TEXPERS ANNUAL CONFERENCE

Credit Long/Short

April 13, 2010

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Tom Stolberg, CFA
Portfolio Manager
Loomis, Sayles & Company, L.P.

Objectives

- What is Credit Long/Short?
- Why use Credit Long/Short?
- Focus on Credit Long/Short

What is Credit Long/Short:
Turning relative return into absolute return

Long-only credit + **Hedge fund transformation** = **Credit Long Short**

Long-only credit

- Credit spread exposure (default risk)
- Interest rate risk

Hedge fund transformation

- Flexibility for short exposure
- Hedge away unwanted risks (interest rates, currency, etc.)
- Potential for leverage

Credit Long Short

- Absolute returns
- More alpha
- Less beta

What is Credit Long/Short: Asset Classes & Instruments

- Strategy typically includes any security that is directly or indirectly tied to an issuer's ability to repay debt

GEOGRAPHY	ASSET CLASSES	INSTRUMENTS/ SECURITIES
Global	Investment grade	Cash bonds
	High yield	Credit derivatives
	Convertible/ hybrid	Bank loans
	Distressed	

What is Credit Long/Short: Typical Strategies

- Toolkit seeks to take advantage of opportunities in the market
- Strategies can be categorized in three ways:

Credit relative value

- Directional (long and short)
- Pair trading
- Curve trading
- Cash/derivatives basis
- Yield to call

Capital structure arbitrage

- Senior/subordinated
- Event and merger arbitrage
- Debt/equity

Quantitative strategies

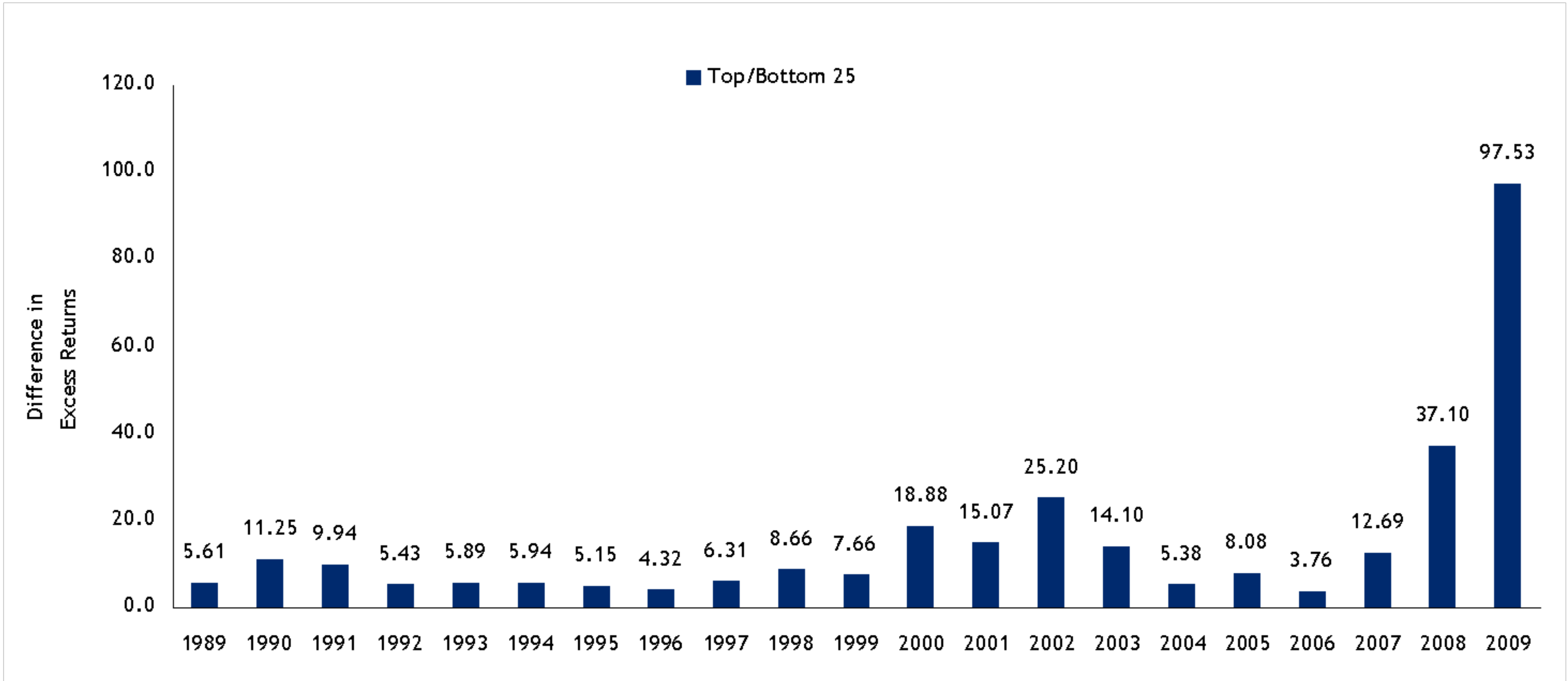
- Index arbitrage/other

Why use Credit Long/Short? Potential advantages of the strategy

- Distinct return pattern, uncorrelated to other investment strategies
- Objective is to generate consistently positive returns
- Controls volatility
- Emphasis is on specific risk/return, attempts to mitigate market ("beta") risks

Why use Credit Long/Short? Opportunities in Credit

Top/Bottom 25 Excess Return Variances for the Investment Grade Market



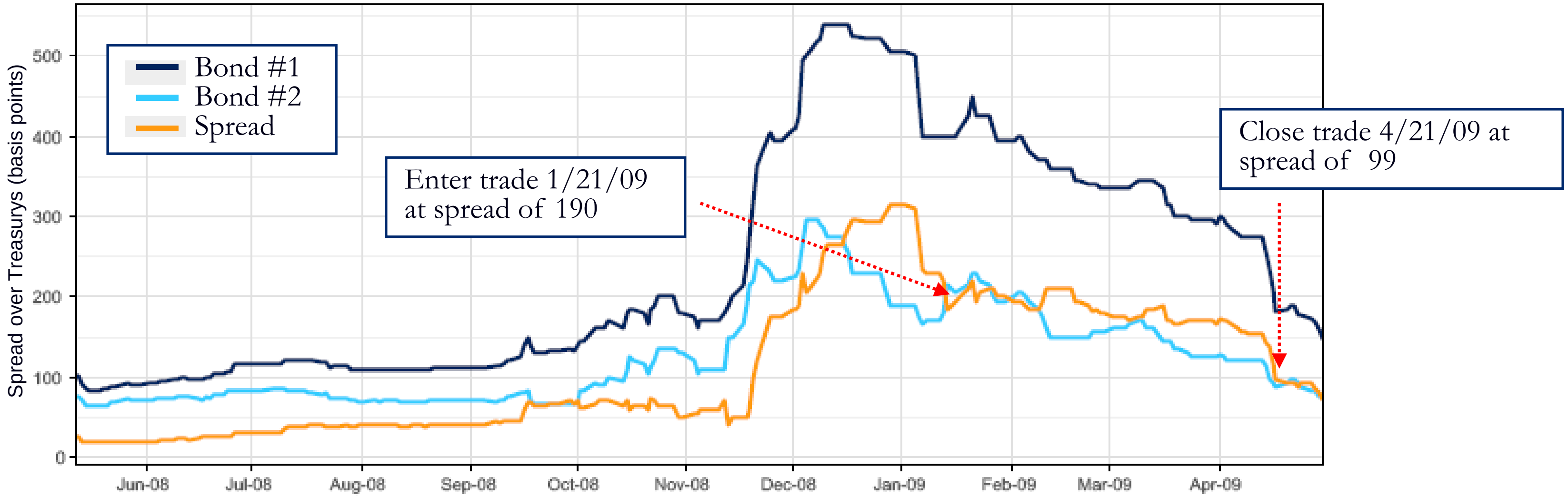
Vertical bars represent the difference in excess return (over similar term US Treasuries) of the top performing securities and the bottom performing securities. Proxy used for the current environment is the Barclays Investment Grade Credit Index. Calendar years 1989-2009

.Data Source: Barclays Index Returns.

Focus on Credit Long/Short Example: Pair Trades

- Usually involves 2 positions (long and short) where the price or spread is expected to converge or diverge based on fundamental and/or technical views. Investments in pair trading positions are usually in the same industry.

- Pair trading largely removes market and industry risk and focuses mainly on security specific risks.



Source: Bloomberg

Focus on Credit Long/Short Example: Curve Trades

- Involves taking a view of the shape of an issuer's credit curve. The shape of the curve is dependent upon many fundamental and technical factors.

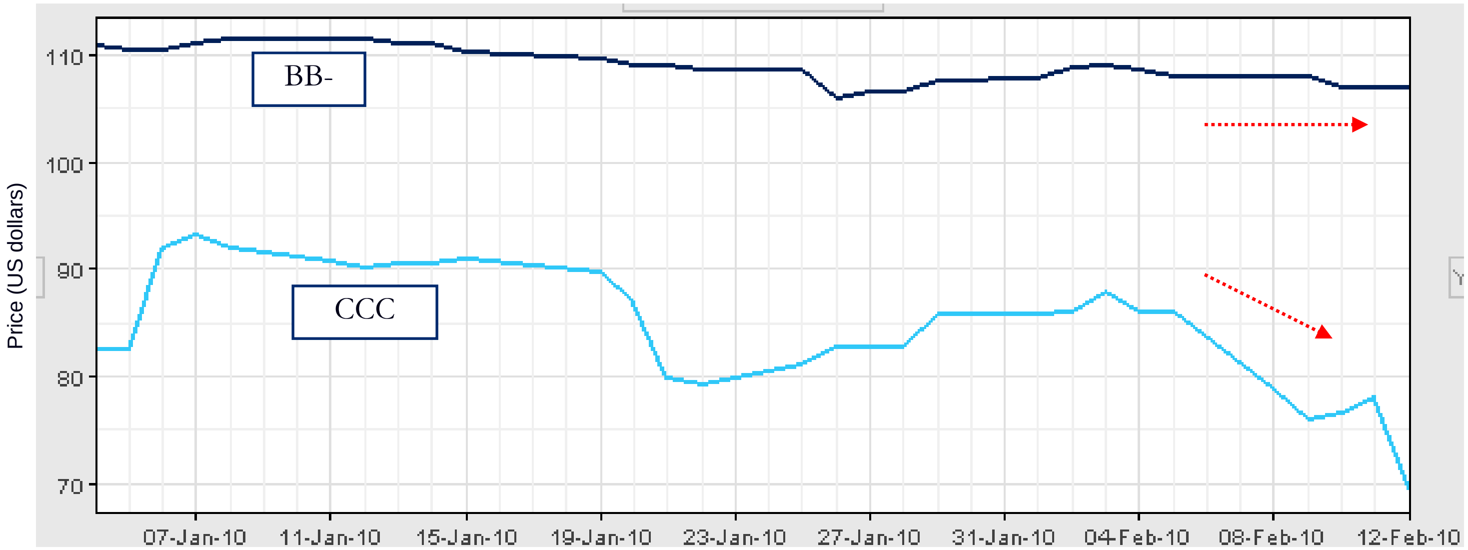
- Examples of typical strategies/trades include: steepeners, flatteners and roll down.

- One example is what we call "Limpers"

Focus on Credit Long/Short Example: Capital Structure Arbitrage

- The investor constructs a trade to potentially profit from a change in one value of the capital structure versus another part of the capital structure.

- Types of capital structure arbitrage trades include *senior vs. subordinated debt, event and merger arbitrage, and debt relative to equity*.



Source: Bloomberg

Considerations for Credit L/S: Evaluating the portfolio

Nominal measurements

- Gross long/gross short
- Sector and industry
- Country and currency
- Interest rate (duration)
- Quality rating
- Individual issuers

Volatility/ risk based measurements

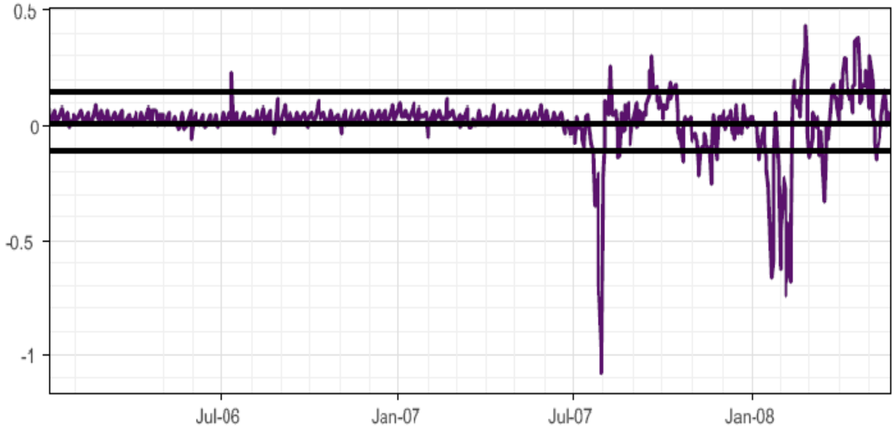
- Credit spread risk
- Interest rate curve
- Volatility/correlation
- Historical simulation/ covariance
- Scenario testing and stress testing

Considerations for Credit L/S: Evaluating potential risks

Leverage:

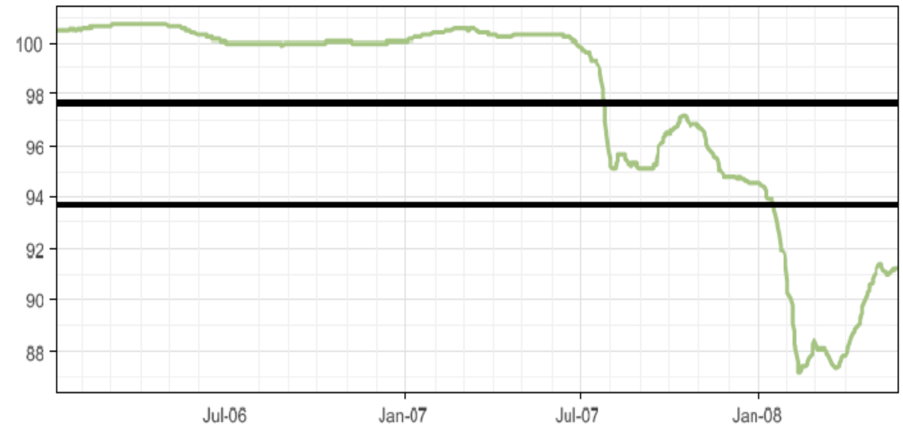
If an asset class exhibits 3% annual volatility and has higher seniority in the capital structure, should an investor be 10X levered to seek large favorable annual returns?

Barclays US High Yield Loan Index
Daily returns (Jan 2006-July 2008)



Source: Barclays

Price (Jan 2006-July 2008)



Source: Barclays

Considerations for Credit L/S: Evaluating the manager

Old Way

- Performance
- Philosophy
- Pedigree

New Way

- Performance
- **Risk Management**
- Philosophy
- **Transparency**
- Pedigree

Considerations for Credit L/S: Evaluating the manager

Non-performance issues

- Legal & compliance capabilities
- Trading
- Back office operations & reporting
- Fee structure
- Liquidity policy

Summary

- Reduction of Market Risk – more α, less β
- Strategy seeks to take advantage of what the market offers
- Strategy allows manager to navigate market conditions
- Robust risk management and operations are critical
- Core component of asset allocation – not opportunistic

Disclosure

All indexes are unmanaged, do not incur fees and it is not possible to invest directly in an index.

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