The timeless case for floating-rate loans as a strategic allocation

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Floating-rate loans deserve consideration as a strategic portfolio allocation because they can offer:

1. **Attractive yields** – The rate on loans was among the highest global fixed-income sectors (as of 30 April 2016).
2. **Protection against interest-rate risk** – Loans have near-zero duration and rates that move with the underlying benchmark – typically Libor.
3. **A structure designed to mitigate credit risk** – Senior/secured positioning in the capital structure offers a layer of protection that is unique in the corporate fixed-income market.
4. **A forward-looking allocation** – Loans historically have outperformed the broad bond market in flat and rising rate environments. We believe loans are likely to be an important source of diversification in the coming years.

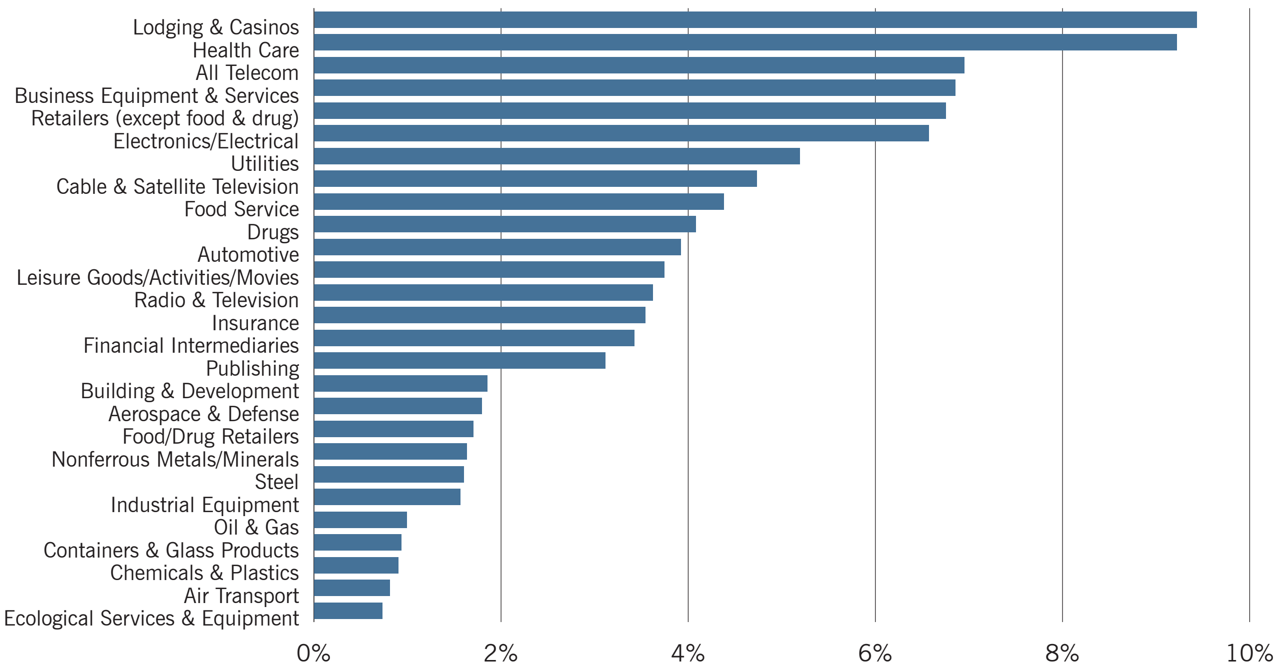
Floating-rate loans occupy a unique capital-market niche. Nothing else in the fixed-income universe combines yields that are among the highest-yielding global sectors (as of 30 April 2016) with the potential to boost total return when rates rise. No other corporate bonds are designed the same way to mitigate credit risk with senior/secured positioning in the capital structure.

The value of floating-rate loans has been proven across a number of credit cycles, thanks to consistently disciplined underwriting standards with a significant margin of safety. Since 2001, loans have returned more than 99% of principal and about 500 basis points (bps) of annual income, based on the S&P/LSTA Leveraged Loan Index (the Index). This paper outlines how fixed-income portfolios can potentially be enhanced by floating-rate loans, and why we believe they should be included as a strategic allocation.

What are floating-rate loans?[1]

Floating-rate loans represent below-investment-grade debt of corporate issuers, which frequently use the market for a variety of purposes such as recapitalisations, acquisitions and refinancings. Most issuers are of significant size and scale, and many are familiar household names, like Burger King, Dell and American Airlines. It is a broadly diversified market, with more than 1,200 issues comprising the Index, from issuers across 27 different sectors (Exhibit A).

Exhibit A **A diverse range of (often familiar) issuers use the floating-rate loan market.**

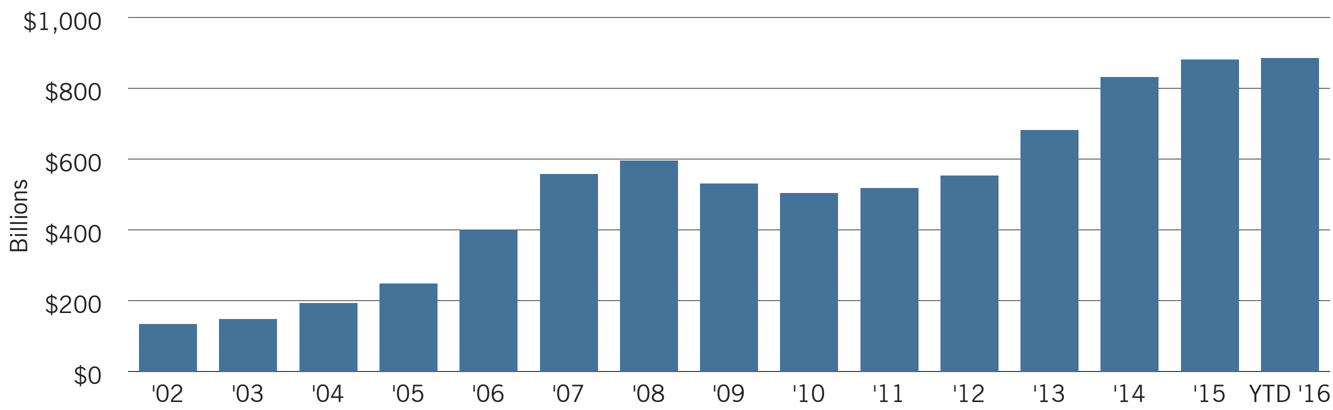


Source: S&P/LSTA, 30 April 2016.

Today's loan market is built on a conservative bank lending tradition that emphasises due diligence and strict underwriting standards. Loans were first originated and syndicated among a relatively small number of banks. But, that arrangement has evolved into a thriving capital market, including a wide range of institutional investors and the participation of a number of loan managers. The par amount outstanding in the U.S. market has increased from a negligible level to almost $900 billion over the past 20 years (Exhibit B), including a deep and liquid secondary market.

[1]Floating-rate loans are also known as leveraged loans, senior loans and bank loans.

Exhibit B **The loan market has grown dramatically over the past two decades.**

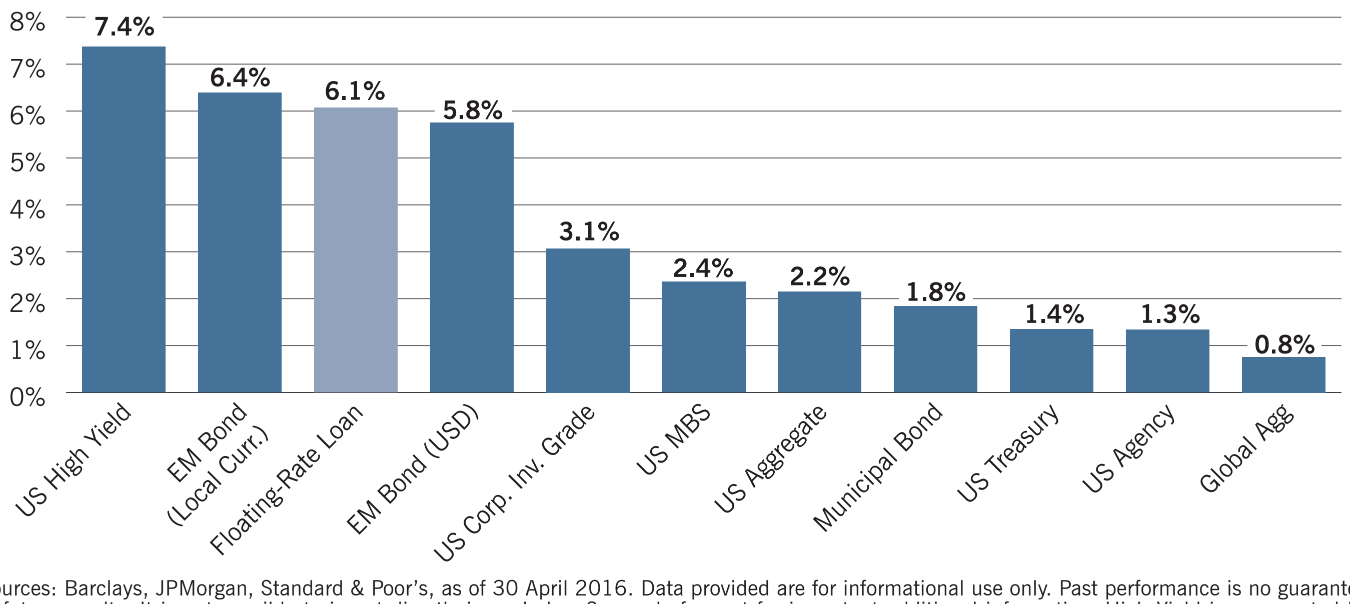


Source: S&P/LSTA, 30 April 2016.

1. Attractive yields

The yields available from floating-rate loans are typically among the highest global fixed-income sectors. For example, on 30 April 2016, the 6.1% yield on loans ranked third, behind U.S. high yield and local currency emerging-market bonds – almost eight times the yield on the Barclays Global Aggregate Ex-USD Index (Exhibit C). In a world of microscopic and negative interest rates, this level of return could be a welcome addition to a fixed-income portfolio.

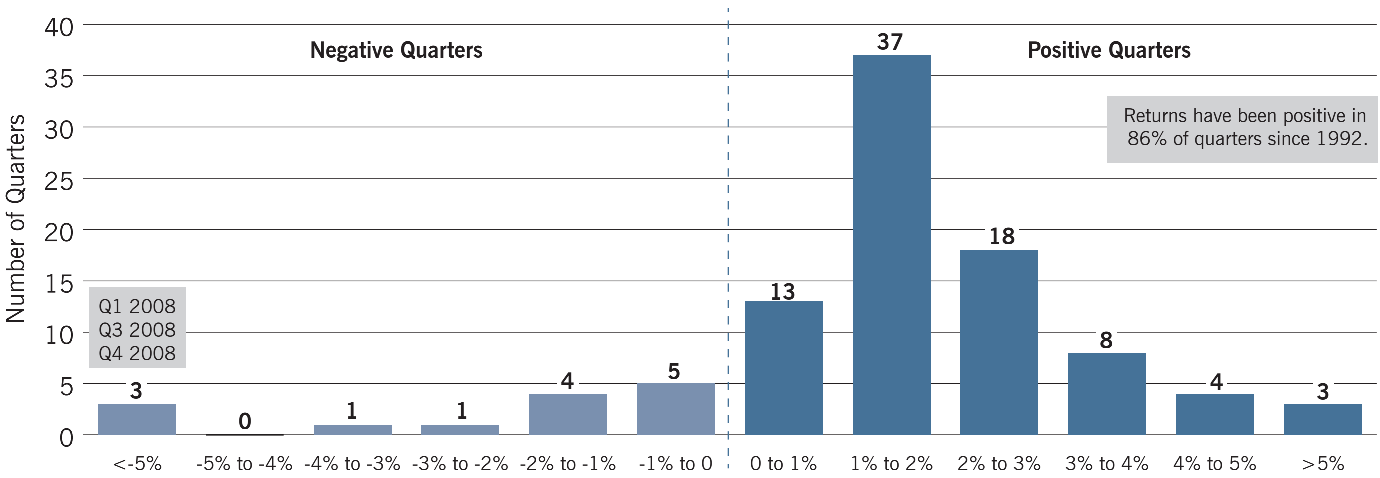
Exhibit C **Loans have been among the highest-yielding fixed-income sectors.**



Sources: Barclays, JPMorgan, Standard & Poor's, as of 30 April 2016. Data provided are for informational use only. Past performance is no guarantee of future results. It is not possible to invest directly in an Index. See end of report for important additional information. High Yield is represented by Barclays U.S. Corporate High Yield. U.S. EM Bond (Local Currency) is represented by JPMorgan Government Bond Index-Emerging Markets (GBI-EM) Global Diversified. Floating-Rate Loans are represented by S&P/LSTA Leveraged Loan Index. EM Bond is represented by JPMorgan Emerging Markets Bond Index Plus(EMBI+). U.S Corporate Investment Grade is represented by Barclays U.S. Corporate Investment Grade Index. U.S. MBS is represented by Barclays U.S. Mortgage-Backed Securities (MBS) Index. U.S. Aggregate represents aabroad range of U.S. investment-grade debt. Municipal Bond is represented by the Barclays Municipal Bond Index. U.S. Treasury is represented by Barclays U.S. Treasury Index. U.S. Agency is represented by Barclays U.S. Agency Index. Global Agg is represented by Barclays Global Aggregate Ex-USD Index.

Loan yields have provided historically strong support for total return. The distribution of quarterly total returns on loans since 1992 in Exhibit D shows that those returns were positive 86% of the time, illustrating how their income stream can cushion price fluctuations. As we will see next, that's especially valuable when interest rates are a big factor weighing on prices of traditional bonds.

Exhibit D **Thanks to the income stream on loans, negative loan returns have been rare.**
Distribution of quarterly total returns 1992 - Q1 2016



Source: Zephyr, as of 31 March 2016. Data provided are for informational use only. Past performance is no guarantee of future results. It is not possible to invest directly in an Index. See end of report for important additional information. Loan performance is represented by the Credit Suisse Leveraged Loan Index.

2. Protection against interest-rate risk

One of the basic features of floating-rate loans is that their coupons reset every 40 to 60 days, on average, with adjustments that are calculated as fixed spread over a variable benchmark – typically the London Interbank Offered Rate, or Libor. For example, on 31 March 2016, the Index traded at Libor + 658 basis points. This means that floating-rate loans have negligible duration – rates rise in tandem with Libor.

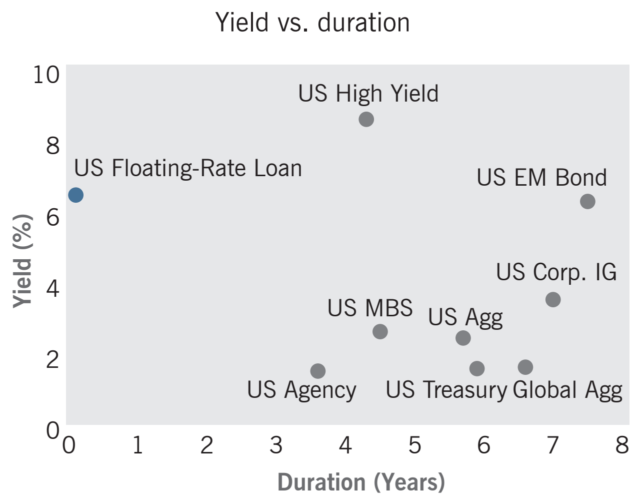
When you combine the facts that loans have had higher historical yields and lower duration than traditional bonds, you wind up with the Exhibit E scatterplot on the left. It shows how loans have the highest ratio of yield per unit of duration versus other major fixed-income sectors. Exhibit E (right) rounds out the picture, showing loans have had low correlation with other sectors, thanks to their low interest rate sensitivity.

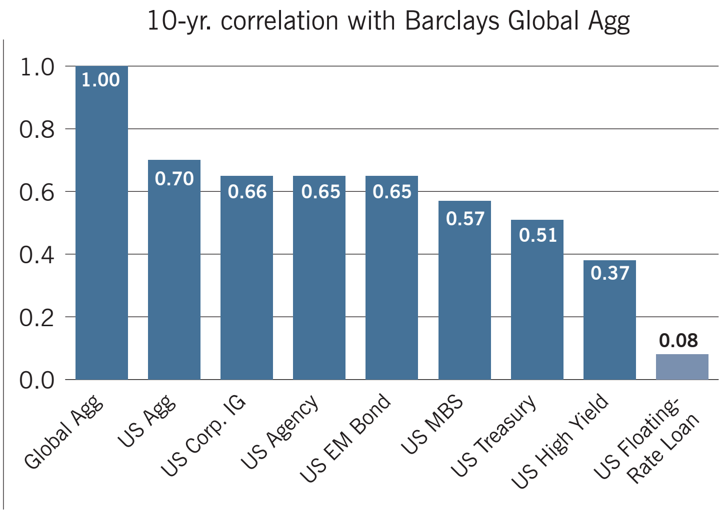
Looking back at the past three periods of rising rates since 1994 in Exhibit F, the historical performance of loans versus bonds bears out the concepts in Exhibit E. For example, when the U.S. federal funds rate increased by 175 basis points for the 12 months ended May 2000, loans returned 3.9% compared with -4.8% for bonds. Most recently, when the U.S. Federal Reserve raised rates from 1.0% to 5.25% over the two years ended June 2006, loans returned 12.7% vs. 10.6% for bonds.

3. A structure designed to mitigate credit risk

Loans have a layer of credit protection that is unique in the corporate fixed-income market, thanks to their senior/

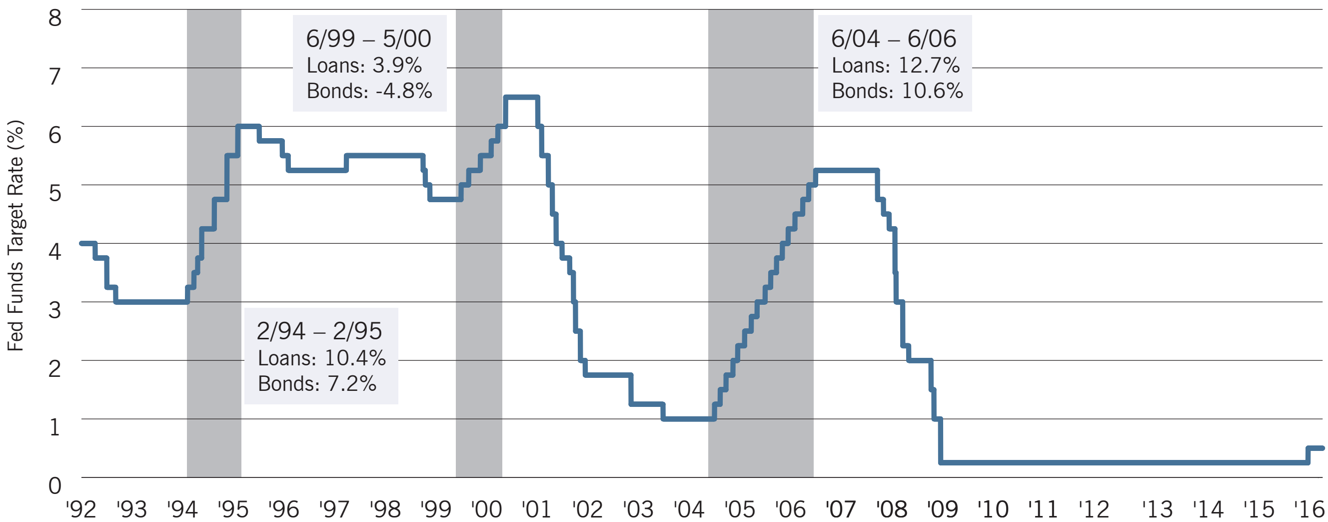
Exhibit E **Floating-rate loans: The highest yield/duration ratio and lowest correlation with other debt.**





Sources: Barclays, JPMorgan, Standard & Poor's, as of 30 April 2016. Data provided are for informational use only. Past performance is no guarantee of future results. It is not possible to invest directly in an Index. See end of report for important additional information. High Yield is represented by Barclays U.S. Corporate High Yield. U.S. EM Bond (Local Currency) is represented by JPMorgan Government Bond Index-Emerging Markets (GBI-EM) Global Diversified. Floating-Rate Loans are represented by S&P/LSTA Leveraged Loan Index. EM Bond is represented by JPMorgan Emerging Markets Bond Index Plus(EMBI+). U.S Corporate Investment Grade is represented by Barclays U.S. Corporate Investment Grade Index. U.S. MBS is represented by Barclays U.S. Mortgage-Backed Securities (MBS) Index. U.S. Aggregate represents aabroad range of U.S. investment-grade debt. Municipal Bond is represented by the Barclays Municipal Bond Index. U.S. Treasury is represented by Barclays U.S. Treasury Index. U.S. Agency is represented by Barclays U.S. Agency Index. Global Agg is represented by Barclays Global Aggregate Ex-USD Index.

Exhibit F **Loans have handily outperformed bonds in rising rate periods.**



Source: Morningstar, 31 March 2016. Data provided are for informational use only. Past performance is no guarantee of future results. It is not possible to invest directly in an Index. See end of report for important additional information. Performance is cumulative and rising rates are defined as any period where the federal funds target rate increased at least 1%. Loan performance is represented by Credit Suisse Leveraged Loan Index. Bond performance is represented by Barclays Global Aggregate Ex-USD Index.

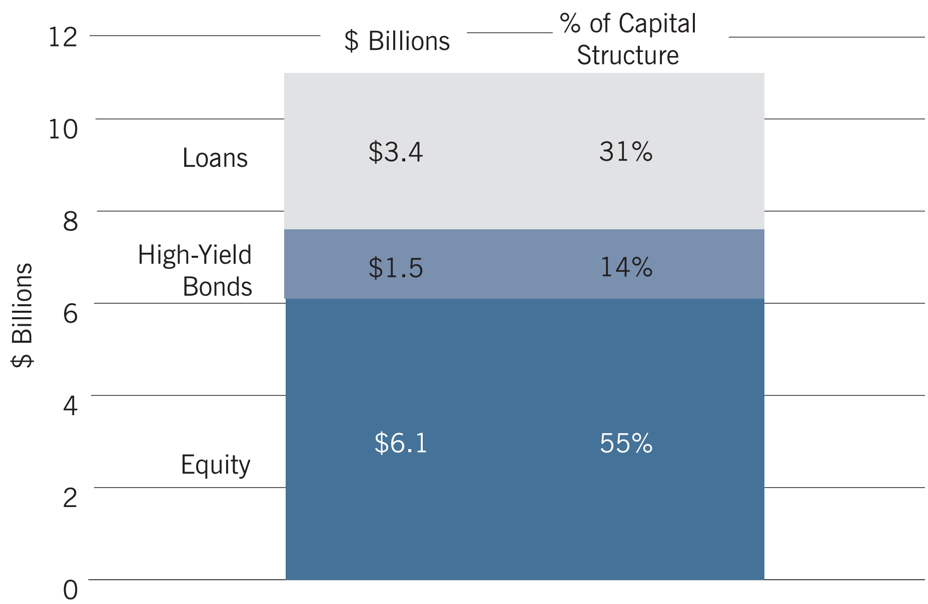
secured positioning in the issuer's capital structure, as illustrated in Exhibit G. In the event of default, the claims of loan investors are ahead of those for high-yield bonds and equity. Because loans comprise 31% of the capital structure, the junior layers of high yield and equity amount to a "capital cushion" equivalent to about two-thirds of the enterprise value. In addition, loans are typically secured by specific corporate assets. This conservative "belts-and-suspenders" approach to lending has been very effective: Over the past 20 years, loans have had a 70% recovery rate from bankruptcies, based on 20 years of experience at Eaton Vance, compared with 40% for high-yield bonds.

Exhibit H shows the powerful impact of the 70% average recovery rate on loans over the past 15 years. With 70% being recovered, net credit loss amounts to 30% of the 3% average default rate since 2001, or about 1%. That means 99% of principal has been returned to investors over a period that has been stressed by two recessions, including the "great" one of 2008.

Exhibit G **Senior positioning for loans is a cushion against credit risk.**

Weighted average company capital structure

- **Revenue: $5.2 billion**
- **EBITDA: $868 million**
- **Enterprise Value: $11 billion**



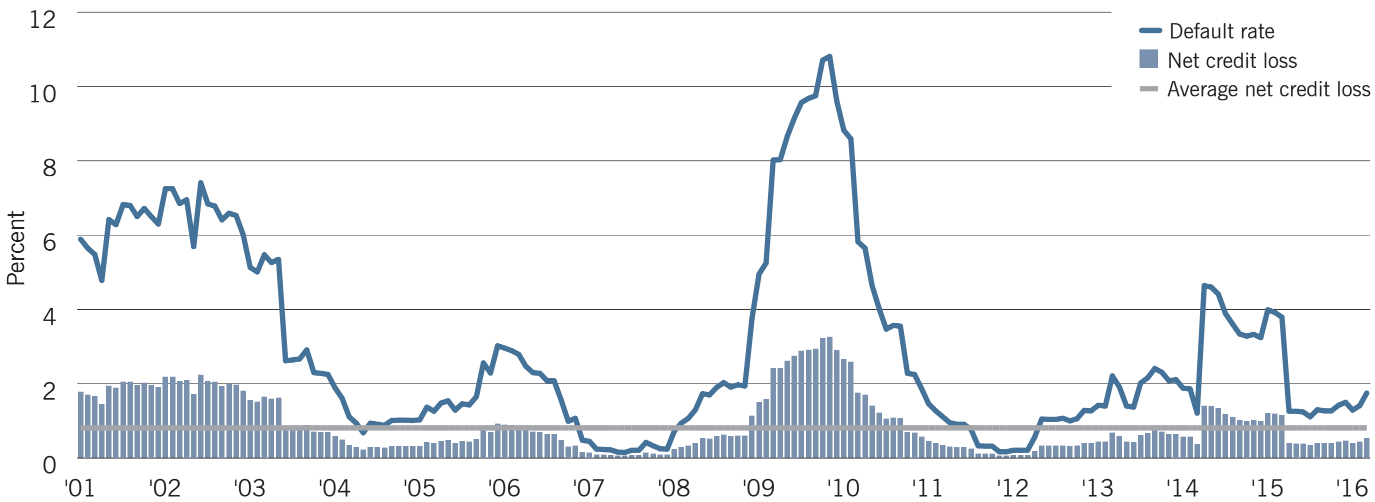
Source: Eaton Vance as of 31 December 2015. Data provided are for informational use only. Past performance is no guarantee of future results. It is not possible to invest directly in an Index. See end of report for important additional information. This information is for illustrative purposes only, is subject to change at any time and should not be considered investment advice or a recommendation to buy or sell any particular security or adopt any particular strategy. The sample is an average of all loans currently tracked across the Eaton Vance loan platform as of 31 December 2015. It does not represent any particular issuer or product. EBITDA is a common measure of corporate cash flow that is defined as earnings before interest taxes depreciation and amortisation.

4. A forward-looking allocation

The history of loan performance over the past 20 years – part of the greatest bond bull market in modern history – provides important clues as to why loans may be key in forward-looking portfolio positioning as we start on the next 20.

For the 20 years ended 31 December 2015, the yield on 10-year German benchmark note fell from 5.9% to 0.18%. This was a tremendous tailwind for traditional bonds, as falling rates pushed up their prices and boosted total return – a relative advantage for bonds over loans, whose prices are relatively unaffected by interest-rate changes. But because of the outperformance of loans during flat and rising rate environments over that period, the Credit Suisse Leverage Loan Index still had a higher average annual return of 4.9% versus 4.5% for the Barclays Global Aggregate Ex-USD Index.

Exhibit H **Conservative loan structure has held net credit losses to 1% over 15 years.**



Source: Eaton Vance as of 31 March 2016. Data provided are for informational use only. Past performance is no guarantee of future results. It is not possible to invest directly in an Index. See end of report for important additional information. Floating-rate loans are represented by the S&P/LSTA Leveraged Loan Index. Net credit loss assumes an average 70% recovery rate – the level experienced by Eaton Vance over 20 years – applied consistently over all periods.

During this epic bull run for the Barclays Global Aggregate Ex-USD Index, loans outperformed that index 64% of the time, when we look at the 276 rolling one-year periods since 1992 and classify them as flat-, rising- or falling-rate.[2] (The interest-rate direction was determined by the change in the U.S. fed funds rate over the period.)

As illustrated in Exhibit I, loans outperformed bonds during the 86 rising rate periods, by an average 7.3% vs. 4.1%, and during the 91 flat rate periods, 8.4% vs. 3.9%. During the 99 falling rate periods, bonds outperformed loans by an average of 8.5% to 2.8%.

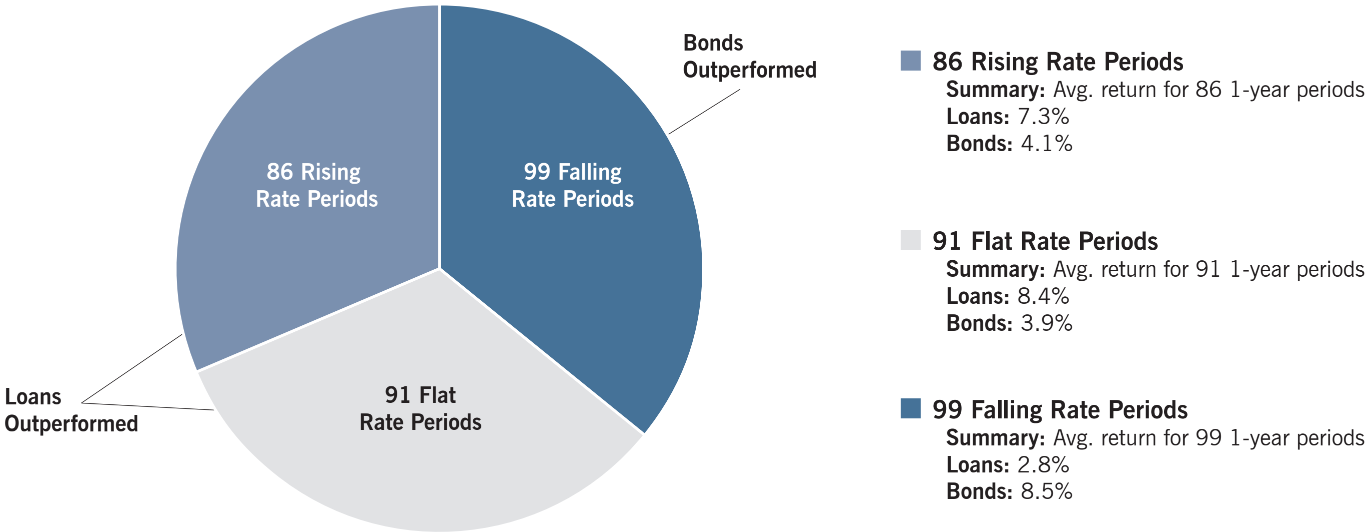
To us, this analysis underscores the importance of fixed-income diversification based on expected performance characteristics. Generally, floating-rate loans are at a relative disadvantage as rates decline and yields are reduced, but have a relative advantage as rates rise. Flat interest-rate environments would also tend to give the yield edge to floating-rate loans because they are generally higher-yielding below-investment-grade quality, while the Barclays Global Aggregate Ex-USD tracks lower-yielding investment-grade bonds. Loans proved their worth as a diversifier in the majority of times when rates were rising or flat.

If we pivot to the likelihood of future possibilities, we find both short- and long-term rates near their lower bounds, the U.S. Federal Reserve starting (with all due caution) to raise rates and other global central banks keeping rates at zero or less.

Exhibit J uses the basic bond math of duration and hypothetical interest-rate moves to illustrate the potential impact on total return over one year. For example, if we assume rates will stay close to flat, the yield advantage of loans works out to a 5.1 point advantage in return. If rates increase by 100 basis points (bps), the differential

[2]For purposes of this analysis, we went back 24 years, to start at the inception of the Credit Suisse Leveraged Loan Index.

Exhibit I **Loans have outperformed bonds in flat- and rising-rate periods.**



Eaton Vance, 31 December 2015. Data provided are for informational use only. Past performance is no guarantee of future results. It is not possible to invest directly in an Index. See end of report for important additional information. Loans are represented by Credit Suisse Leveraged Loan Index and bonds are represented by the Barclays Global Aggregate Ex-USD Index. Analysis includes all rolling one-year periods since inception of Credit Suisse Leveraged Loan Index in February 1992.

between loans and the Barclays Global Aggregate Ex-USD Index widens to 19.5 points. Falling rate scenarios (which are much less likely, in our view) turn the advantage to the Barclays Global Aggregate Ex-USD Index after a decline of more than 50 bps.

Exhibit I shows how loans had value as a portfolio diversifier even when the overall tail wind for bonds was strong for two decades. Exhibit J points to how much more valuable loans could be, now that the era of large interest-rate declines is history.

It's important to note we have not discussed other factors that can influence price movements of both loans and the Barclays Global Aggregate Ex-USD Index, besides interest rates. This could include change due to investor sentiment about credit risk in general (or of particular issuers), the spread level between investment-grade and below-investment-grade debt and so forth. We simply wish to illustrate the principle of duration risk and the importance of positioning portfolios to account for it.

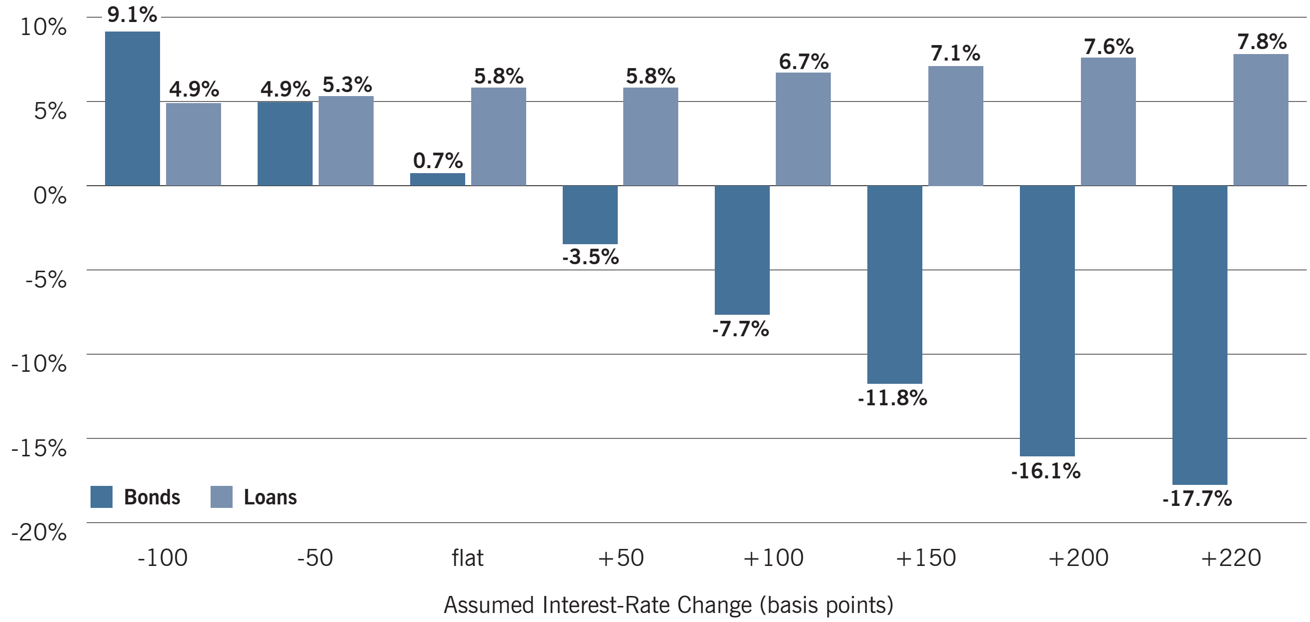
A proven tool for managing uncertainty

Both interest rates and credit risk are cyclical. The insight that has made floating-rate loans useful and enduring is that these cyclical risks can be managed through a prudent lending structure – one that benefits both investors seeking higher rates and below-investment-grade issuers seeking market access. In our opinion, the risks can further be mitigated with the due diligence and expertise of professional management – we do not believe it is a market that lends itself to the "commoditisation" of passive strategies.

Because it's impossible to pinpoint when the next rising rate scenario will occur, the track record of loans makes a good case for a strategic allocation – one that benefits

Exhibit J **The value of loans may increase significantly if rates stay flat or rise.**

Hypothetical one-year returns



Source: Eaton Vance as of 31 March 2016. Data provided are for informational use only. Past performance is no guarantee of future results. It is not possible to invest directly in an Index. See end of report for important additional information. Bonds are represented by the Barclays Global Aggregate Ex-USD Index, with a yield of 0.74% and duration of 8.4 years. For loans, we use the S&P/LSTA Index, with a net yield of 5.8%, based on a market yield of 6.5%, reduced by 30% to account for expected defaults and recoveries — the average level observed by Eaton Vance over 20 years. Duration is 0.1 years. Return calculations are based on standard duration formula, assuming parallel shifts in the yield curve, instantaneous rises in interest rates and adjustments of benchmark yields over a one-year period. Chart represents projections based on various interest-rate scenarios, but is not intended to predict any particular scenario. The information is based, in part, on hypothetical assumptions and the experience of Eaton Vance. Certain of the assumptions have been made for modeling purposes and are unlikely to be realised. Changes in the assumptions and scenarios may have a material impact on the information shown.

from strong current yields, combined with "insurance" for the day when rates tack back upward. Whether we are on the cusp of a new cycle of rising rates, or some ways away from it, loans still offer an immediate benefit: the luxury of not having to make that call.

Index Definitions

Barclays U.S. Aggregate Bond Index is an unmanaged index of domestic investment-grade bonds, including corporate, government and mortgage-backed securities.

Barclays U.S. Treasury Index is an unmanaged index of U.S. Treasury securities, and a component of the Barclays U.S. Aggregate Bond Index.

Barclays U.S. Corporate Investment Grade Index is an unmanaged index that measures the performance of investment-grade corporate securities within the Barclays U.S. Aggregate Index.

Barclays U.S. Mortgage Backed Securities (MBS) Index measures agency mortgage-backed pass-through securities issued by GNMA, FNMA and FHLMC.

Barclays U.S. Corporate High Yield Index measures USD-denominated, noninvestment-grade corporate securities.

Barclays Municipal Bond Index is an unmanaged index of municipal bonds traded in the U.S.

S&P/LSTA Leveraged Loan Index is an unmanaged index of the institutional leveraged loan market.

Credit Suisse Leveraged Loan Index is an unmanaged index of the institutional leveraged loan market.

Barclays Global Aggregate Ex-USD Index is a broad-based measure of global investment-grade fixed-rate debt investments, excluding USD-denominated debt.

JPMorgan Government Bond Index-Emerging Markets (GBI-EM) Global Diversified is an unmanaged index of local currency bonds with maturities of more than one year issued by emerging-market governments.

Unless otherwise stated, index returns do not reflect the effect of any applicable sales charges, commissions, expenses, taxes or leverage, as applicable. It is not possible to invest directly in an index. Historical performance of the index illustrates market trends and does not represent the past or future performance.

About Eaton Vance

Eaton Vance is a leading global asset manager whose history dates to 1924. With offices in North America, Europe, Asia and Australia, Eaton Vance and its affiliates offer individuals and institutions a broad array of investment strategies and wealth management solutions. The Company's long record of providing exemplary service, timely innovation and attractive returns through a variety of market conditions has made Eaton Vance the investment manager of choice for many of today's most discerning investors. For more information about Eaton Vance, visit eatonvance.com.

About EVMI

Eaton Vance Management (International) Limited (EVMI) is a subsidiary of Eaton Vance Management (EVM), a leading U.S. asset management organisation, and markets internationally the investment capabilities of Eaton Vance Management and its affiliates, including Parametric Portfolio Associates, LLC. EVMI has been based in London since 2001.

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