates and higher recovery rates than high yield bonds.

> “ A FURTHER ADVANTAGE… NATURAL PROTECTION AGAINST INTEREST RATE DURATION RISK

Figure 7: Loan Recovery Rates Higher[11]



Source: [10]LCD S&P, Q4 2015, 31 December 2015. [11]Citi Global Structured Credit Focus, as at 4 February 2016.

> “WE BELIEVE FUNDAMENTAL CREDIT ANALYSIS IS AT THE CORE OF ALL CREDIT INVESTING

Loans Offer a Natural Hedge Against Duration Risk

Finally, from a longer-term perspective, senior secured Loans also have a further advantage. With interest rates at historic lows, many investors may become concerned about the high interest rate duration risk associated with traditional fixed income investments. The floating rate structure of senior secured Loans offers a natural protection against this interest rate duration risk.

Exploiting the Opportunity

Senior secured Loans are best viewed as a global sub-asset class. This enables actively managed portfolios to be highly selective on individual credits and to take advantage of opportunities in different geographies which in turn are driven by variations in technical, fundamental and regulatory factors. Critically, having a flexible, global investment approach, supported by a deep research bench and origination capability, enables CQS to best exploit opportunities and mitigate risks.

Carefully navigating such technicals, combined with fundamental research and asset selection, can allow a global loan portfolio to achieve attractive long-term risk-adjusted returns through the cycle. Consistent with the CQS philosophy, we believe fundamental credit analysis is at the core of all credit investing. Coupled with smart asset selection and dynamic portfolio management, we believe a global loan mandate can generate excess returns with lower volatility compared to a static loan portfolio.

> “A FLEXIBLE AND GLOBAL INVESTMENT APPROACH IS BETTER PLACED TO ACHIEVE STRONG ABSOLUTE AND RELATIVE RETURNS

Conclusion

In summary, we believe current spreads, expected probability of default and recoveries and the premium for illiquidity present Loans investors with a very attractive risk adjusted return opportunity. Furthermore, over the last few years, market volatility has structurally increased and is often exacerbated by the lack of inventory held by banks in the wake of tighter regulation. As a result, market conditions can change quickly and agility is increasingly important. We believe a flexible and global investment approach is better placed to achieve strong absolute and relative returns.

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Since inception, the firm has placed fundamental analysis at the heart of its investment process and we follow a collaborative multi-disciplinary approach seeking adjacencies across all areas in which we invest. Our robust operations and risk management platform provides all mandates with liquidity management and risk monitoring which, in our view, should enable our investment professionals to be more nimble and effective throughout all market environments.

Source: [1]CQS, estimated as at 1 March 2016.

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Contact Information

clientservice@cqsm.com
www.cqs.com

CQS (UK) LLP
CQS Investment Management Limited
4th Floor, One Strand
London WC2N 5HR
United Kingdom

Tel: +44 (0) 20 7201 6900
Fax: +44 (0) 20 7201 1200

CQS (Hong Kong) Limited
Unit 1207, 12th Floor
No.9 Queen's Road Central
Hong Kong
China

Tel: +852 3920 8600
Fax: +852 2521 3189

CQS (US), LLC
152 West 57th Street
40th Floor, New York
NY 10019
United States

Tel: +1 212 259 2900
Fax: +1 212 259 2699

CQS Investment Management (Australia) Pty Limited
Suite 9.02, 50 Pitt Street
Sydney
NSW, 2000
Australia

Tel: +61 2 8294 4180