

Diversify Your Portfolio with Senior Loans

White Paper

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Introduction

Stocks and bonds have long been seen as the primary options for investors. Stocks offer the opportunity to gain from the rise in the value of a company, while bonds typically offer a fixed rate of monthly or quarterly income. But another asset class, senior loans, is growing in popularity and should be considered by investors looking for asset class diversification in their investment portfolios.

This investor guide will introduce you to the senior loan asset class. It will describe what a senior loan is, and explain some of the advantages and risks of investing in senior loans.

What are Senior Loans?

Senior loans are extensions of credit made to non-investment grade corporations to finance acquisitions, refinance existing debt, support business expansion, and for other general business purposes*. They are called “senior” loans because they are generally secured by a borrower's assets pursuant to a first priority or “senior” lien, and they are first in priority in receiving payments when a borrower is servicing its debts.

Senior loans are sometimes referred to as “leveraged loans” because, by borrowing, a company is adding leverage to its balance sheet. They can also be called “floating rate loans” because the interest paid on such loans changes as certain market interest rates change.

Senior loans are large, and can range from \$50 million to over \$10 billion. Senior loans are primarily originated by large money center banks and other major financial institutions. When a senior loan is made, portions of it are typically sold or “syndicated” to a large number of banks and institutional investors, including mutual funds. Very large senior loans can be syndicated among hundreds of institutional investors.

Senior loans are privately issued and are not traded on any public exchange. Instead, senior loans are traded directly among banks and institutional investors in a private secondary market. Although senior loans are a relatively illiquid asset class when compared to publicly traded stocks, for example, over the past decade the senior loan market has become deeper and more orderly due to an increased supply of senior loans, a substantial increase in the number of participants in the market, and the efforts of the Loan Syndications and Trading Association (the “LSTA,” which is the trade association for senior loan market participants) to make senior loan trading more uniform and efficient.

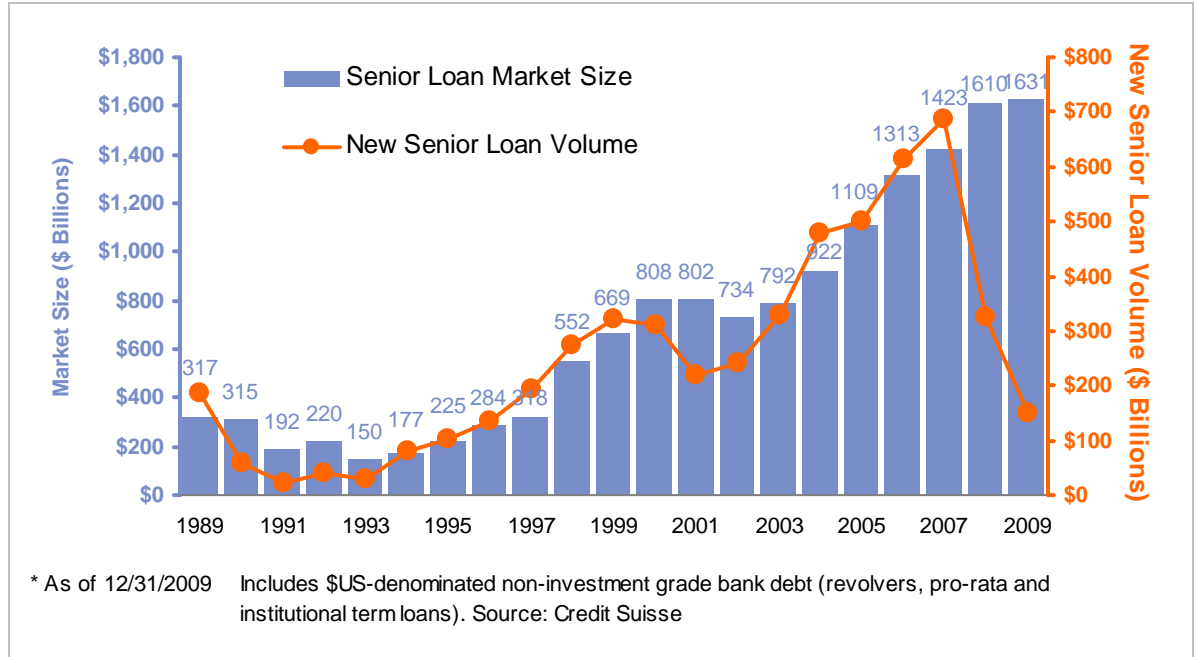
*Non-investment grade businesses are companies that have a credit rating that is BB+ or below or, if not rated, are of similar credit quality. Non-investment grade businesses have been judged as being less credit worthy than investment-grade businesses, and present a greater risk of default and loss than investments in businesses that are rated investment grade. Consequently, an investment in senior loans presents greater risks than investments in money market funds, certificates of deposit, and similar highly rated investments.

Senior loans

- Non-investment grade
- Floating rate
- Large in size: \$50 million to over \$10 billion
- Privately issued and traded

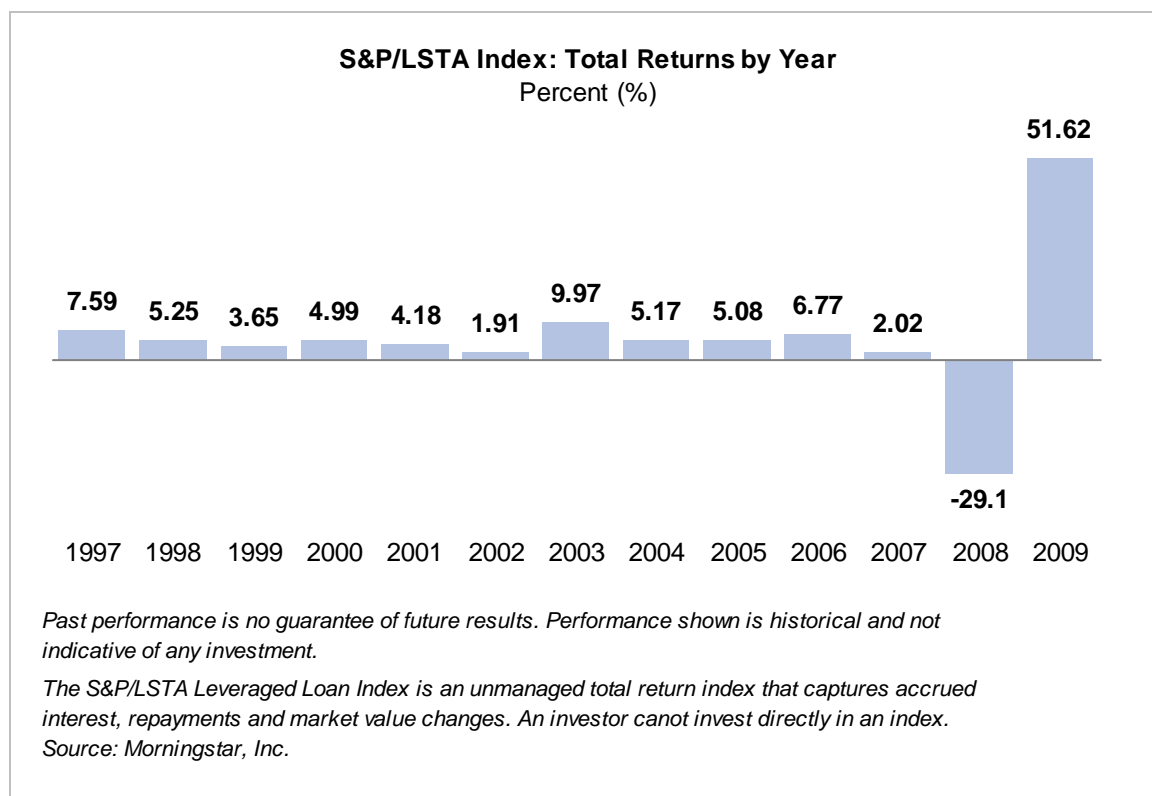
How big is the Senior Loan market?

The senior loan market as we know it today is a product of developments in commercial bank lending over the last 20 years. Prior to that time, loans to businesses were primarily made by commercial banks that kept the loans in their portfolios as investments. However, starting in the late 1980s, banks and other originators of senior loans began to take advantage of the evolving securitization markets in the United States by selling portions of senior loans to institutional investors. Since that time, the senior loan market has witnessed tremendous growth, as shown the table below. In fact, the senior loan market is roughly the same size as the much more well-known high yield bond market.



What is the performance record of the Senior Loan market?

Senior loans have historically provided steady returns, with the S&P/LSTA Leveraged Loan Index (the "Index") having shown positive returns every year since its inception up until the credit disruptions of 2008. As shown in the chart below, 2008 witnessed a significant negative return for the Index, but that negative return has been offset by a record 51% return in 2009.



What are the differences between Senior Loans and High Yield Bonds?

Senior loans represent a debt of a corporate borrower. In this way, they are just like high yield bonds, since companies that borrow money or issue bonds have an obligation to repay the amounts they have received. But that is where the similarity ends.

Floating Rate Income -

First of all, bonds pay interest at a fixed rate that never changes over the life of the bond. That is why they are referred to as "fixed income" securities. Senior loans, on the other hand, typically pay interest at a variable or floating rate. In other words, the rate at which senior loans pay interest changes over time as certain interest rates in the market change.

The interest rate on a senior loan is expressed as a spread over a base rate. The most prevalent base rate is LIBOR, the London Inter-Bank Offer Rate. This is a rate that banks pay to borrow from one another. LIBOR rates can change daily in response to market conditions. Borrowers may also choose to base their loans on LIBOR rates that have different maturities, such as 30-day, 60-day or 90-day LIBOR. The rates for these different maturities track market interest rate expectations, so

borrowers typically choose a rate, or a combination of rates, that they believe will provide the lowest borrowing cost.

The spread is the amount of interest that a borrower will pay in addition to the base rate. The spread is typically a fixed amount, and it is usually expressed in basis points or "bps." A basis point is 1/100th of a percent or 0.01%. Unless there is a fundamental change in the creditworthiness of the particular borrower, the spread amount typically never changes.

To understand the interest rate paid by a borrower on a senior loan, if 30-day LIBOR were currently at 1%, a borrower whose loan agreement requires it to pay an interest rate that is 30-day LIBOR plus 350 bps (typically expressed as L+350) would pay interest at a rate of 4.5%.

When short-term market interest rates go up, the LIBOR component of a borrower's interest rate, and therefore the overall interest rate paid by the borrower, as well as the income to a portfolio invested in senior loans, also goes up. Conversely, when short-term market interest rates go down, the income from senior loans also goes down. The length of time between when market interest rates change and when the rate on a senior loan changes is referred to as the "interest rate reset period."

The interest rate reset period varies from loan to loan, but a large, diversified portfolio of senior loans can be expected to have a weighted average interest rate reset period of 60 days or less. As a result, the income earned from a senior loan portfolio is generally very responsive to changes in short-term interest rates.

Interest Rate Changes Effect on Prices -

Next, changes in market interest rates have a completely different effect on loans than they do on bonds. When interest rates go up, the price of a bond typically goes down, and when interest rates go down, the price of a bond can increase. But regardless of any changes in interest rates, the amount of interest paid by a fixed rate bond never fluctuates.

Senior loans are different. While the amount of interest paid by a senior loan typically goes up and down with changes in market interest rates, the change in rates alone rarely has a direct impact on the price of that loan. Absent other factors, such as changes in the current or prospective creditworthiness for the particular borrower, the price of a senior loan is generally unaffected by changes in market interest rates. Of course, there can be some price fluctuation because of the lag between a change in market interest rates and the weighted average interest rate reset period of a portfolio of senior loans, but because these periods are generally short, such price fluctuations are relatively moderate.

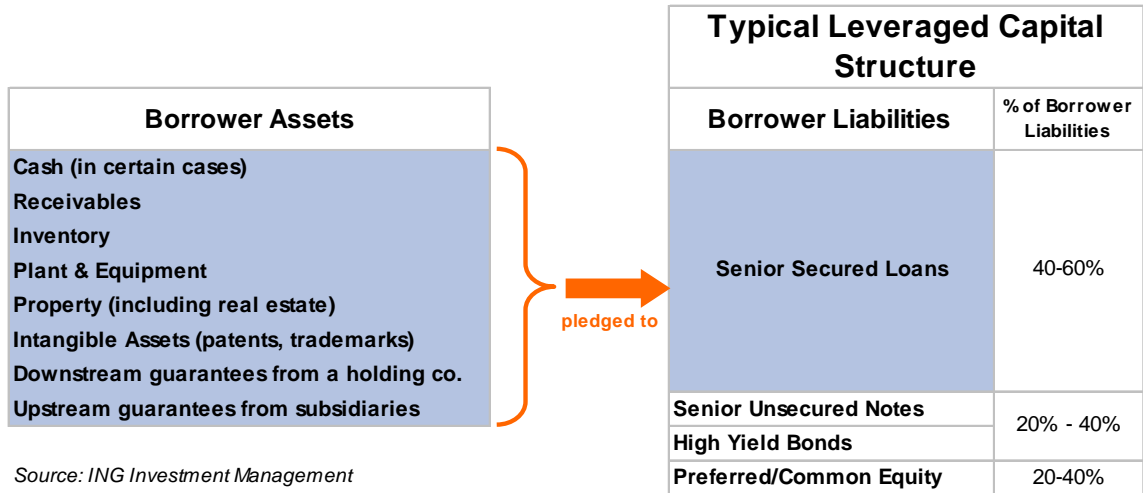
Because of their unique reaction to changes in market interest rates, senior loans have the potential to provide a natural hedge against rising short-term interest rates. This is of particular interest in an environment of historically low interest rates.

Loans are Secured by Collateral -

Another important difference between bonds and senior loans is that senior loans are typically secured by some or all of the assets of the borrower. Bonds, on the other hand, are typically unsecured.

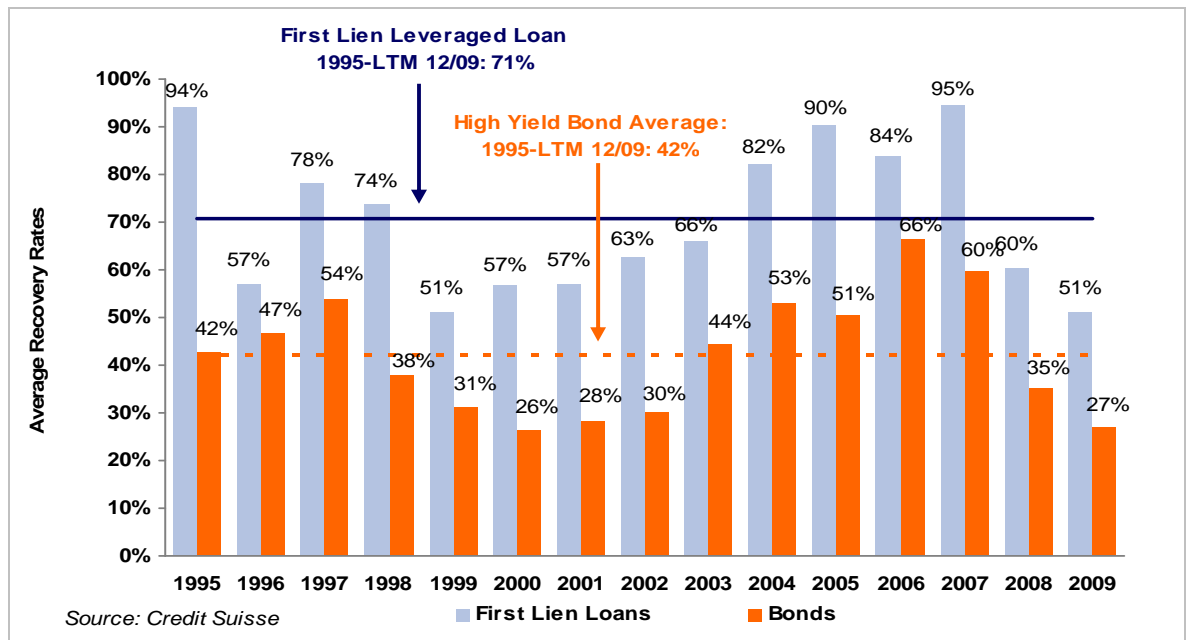
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The figure below shows a typical, simplified capital structure of a non-investment-grade borrower. The components of the borrower's liabilities are shown below in order of priority. As you can see, senior secured loans are at the top of the chart because of their first lien or senior position.



As shown above, senior loans generally have a first priority or senior lien on borrower assets. As a result, if a company becomes distressed and falls into bankruptcy, senior loans are first in line to be repaid and typically get paid back before payments are made to bondholders, preferred shareholders or holders of a company's equity. Although there is no guarantee that the amount of collateral will be sufficient to pay off a borrower's loan in full, the fact that senior loans are secured by collateral has historically translated into significantly higher recoveries on defaulted loans in comparison to recoveries on defaulted high yield bonds.

The chart below shows the historical recovery rates of first-lien, senior secured non-investment grade corporate loans versus high yield bonds. Over the period shown, senior loans have demonstrated a recovery rate of about 71% compared to unsecured high yield bonds, which have historically recovered approximately 42%.



Contractual Protections -

Senior loans are made using a written contract (the credit agreement) which not only governs the manner in which funds are extended to the borrower and sets the interest rate to be paid by the borrower, but also provides significant limitations on a borrower's business operations designed to enhance the ability of the lenders to be repaid. Such limitations, called covenants, are designed to monitor the financial health of a borrower and can limit the total amount of debt that a borrower may incur or restrict certain actions such as purchasing other companies, going into new lines of business, selling lines of business, etc. In addition, these protective covenants typically require mandatory paydowns to lenders upon certain events, such as the issuance of additional stock or the sale of significant company assets.

If these restrictions are violated by the borrower, the credit agreement gives lenders the first right to take certain actions against the borrower, ranging from increasing the spread on the loan to calling the loan and requiring its immediate repayment in full.

Low Historical Correlation to Other Asset Classes

Correlation is an investment concept that seeks to quantify and compare the extent to which different investments react to the same market conditions. If two different investments react in exactly the same manner in response to market conditions, they have a correlation of plus 1.00. If, on the other hand, they were to move in exactly opposite direction, they would have a negative correlation of minus 1.00.

Investing in assets with lower correlation, between $-.50$ and $+.50$, is an effective technique to provide diversification to investment portfolios. Portfolios whose assets show low correlation can expect to experience less volatility over time. As shown on the following table, the correlations between senior loans and most other assets classes over the period from 1992 through June 2009 are relatively low or negative. This means that senior loans have the potential to provide additional diversification to an investor's portfolio and to reduce overall portfolio volatility.

Why invest in a senior loan fund?

Senior loan funds have the potential to provide valuable investment diversification for investors who traditionally invest only in stocks and bonds. Senior loan funds offer:

- The potential for high, risk-adjusted monthly income
- A natural hedge against rising interest rates
- Historically low correlation to other asset classes

Credit Suisse Leveraged Loan Index Correlation	
January 1992 - December 2009	
Credit Suisse High Yield Index	0.75
FTSE NAREIT All REITs	0.48
Dow Jones Wilshire 5000	0.41
MSCI Eafe	0.41
Russell 2000	0.41
Merrill Lynch ABS	0.39
Standard and Poor's 500	0.39
IA SBBI U.S. Inflation	0.34
Merrill Lynch U.S. Corporate	0.31
JPM Emerging Markets	0.22
Gold	0.05
U.S. 30 Day Tbill	-0.01
Lehman U.S. Agg Bond	-0.02
Merrill Lynch Mortgage	-0.11
Lehman U.S. Corporate Aaa	-0.12
U.S. Govt 10+ Years	-0.27
U.S. Govt 5-7 Years	-0.31

Source: Credit Suisse, Bloomberg, Ibbotson Associates

Investing in Senior Loans

The most convenient way for investors to gain access to the senior loan asset class is by investing in a mutual fund. There are two general types of mutual funds – open-end funds and closed-end funds. Open-end funds permit investors to purchase or sell their shares on any day. When an investor buys shares of an open-end fund, the fund issues new shares, which means that the total number of shares outstanding can increase over time. When the shareholder wants to sell shares, the fund repurchases, or redeems, the shares, which means that the number of shares outstanding will go down. Purchases and redemptions of open-end funds are all done at the closing net asset value of the fund on the day of the purchase or sale.

Within the closed-end fund category, there are two different types of closed-end funds. The first is a traditional, or “listed”, closed-end fund. These funds are typically listed on a stock exchange such as the New York Stock Exchange, and can be purchased and sold at any time just like any other stock. Listed closed-end funds rarely sell any new shares to investors after they have been established, so the number of outstanding shares generally remains the same over time. In order to buy or sell shares of a listed closed-end fund, a shareholder must do so by buying or selling listed shares on the applicable exchange. As a result, investors can buy or sell a listed closed-end fund on any day and at any time that the applicable exchange is open for trading. Purchases and sales of listed closed-end funds are made at whatever the price is at the moment of the purchase and sale.

The other type of closed-end fund is a closed-end interval fund. A closed-end interval fund permits investors to invest on any day, but limits the availability of redemptions, either by limiting the amount of such redemptions or limiting the times when such redemptions can occur, or both. For example, such a fund might limit redemptions to only once per month or once per quarter. In addition, it might limit redemptions to no more than 5% per month and must limit redemptions to no more than 25% per quarter. Like an open-end fund, purchases and redemptions of shares in a closed-end interval fund are made at the net asset value of the fund on the day of the purchase or redemption.

Mutual Fund Types

- Open-end fund
- Listed closed-end fund
- Closed-end interval fund

As described above, open-end funds are required to redeem an investor's shares on any day. Because of the less liquid nature of senior loans, open-end senior loan funds typically find it necessary to maintain significant amounts of their assets either in cash or in other assets that are more readily saleable, such as high yield bonds or other public securities. In this way, they seek to assure themselves that they will be able to meet any redemption needs. Maintaining cash balances in such funds has the benefit of making liquid assets readily available when needed, but because the interest earned on cash is typically less than the interest on senior loans, such cash balances can have the effect of reducing overall returns for such funds and changing the correlation profile to other asset classes, possibly resulting in less diversification to the owners of shares in the funds.

Because of the limitations on redemptions, closed-end funds do not need to maintain the same level of cash and/or more liquid investments as required for open-end funds. This allows such funds to be more fully invested in senior loans. It also lessens the potential that the manager of such a fund would need to quickly liquidate a significant portion of the fund in order to meet redemption requirements, thereby avoiding the potential for obtaining less than favorable prices on such sales.

Another difference between funds that invest in senior loans relates to the use of leverage by such funds. Mutual funds are permitted to borrow in order to increase the amount of assets in their portfolios. However, open-end funds do not generally use leverage for investment purposes due to their potential need to raise cash quickly in order to meet redemptions, as well as increased regulatory restrictions.

Loans to mutual funds are typically made on a floating rate basis and require the periodic payment of interest, usually no less frequently than quarterly. As a consequence, mutual funds that borrow in order to seek to enhance investor returns need to generate sufficient cash in order to meet their loan payments.

Because senior loans pay floating rate interest, and make these payments on a quarterly or more frequent basis, funds that invest in senior loans are uniquely able to match the income and interest rates components of their assets as well as their liabilities when they borrow for investment purposes. However, while leverage can be very effective in enhancing investor returns during stable markets as well as in rising markets, the use of leverage will magnify losses in down markets. Consequently, investors need to understand the risks of leverage as well as the extent to which a particular fund uses leverage for investment purposes.

Summary

Senior loans represent a unique asset category with the potential to provide investors with current income as well as significant portfolio diversification. The combination of floating rate income, collateral security and seniority in a borrower's capital structure means that senior loans can act as a natural hedge against rising interest rates while at the same time offering the security of assets that are backed by collateral.

While senior loans will not provide an entire investment program, investors have the opportunity to benefit from the unique characteristics of this asset class by including a senior loan allocation in their portfolios.

Risks of Investing in Senior Loans

Senior loans are non-investment-grade assets, and like all investments, there are risks associated with investing in a portfolio of senior loans. Because of their non-investment-grade status, an investment in senior loans is considered to be speculative.

Below is a description of the primary risks of investing in senior loans. This description is not all-inclusive, and before making an investment in a portfolio of senior loans, investors should read and carefully consider the prospectus or other offering document for such an investment.

The primary risk to an investment in senior loans is credit risk. Credit risk is the risk of nonpayment of scheduled interest or principal payments on a debt instrument. Because senior loans are made to non-investment-grade borrowers, the risk of default on interest or principal payments is greater than on debt instruments of investment-grade borrowers. In the event a borrower fails to pay scheduled interest or principal payments on its debt, a portfolio of senior loans would experience a reduction in its income and a decline in market value.

Senior loans generally involve less risk than unsecured or subordinated debt and equity instruments of the same issuer because the payment of principal and interest on senior loans is a contractual obligation of the issuer that, in most instances, takes precedence over the payment of dividends, or the return of capital, to the borrower's shareholders and payments to bond holders. However, although senior loans are secured with specific collateral, the value of the collateral may not equal the creditor's investment when the loan is acquired or may decline below the principal amount of the senior loan over time. Also, to the extent that collateral consists of stock of the borrower or its subsidiaries or affiliates, the investor bears the risk that the stock may decline in value, be relatively illiquid, or may lose all or substantially all of its value, causing the senior loan to be under collateralized. Therefore, the liquidation of the collateral underlying a senior loan may not satisfy the borrower's obligation to the investor in the event of non-payment of scheduled interest or principal and the collateral may not be readily liquidated.

In the event of the bankruptcy of a borrower, a creditor could experience delays and limitations on its ability to realize the benefits of the collateral securing a senior loan. Among the credit risks involved in a bankruptcy are assertions that the pledge of collateral to secure a loan constitutes a fraudulent conveyance or preferential transfer that would have the effect of nullifying or subordinating the investor's rights to the collateral.

As described above, portfolios of senior loans are also subject to interest rate risk. The principal effect of changes in short-term market interest rates is that the amount of interest paid by a borrower will rise and fall as market interest rates rise and fall. However, since the interest rates on senior loans float with these changes in short-term rates, the underlying principal value of a senior loan tends to be insensitive to such changes. For an example, if short-term interest rates in the market

fall, the principal value of the portfolio's assets will (absent an unfavorable change in the credit risk) tend to remain constant but the amount of the interest payments will decline. On the other hand, if short-term market interest rates rise, the principal value of the portfolio's assets will again tend to remain constant while the amount of the interest payments from such assets will increase. Notwithstanding the foregoing, because of the lag between the time when market rates change and the time when such changes are reflected in the interest rate applied to a particular loan, loan values can experience moderate price fluctuation from changes in market interest rates.

Another risk related to interest rates is the potential for changes in the interest rate spreads for senior loans generally. To the extent that changes in market rates of interest are reflected not in a change to a base rate, such as LIBOR, but in a change in the spread over the base rate which is payable on loans of the type and quality in which a portfolio invests, a portfolio of senior loans could also be adversely affected. This is because the value of a loan is partially a function of whether it is paying what the market perceives to be a market rate of interest, given its individual credit profile and other characteristics. However, unlike changes in market rates of interest for which there is only a temporary lag before a portfolio reflects those changes, changes in a loan's value based on changes in the market spreads on loans may be of longer duration.

If spreads rise as described above, for example in response to deteriorating overall economic conditions and/or excess supply of new loans, the principal value of senior loans may decrease in response. On the other hand, if market spreads fall, the value of senior loans may increase in response, but borrowers also may renegotiate lower interest rates on their debts or pay off their debts by refinancing at such lower rates. In that case, the investment manager for a portfolio of senior loans would be faced with the choice of either accepting the renegotiated lower rates or reinvesting payoff proceeds in other assets at the lower market rates. In addition, substantial increases in interest rates may cause an increase in loan defaults as borrowers may lack the resources to meet higher debt service requirements.

Senior loans trade in a private, unregulated market directly between loan market participants, although most transactions are facilitated by broker-dealers affiliated with large commercial and investment banks. As a result, purchases and sales of senior loans typically take longer to settle than similar purchases of bonds and equity securities. In addition, because senior loan transactions are directly between investors, there can be greater counterparty risk.

Moreover, despite the increase in the size and liquidity of the senior loan market, the market is still relatively illiquid, particularly when compared to the markets for bonds and equities. As a result, portfolios invested in senior loans may experience difficulties and delays in purchasing or selling senior loans, with resulting adverse impacts upon the prices obtained. During periods of severe market dislocation, such as occurred at the end of 2007 and during 2008, the market can experience severe illiquidity and significantly depressed prices.

Finally, many non-investment-grade borrowers are private companies and/or companies that have not issued other debt that is rated by rating agencies such as Standard & Poor's or Moody's Investors Service. As a result, investment decisions related to senior loans may be based largely on the credit analysis performed by the adviser to the fund or portfolio making the investments, and not on rating agency evaluation. This analysis may be difficult to perform. Information about a senior loan and the related borrower generally is not in the public domain, since private companies and companies that have not issued public debt or securities are not subject to reporting requirements under federal securities laws. However, borrowers are required to regularly provide financial information to lenders, typically in much greater detail than is available in the public markets. Furthermore, information about borrowers may be available from other senior loan participants or agents that originate or administer senior loans.

Disclosures

General Risk(s): All investing involves risks of fluctuating prices and the uncertainties of rates of return and yield inherent in investing. Investors should consult the funds' Prospectuses and Statements of Additional Information for a more detailed discussion of the funds' risks.

Senior Loans: Below investment grade loans involve a greater risk that borrowers may not make timely payment of interest and principal on their loans. They also involve a greater risk that the value of such loans could decline significantly. If borrowers do not make timely payments of the interest due on their loans, the yield on a portfolio invested will decrease. If borrowers do not make timely payment of the principal due on their loans, or if the value of such loans decreases, the value of a portfolio invested will decrease. **Demand for loans:** An increase in demand for loans may adversely affect the rate of interest payable on new loans acquired by a portfolio invested, and it may also increase the price of loans in the secondary market. A decrease in the demand for loans may adversely affect the price of loans in a portfolio invested, which could cause such portfolio's value to decline.

For more complete information, or to obtain a prospectus on any ING Fund, please call ING Funds Distributor, LLC at (800) 992-0180 or log on to www.ingfunds.com. The prospectus should be read carefully before investing. Consider the fund's investment objectives, risks and charges and expenses carefully before investing. The prospectus contains this information and other information about the fund. Check with your Investment Professional to determine which funds are available for sale within their firm. Not all funds are available for sale at all firms.

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Dan is Senior Vice President and Group Head of the ING Investment Management Senior Loan Group. He co-manages the Group with Jeff Bakalar, and he is co-chairman of the Group's Investment Committee and the Loan Pricing and Valuation Committee. Dan has over twenty years of investment experience. He began managing senior bank debt portfolios in 1995 when ING's predecessor acquired the management rights to ING Prime Rate Trust. Dan became the co-head of ING's senior bank loan business in January of 2000 and with Jeff Bakalar created and implemented the ING Senior Loan Strategy and the ING Senior Loan Group in January of 2001. Dan has a wide variety of business and investment experience, having begun his career at Arthur Andersen & Co. in 1981. He joined ING's predecessor in 1992. Dan received his B.A. degree in 1980 from the University of Nebraska and completed the University of Nebraska M.B.A. program in 1981.