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S&P/LSTA Loan Index

A 10-year Retrospective

April 2007



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Speaking of clarity, can someone please translate this memo from IT for me?



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Contents

The S&P/LSTA Loan Index 1997-2006	3
Section 1: Loan Market Overview	4
Section 2: S&P/LSTA Index Demographics	6
Section 2: Loan Market Performance	8
Section 4: Loan Market Versus Other Asset Classes	10
Appendix: S&P/LSTA Leveraged Loan Index	14
Key Contacts/Directory	16

The S&P/LSTA Loan Index 1997–2006

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When Standard & Poor's Ratings Services and the Loan Syndications & Trading Association rolled out the S&P/LSTA leveraged loan index in 2000, it was back-loaded with four years of data dating to 1997. At the end of 2006, the index had accumulated 10 years of performance history for the leveraged loan market. This report describes the leveraged loan market's performance over the past decade, which has been a time of stupendous growth for the loan asset class.

By way of background, the leveraged loan market consists of loans made to speculative-grade borrowers. The vast majority of loans are senior secured floating-rate paper that the issuer can prepay with little or no restrictions or fees. In this universe, loans are either first-lien or second-lien. As their monikers imply, first-lien loans have a senior claim on collateral, while second-lien loans have a junior claim.

In general, loans range in size from \$50 million at the low end to upward of \$10 billion on the high end. They are used for a variety of purposes, most commonly for leveraged buyouts, recapitalization, and refinancings.

Most leveraged loans are structured and syndicated to accommodate the two primary syndicated lender constituencies: banks (domestic and foreign) and institutional investors (mainly structured finance vehicles, mutual funds, and insurance companies). As such, leveraged loans consist of:

- Pro rata debt consists of the revolving credit and amortizing term loan (TLA),

which are packaged together and usually syndicated to banks. In some loans, however, institutional investors take pieces of the TLA and, less often, the revolving credit, as a way to secure a larger institutional term loan allocation. Why are these tranches called "pro rata"? Because arrangers historically syndicated revolving credit and TLA's on a pro rata basis to banks and finance companies.

- Institutional debt consists of term loans structured specifically for institutional investors, although there are also some banks that buy institutional term loans. These tranches include first- and second-lien loans, as well as prefunded letters of credit. Traditionally, institutional tranches were referred to as TLB's because they were bullet payments and lined up behind TLA's.

The S&P/LSTA index consists largely of institutional loans and is intended to illustrate the performance of these loans. Thus, most of the data in this report surround the loan market's institutional segment.

Section 1:

Loan Market Overview

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As a result, institutional loans grew to 41% of the overall universe of institutional and high-yield bonds, or \$355 billion of \$953 billion, from 28% a year earlier and from 25% at the end of 2004.

Over the past decade, a growing and vibrant base of nonbank investors has transformed the leveraged loan market. At the end of 2006, their ranks had swelled to 254 accounts from just 40 10 years earlier. As a result, these institutional loans accounts provided 74% of the capital backing leveraged loans, up from 33% in 1997. (Except where otherwise noted, all data in this article is sourced from Standard & Poor's LCD.)

As nonbank investors have gone from supporting players to leading actors in the leveraged loan market, the market has expanded, deepened, and become more driven by “technicals,” or simple supply and demand dynamics. After all, where banks can, in essence, manufacture credit, these investors need to raise funds to put to work, and when supply overwhelms inflows then the market backs up; when the opposite is the case the market goes into bull mode with spreads tightening and secondary prices rising

In recent years, structured finance vehicles have been a large source of loan market liquidity. In 2006, the volume of collateralized loan obligations (CLO) nearly doubled to a record \$97 billion from \$53 billion in 2005, according to data from JP Morgan CDO research and Merrill Lynch structured finance research. Hedge funds have also been a big liquidity source. These accounts boosted their share of the primary market for leveraged loans to 13% in 2006 from 8% in 2005.

Market Size

Powered by strong demand, the pool of outstanding institutional loans grew to \$400 billion at the end of 2006 from \$35 billion at year-end 1997. As a result, institutional loans grew to 41% of the overall universe of institutional and high-yield bonds, or \$355 billion of \$953 billion, from 28% a year earlier and from 25% at the end of 2004, according to loan data from Standard & Poor's Leveraged

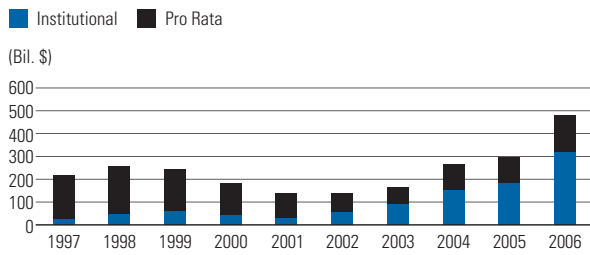
Commentary & Data (LCD) and bond data from Merrill Lynch high-yield research.

Arrangers expect loans to continue to dominate the leveraged finance landscape in 2007. Issuers—particularly on the private equity side—have embraced loans for a number of obvious reasons:

- The prepayment option is a handy choice, for sure, in this age of rapid flips and dividends;
- Covenants are becoming less and less restrictive, making them more appealing to leveraged issuers;
- The second-lien loan juggernaut allows private issuers to layer in—and leverage up—their balance sheet while avoiding the tedious SEC disclosure process; and
- The amortizing term loan is becoming an anachronism, meaning issuers can go with a loan package and still largely avoid principal repayments (just 6% of 2006's LBO loans had an A tranche, down from 8% in 2005 and from 13% in 2004; in 2001, by contrast, 75% had an A loan).

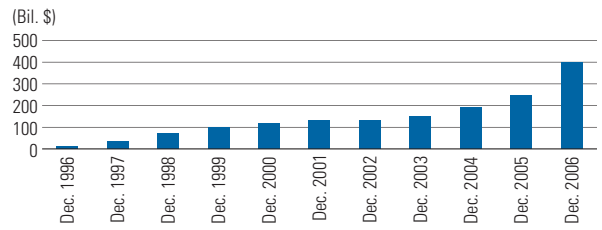
Therefore, loans appear likely to climb to near parity with high-yield bonds in terms of outstanding debt by the end of 2007. In fact, if 2006's new-issue volume and repayment patterns continue throughout 2007, loans will end the year at \$530 billion, or 47% of the overall total. By this logic, by 2009, loans will achieve a majority position in the leveraged finance universe. ●

Chart 1 U.S. Leveraged Loan Volume



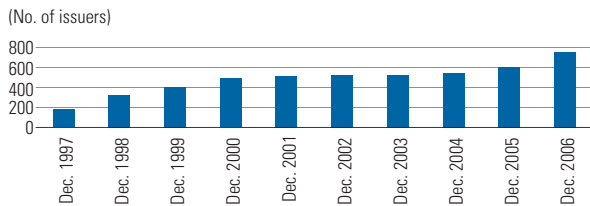
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Chart 2 Par Amount Of Outstanding Leveraged Loans



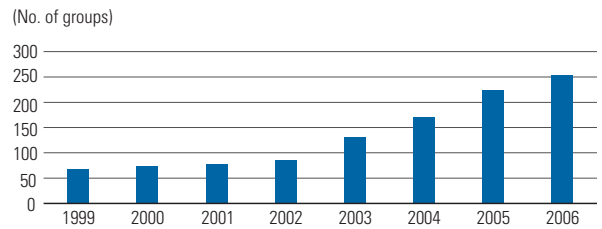
Source: Standard & Poor's LCD.
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Chart 3 Number Of Issuers With Outstanding Leveraged Loans



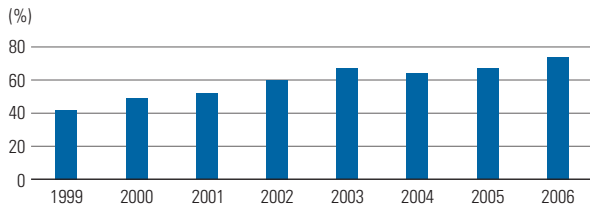
Source: Standard & Poor's LCD.
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Chart 4 Number Of Institutional Loan Investor Groups



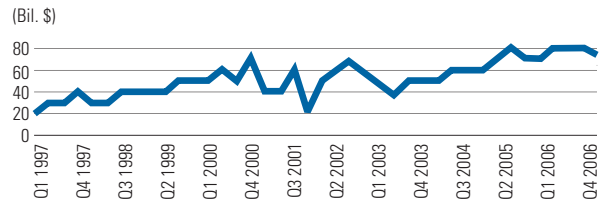
Source: Standard & Poor's LCD.
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Chart 5 Institutional Investors' Share Of The Primary Market For Leveraged Loans



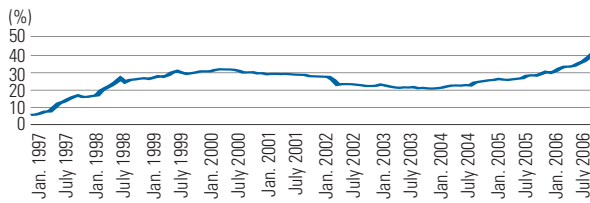
Source: Standard & Poor's LCD.
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Chart 6 Institutional Volume As A % Of Total High-Yield Finance Volume



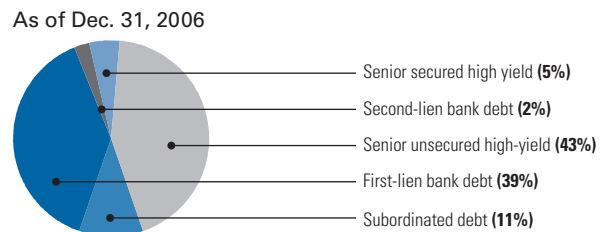
Source: Standard & Poor's LCD and Merrill Lynch Global High-Yield Strategy.
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Chart 7 Institutional Bank Debt As A % Of Total Outstandings In The High-Yield Market



Source: Standard & Poor's LCD and Merrill Lynch Global High-Yield Strategy.
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Chart 8 Leveraged Finance Market By Facility Type



Source: Standard & Poor's LCD and Merrill Lynch Global High-Yield Strategy.
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Section 2:

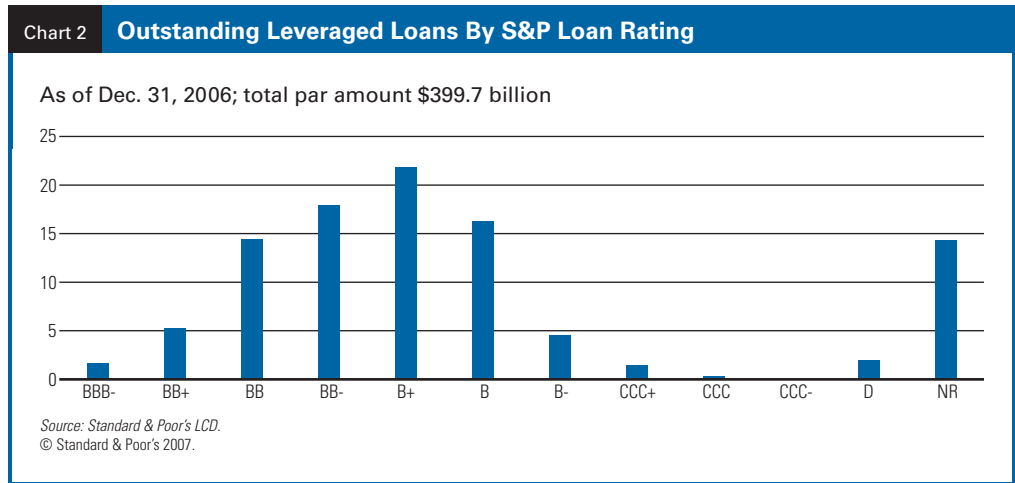
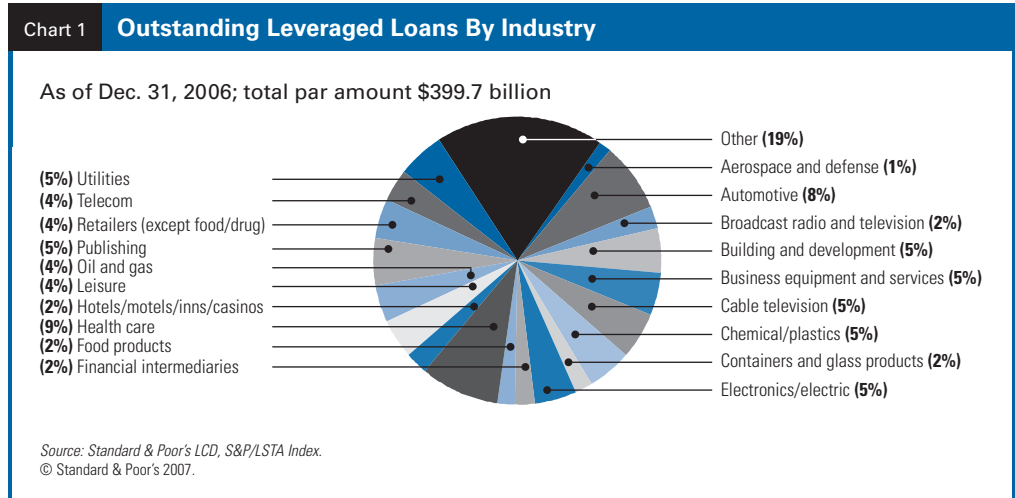
S&P/LSTA Index Demographics

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The following charts describe the demographic aspects of the index by sector and rating.



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Loan Market Performance

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In general, the loan market lived up to expectations over the past decade by generating a low alpha—but even lower beta—product. Thus, loans rewarded investors with superior risk-adjusted returns. The structured finance market certainly took notice. CLO issuance nearly doubled in 2006 to \$97 billion from the record \$53 billion in 2005, according to JP Morgan CDO research, Merrill Lynch Structured Finance research, and Standard & Poor's CDO chief David Teshler.

Indeed, despite some turbulent times for the capital markets, especially in 2001 and 2002, the loan market has turned in 10 successive years of positive returns.

Loans have performed like the financial market's version of baseball great Wade Boggs, hitting for average, but not power, year after year. Indeed, returns from 1997 through 2006 averaged 5.46%, ranging from a high of 9.97% in 2003 to a low of 1.91% in 2002.

Over this same period, the band for high-yield returns was much wider, from a low of negative 5.1% in 2000 to a high of 28.15% in 2003. The S&P 500 was more ambitious still, with a range of negative 22% in 2002 to 33% in 1997.

Steady-but-unspectacular returns have been compelling enough—especially when turned up with leverage in the form of CLOs and credit opportunity funds—to attract a large and growing investor following. To wit: the ranks of institutional loan investors swelled to 254 at year-end 2006 from just 40 recorded 10 years earlier. As a result, the institutional loan asset class has grown mightily. At year-end 2006, outstanding institutional loans totaled \$400 billion, up more than 10-fold from 1997, when that universe stood at \$34 billion.

'BB' Versus 'B' Loan Returns

Over the past 10 years, credit quality was king in the loan market. 'BB' rated loans out-

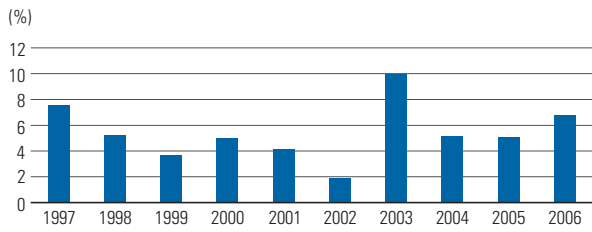
performed 'B' rated loans, with an average annual return of 5.32%, versus 4.95%. This lead was built up between 1997 and 2001. During that period, loans in the 'BB' category outperformed those in the 'B' category each year, by an average of 5.73% to 2.94%. Since 2002, the tide has turned. 'B' loans have outperformed for five successive years, 6.96% versus 4.91%.

That 'B' loans led the way over the past five years is understandable, what with default rates receding to record lows and the market in a fully bullish mode. It is not surprising, either, that 'BB' loans outperformed in the more stressful years of the late 1990s and early 2000s. Looking ahead, 'B's might be better positioned to keep up with 'BB' loans over the next cycle. The reason: investors have responded to better 'BB' performance by driving 'BB' spreads lower, relative to 'B' spreads. Since 1997, 'BB' loan spreads have averaged 55 bps inside that of 'B' loans. Over the past year, the gap between the two categories has widened 26 bps, to 81 bps. This goes a long way toward closing the 37 bps gap between the historical performance of 'BB' and 'B' Index loans.

Where the 'BB's really hit the cover off the ball was relative returns. The Sharpe ratio for 'BB' loans between 1997 and 2006 was 0.97, compared with 0.40 for 'B' loans. Today's increased 'BB'/'B' spread gap seems woefully inadequate to make 'B' loans a contender on a Sharpe ratio basis. ●

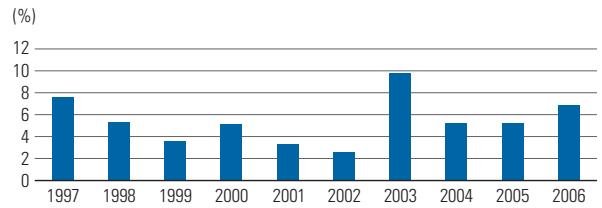
The ranks of institutional loan investors swelled to 254 at year-end 2006 from just 40 recorded 10 years earlier.

Chart 1 Leveraged Loan Returns



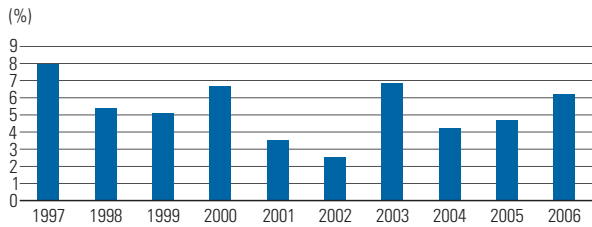
Source: Standard & Poor's LCD.
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Chart 2 Performing Leveraged Loan Returns*



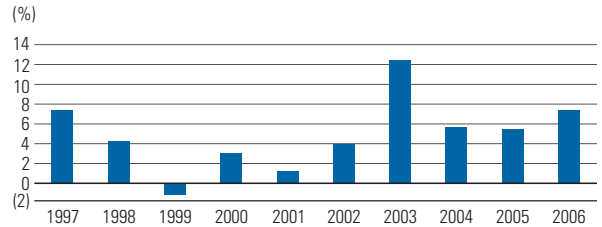
*Excludes defaulted loans.
Source: S&P/LSTA Index.
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Chart 3 'BB' Leveraged Loan Returns



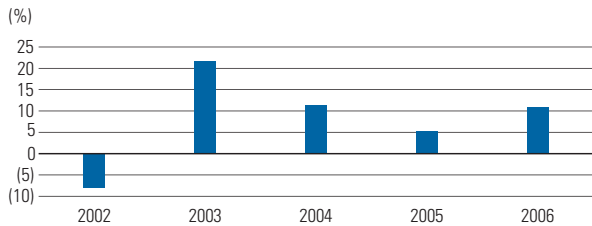
Source: S&P/LSTA Index.
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Chart 4 'B' Leveraged Loan Returns



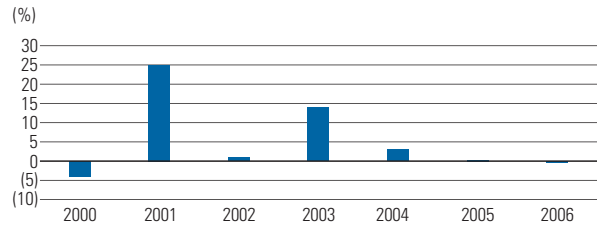
Source: S&P/LSTA Index.
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Chart 5 'CCC' Leveraged Loan Returns



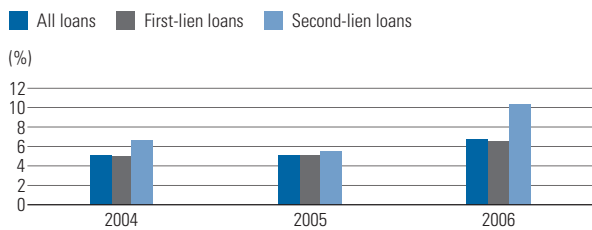
Source: S&P/LSTA Index.
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Chart 6 Defaulted Leveraged Loan Returns



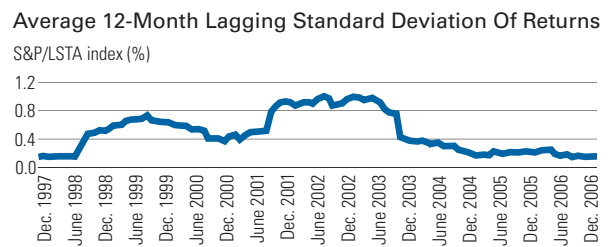
Source: S&P/LSTA Index.
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Chart 7 Leveraged Loan Returns By Collateral Package



Source: S&P/LSTA Index.
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Chart 8 S&P/LSTA Index Volatility



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Section 4:

Loan Market Versus Other Asset Classes

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As discussed in Section 3, the loan market over the past decade has generated relatively low alpha but even lower beta, resulting in superior risk-adjusted returns. Indeed, the S&P/LSTA Index racked up an average monthly return of 0.44% over the past 10 years. This is the lowest of the five asset classes that Standard & Poor's normally tracks the Index against, lagging the S&P 500, which returned 0.77%, the Merrill Lynch High-Yield Master Index (0.56%), 10-year Treasuries (0.48%) and the Merrill Lynch Higrade Master Index—a measure of investment-grade bond returns (at 0.55%).

On the other side of the risk/return equation, loans topped the list at a standard deviation of monthly returns of 0.54%, compared with the S&P 500 at 4.43%, high-yield bonds at 2.08%, 10-year Treasuries at 2.05%, and investment-grade bonds at 1.32%. As a result, then, loans produced stellar risk-adjusted returns, with a 10-year Sharpe ratio of 0.92 versus 0.39 for the S&P 500, 0.44 for high-yield bonds, 0.31 for 10-year Treasuries, and 0.67 for investment-grade bonds.

Looking more broadly, there are three asset classes among the 56 LCD surveyed that generated a better risk-adjusted return than loans over the past 10 years: Australian Corporates at 1.10%, Global Emerging Markets Sovereign and Corporate debt at 1.08%, and Mortgage Master Index at 0.97%.

Correlations

Loans are idiosyncratic instruments—floating rate, callable, and highly structured. For this reason, while loans do broadly track the ups and downs of the equity or high-yield markets during periods of turbulence or ebullience, they remain a largely uncorrelated asset class, generally unaffected by interest rate movements and insulated to a large degree from credit problems by collateral.

Loans produced stellar

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versus 0.39 for the S&P 500,

0.44 for high-yield bonds, 0.31 for

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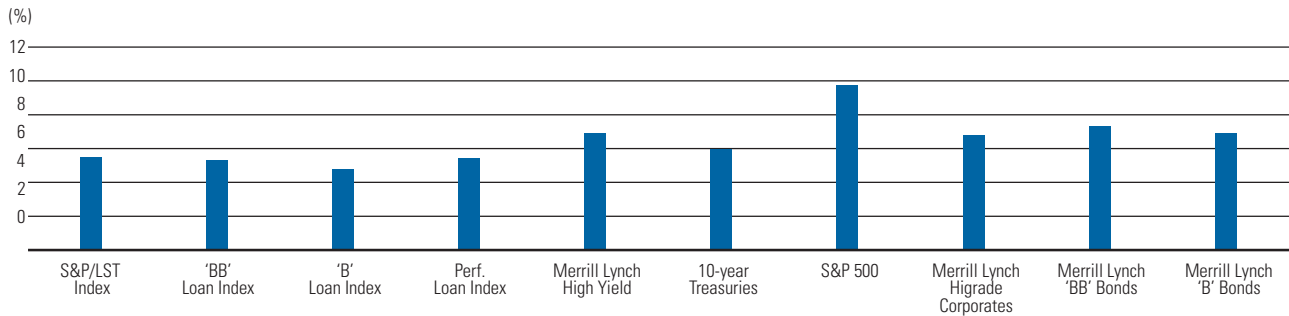
investment-grade bonds.

Therefore, even comparing loans with high-yield bonds—despite an overlapping issuer pool—produces a correlation coefficient of 0.60. This is the highest correlation of any broad asset class.

The correlation coefficient falls to 0.35, relative to speculative-grade convertible bonds, 0.19 for the S&P 500, 0.18 for global emerging-markets debt, 0.03 for investment-grade bonds, negative 0.05 for three-month T-bills, negative 0.21 for mortgage-backed securities, and 0.23 for 10-year Treasuries. ●

Chart 1 Average Annualized Monthly Return Of The S&P/LSTA Index Vs. Other Asset Classes

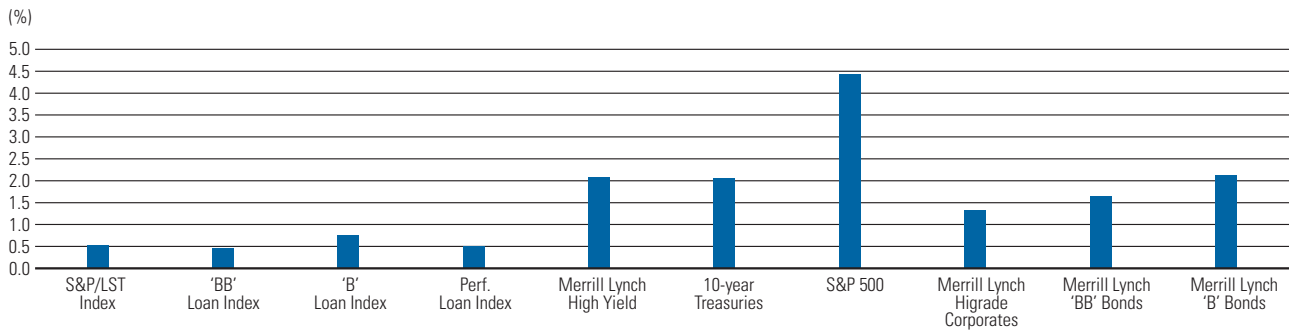
Jan. 1997 to Dec. 2006



Sources: Standard & Poor's; S&P/LSTA Index; Merrill Lynch; Bloomberg.
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Chart 2 Standard Deviation Of Monthly Returns Of The S&P/LSTA Index Vs. Other Asset Classes

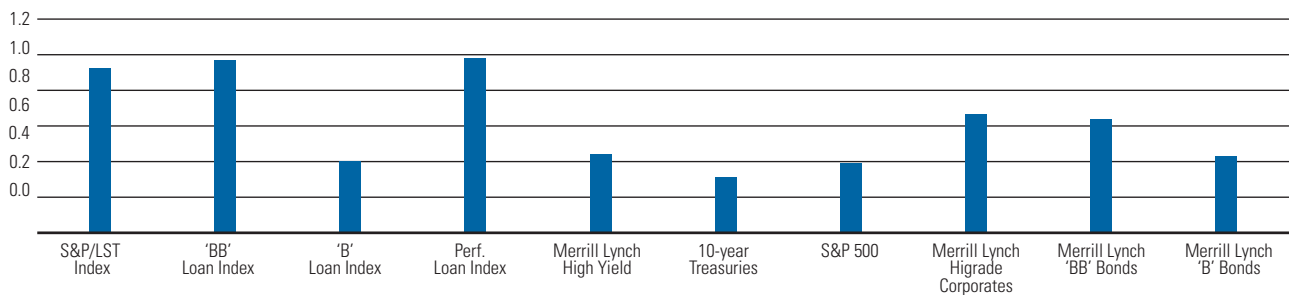
Jan. 1997 to Dec. 2006



Sources: Standard & Poor's; S&P/LSTA Index; Merrill Lynch; Bloomberg.
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Chart 3 Sharpe Ratio* Of The S&P/LSTA Index Vs. Other Asset Classes

Jan. 1997 to Dec. 2006



*Defined as average annualized monthly return minus risk-free rate (three-month Treasuries) divided by annualized standard deviation of monthly returns (standard deviation multiplied by square root of 12).
Sources: Standard & Poor's; S&P/LSTA Index; Merrill Lynch; Bloomberg.
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Loan Market Versus Other Asset Classes

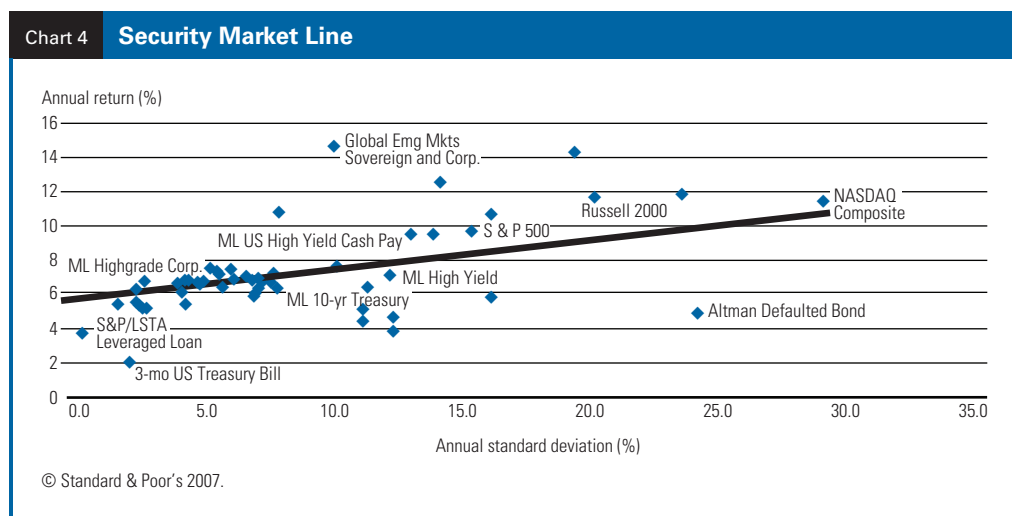


Table 1 Correlation Of The S&P/LSTA Leveraged Loan Index With Other Asset Classes

Asset class	Ratio	Asset class	Ratio
U.S. High Yield Small Caps	0.68	All Convertibles (Exclude Mandatory Spec Quality)	0.35
U.S. High Yield Cash Pay CCC/CC/C	0.66	HDAX Index (Frankfurt)	0.31
U.S. High Yield CCC/CC/C	0.65	All Convertibles (Exclude Mandatory All Qualities)	0.31
U.S. High Yield Distressed	0.65	SBF-250 (Paris)	0.29
US High Yield Cash Pay	0.60	FTSE 350 (London)	0.23
U.S. High Yield Master II Construction	0.59	S&P 500	0.19
High Yield	0.59	Global Emerging Market Sovereign and Corporates	0.18
U.S. Original Issue High Yield	0.58	NASDAQ Composite	0.17
U.S. High Yield Large Caps	0.58	US\$ Emerging Market Sovereign Plus	0.16
U.S. High Yield Cash Pay BB-B	0.57	U.S. Corporates 'BBB'	0.12
U.S. High Yield Cash Pay B	0.55	EMU Corporates Nonfinancial	0.06
Sterling High Yield	0.54	Higrade Corporates	0.03
U.S. High Yield Cash Pay BB	0.53	EMU Corporates	(0.02)
U.S. High Yield B	0.53	U.S. Corporates 'A'	(0.05)
U.S. High Yield BB	0.52	3-month U.S. Treasury	(0.05)
U.S. High Yield 100 Index	0.52	U.S. Treasuries Inflation-adjusted	(0.10)
U.S. Fallen Angel High Yield	0.51	Australian Corporates	(0.11)
Canada High Yield	0.49	Japan Extended Corporates	(0.11)
U.S. High Yield Nondistressed	0.49	U.S. Corporates 'AAA'	(0.12)
European Currency High Yield 3	0.49	U.S. Corporates 'AA'	(0.12)
European Currency High Yield	0.47	U.K. Gilts 7-10 year	(0.14)
Altman Defaulted Bond	0.46	German Federal Govts 7-10 year	(0.15)
Global High Yield European Issuers	0.46	Mortgage Master	(0.21)
Euro High Yield 3% Constrained	0.44	US Treasuries 10-year	(0.23)
Euro High Yield	0.42	US Treasuries 7-10 year	(0.25)
Moody's Bankrupt Bond	0.37	US Treasury Current 5 year	(0.28)
Russell 2000	0.36	US Treasury Current 3 year	(0.29)

Table 2 Security Market Line Data

	Annualized standard deviation	Annualized return (%)		Annualized standard deviation	Annualized return (%)
S&P/LSTA Leveraged Loan	1.9	5.5	US\$ Emerging Market Sovereign Plus	14.2	12.5
High Yield	7.2	6.9	Altman Defaulted Bond	16.1	5.9
10-year Treasuries	7.1	5.9	Canada High Yield	7.3	6.4
S&P 500	15.4	9.7	Global High Yield European Issuers	11.2	4.5
Higrade Corporates	4.6	6.8	European Currency High Yield	11.2	5.3
U.S. High Yield Cash Pay	6.7	7.1	Sterling High Yield	10.2	7.7
Mortgage Master	2.6	6.3	Euro High Yield	12.4	4.6
3-month U.S. Treasury	0.5	3.8	Japan Extended Corp	2.3	2.1
Russell 2000	20.1	11.7	Australian Corporates	2.9	6.9
NASDAQ Composite	28.7	11.5	EMU Corporates Nonfinancial	2.8	5.3
Moody's Bankrupt Bond	24	4.9	EMU Corporates	2.7	5.5
German Federal Govts. 7-10 year	4.3	6.1	HDAX Index (Frankfurt)	23.4	11.8
U.K. Gilts 7-10 year	4.5	6.8	SBF-250 (Paris)	19.3	14.3
FTSE 350 (London)	13.9	9.6	U.S. Treasuries Inflation-Adjusted	5	6.8
U.S. Corporates 'AAA'	4.5	6.8	All Converts (Exclude Mandatory Spec Quality)	16.1	10.6
U.S. Corporates 'AA'	4.2	6.7	All Converts (Exclude Mandatory All Qualities)	13.1	9.6
U.S. Corporates 'A'	4.6	6.8	U.S. Treasury Current 3 year	2.7	5.4
U.S. Corporates 'BBB'	4.9	6.6	U.S. Treasury Current 5 year	4.5	5.5
U.S. High Yield Cash Pay 'BB'	5.7	7.3	U.S. Treasury 7-10 year	5.9	6.5
U.S. High Yield Cash Pay 'B'	7.3	6.7	U.S. High Yield 'BB'	5.7	7.3
U.S. High Yield Cash Pay CCC/CC/C	11.4	6.4	U.S. High Yield 'B'	7.9	6.3
U.S. High Yield Cash Pay BB/B	6.3	6.9	US High Yield CCC/CC/C	12.2	7.1
U.S. High Yield Small Caps	6.2	7.5	US High Yield 100 Index	7.8	7.2
U.S. High Yield Large Caps	7.7	6.7	US High Yield Master II Construction	7	6.9
U.S. High Yield Distressed	20.4	0.5	European Currency High Yield 3	11.2	5.2
U.S. High Yield Nondistressed	5.4	7.5	Euro High Yield 3% Constrained	12.4	4
U.S. Fallen Angel High Yield	8	10.8	Global Emerging Market Sovereign and Corporate	10.1	14.7
U.S. Original Issue High Yield	7.1	6			

Appendix:

S&P/LSTA Leveraged Loan Index

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The S&P/LSTA Leveraged Loan Index (LLI) reflects the market-weighted performance of U.S. dollar-denominated institutional leveraged loan portfolios. The LLI is the only U.S. leveraged loan index that uses real-time market weightings, spreads, and interest payments.

The LLI was calculated monthly from Jan. 1, 1997 to Jan. 1, 1999, and is now calculated weekly. There are five subindexes published weekly in addition to the base index:

- **'BB' Index**—Facilities with a rating of 'BB+' to 'BB-' from Standard & Poor's;
- **'B' Index**—Facilities with a rating of 'B+' to 'B-' from Standard & Poor's;
- **Original-Issue 'BB' Index**—Facilities with an initial rating of 'BB+' to 'BB-' from Standard & Poor's;
- **Original-Issue 'B' Index**—Facilities with an initial rating of 'B+' to 'B-' from Standard & Poor's; and
- **Performing Loan Index**—All loans excluding those in payment default.

Data Sourcing And Management

The LLI is unique in that it uses real-time market weightings and spreads for the facilities constituting the index. This data is sourced from current investors in these credits.

The index uses the Average Bid from LSTA/LPC Mark-to-Market Pricing for its market value return calculations. In addition, S&P/LCD's comprehensive and detailed database of credits supports the index, allowing for the provision of an array of detailed analysis and comparables. JPMorgan FCS's Wall Street Office is the data platform.

S&P's Index Services group, which supports all of S&P's indexes, created a calculation platform specifically tailored to the nuances of the syndicated loan market. The LLI calculation platform runs according to the rigorous standards and methodologies applied to all of Standard & Poor's indexes.

Criteria For Inclusion And Deletion

Facilities are eligible for inclusion in the index if they are U.S. dollar-denominated term loans from syndicated credits and meet the following criteria at issuance:

- Minimum initial term of one year,
- Minimum initial spread of LIBOR+125, and
- Minimum initial size of \$50 million.

The index primarily consists of senior secured facilities. However, it does include second-lien and unsecured loans if they are broadly held by CLOs and other traditional loan accounts.

Loans are retired when there is no bid posted on the facility for at least 12 successive weeks or when the loan is repaid.

Performance Calculation Formulas

The LLI and its subindexes are all market-weighted. The return for each index is the composite of each component facility's return times the market value outstanding from the prior time period:

$$\text{Index Return} = \sum_{i=1}^n \{ \text{TRFi,t} \times (\text{pi,t-1} \times \text{OSi,t-1}) \}$$

n—Number of component facilities in the index

TRFi,t—Total return for component facility

pi,t-1—Price in prior time period (t-1)

OSi,t-1—Current outstanding for component facility

The total return for each facility reflects both market value change and interest accrued, as well as an adjustment for any repayments made during the calculation period because repayments are assumed to be made at par. (See formula below.)

Interest is calculated on a 30/360 basis. It accrues daily, compounds quarterly, and pays in cash in real-time with the interest payment exiting the portfolio at the time of payment. ●

$$TRFi,t = (((pi,t + Ali,t) \times OSi,t + ((100 - pi,t) \times (OSi,t-1 - OSi,t))) / ((pi,t-1 + Ali,t-1) \times OSi,t-1))$$

pi,t-1—Price in prior time period (t-1)

Ali,t—Accrued income (base LIBOR plus spread over LIBOR) in current time period (t)

Ali,t-1—Accrued income (base LIBOR plus spread over LIBOR) in prior time period (t-1)

OSi,t-1—Dollars outstanding in prior time period (t-1)

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