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Floating-rate loans: Core value remains as the need for selectivity rises

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SUMMARY

- The strategic case for the floating-rate loan asset class has historically centered on the unique combination of attractive yield potential and near-zero duration, delivered through senior/secured debt obligations.
- The sector experienced strong investor interest and inflows in 2013, followed by some net outflows so far this year. We examine a number of considerations that have arisen to determine if the strategic case, indeed, remains valid. These include: valuation, Libor floors, credit risk, covenant-lite issuance, an expanding retail investor base, the default of Energy Future Holdings (formerly TXU), and potential new regulations.
- The loan market is entering a phase in which selectivity is especially important. We see a growing portion of the market that is of questionable credit quality – issuers who we believe may be too small, too leveraged, too vulnerable to a business downturn, or some combination of these.
- However, we find that there is currently no lack of issuers with sound credit profiles and low default risk, buoyed by low financing costs, strong balance sheets and EBITDA growth. The loan market has offered what we believe are reasonable spreads, attractive yields relative to other market segments and a healthy supply/demand balance.
- Given the dearth of attractive income-generating asset classes today and the threat to bond values in rising-rate scenarios, we conclude that the strategic allocation to floating-rate loans may be as important as ever.

The strategic case for the floating-rate loan asset class has historically centered on the combination of attractive yield potential and near-zero duration, delivered through senior/secured debt obligations. The sector experienced tremendous investor interest and inflows in 2013, but some net outflows so far this year. We examine a number of considerations that have arisen to determine if the strategic case, indeed, remains valid. These include: valuation, Libor floors, credit risk, covenant-lite issuance, an expanding retail investor base, Energy Future Holdings (formerly TXU), and new regulations.

How do these issues relate to the case for floating-rate loans today? We feel that the core value proposition of a strategic allocation to loans remains firm, with an important qualification. At this phase in the credit cycle we see a growing portion of the market that is less creditworthy, which makes issuer selectivity and fundamental credit research especially important for investors. In this paper, we illustrate the ongoing core value of floating-rate loans by addressing the recent considerations cited above, starting with valuation.

1. Valuation: *Relative to historical spreads and other sectors, we believe that the floating-rate loan asset class still offers value.*

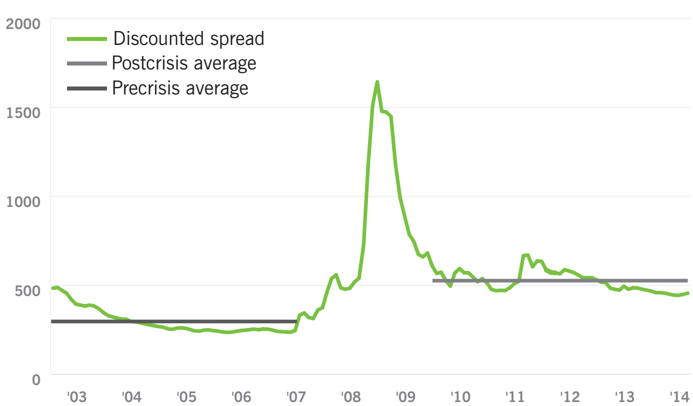
We look at loan valuations from two perspectives: their historical spread over Libor[1] and their current yield relative to other fixed-income asset classes.

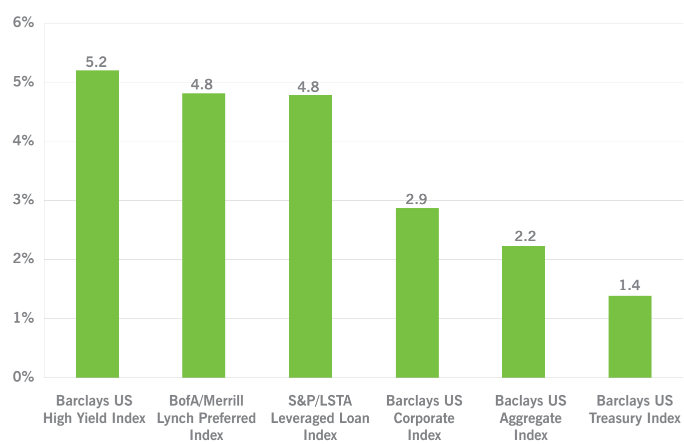
Starting with a review of spreads[2], Exhibit 1 (left) shows that the discounted spread on the S&P/LSTA Leveraged Loan Index (S&P/LSTA Index) has tightened over the past two years – a trend similar to fixed-income asset classes at large – as the relative attractiveness of loans drove strong demand from income investors and resultant refinancing activity by issuers. The S&P/LSTA spread over Libor, as of August 31, 2014, was 454 bps. While this is a tighter spread than the postcrisis average of 523 bps, it is still substantially wider – by 159 bps – than the average prior to the crisis.

Why have spreads not tightened to the level of the precrisis era? A key reason, we believe, is that the historically low yields have attracted many issuers, helping expand supply and offset further spread compression. Thus, supply and demand have exhibited reasonable equilibrium, serving as an invisible floor for the asset class. To us, the combination of wider spreads and lower fundamental credit risk relative to the precrisis period suggests that floating-rate loans still offer reasonable value.

Exhibit 1 (right side), also shows that relative to other

Exhibit 1 **Loan spreads are wider than the pre-crisis years and yields were among the highest in U.S. sectors.**





Sources: S&P Capital IQ LCD and S&P/LSTA Leveraged Loan Index, as of August 31 2014. Data are provided for informational purposes only. It is not possible to invest directly in an index. Past performance is no guarantee of future results. See end of this material for index definitions as well as additional important information and disclosure.

[1]Libor, or London Interbank Offered Rate, represents an average of borrowing costs among major banks and is a common benchmark for short-term borrowing rates.
[2]The discounted spread refers to the yield on a loan above its benchmark rate plus the yearly price increase that is expected as the bond's discounted price accrues to par.

fixed-income sectors, the 4.8% yield on the S&P/LSTA Index as of August 31, 2014, was only exceeded among U.S. fixed-income sectors by high yield (5.2%). Of course, absolute yield levels in all sectors have declined in recent years, in the context of stimulative policies of global central banks. Given that the market is close to the historic lows loans experienced in the early 2000s, we believe the majority of the yield decline is finished, and that the more likely scenarios over the long-term entail flat or rising loan yields.

Recall also that the only higher-yielding U.S. sector – high-yield bonds – comes with inherent duration[3] risk that has been almost completely absent from floating-rate loans. High-yield also entails greater credit risk. So when inevitable tightening of monetary policy takes place, the value of loans as a shelter from the impact of rising rates is likely to increase, in our opinion.

2. Libor "floors." *We see these as innovations that enhance minuscule risk-free yields and add little risk to the market.*

The post-crisis, low-yield environment sparked the introduction of Libor floors as a "sweetener" for investors, with floor-structured loans representing some 89% of all loans outstanding, as of August 31, 2014, and nearly all new floating-rate loan issuance in the last few years. We see Libor floors as a welcome innovation and do not believe they amount to much of a new risk factor – contrary to some opinions in the financial media. For example, if a loan has the typical 100 bps floor, the issuer pays that amount in addition to the "straight spread" over Libor, no matter how low that benchmark may go or for how long.

Once Libor starts to rise from its currently level of about 25 bps, the issuer pays no more interest until Libor gains another 75bps – it is effectively a fixed-rate obligation until the floor is reached (Exhibit 2). One concern investors may have is that the price of Libor-floor loans may fall as rates rise until the floor is reached, like other traditional fixed-coupon bonds. While short-term rates haven't experienced a recent sustained rise, we have not observed Libor-floor loans trading any differently than non-floor loans during upward bounces in rates.

We believe that any modest duration-related price impact associated with a higher Libor would be minimal and temporary[4], given that loans have short three-year average lives and the fact that there is only a small sliver of the current market that does not contain a floor. As a result, there is little alternative for an investor who might want to swap out of a Libor-floor loan to a comparable non-floor loan to benefit right away from a rate back-up. Thus, we do not see a large source of selling pressure on Libor-floor loans.

Another related concern is that a typical loan's rate will not immediately increase once Libor does – something that may surprise and disappoint investors who are not aware of the floors, or how they work. We view this as a "glass half-full" situation. Investors in "floored" loans have been compensated as if Libor were 100 bps since the time they were issued – this may be viewed as a down payment on rising short-term rates. It is, in our view, a favorable trade-off: accept front-loaded extra income for as long as Libor remains near its historic lows, in return for forgoing the immediate yield "pop" once it starts to rise.

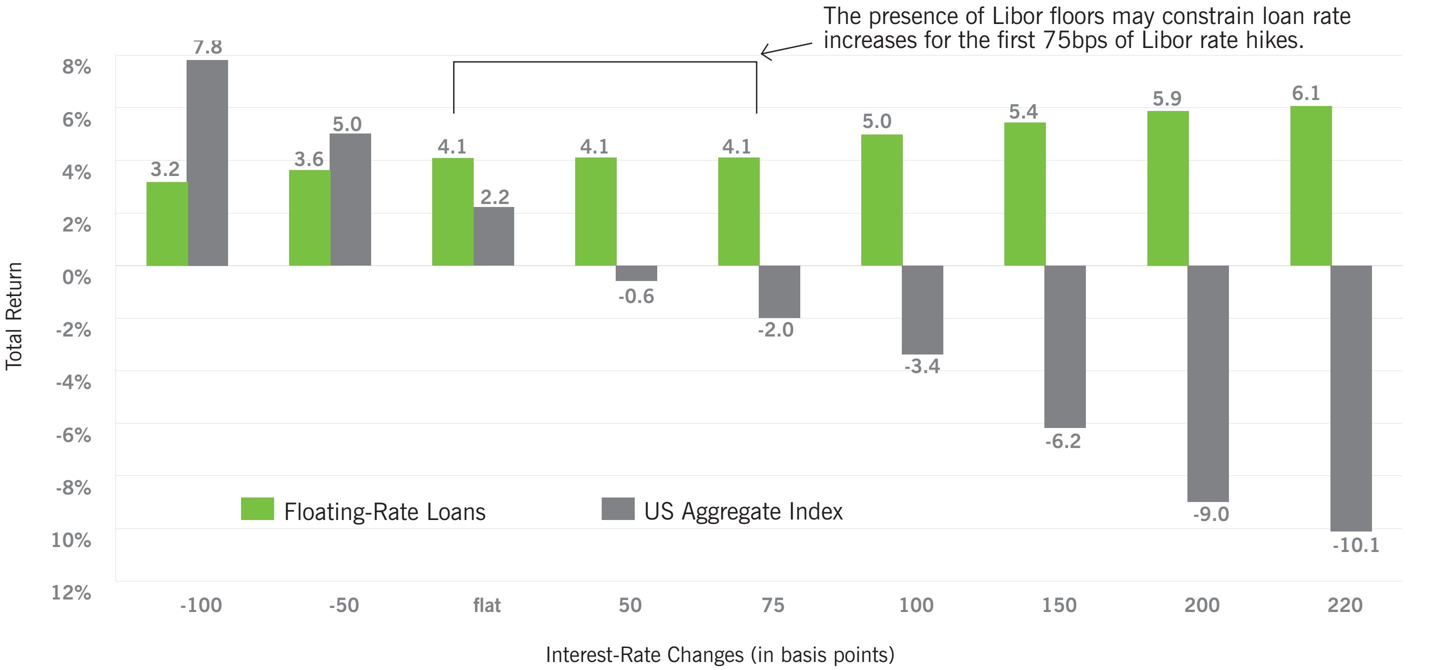
Also, bear in mind that from a total return perspective, bonds with significant duration, like the 5.5 years as of August 31, 2014, for the Barclays U.S. Aggregate Index, would likely lose value as rates began to increase. So in relative terms, the floating-rate advantage of loans would likely be maintained – all else being equal, their price doesn't fall when interest rates rise.

At this juncture, loan investors may be well-served to separate the case for loans into shorter- and longer-term

[3]Duration is a measure of sensitivity of a bond's price to changes in interest rates. The price of a bond with a longer duration rises or falls further with decreases or increases in rates, respectively, compared with a shorter-duration bond. [4]The same considerations in this section would apply to investors who used leverage to buy loans. Once Libor first started to rise, they would see the cost of their liabilities – pegged to Libor – grow, while their Libor-floor assets had a fixed yield until the floor was reached. But unless the leverage were significant, their net return should still be positive, albeit less so. Further, the Libor-based liabilities could be viewed as just "catching up" to the higher yield on the Libor-floor assets.

Exhibit 2 **How Libor-floor floating-rate loans may perform in a rising-rate environment.**

Loans vs. Bonds: hypothetical returns in various interest rate scenarios.



Source: Eaton Vance as of August 31, 2014. Data provided are for informational use only. Bonds are represented by the Barclays U.S. Aggregate Index, with a yield of 2.3% and duration of 5.5 years. For loans, we use the S&P/LSTA Index, with a net yield of 4.4%, based on a market yield of 5.1%, reduced by 0.7% to account for expected defaults and recoveries—the average level observed by Eaton Vance over 20 years. Duration is 0.1 years. Calculations are based on standard duration formula, assuming instantaneous rises in interest rates and adjustments of benchmark yields on loans. Chart represents projections based on various interest-rate scenarios, but is not intended to predict any particular scenario. The information is based, in part, hypothetical assumptions and the experience of Eaton Vance. Certain of the assumptions have been made for modeling purposes and are unlikely to be realised. Changes in the assumptions and scenarios may have a material impact on the information shown. Past performance is no guarantee of future results. It is not possible to invest directly in an index. See end of this material for index definitions as well as additional important information and disclosure.

perspectives. The rising income benefit of a rate that floats may still be a way off – 2015 or later, given the sluggish growth of the global economy. And, as noted, once Libor does rise, the floors represent a modest delay factor. So until loan rates once again float upward (the longer-term benefit), the more likely short-term advantages of loans, in our view, would be as an attractive source of potential income and as a portfolio bulwark against possible losses incurred by longer-duration bonds once a rising-rate environment is at hand.

3. Credit risk: *Issuer ability to service debt through cash flow is near an all-time high, while leverage has expanded just modestly.*

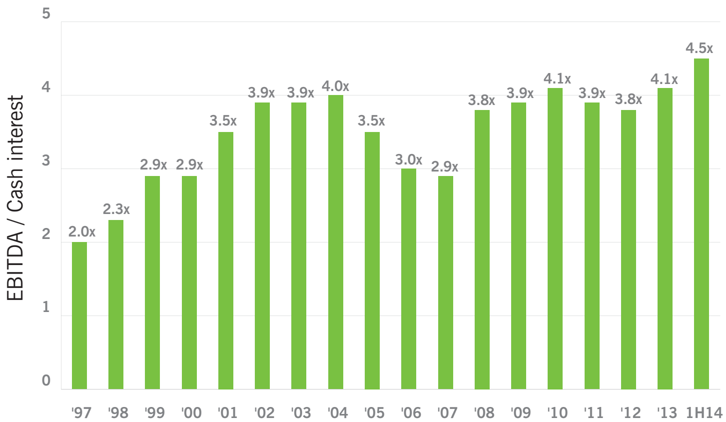
We find that there is currently no lack of issuers with sound credit profiles, buoyed by low financing costs, strong balance sheets and EBITDA[5] growth. Despite recent inflows, today's $700-billion-plus loan market[6] remains a robust pool that allows us to be highly selective and fully invested – for example, we turned down approximately 75% of the new deals we reviewed in 2013.

Cash flow coverage – the ratio of EBITDA to a company's recurring cash obligations – stands at about 4.5x, its highest level in a decade (Exhibit 3, left) as of August 31, 2014. Balance sheet strength is also reflected in a benign default picture, as reported by Standard and Poor's Leveraged Commentary and Data (S&P/LCD).

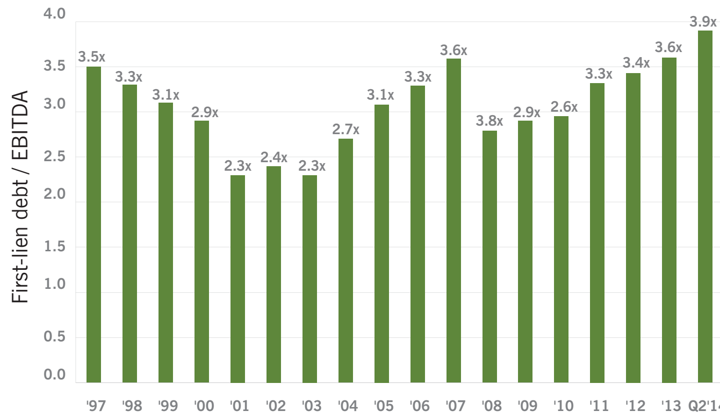
[5]EBITDA is a common measure of cash flow, referring to earnings before interest, taxes, depreciation and amortization. [6]Source: S&P Capital IQ as of December 31, 2013.

Exhibit 3

Cash flow coverage is at an all-time high …



while leverage has increased from crisis-period lows.



Sources: S&P Capital IQ LCD and S&P/LSTA Leveraged Loan Index, as of June 30, 2014. Data provided is for informational use only. Past performance is no guarantee of future results. It is not possible to invest directly in an index. See end of this material for index definitions as well as additional important information and disclosure.

The default rate for the S&P/LSTA as of August 31, 2014 was 3.6%. If we exclude the unique case of the default of Energy Future Holdings (formerly known as TXU) that we discuss below, the default rate drops to 0.6%, well below its annualised historical average of 2.4%.

Some other factors are also aligning that may enhance the overall credit quality of the floating-rate loan sector. Recall that the crisis forced many weaker companies into default and/or bankruptcy, so there is a beneficial form of survivorship bias among today's issuers. And most of them have refinanced over the past few years, meaning there are very few near-term maturities pressuring their finances. Finally, the improving overall economic backdrop in the U.S. makes a continuation of positive loan fundamentals likely, in our opinion.

With economic expansion we typically see leverage increase, and that has been the case in this recovery. So far, it has been relatively modest and contained, increasing from the low base of the financial crisis. Measured as first-lien debt of the S&P/LSTA Index over EBITDA, leverage has crept up 3.9% (Exhibit 3, right). However, just as importantly, what we have not seen are many highly leveraged mega-deals that typified the excesses leading up to the financial crisis.

Clearly, leverage needs to be watched carefully – historically, the initial leverage ratio has been a good indicator of subsequent default experience, according to S&P Capital IQ LCD, and it is an integral part of good fundamental analysis. It is fair to say, however, that we do not see overall leverage as a near-term threat to the generally positive credit quality of the market.

4. "Covenant-lite:" *Issuance of covenant-lite loans has increased, but their quality may often be better than fully covenanted issues.*

"Covenant-lite" refers to loans whose legal agreements do not contain traditional financial constraints on the issuer such as maximum leverage and minimum interest coverage. In traditional fully covenanted loans, failure to adhere to such terms can place the issuer in default, even if interest is paid in full, on time. The 2008 financial crisis wasn't really a good stress test of whether covenant-lite issues represented greater risk than fully covenanted deals, given that they only started in 2006 and comprised just over 15% of the outstanding market (though among that small group, default rates were below the rest of loans according to S&P Capital IQ LCD).

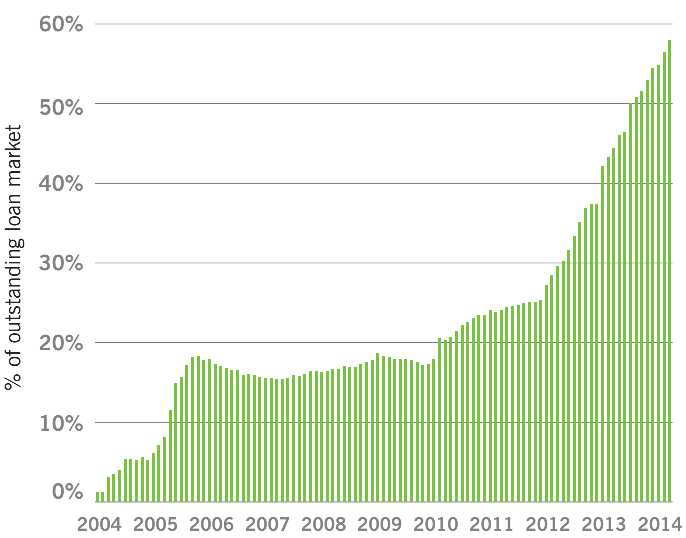
Covenant-lite issuance ceased with the financial crisis, but returned in 2011 as risk-taking increased and tremendous demand enabled more issuers to negotiate deals with fewer legal constraints. Over the past two years, covenant-lite loans have grown from about 25% of outstanding loans to 58% (Exhibit 4 left), as of August 31, 2014, according to S&P Capital IQ LCD.

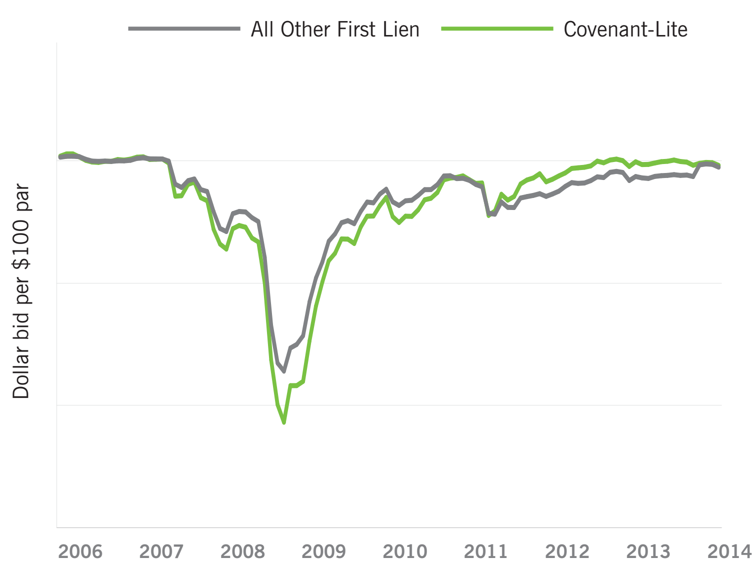
All else being equal, as loan investors, we would prefer to have covenants with traditional financial constraints – it does give us a certain element of control. However, in our view, the absence of covenants does not materially increase credit risk. Rather, for us the fundamentals of the issuer – i.e., the strength of the issuer's business model, collateral, degree of leverage, etc. – are much more important. In that regard, our analysis has found that most covenant-lite issuers are larger companies with greater liquidity. Further, we have found that as the issuer base of covenant-lite deals has broadened, average credit quality and leverage (both of which had been inferior to covenant-heavy loans) have almost converged to the same level today. This is borne out by S&P/LCD data showing that secondary market prices on covenant-lite loans historically have tended to be higher than fully covenanted loans – most recently lite and fully covenanted have both traded close to par (Exhibit 4, right).

We would also point out that covenant-lite issues are still senior/secured debt obligations and remain subject to substantive legal constraints not typically found in the high-yield bond market. For example, issuers must provide ongoing standardised financial statements and are prohibited from issuing new debt ahead of senior/secured loans.

To these general observations, we would add some current market examples. Consider that Energy Futures Holdings (formerly known as TXU), a large issuer currently in bankruptcy discussed below, is fully covenanted. In contrast, in 2014 we observed numerous deals from attractive companies issued in the covenant-lite model.

Exhibit 4 **"Covenant-lite" loan issuance has increased, while strong pricing is an indicator of perceived financial strength.**





Sources: S&P Capital IQ LCD and S&P/LSTA Covenant-Lite Index, as of August 31, 2014. Data provided are for informational use only. See end of report for index definitions. Past performance is no guarantee of future results. It is not possible to invest directly in an index. See end of this material for index definitions as well as additional important information and disclosure.

The bottom line is that for us, solid issuer fundamentals are more important than covenants, and that the rise in covenant-lite issuance, by itself, does not make the loan market riskier.

5. Greater retail loan ownership: *We view this trend as a net positive for the market that may bring both volatility and opportunities.*

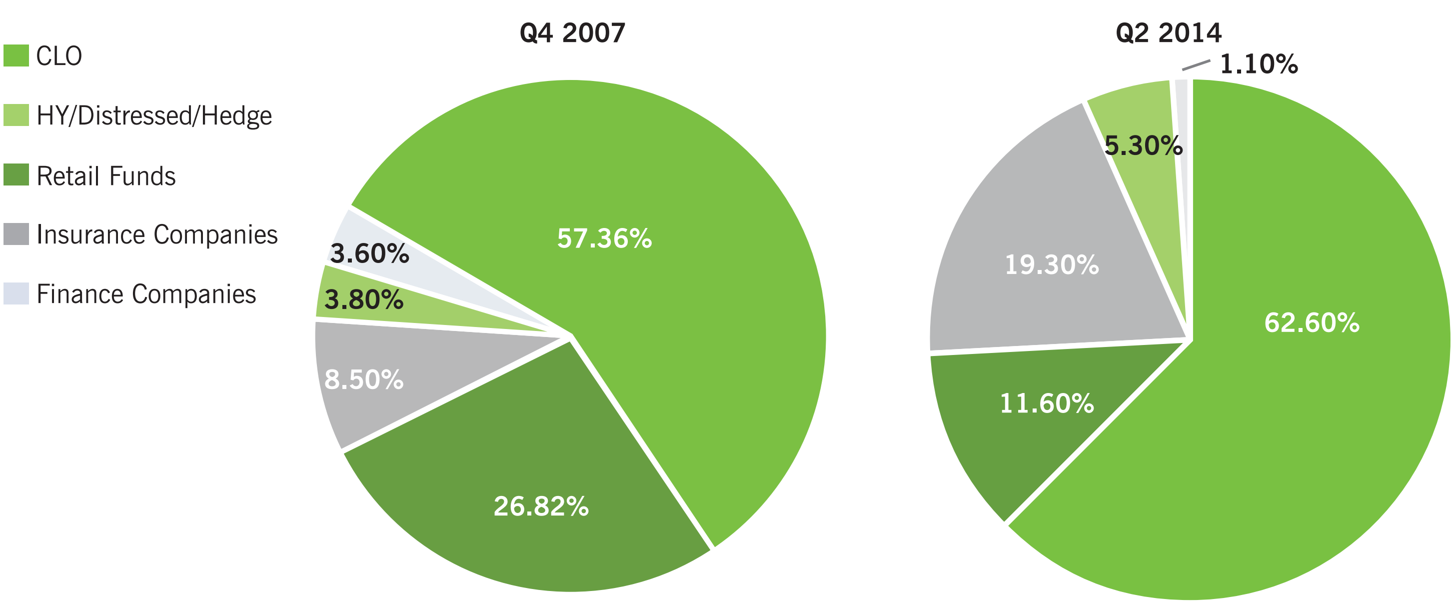
Over the past six years, retail mutual fund ownership of floating-rate loans has grown to about 19% the market outstanding, from about 8% (Exhibit 5) as of June 30, 2014. As a result, retail cash flows are now a bigger factor in secondary market pricing and a potential source of greater volatility. Since the dislocation of the financial crisis, volatility in the loan market has been sharply decreasing with the recovery, and subsided to just 1% standard deviation for the trailing 12 months ended June 30, 2014, comparable to the precrisis historical average, as measured by the S&P/LSTA Index.

Overall, we see the broadened investor base as a net positive, resulting in greater diversification of demand and improved liquidity. Of course, retail sentiment can change quickly and increasing mutual fund ownership may magnify temporary price swings, which can be disconcerting to investors. However, to the extent such volatility is not reflective of the underlying fundamentals – as is frequently the case – we view such price fluctuations as a potential source of opportunities for longer-term loan investors.

6. Energy Future Holdings (TXU): *The April default of this major issuer had little fundamental impact on the market.*

On April 29, 2014, Energy Future Holdings (EFH) formerly known as TXU, declared bankruptcy, in a widely expected move[7]. EFH is a Texas utility that was taken private in 2007 in a $44 billion leveraged buyout – the largest floating-rate loan issuance ever (in terms of dollars), with

Exhibit 5 **Retail floating-rate loan demand has grown significantly in recent years.**



Sources: Standard and Poor's LCD, Capital IQ and S&P/LSTA Leveraged Loan Index, as of June 30, 2014. Data provided are for informational use only. CLOs are collateralised loan obligations, structured products designed to invest in loans. Totals do not add to 100% due to rounding. Past performance is no guarantee of future results. It is not possible to invest directly in an index. See end of this material for index definitions as well as additional important information and disclosure.

[7]As of November 30, 2013, no Eaton Vance fund had exposure to TXU loans greater than .18% of its assets.

leverage that approached 7x debt/EBITDA at issuance. However, as we anticipated, the loan market took the default in stride for several reasons:

- Given the long decline in gas prices and the high degree of leverage assumed by EFH, the likelihood of a default had long been incorporated in the secondary market pricing of EFH loans, which was around 70 cents on the dollar, as of 31 December 2013, according to Bloomberg LLC.
- EFH's condition was unique among large, highly leveraged companies whose issues predate the crisis. There are about a dozen of those issuers who were able to refinance the vast majority of their debt and extend maturities.
- Among issuers in the market today, we do not see anything comparable to the EFH situation, in terms of size, degree of leverage and likelihood of default.

As of December 31, 2013, EFH comprised about 3% of the S&P/LSTA Index, according to S&P Capital IQ, so its default represents most of the current 3.6% default rate for the overall market (see discussion above). Once the EFH data point rolls off the 12-month default calculation in April 2015, we believe the overall rate will revert to below the historical 2% long-term average.

For us, EFH is a reminder of the value of fundamental research in credit selection. According to our research, a passive strategy that tracked the S&P/LSTA Index at the time of EFH's issuance in 2007 would have had a 4% portfolio allocation, and a potential 30% loss through November on that holding.

7. New regulations: *Initiatives in Washington on floating-rate loans and CLOs have the potential to make issuance more expensive and may widen spreads.*

Several Washington regulatory initiatives may have an impact on loans and collateralised loan obligations (CLOs[8]), which are a form of structured financing based on loans:

- Recent "leveraged loan guidance" from the major U.S. banking regulators[9] calls on banks to tighten underwriting standards for loans and may require them to devote higher capital levels to loans they hold.
- CLO sales have represented more than half of the historical demand for loans (Exhibit 5). However, recent regulations and proposed rules may make CLO issuance less attractive. First, federal regulators have proposed "risk retention" rules that could require CLO managers to retain on their books 5% of the overall value of the CLOs they manage. In other words, in a $500 million deal, the manager would have to keep $25 million on its books – an exposure that could not be sold or hedged. We have estimated that this could reduce CLO activity by as much as 70% – demand that would ultimately need to be replaced elsewhere.
- Similarly, new FDIC rules require banks to treat CLO tranches – even those rated AAA[10] – the same as loans themselves, for the purposes of capital requirements, which effectively makes CLOs less attractive for banks.

These initiatives are likely to make floating-rate loan and CLO issuance more expensive for issuers, which reduces supply. CLO issuance has already fallen recently, and we are likely to see pressure for widening of spreads of both loans and CLOs to provide greater compensation to investors to cover the additional expense. On the other hand, the fundamental need investors have for income remains strong, and capital markets historically have been quite effective at innovating alternative structures to meet investor demand. For example, while loans have traditionally been originated by commercial banks, to the extent their role is diminished we would anticipate investment banks – already large players in the issuance of new loans – to play a more significant role, possibly along with new nonbank participants. Likewise, should the CLO share of the market become diminished, we may see more retail, institutional and other investor channels take its place.

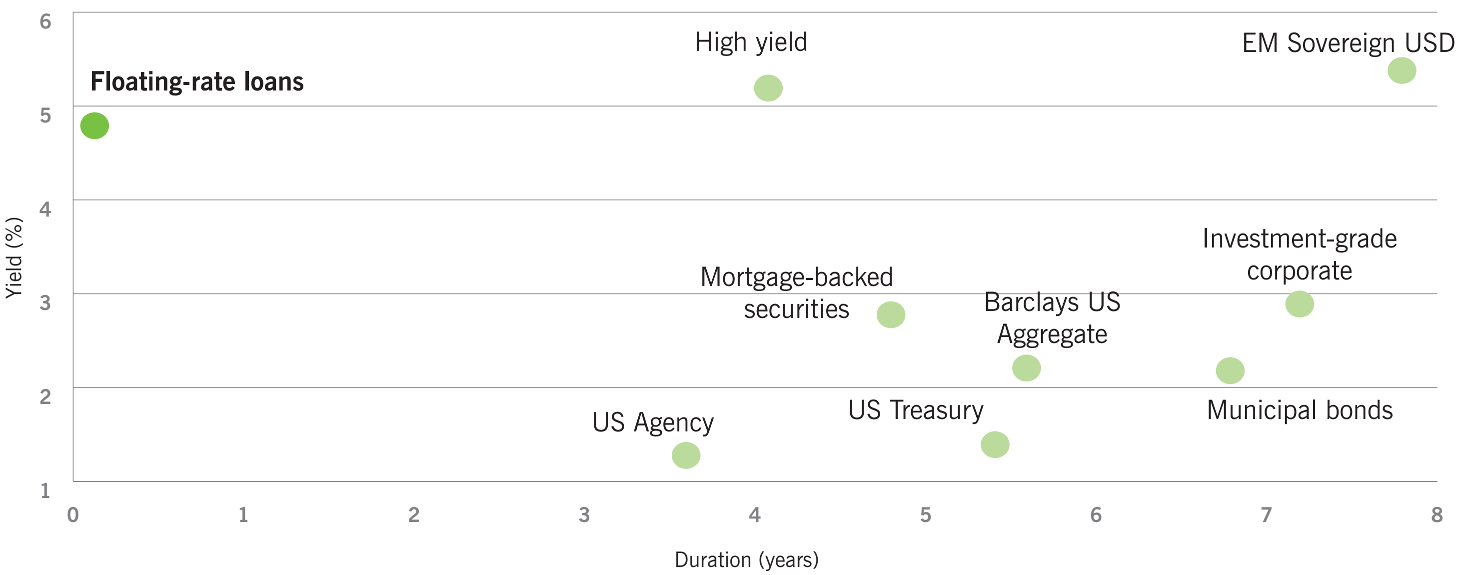
[8]A collateralized loan obligation (CLO) is a form of structured financing in which the cash flow from a pool of floating-rate loans is directed to investors in different tranches, or slices. By prioritizing the payments among the CLO tranches, the issuer can create a structure with debt ranging from higher to lower in credit quality. [9]The U.S. Federal Reserve Board, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation. [10]Please see end of report for definition of bond ratings.

Finding value as credit risk evolves

The concerns we have discussed, like growth of leverage and covenant-lite issuance, underscore the fact that we are entering a phase in the credit cycle where risk-taking is growing. While we are confident that significant fundamental strengths still underpin the overall floating-rate loan market – like reasonable spreads, strong balance sheets, low overall default risk and supportive technicals – the need today for vigilance and due diligence on the part of investors is especially important. Neither the economic clock nor the cyclicality of credit markets has been repealed. As a result, we believe default avoidance should be a growing factor for investor returns in the loan market ahead.

Seen in this light, we would argue that one particular risk that is clearly increasing for loan investors is that of a passive approach, which typically uses an index as the basis for portfolio construction. For example, the S&P/LSTA Index, like most other fixed-income benchmarks is capitalisation-weighted, meaning that the more debt a company issues, the larger its weighting in the index. This has it backward in our view. An increasing debt load should usually be a cause for concern, not a criterion for a larger allocation. More generally, passive investing requires a leap of faith that every issuer who meets the benchmark's inclusion criteria represents a good risk/reward proposition. The troubles of TXU serve as a reminder that the leap isn't always justified, and without fundamental credit research it is always a blind leap. As the appetite for risk grows, so do the odds that there will be more ill-conceived, low-value deals worth missing.

Exhibit 6 **Floating-rate loans' high yield-to-duration ratio may be a major asset when interest rates rise.**
Floating-rate loans vs. select fixed-income asset classes (8/31/14)



Sources: Morningstar, Eaton Vance as of August 31, 2014. Data provided are for informational use only. Yield to worst is the lowest potential yield that can be received on a bond without an issuer actually defaulting. Yield to worst is generally calculated by making worst-case scenario assumptions by calculating the returns that would be received if certain provisions, including prepayment, call or others, are used by issuers. Duration is a measure of the sensitivity of a bond's price to a change in interest rates. It represents the number of years until a bond's interest and principal payments are received. U.S. Treasury is represented by the Barclays U.S. Treasury Index. U.S. Agency is represented by the Barclays U.S. Agency Index. The Barclays U.S. Aggregate refers to the Barclays U.S. Aggregate Index. Mortgage-backed securities are represented by the Barclays U.S. Mortgage Backed Securities (MBS) Index. Investment-Grade Corporate is represented by the Barclays U.S. Corporate Index. Municipal bonds are represented by the Barclays Municipal Bond Index. Emerging Markets Sovereign (USD) is represented by the JPMorgan Emerging Markets Bond Index Plus (EMBI+). High Yield is represented by the Barclays U.S. Corporate High Yield Index. Floating-rate loans are represented by the S&P/LSTA Leveraged Loan Index. Past performance is no guarantee of future results. It is not possible to invest directly in an index. See end of this material for index definitions as well as additional important information and disclosure.

Floating-rate loan core value remains: the most yield for the least duration exposure

Taking a step back to look at the relative value of the floating-rate loan sector, we continue to believe that the biggest risk for fixed-income investors today remains interest-rate exposure, which is almost completely absent from loans. Exhibit 6 shows that as of August 31, 2014, loans have had the highest yield-to-duration ratio among fixed-income sectors.

With the global economy sluggish, especially in Europe, we do not expect precipitous rate increases from global central banks. At the same time, prudent positioning of fixed-income portfolios should anticipate the inevitable day when monetary policy tightens, given the potential for capital losses among traditional bond allocations. In that light, we believe that floating-rate loans deserve special consideration. With attractive relative yields and a solid credit foundation, we believe that today's case for floating-rate loans as a strategic portfolio allocation, guided by fundamental credit research, may be as important as ever.

INDEX DEFINITIONS

The S&P/LSTA Leveraged Loan Index is an unmanaged index of the institutional leveraged loan market.

The Barclays U.S. Aggregate Index is an unmanaged index of domestic investment-grade bonds, including corporate, government and mortgage-backed securities.

The BofA/Merrill Lynch Preferred Index is an unmanaged index of domestic preferred bonds.

The Barclays U.S. High-Yield Index is an unmanaged index of domestic high-yield bonds.

The Barclays U.S. Corporate Index is an unmanaged index of domestic corporate investment-grade bonds.

The Barclays U.S. Treasury Index is an unmanaged index of U.S. Treasury obligations, across the spectrum of maturities from short to long term.

The JPMorgan Emerging Markets Bond Index Plus (EMBI+) is a market-cap-weighted index that measures USD-denominated Brady Bonds, Eurobonds, and traded loans issued by sovereign entities.

The Barclays Capital Municipal Bond Index is an unmanaged index of municipal bonds traded in the U.S.

The Barclays U.S. Agency Index is an unmanaged index of securities issued by U.S government agencies, quasi-federal corporations, and corporate or foreign debt guaranteed by the U.S. government.

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About Asset Class Comparisons

Elements of this report include comparisons of different asset classes, each of which has distinct risk and return characteristics. Every investment carries risk, and principal values and performance will fluctuate with all asset classes shown, sometimes substantially. Asset classes shown are not insured by the FDIC and are not deposits or other obligations of, or guaranteed by, any depository institution. All asset classes shown are subject to risks, including possible loss of principal invested.

The principal risks involved with investing in the asset classes shown are interest-rate risk, credit risk and liquidity risk, with each asset class shown offering a distinct combination of these risks. Generally, considered along a spectrum of risks and return potential, U.S. Treasury securities (which are guaranteed as to the payment of principal and interest by the U.S. government) offer lower credit risk, higher levels of liquidity, higher interest-rate risk and lower return potential, whereas asset classes such as high-yield corporate bonds and emerging market bonds offer higher credit risk, lower levels of liquidity, lower interest-rate risk and higher return potential. Other asset classes shown carry different levels of each of these risk and return characteristics, and as a result generally fall varying degrees along the risk/return spectrum.

Costs and expenses associated with investing in asset classes shown will vary, sometimes substantially, depending upon specific investment vehicles chosen. No investment in the asset classes shown is insured or guaranteed, unless explicitly stated for a specific investment vehicle. Interest income earned on asset classes shown is subject to ordinary federal, state and local income taxes, excepting U.S. Treasury securities (exempt from state and local income taxes) and municipal securities (exempt from federal income taxes, with certain securities exempt from federal, state and local income taxes). In addition, federal and/or state capital gains taxes may apply to investments that are sold at a profit. Eaton Vance does not provide tax or legal advice. Prospective investors should consult with a tax or legal advisor before making any investment decision.

Important Additional Information and Disclosure

The views expressed in this report are those of portfolio manager(s) and are current only through the date stated at the top of this page. These views are subject to change at any time based upon market or other conditions, and Eaton Vance disclaims any responsibility to update such views. These views may not be relied upon as investment advice and, because investment decisions are based on many factors, may not be relied upon as an indication of trading intent on behalf of any Eaton Vance fund. This commentary may contain statements that are not historical facts, referred to as “forward looking statements.” The Fund’s actual future results may differ significantly from those stated in any forward looking statement, depending on factors such as changes in securities or financial markets or general economic conditions, the volume of sales and purchases of Fund shares, the continuation of investment advisory, administrative and service contracts, and other risks discussed from time to time in the Funds filings with the Securities and Exchange Commission.

About Risk

An imbalance in supply and demand in the income market may result in valuation uncertainties and greater volatility, less liquidity, widening credit spreads and a lack of price transparency in the market. There can be no assurance that the liquidation of collateral securing an investment will satisfy the issuer’s obligation in the event of nonpayment or that collateral can be readily liquidated. The ability to realize the benefits of any collateral may be delayed or limited. Investments in income securities may be affected by changes in the creditworthiness of the issuer and are subject to the risk of non–payment of principal and interest. The value of income securities also may decline because of real or perceived concerns about the issuer’s ability to make principal and interest payments. Borrowing to increase investments (leverage) will exaggerate the effect of any increase or decrease in the value of Fund investments. Investments rated below investment grade (typically referred to as “junk”) are generally subject to greater price volatility and illiquidity than higher rated investments. As interest rates rise, the value of certain income investments is likely to decline. Bank loans are subject to prepayment risk. Investments in foreign instruments or currencies can involve greater risk and volatility than U.S. investments because of adverse market, economic, political, regulatory, geopolitical or other conditions. In emerging or frontier countries, these risks may be more significant. Changes in the value of investments entered for hedging purposes may not match those of the position being hedged. No Fund is a complete investment program and you may lose money investing in a Fund. A Fund may engage in other investment practices that may involve additional risks and you should review a Fund prospectus for a complete description.

About Eaton Vance

Eaton Vance Corp. is one of the oldest investment management firms in the United States, with a history dating to 1924. Eaton Vance and its affiliates offer individuals and institutions a broad array of investment strategies and wealth management solutions. The Company’s long record of exemplary service, timely innovation and attractive returns through a variety of market conditions has made Eaton Vance the investment manager of choice for many of today’s most discerning investors. For more information, visit eatonvance.com.

Before investing, investors should consider carefully the investment objectives, risks, charges and expenses of a mutual fund. This and other important information is contained in the prospectus and summary prospectus, which can be obtained from a financial advisor. Prospective investors should read the prospectus carefully before investing.