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What are Floating Rate Bank Loans?

A floating-rate loan is a debt obligation whose interest rate is tied to another rate, such as the Prime rate or the London Interbank Offered Rate (LIBOR). They are also known as bank loans, senior loans, or leveraged loans.

Floating rate bank loans are loans made by a bank or other lender to a company, typically secured by the assets of the borrower. Proceeds of the loans are often used to finance leveraged buyouts, recapitalizations, mergers, acquisitions, stock repurchases and other transactions. Although the loans are typically backed by specific collateral, such as property, plant, equipment or subsidiary stock, the loans often carry a below-investment-grade rating and are, therefore, subject to greater risk of default than investment-grade securities.

Because the loans are senior and secured, they typically provide lenders with the first right to any cash flows from the sale of collateral in the event that the borrower defaults on its obligations under the loan. As a result, lenders historically have recovered a high proportion of their outstanding loan amount (approximately 70%) if the company has defaulted, as compared to unsecured obligations such as bonds of the same issue (approximately 35%)*. The rate of the loan is reset periodically, often taking place every 30, 60, 90 or 180 days.

Floating rate loans tend to receive a lot of attention in times when investors expect interest rates to rise because investors believe their performance is inversely correlated to the overall bond market. However, as the table on the following page demonstrates, the correlation has been a weak one; performance has reflected credit market health and the very limited interest rate risk these funds possess.

*Source: Pioneer Research.

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As the table demonstrates, the perceived inverse correlation between floating rate bank loan performance and the overall bond market has been a weak one.

Because floating rate bank loans are rated below investment grade (“junk”), they are not considered suitable alternatives to money markets and are not akin to certificates of deposit (CDs) or money market funds.

Bank loans were introduced in the commercial bank arena, where banks made variable rate financing available to corporations that found traditional bond or equity financing unavailable or less attractive.

Correlation of Floating Rate Loans to other Fixed Income Asset Classes – October 1997 to September 2009

	1	2	3	4	5	6
1. U.S. Investment Grade Bonds <i>Barclays Capital U.S. Aggregate</i>	1.00					
2. U.S. Treasuries <i>Merrill Lynch U.S. Treasury Master</i>	0.90	1.00				
3. U.S. Corporate Bonds <i>Merrill Lynch U.S. Corporate Master</i>	0.85	0.58	1.00			
4. U.S. Stock Market <i>Standard & Poor's 500 Index</i>	-0.04	-0.26	0.22	1.00		
5. U.S. High Yield Bonds <i>Merrill Lynch U.S. High Yield Master II Index</i>	0.20	-0.16	0.56	0.61	1.00	
6. Floating Rate Loans <i>S&P/LSTA U.S. Leveraged Loan Index</i>	-0.02	-0.36	0.37	0.76	0.42	1.00

Data represents past performance. Past performance does not indicate future results.

Source: Morningstar Direct. Barclays Capital U.S. Aggregate Index represents the performance of U.S. government bonds; Merrill Lynch U.S. Treasury Master Index represents the performance of U.S. Treasury Bonds. Merrill Lynch U.S. Corporate Master Index represents the performance of U.S. corporate bonds. S&P 500 Index represents the performance of the U.S. stock market. S&P/LSTA U.S. Leveraged Loan Index measures the performance of U.S. floating rate loans. Indices are unmanaged and, unlike fund returns, do not reflect any fees or expenses associated with a fund. It is not possible to invest directly in an index.

Because floating rate bank loans are rated below investment grade (“junk”), they are not considered suitable alternatives to money markets and are not akin to certificates of deposit (CDs) or money market funds. CDs are backed by FDIC insurance to a total aggregate amount of \$250,000 for each depositor in each bank or thrift institution, and money market funds invest in high quality investments designed to keep NAV stable at \$1 per share.

In addition, as their name suggests, floating rate bank loans differ from traditional fixed rate bonds in that their rate floats, so while expected capital depreciation for loans would be lower in a rising rate environment (all else equal), expected capital appreciation in a falling rate environment would also be lower.

The History of Floating Rate Bank Loans

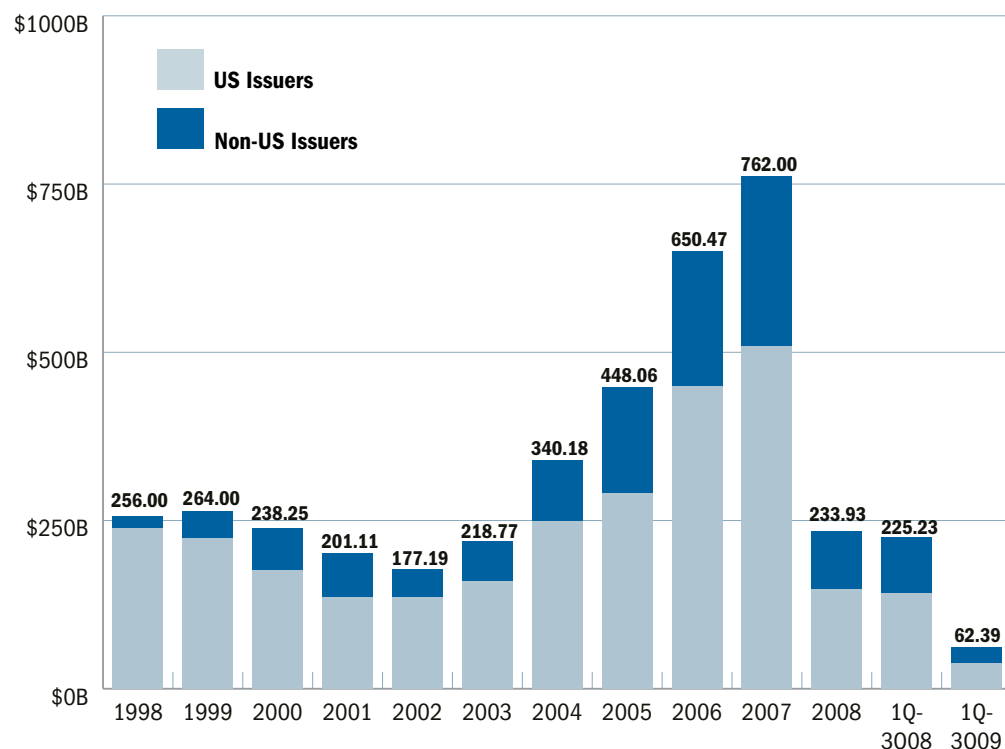
Bank loans were introduced in the commercial bank arena, where banks made variable-rate financing available to corporations that found traditional bond or equity financing unavailable or less attractive. The prepayable nature of a bank loan, together with its lower overall interest cost and ability to capitalize on floating rate markets, helped add flexibility to a firm’s capital structure.

The banks held these loans on their books and internally priced them at fair value. This opaque pricing together with the lack of a liquid secondary market prevented investor participation. Large money center banks and third party pricing services saw the demand for bank loans from insurance companies, mutual funds, collateralized loan obligations (CLOs), and hedge funds rise. This provided a secondary market and more accurate pricing, thus increasing liquidity and institutional participation in the loan market. This also served to spread loan risk among a wider investor base.



In 1999, mark-to-market pricing of loans mandated by the SEC brought about more transparency and greater liquidity. As the bank loan market has grown, regulations and practices have changed, bringing about an even more efficient secondary market with uniform trading and settlement procedures.

Global New-Issue Bank Loan Volume Increased Dramatically from 1999 to 2007



Source: S&P LSTA Leveraged Loan Index. Data excludes existing tranches of add-ons and amendments & restatements with no new money. These numbers comprise loans denominated in all currencies and are subject to revision as Standard & Poor's LCD collects additional data.

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The Risks Associated with Floating Rate Bank Loans

Floating rate bank loans may be beneficial as part of an overall asset allocation strategy, but should not be used for assets that an investor has earmarked for a short-term goal. It is important to understand that these loans are from junk-rated issuers (credit rating of BB or lower).

Sinking credit quality can therefore erode value and lead to poor returns despite a high yield. This was the case from 1999 to 2002 when the market suffered from credit deterioration, although loans still had positive returns. In 2002, the bank loan market endured losses for most of the year, recovering in the last quarter. Rapid growth in the asset class in 2006-07 was predicated on investors using leverage. When the last quarter of 2008 saw massive deleveraging, the result was a large technical downdraft and poor returns for 2008. It was the first year in their 11-year history that bank loans recorded a negative return.

The following provides a deeper discussion of the primary risks associated with bank loans:

Interest Rate Risk: When interest rates decline, the value of fixed-rate securities can be expected to rise. Conversely, when interest rates rise, the value of fixed-rate portfolio securities can be expected to decline. The rate on bank loans periodically adjusts with changes in



interest rates. Consequently, exposure to fluctuations in interest rates will generally be limited until the interest rate on the loan is reset. To the extent that changes in market rates of interest are reflected – not in a base rate such as LIBOR, but in a change in the spread over the base rate – the loan’s value could be adversely affected. This is because the value of a loan asset is partially a function of whether it is paying what the market perceives to be a market rate of interest for the particular loan, given its individual credit and other characteristics.

Reinvestment Risk: Income from investing in loans will decline if the proceeds, repayment or sale of loans are invested into a lower yielding instrument with a lower spread of the base lending rate. A decline in income could affect the yield and overall return.

Credit Risk and Junk Bond Risk: Credit risk is the risk that an issuer of a loan will become unable to meet its obligation to make interest and principal payments. Bank loans are typically debt securities that are rated below-investment-grade. Investment in loans below investment grade quality involves substantial risk of loss. Junk debt is considered predominantly speculative with respect to the issuer’s ability to pay interest and repay principal and is susceptible to default or decline in market value due to adverse economic and business developments. The market values for fixed income securities of below-investment-grade quality tend to be more volatile, and these securities are less liquid than investment grade debt securities.

Adverse changes in economic conditions are more likely to lead to a weakened capacity of a high yield issuer to make principal payments and interest payments than an investment grade issuer. Economic downturns could severely affect the ability of highly leveraged issuers to service their debt obligations or to repay their obligations upon maturity.

Issuer Risk: The value of bank loans may decline for a number of reasons, which directly relate to the issuer, such as management performance, financial leverage, and reduced demand for the issuer’s goods and services. More broadly, there is industry risk, in so far as it could affect a group of similar companies.

Liquidity Risk: Adverse market conditions may result in markets where there is no readily available trading or that are otherwise illiquid, which can lead to sales at prices below those at which the investor could sell such securities if they were more widely traded. In addition, the limited liquidity could affect the market price of the securities, thereby adversely affecting the bank loan’s value. Most loans are valued by an independent pricing service that uses market quotations of investors and traders in bank loans.

Potential Benefits Associated with Bank Loans

Bank loans typically have their coupons reset every 30, 60 or 90 days and have short-term maturities, making them short duration vehicles with reduced exposure to interest rate risk. Floating-rate loans have historically paid increasing income in periods of rising rates and decreasing income in periods of falling rates. In those periods where rates have been flat, the extra yield that floating rate loans have offered had the potential to benefit performance.

Many cross-over bond managers see buying opportunities in floating rate bank loans during rising rate environments due to the combination of rising coupons and the collateral securing the loans. However, a rise in interest rates does not necessarily mean that floating rate loans will always benefit. If investors perceive the increase in interest rates will damage credit quality, then lower prices for loans (in the secondary market) could offset the benefit of higher interest rates. But historically, under poorer economic circumstances, loans have outperformed other

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fixed income asset classes because they have filled the highest level of the capital structure and recovered more in bankruptcy. Of course, past performance does not indicate future results.

Bank loans carry some technical advantages to investors as well. First, they allow the buyer of the loan to hold an interest in the assets of a company, which provides power to negotiate with the company to get adequately paid for the underlying risk of the loan. This has helped reduce price volatility. Second, in many instances where there are defaults in a firm's capital structure, bank loans have continued paying interest because of their senior collateral position.

Why Floating Rate Bank Loans May Be Attractive Investments

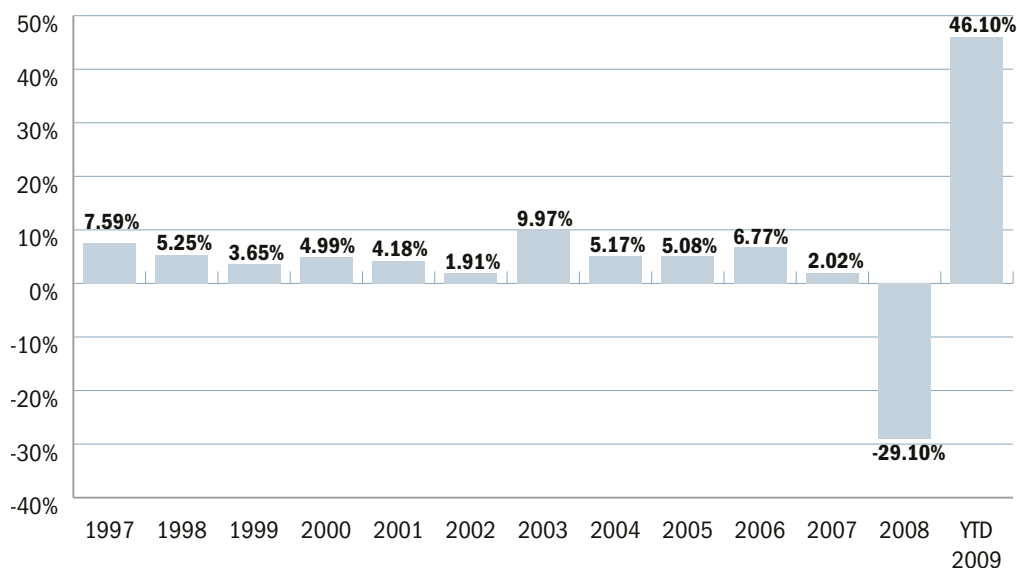
Lower Default Risk: Bank loans have typically provided lenders with the first right to any cash flows from the sale of collateral in the event that the borrower defaults on its obligations under the loan. As a result, the senior lenders historically have recovered a higher proportion of the outstanding loan amount if the company has defaulted, as compared to unsecured obligations such as bonds of the same issuer – particularly high yield or below investment-grade bonds.

Greater Yield Potential: Historically, bank loans have offered higher yields than short-term Treasury securities. They have also had greater risk. Bank loans generally pay interest at rates that are based on recognized lending rates, such as LIBOR, plus a premium. Historically, bank loans have averaged LIBOR plus 300 basis points. Rates on bank loans reset regularly to maintain a spread over these widely accepted floating base rates.

Attractive Growth and Return History: The market for bank loans has grown considerably over the past couple of decades, rising in tandem with new leveraged loan volume. The institutional loan market, which is where CLOs/Mutual Funds/Hedge Funds buy, is currently \$556.7B par value through August. That is down from the high of \$585 in 3/31/09. For context, the year-end values for 2005, 2006, and 2007 were \$256B, \$400B, and \$557B, respectively.

Floating Rate Bank Loans Have Experienced a Dramatic Recovery Following 2008's Credit Crisis

Total Returns of the S&P/LSTA Leveraged Loan Index



Data represents past performance, which is no guarantee of future results. Last data point 9/30/09.



An Asset to Consider in Rising Rate Environments: For investors willing to accept the risks involved, floating rate loans may be beneficial in seeking greater diversification and performance potential for existing fixed-income portfolios during rising interest rate environments. If rates do stay the same, the higher income offered with floating-rate loans should be beneficial.

Investors should consult with their financial advisor to determine if these investments are suitable for their needs.

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23393-00-1009

