Voya Senior Loan Group

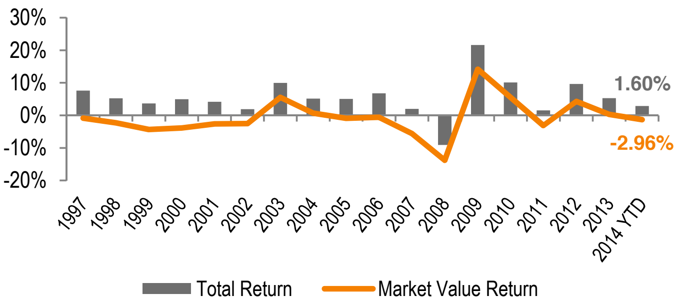
2014 Recap and 2015 Outlook

2014 – The Big Picture

Notwithstanding a full year total return that fell short of initial expectations, the global loan market navigated 2014's choppy waters in reasonably sound fashion. While credit fundamentals remained relatively healthy, overall investor sentiment and, in turn, average loan prices were buffeted by a series of external headwinds. These included, but were certainly not contained to: widely divergent views as to interest rate expectations and the health of the global economy; intensifying geopolitical risk globally; and escalating regulatory pressure on U.S. financial markets.

Adding a little extra drama to the equation was the post-Thanksgiving oil spill, and despite the loan market's significant underweight to energy as compared to high yield bonds (4-5%, vs. 15-17%), loans were pressured by the stress and sell-off in both high yield and equities. As a result, the S&P/LSTA Leveraged Loan Index (the "Index") returned 1.60% for the year. The final number was not what we and other managers were envisioning, but it was still in the black, marking another positive annual episode for an asset class with only one negative year in its recorded history (*i.e.*, the watershed year of 2008).

S&P/LSTA Leveraged Loan Index
Total Returns by Calendar Year



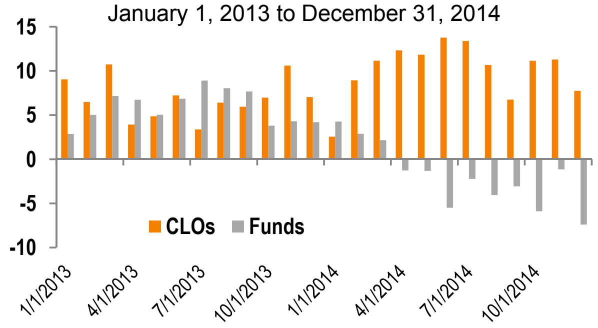
Relatively speaking, 2014 underscored the behavior of loans and high yield bonds ("HYB") in both robust and stressed market conditions, at least in the post-crisis era. Loans underperformed HYB (2.50%, as represented by the Bank of America/Merrill Lynch High Yield Bond Index) for the full year, but outperformed significantly in the second half of 2014 (-0.98%, vs. –2.97%). Since loans can rarely compete with HYB on coupon alone, the difference was volatility. True to historical form, loans during the year posted a lagging 12-month standard deviation of 0.56%, less than one-half that of HYB (1.30%).

2014 – Technically Speaking

With fundamental credit risk still largely under wraps, shifting market technicals (*i.e.*, investor demand versus overall supply, both new issue and secondary market) were the real story of the year. Arguably the most significant impediment to projected loan performance was the reality that short term rates spent another year stuck at all-time lows, with little forward visibility, despite increasingly positive U.S. economic data.

Stemming from this disappointment, demand from U.S. retail investors, so strong in 2013 when the fear of rising rates was palpable, waffled, regardless of the fact that loan spreads and yields improved throughout the year. And while the approximate $35 billion decline in mutual fund/ETF loan investment from a March 31 peak of $175 billion was, in the aggregate, more than offset by CLO and institutional inflow

Monthly Fund Flows
January 1, 2013 to December 31, 2014



Source: Lipper, Standard & Poor's Structured Finance Group, JP Morgan, Merrill Lynch, Citigroup, S&P/LSTA Index, Standard & Poor's LCD;

Portfolio Managers

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Voya Senior Loan Strategy

The Voya Senior Loan Group is a part of Voya Investment Management. The team is comprised of 28 investment professionals and 27 dedicated support staff. There are five portfolio management teams in Scottsdale, each of which is responsible for particular industries, and a team located in London that is responsible for sourcing overseas loans.

The Voya Senior Loan Strategy is an actively managed, ultra-short duration floating rate income strategy that invests primarily in privately syndicated, below investment grade senior secured corporate loans. Senior loans are floating rate instruments that can provide a natural hedge against rising interest rates. They are typically secured by a first priority lien on a borrower's assets, resulting in historically higher recoveries than unsecured corporate bonds.

(the former posting an annual record of $125 billion), selling pressure from open-end retail funds (and many HYB portfolio managers, to boot) in order to proactively create liquidity, put persistent weight on secondary prices for much of the year.

The other side of the technical "coin," new issue supply was, at times during the year, surprisingly strong, causing the universe of Index loans to expand to a record $831 billion at year-end, a 22% increase from the prior year end. Clearly, the long-awaited surge in M&A, one that loan investors had been clamoring for throughout 2013 as tool to absorb record inflows, and thus thwart the then seemingly endless wave of opportunistic re-pricings, finally came to fruition. Alas, it occurred during a period of moderating demand. Such can be the case in active markets.

2014 – The Riskiest Still Ruled

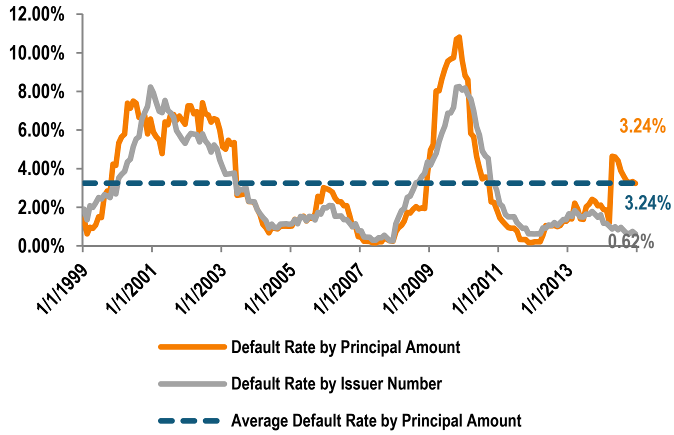
In the low rate, low default environment that defined most of 2014, the best performing credit rating cohort of the Index was the CCC component, at 6.09%. This compared to 1.52% and 1.43% for double and single Bs, respectively. As was the case throughout 2014, most of the action within the CCC bucket was idiosyncratic in nature and increasingly concentrated within a small number of issuers.

Somewhat surprisingly, the Index's CCC cohort performed relatively well during the December pullback, perhaps traceable to two major factors: (1) smaller exposure to the oil and gas sector and (2) better-than-expected Q3 results for a few distressed credits.

Default Activity - Still Benign and Expected to Remain That Way

Although trailing default rates by amount picked up slightly in 2014, they were down when measured by issuer count. During the year, there were five defaulters, down from twelve in 2013 (totaling $11.4 billion). The default rate by principal amount closed the year at 3.24%, up from 2.11%, but identical (literally) to the long term average, and inclusive of the very large, but anticipated, default of Energy Future Holdings ("EFH," formerly, TXU). Excluding EFH, the year-end figure was a scant 0.34%. As calculated by the number of loans within the Index, the rate decreased to 0.62%, from 1.61% at the end of 2013.

Lagging 12-Month Default Rate[1]
S&P/LSTA U.S. Leveraged Loan Index
December 31, 1998 to December 31, 2014

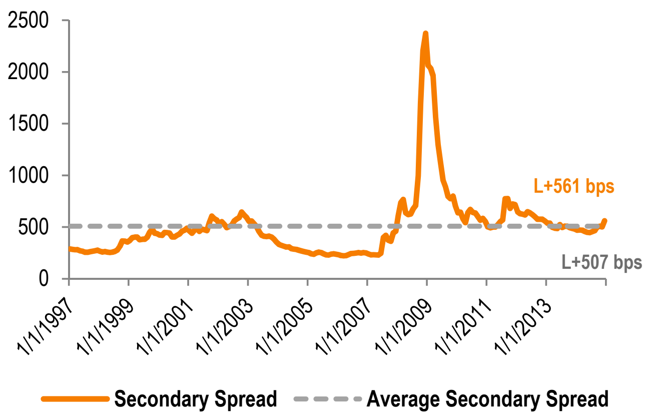


As for 2015, consensus default expectations continue to be quite modest, at least under a status quo economic forecast. As of the date of this publication, the first default of 2015 has occurred – Caesars Entertainment Operating Co., which tripped a default after skipping its Dec. 15th bond coupon payments. The Caesars default moved the LTM default rate by principal amount to 3.99%, but with the EFH default scheduled to fall off the rolling calculation in April, default rates for 2015 and early 2016 should remain moderate (again, subject to no material untoward economic or macro developments), a view supported by relatively benign forward default indicators within the Index.

The Meat and Potatoes: Valuation, Structure and Credit Fundamentals

The combination of weaker technicals and the energy-related risk-sell off at the end of 2014 had the effect of pushing loan prices to 95.92% of par at year end, the lowest level since September 2012. While clearly a negative for full-year total return, it does, we believe, provide an interesting set-up for 2015, particularly within the context of a relatively sanguine credit outlook. In addition, the shift in the balance of power, away from issuers to some degree, has worked to lift average new issue credit spreads and, consequently, overall yields. As of December 31, the discount yield to 3-year call for loans stood at L+561, *vs.* L+482 at the end of 2013.

Average Secondary Spreads of Leveraged Loans[2,3]
January 1, 1997 to December 31, 2014



Another positive, albeit nuanced, by-product of a more balanced market has been increased investor leverage in terms of deal structuring and underlying credit terms. Although covenant-lite is likely here to stay in some fashion until we hit the next real leverage-driven downturn (the last one being in 2001), many of the more egregious examples of documentation deterioration are now being actively challenged by loan managers and a few have now become the exception rather than the rule.

Speaking of credit fundamentals, average debt leverage multiples (*i.e.*, debt/EBITDA) indeed crept higher during 2014. At December 31, the Index averages stood at roughly 5x *total* debt (including the unsecured debt cushion) and 4x at the *senior secured* (*i.e.*, bank loan) level. While this number might seem reminiscent of where we stood in 2007, there are a couple of reasons why we don't think this story will end in the same sorry fashion.

For one, corporate earnings have remained healthy and average interest and fixed charge coverage ratios, important and often overlooked credit metrics, are at historically high levels (a good thing). While leverage levels have been edging higher over the last few years, they are, from a secured lender's perspective, within the historical range for the asset class. And while the trend in leverage "creep" looks eerily similar to what we saw in the 2005-2007 period, drawing a conclusion that we must therefore book an outcome similar to 2008 is dubious at best, given the nature of that unprecedented liquidity-driven correction. Excess debt leverage *on company balance sheets* was not the catalyst to that unprecedented drawdown; overall financial system leverage and the fear of systemic failure was the culprit.

Secondly, leveraged lending guidance, jointly issued by the U.S. Federal Reserve, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency in 2013, took root as regulators began actively reviewing bank underwriting practices and, as time passed, started publically calling out the worst violators. The guidance is intended to modify the behavior of corporate and investment bankers, highlighting leverage in excess of certain thresholds, debt servicing capacity and an absence of certain financial covenants.

The process of implementation has been slow thus far, but we believe that the main intention of regulators is to improve the safeguards against aggressive leveraged lending, not impair growth financing for below investment grade corporations. That's not to say there might not be some unintended consequences – potentially constraining capital formation and/or pushing the excesses into the unregulated non-bank part of the financial system. Only time will tell, but ultimately we believe it will still be a positive step toward maintaining a healthy balance within the asset class.

More Regulation

On the topic of regulation, we would be remiss not to mention the additional challenge of the U.S. Credit Risk Retention Rules, which were adopted on October 22, 2014. CLO managers will be required to retain 5% risk or "skin in the game." As these rules do not become effective until 2016, it is too early to make any definitive assertions on the likely impact, but it is not unreasonable to think that the CLO market landscape will change over the medium term, with perhaps reduced CLO issuance and fewer managers going forward.

In the short term, as the market digests the new rules, we might experience a reduction in CLO issuance, especially among managers of lesser scale, as investors question the sustainability of small-scale managers. It is our belief that a workable solution will be identified to keep, at a minimum, the larger, more experienced loan managers in the CLO origination business, be it through new capital-raising initiatives and/or iterative changes to the pending legislation. To that latter point, the financial markets have a history of adapting and finding solutions to regulatory changes.

As a final thought on this issue, we also firmly believe a rising short-term rate environment would effectively mitigate the potential worst-case outcome surrounding risk retention. Under that scenario, CLOs will be but one of several types of investors, institutional and retail alike, attracted to our floating rate asset class.

The Road Ahead

So that brings us to the outlook for 2015. With a couple of weeks of the New Year now under our belt, we can say with perfect hindsight that things did not start off terribly well. The energy crash that so disrupted this past December continues to dominate financial headlines and, at best, cause investment gridlock across many asset classes. Add to that a few new headwinds, including but not limited to, a potential global currency war, renewed political discord between the executive and legislative branches of the U.S. government, and the pending Greek election (the last two conjuring less than fond memories of 2001!). Taken together, these issues constitute a classic "wall of worry," almost certain to cause further market turbulence.

But worry itself isn't much of an investment strategy, and there are solid reasons why loans look interesting, even in the face of these challenges. Among those front and center: attractive yields, regardless of any movement upward in short term rates; improved valuations and potential capital gain upside; and widening credit spreads. Not to mention the potential benefit of being a floating rate asset class. (Dare we mention the prospects of rising interest rates…?) For those concerned about taking greater credit risk, historical data clearly proves secured loans clearly carry less risk of loss given default than a typical unsecured HYB. And, important when viewed through a lens of expected macro uncertainties, loans, by way of being secured by issuer assets and interest rate neutral, are inherently less volatile than most other high income producing asset classes.

That is not to say that we enter into 2015 without a strong appreciation for a unique set of risk factors. December in particular reminded us of the liquidity challenges loans continue to face. While asset-level liquidity (*i.e.*, actual trading volumes, the number of dealer desks making a market in a given issue, and the width of the bid-ask spread) has been adequate through most market conditions, settlement liquidity, *i.e.*, the time it takes for cash to change hands, remains a concern, particularly against a backdrop of persistent outflows from open-end retail platforms and less capital buttressing banks' trading activities. So far, so good in this area, but the astute loan investor is wise to remain vigilant in his/her analysis of this dynamic.

Last, but certainly not least – the "number." At the risk of being caught repeating ourselves, we fully expect the global hunt for yield to continue, and, again, the loan asset class is well positioned to deliver on that thesis. Our overall Index total return expectation for 2015 falls within the 4%-5% band, with a mild bull case at 6-7% (*i.e.,* coupon plus two to three points of market value pickup). A moderate to "angrier" bear case would fall in the range of 2-3% and getting there would necessitate an unexpected spike in volatility, again, we believe, driven by factors external to the loan market itself.

General Risks for Floating Rate Senior Bank Loans: Floating rate senior bank loans involve certain risks. Below investment grade assets carry a higher than normal risk that borrowers may default in the timely payment of principal and interest on their loans, which would likely cause the value of the investment to decrease. Changes in short-term market interest rates will directly affect the yield on investments in floating rate senior bank loans. If such rates fall, the investment's yield will also fall. If interest rate spreads on loans decline in general, the yield on such loans will fall and the value of such loans may decrease. When short-term market interest rates rise, because of the lag between changes in such short term rates and the resetting of the floating rates on senior loans, the impact of rising rates will be delayed to the extent of such lag. Because of the limited secondary market for floating rate senior bank loans, the ability to sell these loans in a timely fashion and/or at a favorable price may be limited. An increase or decrease in the demand for loans may adversely affect the loans.

Unless otherwise noted, the source for all data in this report is Standard & Poor's/LCD. S&P/LCD does not make any representations or warranties as to the completeness, accuracy or sufficiency of the data in this report.

1 – Comprises all loans, including those not tracked in the LSTA/LPC mark-to-market service. Vast majority are institutional tranches. Issuer default rate is calculated as the number of defaults over the last twelve months divided by the number of issuers in the Index at the beginning of the twelve-month period. Principal default rate is calculated as the amount defaulted over the last twelve months divided by the amount outstanding at the beginning of the twelve-month period.

2 –Assumes 3 Year Maturity. Three year maturity assumption: (i) all loans pay off at par in 3 years, (ii) discount from par is amortized evenly over the 3 years as additional spread, and (iii) no other principal payments during the 3 years. Discounted spread is calculated based upon the current bid price, not on par.

3 – Excludes facilities that are currently in default.

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