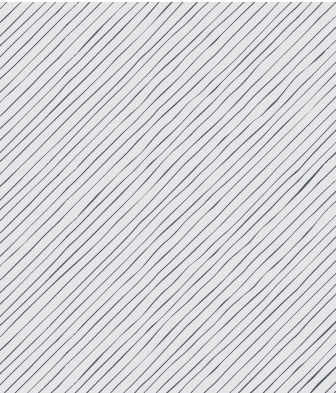
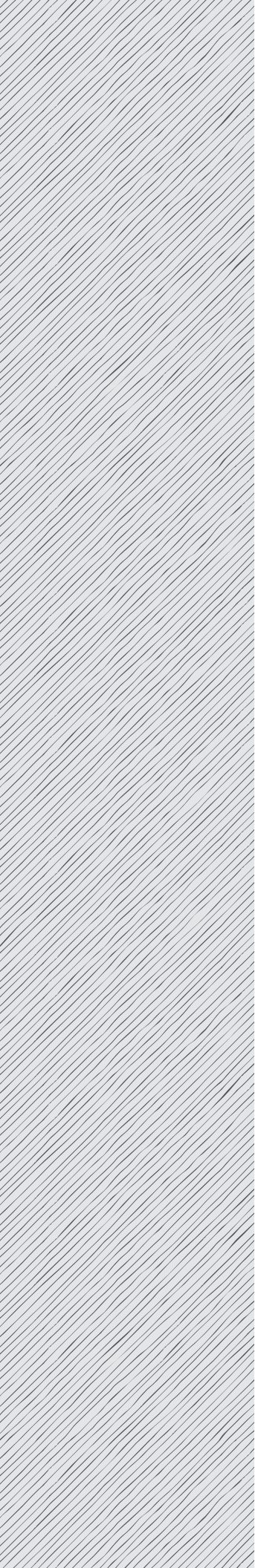




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Senior Floating Rate Loans



Senior floating rate loans have become a staple of the U.S. debt market, growing from a market value of \$126 billion in 2001 to \$667 billion as of year-end 2012.¹ As the floating rate loan market has matured, retail investors have recognized the value that managed senior floating rate loan portfolios have the potential to provide.

Floating rate loans may provide investors with:

- An attractive yield compared with higher quality short duration products.
- Minimal exposure to interest-rate risk.
- Additional portfolio diversification as part of a long-term investment portfolio.

The pages that follow provide a primer on the background and structure of senior floating rate loans, as well as a discussion of the potential behavior of these securities in certain market environments.

By definition, senior floating rate loans are debt instruments made by banks and other financial institutions to large corporations that feature a variable interest rate that is tied to a market reference rate and adjusted periodically. Adjustments are typically made every 30, 60, or 90 days and can make these loans especially attractive to investors who anticipate a rising interest rate environment because the yield on floating rate loans rises with interest rates. For our purposes, “senior floating rate loans” will be used interchangeably with floating rate loans, bank loans, and leveraged loans.

Floating rate loans should not be compared equally in terms of credit risk with other short-term investments, such as: money market securities; money market funds; certificates of deposit, which offer a fixed rate of return when held to maturity and are generally insured up to certain limits by the FDIC; or U.S. government obligations, which generally offer a government guarantee as to timely payment of interest and repayment of principal at maturity.

An investment in a money market fund is not insured or guaranteed by the FDIC or any other government agency. Although the Fund seeks to preserve the value of your investment at \$1.00 per share, it is possible to lose money.

Background

The floating rate loan market began in the 1980s, when banks first made floating rate loans to large corporations in need of capital. These corporations chose floating rate loans because credit lines and/or traditional bond or equity financing were either unavailable or relatively less attractive. In 1989, the first floating rate loan closed-end mutual fund was launched, providing retail investors access to a market segment previously available only to large institutions and accredited investors. Without a developed secondary market, floating rate loans were generally considered illiquid; therefore, floating rate mutual funds did not gain significant market share, relative to other fixed-income securities.

In 1992, the Credit Suisse Leveraged Loan Index was created, providing a benchmark for floating rate loans. In 1995, Standard & Poor’s and Moody’s began rating floating rate loans, which are categorized as “non-investment grade” due to their credit risk. The ratings reflect the current opinion of the obligor’s capacity and willingness to meet its financial commitments. The remainder of the 1990s saw steady growth in investor interest in floating rate loans—with assets nearly tripling by the end of the decade.

In 1999, the U.S. Securities and Exchange Commission directed bank fund managers to use “mark-to-market” data from third-party pricing services to determine the value of floating rate loans for portfolio-valuation purposes. Previously, most managers used a “fair value pricing” method, which was thought to be subjective, as fund managers were valuing the loans according to their internal valuation processes. “Mark-to-market” pricing eliminated this pricing bias as the loan’s price is based upon the bid-and-ask levels in the marketplace. This transparency in pricing helped facilitate greater liquidity. In 2000, the first senior floating rate loan open-end mutual fund with daily liquidity was offered—a major step forward, as floating rate mutual funds introduced to that point were closed-end interval funds that offered only quarterly or monthly redemptions.

Today, the floating rate loan market stands at \$667 billion in assets and continues to attract interest from both institutional and retail investors alike.¹

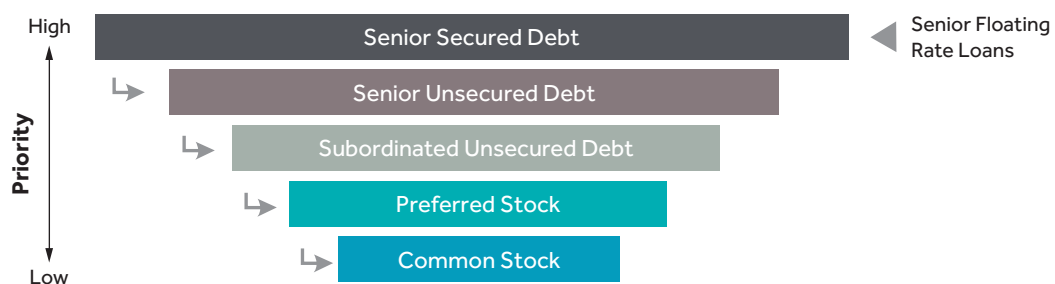
1. Source: Credit Suisse Leveraged Loan Index, 12/31/12. Market value of index.

Characteristics of senior floating rate loans

Senior floating rate loans are typically made to companies that have below-investment grade credit ratings. While they share non-investment grade ratings with high-yield bonds, floating rate loans are generally secured and senior within the borrower's capital structure and typically have higher asset-specific ratings than bonds.

- **Senior in the borrower's capital structure.** Floating rate loans are senior debt, which means that they have the highest priority claims on the borrower's assets and have seniority over other debt including subordinated debt, senior unsecured debt, subordinated unsecured debt, and preferred and common stock.

Floating Rate Loans



- **Loans backed by the borrower's assets.** Floating rate loans are generally secured through the pledge of assets of the borrower. This pledge is specified in the Credit Agreement, a contract between the lending institution and the borrower that includes the terms of the loan. Collateral may include inventory, real estate, receivables, intellectual property, and stock.
- **Covenant protection.** Floating rate loans typically are structured with financial covenants that allow lenders to intervene earlier to mitigate potential losses in the event that problems arise. These covenants are generally maintenance covenants, with which the borrower must comply on an ongoing basis.
- **Rates float with the market.** Floating rate loans pay a spread over a pre-determined reference rate—generally the U.S. Dollar London Interbank Offered Rate (LIBOR). Usually quoted in 30-, 60-, and 90-day periods, LIBOR is the rate at which the most creditworthy banks from around the world offer to lend money to one another.

The rate paid by the borrower is typically reset periodically (every 30, 60, or 90 days), so that the aggregate rate “floats” and is highly correlated with the reference rate. Consider this example: If a floating rate loan of ABC Company has a coupon of 5.0% (3.0% higher than its benchmark, LIBOR, which in this example is 2.0%) and LIBOR moves to 3.0% as of the next reset date, the coupon of the floating rate loan of ABC Company is changed to 6.0%.

Benefits of investing in senior floating rate loans

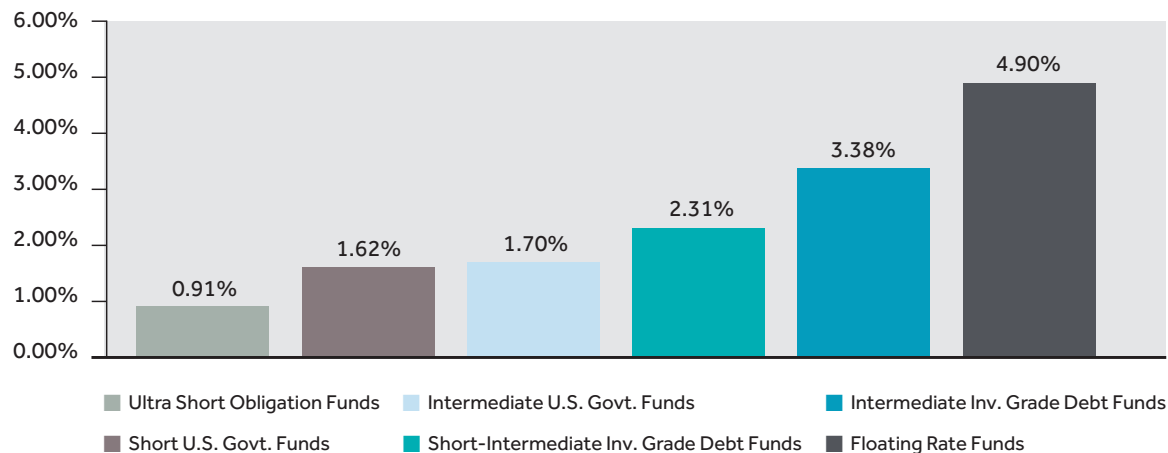
Bank loans may be a viable option for investors for a portion of a fixed-income allocation because they offer several benefits compared to other fixed-income securities.

- **Higher current income potential.** As bank loans are generally below investment grade and have higher credit risk, investors receive a premium over the yield they would receive compared to investments in higher-rated bonds. The additional yield is provided to compensate investors for assuming higher default risk.

Floating rate loans may also provide an attractive yield versus other short and intermediate duration investments. The historic low interest rate environment has resulted in low yields across many of these securities. As interest rates begin to rise, investors will look for short duration investments that may help to limit price depreciation in a rising interest rate environment. Investors may benefit from floating rate loans as they can offer a more attractive yield relative to some short and intermediate asset classes and also a near zero duration.

The chart below illustrates the average current distribution yields for some short and intermediate duration asset classes.

Average Current Distribution Yields as of December 31, 2012



Source: Lipper, 12/31/12. Lipper calculates distribution yields based on income dividends paid during the previous 12 months divided by the latest net asset value (NAV). Lipper Categories: Ultra Short Obligation Funds invest primarily in investment-grade debt issues or better and maintain a portfolio dollar-weighted average maturity between 91 days and 365 days. Short U.S. Government Funds invest primarily in securities issued or guaranteed by the U.S. government, its agencies, or its instrumentalities, with dollar-weighted average maturities of less than three years. Intermediate U.S. Government Funds invest primarily in securities issued or guaranteed by the U.S. government, its agencies, or its instrumentalities, with dollar-weighted average maturities of five to 10 years. Short-Intermediate Investment Grade Debt Funds invest primarily in investment-grade debt issues (rated in the top four grades) with dollar-weighted average maturities of one to five years. Intermediate Investment Grade Debt Funds invest primarily in investment-grade debt issues (rated in the top four grades) with dollar-weighted average maturities of five to 10 years. Floating Rate Funds invest primarily in participation interests in collateralized senior corporate loans that have floating or variable rates. **Past performance is no guarantee of future results.**

- **Lower interest-rate risk.** Compared to other fixed-income instruments, the prices of senior floating rate loans are generally less sensitive to changes in interest rates because interest rates on floating rate loans reset periodically to reflect current market rates. With bonds, when interest rates rise, the prices of bonds in the market fall, thereby raising the yield of the older bonds and bringing them in line with newer bonds being issued with higher coupons. When interest rates fall, the prices of bonds in the market rise, thereby lowering the yield of the older bonds and bringing them in line with newer bonds being issued with lower coupons, all else being equal. Floating rate securities may be subject to lower interest rate risk compared to other types of bonds; however, when interest rates rise, the value of these securities will most likely decline.

The Impact of Interest Rates on Bonds vs. Floating Rate Loans

Rising Interest Rates					
	Bonds	Floating Rate Loans		Bonds	Floating Rate Loans
Price	Down	Lower Volatility	Price	Up	Lower Volatility
Income	Stable	Up	Income	Stable	Down
			Falling Interest Rates		

- **Fed Funds Rate and LIBOR: High degree of correlation historically.** Two of the major influences on interest rates are the economy and inflation. To stimulate the economy or keep it from growing too quickly, the Federal Reserve (Fed) may decrease or increase the federal discount rate. The Fed uses the discount rate as a tool to shape monetary policy and influence the fed funds rate. The fed funds rate is the interest rate charged by banks with excess reserves at a Federal Reserve Bank on loans to other banks overnight. The most sensitive indicator of the direction of interest rates, the fed funds rate has a ripple effect on all other types of interest rates, including the prime rate and LIBOR. Since floating rate loans pay a spread over a reference rate (e.g. LIBOR), the interest rate on the floating rate loan will increase if the reference rate rises. Of course, the opposite holds true if the reference rate falls.

While LIBOR does not move in lock-step with the fed funds rate, there has been a high degree of correlation historically between movements in the fed funds rate and LIBOR, as both are similar short-term rates. Over the 10-year period ended December 31, 2012, there was a correlation of 0.90 between the three-month LIBOR and the fed funds rate.² Historically, the three-month LIBOR has tended to trend up or down when the Fed tightened or eased, respectively.

The chart below highlights the performance of various fixed-income investments, including floating rate loans, on a calendar year basis during periods of rising, declining, and flat interest rates. Floating rate loans provided positive returns in each of these periods except in 2008, a year when most asset classes underperformed. **Past performance is no guarantee of future results.**

Fed Action	Year	Floating Rate Loans (Annual Total Return)	High-Yield Bonds (Annual Total Return)	Corporate Bonds (Annual Total Return)	Government Bonds (Annual Total Return)
Fed lowered rates 3 times	1992	6.75%	15.75%	8.69%	7.23%
Fed made no changes	1993	11.17	17.12	12.16	10.66
Fed raised rates 6 times	1994	10.32	-1.03	-3.93	-3.38
Fed raised rates 1 time then lowered rates 2 times	1995	8.91	19.17	22.25	18.34
Fed lowered rates 1 time	1996	7.48	11.35	3.28	2.77
Fed raised rates 1 time	1997	8.30	12.76	10.23	9.59
Fed lowered rates 3 times	1998	5.31	1.87	8.57	9.85
Fed raised rates 3 times	1999	4.69	2.39	-1.96	-2.23
Fed raised rates 3 times	2000	4.94	-5.86	9.39	13.24
Fed lowered rates 11 times	2001	2.65	5.28	10.40	7.23
Fed lowered rates 1 time	2002	1.12	-1.41	10.52	11.50
Fed lowered rates 1 time	2003	11.01	28.97	7.70	2.36
Fed raised rates 5 times	2004	5.60	11.13	5.24	3.48
Fed raised rates 8 times	2005	5.69	2.74	1.96	2.65
Fed raised rates 4 times	2006	7.33	11.85	4.26	3.48
Fed lowered rates 3 times	2007	1.88	1.87	5.11	8.66
Fed lowered rates 7 times	2008	-28.75	-26.16	-3.08	12.39
Fed made no changes	2009	44.87	58.21	16.04	-2.20
Fed made no changes	2010	9.98	15.12	8.47	5.52
Fed made no changes	2011	1.82	4.98	8.35	9.02
Fed made no changes	2012	9.43	15.81	9.37	2.02

Sources: Morningstar Direct and Federal Reserve Bank of New York, 12/31/12. Floating rate loans are represented by the Credit Suisse Leveraged Loan Index, a representative index of tradable, senior secured, U.S. dollar denominated non-investment grade loans. High-yield bonds are represented by the Barclays U.S. Corporate High Yield Total Return Index, which covers the universe of fixed-rate, non-investment grade debt. Corporate bonds are represented by the Barclays U.S. Credit Index, which includes all publicly issued, fixed rate, non-convertible investment-grade dollar denominated, SEC-registered corporate debt. Government bonds are represented by the Barclays U.S. Government Bond Index, which is composed of the Barclays Treasury Bond Index (all public obligations of the U.S. Treasury, excluding flower bonds and foreign-targeted issues) and the Barclays Agency Index (all publicly issued debt of U.S. Government agencies and quasi-federal corporations, and corporate debt guaranteed by the U.S. Government). An investment cannot be made directly into an index. **Past performance is no guarantee of future results.**

- **Low correlation may provide additional portfolio diversification.** Historically, floating rate loans have a low or even negative correlation compared to other traditional investments. Correlation coefficient indicates the strength and direction of the relationship between the movement of two investments. If two securities are perfectly correlated—that is, they have a correlation of 1.00—their prices move in lock-step with one another. Diversifying a portion of the portfolio with securities that are not highly correlated may help reduce volatility in the portfolio. Generally, a correlation of 0.70 or less would indicate that the two investments are not highly correlated. If the correlation coefficient is negative, the two investments will move in opposite directions from one another. A correlation coefficient of -1.00 would indicate that two investments move in exactly the opposite direction from one another.

10-Year Correlation Matrix

Name	Municipal Bonds	Government Bonds	Corporate Bonds	High-Yield Bonds	Large-Cap Stocks	Floating Rate Loans
Municipal Bonds	1.00	0.43	0.63	0.35	0.10	0.25
Government Bonds	0.43	1.00	0.60	-0.18	-0.24	-0.39
Corporate Bonds	0.63	0.60	1.00	0.56	0.31	0.31
High-Yield Bonds	0.35	-0.18	0.56	1.00	0.72	0.84
Large Cap Stocks	0.10	-0.24	0.31	0.72	1.00	0.60
Floating Rate Loans	0.25	-0.39	0.31	0.84	0.60	1.00

Source: Morningstar, 1/1/03-12/31/12. Municipal bonds are represented by the Barclays Municipal Bond Index, which is a return performance benchmark of the long-term, investment-grade tax-exempt bond market. High-yield bonds are represented by the Barclays U.S. Corporate High Yield Total Return Index, which covers the universe of fixed-rate, non-investment-grade debt. Corporate bonds are represented by the Barclays U.S. Credit Index, which includes all publicly issued, fixed-rate, non-convertible investment-grade dollar denominated, SEC-registered corporate debt. Government bonds are represented by the Barclays U.S. Government Bond Index, which is composed of the Barclays Treasury Bond Index (all public obligations of the U.S. Treasury, excluding flower bonds and foreign-targeted issues) and the Barclays Agency Index (all publicly issued debt of U.S. Government agencies and quasi-federal corporations, and corporate debt guaranteed by the U.S. Government). Large-cap stocks are represented by the S&P 500 Index, an unmanaged index that is widely regarded as the standard for measuring large-cap U.S. stock market performance. Floating rate loans are represented by the Credit Suisse Leveraged Loan Index, a representative index of tradable, senior secured, U.S. dollar denominated non-investment grade loans. Results assume the reinvestment of all capital gains and dividend distributions. An investment cannot be made directly into an index. **Past performance is no guarantee of future results.**

- **Potential for higher recovery in the event of defaults.** Historically, bank loans have experienced lower default rates and higher recovery rates than senior-unsecured bonds, both of which potentially have a positive impact on bank loan returns. Default risk is the likelihood that a borrower will be unable to fulfill its payment obligations. To determine the default risk of an issuer, analysts conduct exhaustive research of a firm's free cash flow, debt service obligations, future expected income stream, and overall strategic plan. In most cases, rating services, such as Standard & Poor's and Moody's, provide ratings based on the financial condition of the company.

The recovery rate represents the ability of the lender to realize the value of its loan in the underlying collateral (e.g., collateral may include inventory, real estate, receivables, intellectual property, and stock) should the borrower default. Since holders of bank loans enjoy first priority claim among creditors, a bank loan's recovery rate is typically much higher than those of more junior investments. Floating rate loans had an average recovery rate of 80.6% from 1987 through 2012, while senior-unsecured bonds have averaged 48.6% over this same time period.³

Principal risks of senior floating rate loans

Senior floating rate loans are not without risk. While interest-rate risk is less of a factor due to their low duration (i.e., sensitivity to interest rates), the values of debt securities fluctuate depending upon various factors including credit risk, economic and market factors, and interest-rate risk.

- **Credit risk.** Floating rate loans are usually rated below investment grade and are generally considered speculative because they present a greater risk of loss, including default, than higher quality debt securities. These securities pay investors a higher interest rate because of the increased risk of loss. Although certain floating rate loans are collateralized, there is no guarantee that the value of the collateral will be sufficient to repay the loan.
- **Economic and market factors.** As with all investments, economic and market factors have a major impact on the performance of the floating rate loan market and a company's ability to meet its obligations. Perception can change quickly and cause fairly sharp movements in price (as with high-yield bonds). Investors must be prepared to withstand potential fluctuations in price.
- **Interest-rate risk.** Loans and other debt securities are also subject to the risk of changes in prevailing interest rates, although floating rate loans are less susceptible to this risk than other fixed-rate obligations. If interest rates rise (or decline), yields on bank loans will also rise (or decline). However, because floating rates on senior loans only reset periodically, changes in prevailing interest rates can be expected to cause some fluctuation in price. There are two reasons why floating rate loans may underperform traditional investment-grade bonds during periods of **falling interest rates**. First, the frequent interest rate adjustments make floating rate loans less desirable than fixed-rate securities during periods of declining rates. Periods of declining rates tend to precede or coincide with a weakening economy. Second, economic weakness can hurt the trading price of floating rate loans, since buyers may be less sure of companies' ability to keep up with their debt payments in that environment.

Floating rate loans are generally considered to have speculative characteristics that involve default risk of principal and interest, collateral impairment, non-diversification, borrower industry concentration, and limited liquidity.

It is also important to note that floating rate loans are not, and should not be considered to be, an alternative to money market securities, money market funds, or certificates of deposit.

3. Source: Moody's Special Comment - Corporate Default and Recovery Rates, 1920-2012, February 2013.

Potential investors

Floating rate loans may help benefit investors who:

- **Are looking for income.** Floating rate loans might be a viable option for a portion of an investor's fixed-income portfolio.
- **Are seeking to diversify an overall portfolio.** Historically, floating rate loans have shown little correlation to the movements of high-grade bonds, U.S. government securities, and other traditional investments.
- **Understand the merits of non-investment grade investments.** Like high-yield bonds, the lower credit quality of floating rate loans makes them subject to default risks. It is important for investors in this asset class to understand that a certain amount of risk, commensurate with the return potential, may provide significant long-term advantages.

With its floating interest rate, attractive risk/reward characteristics, and low correlation to other investments, floating rate loans are an asset class with a wide range of benefits for institutional, high net worth, and retail investors.

For more information about MainStay Funds®, call 800-MAINSTAY (624-6782) for a prospectus or summary prospectus. Investors are asked to consider the investment objectives, risks, and charges and expenses of the investment carefully before investing. The prospectus or summary prospectus contains this and other information about the investment company. Please read the prospectus or summary prospectus carefully before investing.

For more information

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