REPRINTED FROM MARCH 21, 2011

THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

Alternative Investment Strategies

MATTHEW G. KOSARA, CAIA, is a Portfolio Manager at HGK Asset Management, Inc. He joined HGK in 2006 to develop the firm's alternative investments division and is the Portfolio Manager for the HGK Strategic Income Fund. Mr. Kosara is a member of the New York Society of Security Analysts and the Co-Founder of The Alliance of Alternative Asset Professionals. He holds the Chartered Alternative Investment Analyst designation and is a Level III candidate in the Chartered Financial Analyst program. Mr. Kosara earned a B.S. in management with a concentration in finance and a minor in economics from Rensselaer Polytechnic Institute's Lally School of Management & Technology.

SECTOR — GENERAL INVESTING

TWST: Please start with a brief history and an overview of HGK Asset Management.

Mr. Kosara: HGK is a registered investment adviser, founded in 1983, founded originally to work with Taft-Hartley-defined benefit and continuing to this day working with tax-exempt benefit plans. For the majority of our history, we have been investing through the asset classes that those tax-exempt benefit plans have been really focused on, so long-only equity, long-only fixed income in both domestic and international arenas.

About five years ago HGK hired me to come on and build them something of an alternative investments division, because as they saw rather astutely at the time, there was beginning to be a larger push among these larger plans to invest in a more broadly diversified scheme across assets and diversifying at least somewhat away from the more, what I guess you would call, traditional assets.

So after having worked for a number of years at a small investment shop in upstate New York called MAP Management, where I began to develop that firm's alternatives program, I then came over here to HGK of a similar mind. MAP worked with a very similar investor base as well. I was then able to start building up the products that we have here. The one that we really started with right out of the gate was the senior loan fund. This fit was very good for these more conservative kinds of investors as a way to access what they would see as an alternative, something that they didn't have in their plans already and to be able to augment their existing positions. And hopefully add some return and help their overall diversification mix.

TWST: Please give us a snapshot of the Strategic Income Fund. What are your key holdings, diversification strategy, key portfolio statistics, etc.?

Mr. Kosara: The Strategic Income Fund, as I mentioned, is a senior secured loan fund that we invest primarily in middle market kinds of names. We think that there is the most benefit, the most added value, in the middle market, as opposed to the broadly syndicated pieces, though regardless you do get benefit to an existing portfolio by adding loans at all. For the smaller pieces that we're typically dealing with, for the individual pensions that we work with, we find that the middle market does work the best. Though because it is more middle market, you don't have multi-billion-dollar loans out there. The credit work is number one. That is the priority when investing in this kind of sector.

The benefit of the asset class really is the fact that it is something distinct from the other sides of the fixed income market, as it were. They are floating rates loans, so all loans float, typically, off of LIBOR. So you really have minimal, if any, interest rate risk, as opposed to the way that a traditional fixed income portfolio works, with any change in rates you get a lot of volatility. You also get volatility due to default risk or downgrade risk. Working on the floating rate side, alternatively, we get the benefit of nearly eliminating that duration or interest rate risk and being able to solely focus on the credits. Here we think we're able to more fully compensate the investor for making that credit bet. And since we're looking more in that middle market, we're able to find loans that are able to compensate well — due to the smaller nature of the company and perhaps the illiquidity of the investment itself — that are able to deliver fairly sizable returns given the fixed income class.

TWST: Would you add anything else in your description of the fund's overall investment strategy?

Mr. Kosara: We like to keep it fairly well diversified, and diversified not only to issuer, but also to industry, geography, vintage, being that the fund is predominantly a buyer of existing paper. We invest in pieces of loans back from 2006, 2007. Typically these loans will come about due to mergers, acquisitions, buyouts, anything of the sort. So during that time of a lot of buyouts in the market, there was a lot of this paper raised, all the way through to more recently raised loans.

As far as geography goes, we typically stick to North America, so we are investing mainly in companies that have the predominance of theirs assets in the United States and Canada. And then across different areas of industry, from manufacturing, industrial through to health care, education, any of sectors that we think we are able to look at for the portfolio from an overall prudent investor basis, to be able to minimize any kind of real volatility.

Highlights

Matthew G. Kosara manages the HGK Strategic Income Fund and invests primarily in middle-market products, senior secured loans. Mr. Kosara diversifies the fund in terms of issuer, industry, vintage and geography, but limits the geographical diversity to North America only, because of its relatively low volatility. Mr. Kosara doesn't touch on specific stocks, but says he is bullish on the automotive sector.

points — if we have a floor in there of 150, 175, sometimes 200 basis points, that gives the investment the ability to provide a minimum of return in addition to the roughly LIBOR plus 500, 600 bps coupon. Still there you're looking at a roughly 8% annual return on that piece. Obviously a company doesn't want to have that expensive capital on its books for all that terribly long if it can avoid it, and therefore will look to refinance that piece as soon as they can, which is one of the benefits to buying in the secondary market.

There was great dislocation in this market over a year ago. In early 2009 you could buy pieces in the 60s, 70s, and then the market over the past, say, year and a half has run up quite a bit into now trading in the mid-90s or so today. But it's been a good environment to be a secondary buyer and to also amortize in gains along with the coupon payment.

TWST: How do you underwrite loans and more broadly, how do you approach risk management?

Mr. Kosara: From our perspective, HGK isn't a huge company, but we have a staff of eight analysts at HGK that cover all of our products on the equity side, the fixed-income side, as well as the alternatives side. We do a lot of the individual work here, as well as work with our partner in the space, an underwriter based out of Chicago called Monroe Capital, that has a staff of 20 to 25 people solely devoted to the underwriting and credit work on these types of issues. So we'll work in conjunction a lot on doing the research, we're going back and forth between us to be able to find pieces that we think give us the best risk/return for a given credit and fit the best with the existing portfolio.

"We like to keep it fairly well diversified, and diversified not only to issuer, but also to industry, geography, vintage, being that the fund is predominantly a buyer of existing paper. "

It's really the reliance on the cash flows in this kind of investment, because most of these loans will typically be made with maybe a five- to seven-year initial maturity. I don't think many of these loans will usually go to maturity. A lot of the pieces that we hold may only be held for two to three years, maybe four years on the outside, dependent on the structure and circumstance. Typically a middle market company doesn't want to have this loan on its books for a long period of time. On a first-lien basis, right now you're looking at maybe LIBOR plus 600 with a floor, which is good for us as the investor, because with rates as low as they are — 3-month LIBOR right now is around 31 basis

TWST: What opportunities do you see in this area today, especially in the context of what the capital markets have been like the last few years?

Mr. Kosara: We think that the space is becoming ever the better and ever the more ripe for investment, especially for an institutional class of investor, because of the real institutionalization of it. Since the mid 1980s to today there are now multiple independent pricing services out there, market indices that track the space, a lot more liquidity today than there was even four or five years ago.

Now with many of the pieces out there and with the fact that there has been a lot raised into this space recently, we're able look more at monthly to quarterly kinds of liquidity. So the market itself has changed quite a bit. As far as from our perspective, for investments that we're looking at, there are numerous opportunities out there, many of which have to do with refinancings that are taking place right now, which can reset older loans to current standards — brings pieces that might have be been able to come to market with a covenant-lite structure, which we typically won't invest in in 2006, 2007, back now with full covenant packages, much more investor-friendly standards now than we had seen.

TWST: What are the main pros and cons of this type of investing?

Mr. Kosara: One of the major upsides is that floating rate ability. Including that floating rate-type of investment in an overall diversified fixed income bucket is the way we see it adding the most value. A number of investors that we've worked with in the past have not been able to quite bucket the investment as either an alternative on one hand or as a fixed income investment on the other. In our opinion it really belongs as a fixed income investment, because of the now increasing liquidity and limited volatility of the asset class and the fact that it's then able to diversify that overall fixed income allocation. Between the floating rate nature, the fact that all these loans sit on top of the capital structure of any of these companies, should there be another economic downturn that affects a broad swath of the economy, you as a holder of this first-lien paper are collateralized by the hard assets of that company. So with that kind of backing the risk of loss is fairly low, especially compared to the rest of the fixed income market. On a return spectrum, you would often look at comparing the loan asset class with the high-yield space. In my personal opinion, the loan asset class offers a higher place in the capital structure, better return on default with fairly similar return streams. The argument before to go with high yield was the obvious liquidity. Now I think that's changing quite a bit, to be able to trade in and be a lot more transparent in these loans than we were before.

TWST: What further advice would you give investors considering your fund or this kind of investment in general? How would this type of investment fit into their overall portfolios?

Mr. Kosara: I'd offer a few, actually. One would definitely be to work with a group of professionals that has experience dealing with the asset class, since each loan is very different. The difference is between a securitized market and an institutionalized market. This market has become very institutionalized, but it doesn't have the standardization of a securitized market. Work with a group of professionals that has experience in working through credit agreements, collateral value, that has seen different workouts before, that knows how — if you get into a bind — to work through it and has some experience there; as well as, on the deal-flow side, you can't just turn on your Bloomberg terminal and be able to access any loan out there. Much of this market is fairly closely held, and it's the knowledge of the other lenders, syndicators, agents out there that gives you the ability to access the top class of investments.

Also as I've mentioned already, look to including it, as far as an allocation in your fixed income side as opposed your alternative side. Many of the plans that we work with, especially on the defined benefit side — be they of overfunded, underfunded or fully-funded status — are looking from their alternatives bucket for the greatest amount of return for, obviously, as minimal a risk as they can get. But when we're looking at this asset class, that in our mind should maintain around a high-single-digits to 10% or so return in the longer term. It might not fit with the needs of that part of your allocation, but fit more with your fixed income allocation, which still for many investors is quite high, some upwards of 40% or so. We think that this has great benefits to that piece.

"The loan asset class offers a higher place in the capital structure, better return on default with fairly similar return streams. The argument before to go with high yield was the obvious liquidity. Now I think that's changing quite a bit, to be able to trade in and be a lot more transparent in these loans than we were before."

TWST: Please tell us about your access to deal flow.

Mr. Kosara: We have relationships with many of those agent banks, private equity sponsors, syndicators, arrangers, guys out there that we've worked with, both HGK and Monroe, for years. That gives us the ability to see an awful lot of paper. While we don't invest in all that much of what we see, it's that ability to have the opportunity to review that really makes for the investment.

TWST: Have you had to deal with any workouts?

Mr. Kosara: No, none in our fund vehicles. We've had no payment defaults.

TWST: Tell us about the fund's performance to date and how you benchmark performance.

Mr. Kosara: The fund itself in its current guise has been operating for just shy of two years now. Last year our full-year gross return was about 12.9%. When we look at that performance, we sometimes compare to S&P and Credit Suisse indices in the leveraged loan space. For last year, I think they were both up around 10%, but the predominance of those assets are in your more broadly syndicated names, so your much larger companies. Our portfolio is a lot more, as I said, invested in the middle market, so the direct corollary between our return and the benchmark return might be a little bit off there.

TWST: What's your outlook for the rest of the year in terms of continued good investment opportunities?

Mr. Kosara: We've already started to see a lot of activity in the space. There was quite a bit of asset raise in the area going through the end of 2010 and into the beginning of 2011, and we see that there will be a lot of opportunities on both the new issuer side as well as what we had seen in the past — a number of banks or hedge funds looking to exit the space, which gives us the ability to have a look at some other names there. But we see the new issue market coming back fairly strongly, which should drive quality on a whole. That then goes back to the need to do even more credit work, because if there is a lot more money flowing back into the space and you do have a lot more loans getting funded, that means that there will also be a wider breadth and fatter tails out there in the distribution of good investments to poor. So we're going to make sure, just because there are a lot of opportunities out there, that it's only the high-quality names that we're getting into for our funds and for our investors.

TWST: Would you give us some examples of your holdings?

Mr. Kosara: I can give more general examples. I can't name names because all of the holdings in the funds are private, so we can't disclose. But a few of the loans we've purchased into recently have been in the automotive sector, which we're bullish on. It does seem to be coming back quite strongly, with much lower leverage multiples, higher EBITDA, good technicals backing up the recent pieces that we've looked at, many of which are the sole source suppliers of parts to major manufacturers. One that we just had refinance out on us was on the ecological or chemicals side. We're seeing more interest there, and even on the technology side as well. There have been a number of changes. Sectors that we didn't see raising assets in the past number of years have started being more active in the space of late.

TWST: Would you like to discuss anything else?

Mr. Kosara: In keeping with what we were talking about before and for an investor to think about where to put this, there is evidence of very limited correlation with even your other fixed income asset classes. You can figure on close to 0.50 correlation with equities, roughly 0.70 to high yield and zero or even negative correlation with major bond indices. To the point of trying to look at including loans from a more broadly diversified whole portfolio perspective, the overall correlation with other asset classes is decidedly low, and in our opinion does create a good benefit to adding the class overall.

We think that the other benefit of investing in the class now, with very low rates in the market, is that if you're a holder of say 40% fixed-income assets, even though we see rates being fairly steady for now, once they do increase — which obviously they have to at some point — your traditional fixed income assets will suffer because of it. So we think that an allocation to a floating rate class would have a great benefit of reigning in that negative volatility that you'll have at that point. With a floating rate loan holding you should be seeing your return increase due to the LIBOR plus structure of the investments, and you'll be able to mitigate any capital losses you might have from your more traditional bond holdings.

TWST: Thank you. (MN)

MATTHEW G. KOSARA, CAIA
Portfolio Manager
HGK Asset Management, Inc.
525 Washington Blvd.
Suite 2000
Jersey City, NJ 07310
(201) 659-3700
(201) 659-4566 — FAX
www.hgk.com