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THE SCOTT LETTER is intended to educate global investors about closed-end funds. Closed-end funds can be a valuable and profitable investment tool. To learn about closed-end funds, visit our web site, www.CEFAdvisors.com, and in particular, read our article, What Are Closed-End Funds.

Feel free to forward this newsletter to anyone who you believe could benefit from information on closed-end funds or global portfolios.

– George Cole Scott, Editor-in-Chief

– John Cole Scott, Contributing Author

IN THIS ISSUE:

Invesco's VVR Senior Loan Fund: A Favorable Way To Generate Income in a Rising Rate Environment

On March 9, 2012, John Cole Scott interviewed portfolio managers, Thomas Ewald and Philip Yarrow of Invesco Fixed Income, via telephone.

SL: Why do you think the closed-end structure is the best format for a senior loan investment company?

Ewald: Let me start off by saying it isn't necessarily the best format.

SL: Interesting, I wasn't expecting that answer.

Ewald: However, it may be the best format for certain investors. You have a wide range of investors within this asset class. The way I think about it is that on the retail side you have three product choices. First, you can invest in a daily liquidity fund which should have the lowest level of volatility. These funds allow you to redeem and get your money back on a daily basis.

Then there are interval funds which allow investors to redeem their money on a periodic (normally monthly) basis. These funds are going to have higher levels of volatility but should have higher levels of current income than the daily liquidity funds.

And, then finally, you have the closed-end funds which you would expect to have the highest level of volatility. They should offer the greatest long-term returns whether that's a combination of, in today's environment, capital appreciation plus interest earnings, or in a more traditional environment, primarily just interest earnings.

SL: When you say closed-end funds have higher volatility, are you talking about market price volatility or NAV volatility?

Ewald: Both. Because the equity in a closed-end fund ("CEF") trades on an exchange, the market price can and normally does vary from the NAV. There is market price volatility in CEFs compared to daily liquidity and interval funds where the NAV is the market price. As the CEF manager does not have to worry about redemptions, this allows for investing in individual assets with a long-term perspective. Over time, this should give you a higher return than funds that have to be concerned about inflows and outflows but will also potentially have increased NAV volatility.

SL: Would you agree that the leverage ability of the CEF format allows you to get compelling yields to make the fund more attractive to investors?

Ewald: Yes, I would agree. Because of where loan prices are in the secondary market right now, we think that on an unlevered basis, leverage loans are extremely attractive and are paying outsized returns. The ability to add leverage certainly enhances that.

SL: Are there any ETFs that go after the Senior Loan sector?

Ewald: There's only one leverage loan ETF in the market today. It is managed by Invesco.

At Invesco, we have both a daily liquidity open-end fund and an interval fund in addition to two different closed-end funds. The Invesco Van Kampen Senior Income Trust (NYSE: VVR) is our closed-end fund with a goal of being a relatively plain vanilla fund in terms of its asset allocation – predominantly investing in U.S. domestic senior secured loans. Then we have the Invesco Van Kampen Dynamic Credit Opportunities fund (NYSE:VTA) which is a closed-end fund that has a greater tolerance for riskier investments.

SL: I'd like to dive deeper in comparing the closed-end and open-end versions of Senior Loan funds. Besides liquidity or volatility concerns for shareholders, let's cover the benefits as a portfolio manager when you're looking at the underlying loans in the portfolio. How does the fixed capitalization change what you can do with the portfolio? Is this the reason you feel the CEF structure is the best long-term vehicle for the Senior Loan objective?

Ewald: It's one of the reasons. As I mentioned in the beginning, if you have a fund that has everyday inflows and outflows that you need to manage, it creates a head wind in terms of performance for the fund. By having a closed-end fund, you've got a fixed amount of capital, and you can deploy that optimally without having to worry about having to say "I must now invest $20 million," or conversely "I must immediately raise $20 million." Inherently, any time you have a closed-end fund you should be in a position to outperform funds that allow inflows and outflows. Open-end fund managers have to ensure they are invested in enough liquid assets so that they can sell quickly to meet redemptions. Closed-end fund managers have more leeway with respect to investing in less liquid assets and thus have a wider choice of investments in the asset class. For example, this enables closed-end funds to have a greater proportion of assets in middle-market deals if the risk/return appears to be more attractive in this segment at a particular point in time.

The fixed capitalization also makes it far easier to add leverage to the fund, which we believe enhances returns over the long term. Generally speaking, open-end fund investors are very reluctant to have leverage added into their fund.

[**Editor's Note:** Only closed-end investment companies can add a second share class of stock to leverage the portfolio. Open-end funds usually use derivatives to leverage the portfolio.]

SL: How are the operational aspects of managing a Senior Loan portfolio different than managing investment grade debt, high yield debt or muni debt? Please share with our readers the nuances in managing this kind of portfolio.

Ewald: Yes, there are a number of differences. Unlike an investment grade bond fund and to a lesser extent high yield bonds, you want a manager who has a long track record and expertise in Senior Loans because each individual trade is negotiated. We're not talking about securities where you've got everything moving through central clearing houses. These negotiations on loan trades in specific instances can be complex and can involve attorneys on both sides of the transaction. You do need to have a fair amount of in-house expertise to manage this asset class.

TOM EWALD, Portfolio Manager
Senior Secured Bank Loan Team, Invesco Fixed Income

Mr. Ewald entered the financial industry in 1987 and joined Invesco in 2000 as a credit analyst. He was promoted to portfolio manager in 2001. Prior to joining Invesco, Mr. Ewald was one of the founding portfolio managers of First Union Institutional Debt Management, and prior to that he worked for several departments within First Union Securities, including par loan research, syndications and mergers and acquisitions. After graduating from college, Mr. Ewald joined Barclays Bank PLC, where he worked in middle-market lending, real estate and credit. After leaving Barclays, Mr. Ewald joined Al-Ahli Bank of Kuwait where he served as deputy head of international lending.

Mr. Ewald earned a B.A. from Harvard College and a MBA from the Darden School of Business at the University of Virginia.

PHILIP YARROW, CFA, Senior Analyst/Portfolio Manager
Senior Secured Bank Loan Team, Invesco Fixed Income.

Mr. Yarrow entered the financial industry in 1995 and joined Invesco in 2010. He was previously a portfolio manager in the Senior Loan group and member of the group's investment committee at Van Kampen, which he joined in 2005.

Prior to that, he served as a credit analyst and a portfolio manager at Bank One/JPMorgan.

Mr. Yarrow earned a B.S. in mathematics and economics from the University of Nottingham and a MBA in finance from Northwestern University. He is a CFA charterholder.

As far as managing the different kinds of portfolios, one major difference is the likely recoveries if a position defaults. When investing in debt, one of two things will occur: (1) the company pays you the interest and principal as agreed, or (2) the company doesn't and then files for bankruptcy. It is a very binary outcome. In the case of Senior Loans, when the company files historically, the average recovery is about 70 cents on the dollar. There will be some cases where the recovery is zero, and others where the recovery is 100 cents on the dollar or even higher.

Ewald: That's a big contrast to the investment grade space where typically when a company files, the recovery is extraordinarily low. With high yield bonds, when a company files for bankruptcy, the average recovery is typically somewhere in the neighborhood of 20 cents to 30 cents. In order to maximize the recovery to the Senior Loan lenders, it's important to have a manager who has a track record and history in the asset class because, depending upon the situation, they may end up on a steering committee negotiating for the secured class of creditors.

SL: Besides credit and recovery, can you discuss the difference of duration in Senior Loan funds versus other fixed-income funds?

Ewald: Yes, another difference, which is a big issue given the current environment, is the concept of duration. If you are managing a bond fund, you have to be acutely aware of what's going to happen with interest rates. If interest rates fall, you want to have a very long duration portfolio; conversely, if you think they're going to rise, you would want to have a short duration portfolio. With Senior Loans, the interest rate resets typically every 90 days so there is very low duration in the asset class.

Yarrow: To add to Tom's first point about loan trades being privately negotiated, each individual loan deal when first originated is heavily negotiated, and credit agreements can vary substantially from deal to deal. This is unlike the bond market where documentation is much more standardized. It is important to have a deep and experienced analyst team that is not only able to assess the fundamentals of the credit but also can look closely at the documentation to understand the nuances of the deal terms. Differences in the documentation can lead to vastly different outcomes for two otherwise similar credits if things start to deteriorate towards a default.

SL: That's definitely helpful. For the Fund's investment management style, how would you categorize it – fundamental, tactical, value-based, technical, or is there another way of understanding your style of portfolio management that is more appropriate for Senior Loans?

Ewald: Our approach is not all that different from most good managers. It's going to be a combination of top-down and bottom-up analysis, as well as a technical component. When you talk about all three of those different aspects and how we apply it to the portfolio, everything comes down to credit. Making the right credit decision is absolutely imperative.

SL: How does experience come into play with your research team?

Ewald: Our research team is set up such that we have team leaders who are experienced veteran analysts; under them, they have a team of experienced analysts. The average experience of our team leaders is north of 15 years, and they have analysts under them typically with between 5 to 20 years of experience covering individual sectors. The research group ultimately reports to the investment committee. The investment committee all have over 20 years of experience, and the core has been together since 2000. There has been one addition to the investment committee, Kevin Egan who was co-head of the Morgan Stanley/Van Kampen bank loan team that Invesco acquired in June 2010.

Our veteran team has the goal of assessing risk and return, answering two principal questions: (1) What is the probability that the company does not pay us back in full? And (2) if they don't, what will our ultimate recovery be? Bottom-up analysis is the most important component of portfolio construction for this asset class.

We also take a top-down approach to Senior Loans where we look at determining where the best relative value is, given our view on the economy. For example, we will look at whether we think that at any particular time there is more value in BB rated credits versus B or CCC names. We will constantly assess our industry exposures in light of current macro conditions. Finally, we will sometimes take a short term technical approach to buying and selling of individual securities. If our traders think that various ideas are either good or bad from a technical perspective, that might drive our decision as to whether we are a buyer or a seller of a specific asset. However, the fundamental credit call is the most important consideration when building a portfolio, which is why we maintain a highly experienced team of analysts.

SL: It sounds like you blend the art and science of investing. Would you agree that investment decisions are not simply what a spreadsheet or credit ratings show, but it's also what your gut says, what you inherently know from experience?

Ewald: It sounds very cliché; however, I think it's accurate. We do have a tremendous amount of science built around portfolio construction and portfolio optimization. We have software systems that I think are second to none in the industry, systems that our analysts have helped to construct. I believe they take portfolio optimization to a new level.

However, I think the art comes in more on the investment committee side, where you have members who have been working together for 12 years in a senior role. You can expect them to have a consistent style. In other words, they're not going to go from a diversified bottom-up approach one day and then switch to being extreme momentum players, taking enormous bets the next.

SL: I'd like to take a moment to clarify for our readers the organizational structure of portfolio management, specifically the investment committee and the Board of Trustees and how they support the business of running the Fund, VVR.

Ewald: The investment committee is made-up of our senior portfolio managers, and then you have Phil, also a portfolio manager, who listens in on all of the investment committee discussions. Phil and I work together in terms of setting the strategy and optimizing the credit selection for the individual portfolio. The principal role of the investment committee is to take a look at individual assets and opine on the probability of default and the likely recovery as well as on risk-return relative to similar assets. Overseeing everything, you have two different layers of oversight: senior management within Invesco who meet on a monthly basis, reviewing reports on the performance of the different funds, and the board of trustees who meet with us on a quarterly basis to discuss historical peformance and current portfolio strategy.

SL: Senior Loan funds are a large grouping in the CEF industry. We track 24 Senior Loan funds out of the 154 taxable closed-end bond funds (15.7%). How would you compare VVR in the spectrum of peer closed-ended Senior Loan funds?

Ewald: VVR is a fairly plain vanilla fund in the sense that it is invested in predominantly senior secured, leveraged loans. It has a relatively small exposure to fixed-rate bonds, and within those bonds, the vast majority are also senior secured as opposed to being unsecured. As a reminder, there are two principal differences between loans and bonds. Bonds have duration risk, and they typically recover on average around 20-30 cents on the dollar if the issuer defaults compared to 70 cents with loans. However, if you are in a senior secured bond, the expected recovery is much closer to that of a senior secured loan.

SL: Okay, credit risk, recovery risk.

Yarrow: Exactly. Our fund is predominantly a senior secured loan fund. The 7% or so invested in high yield bonds are in senior secured bonds. There is only a relatively small amount of added volatility from that bond position. You can contrast that with some closed-end funds which have larger proportions in bonds and/or are largely distressed opportunity funds. Those funds, while they are in the closed-end loan space, are different in terms of the return and the volatility expectations. They are not really comparable to VVR.

If you look at another fund for example, like our Dynamic Credit Opportunities Fund (NYSE:VTA), it has a very large European component. If you simply looked at VVR versus VTA, you would see that over the past year there's been quite a divergence in their returns. It's the same manager for both, and it's not that we did a better job with one than the other or vice versa, but rather the investment mandate (where the funds are supposed to be invested) produced different results. Obviously Europe was not a place that you wanted to be in 2011, which significantly impacted VTA's returns, but so far this year, VTA has been a fantastic fund.

SL: As a follow-up question regarding the bond exposure in VVR, did you end-up buying those bonds because you were looking to have "X" percent in that exposure, or did they just fit the mix of opportunity you wanted in the fund?

Yarrow: There are three main reasons why we added the bond exposure. First, there is the bottom-up approach where an analyst concludes that we like a company but that we can either only get exposure through the bond or that the bond offers a better relative value than the company's loan. Second, you have a portfolio decision that we would like a certain percentage allocated to high yield bonds because of our view of interest rates. And finally, we may be a buyer or seller of bonds from a technical perspective. All three of these reasons go into our decision with respect to our overall bond allocation in the portfolio.

SL: Over the summer when the Fed said they were going to keep rates low for a long time, it significantly impacted the market prices in the sector. From a portfolio management perspective point, how was your management of the underlying loans affected by this new framework of expectations from the Federal Reserve?

Ewald: It's a great question. Over the summer, open-end loan funds did see some fairly sizeable outflows right around the time the Fed announced that it expected to keep interest rates low for a long period of time. Obviously VVR was not impacted directly by the outflows as it is closed-end. It forced open-end loan managers though to sell assets rapidly to meet these redemptions which, in turn, contributed to the decline we saw in loan prices in the late summer/early fall period. Essentially, anytime you have a situation where you have lots of investors who are exiting an asset class, the prices for the securities in that asset class are going to start to move below where they should be based upon efficient market theory. We try to take advantage of that within VVR.

There's another component to this that you did not raise in your question. At the same time that the Fed said it wasn't going to be raising rates, there were tremendous concerns about Europe, and you had a sell-off in virtually all asset classes except for gold. We, like other proactive managers, took a view as to the level of risk that we wanted to have in the portfolio and decreased risk. Fortunately, we had decreased leverage in the portfolio and started to rotate out of certain sectors. We had decreased our exposure to CCC-rated credits. As the fundamental issues in Europe seem to have improved, we've been more comfortable as of late adding risk back into the portfolio.

Yarrow: It seems to me that it was not so much the Fed's decision to hold interest rates low for a long period of time but that these other macro issues, such as the sovereign debt crisis, that had more of an effect on loan prices in the market. Inflows into loan funds have been fairly sanguine for quite a while. We saw loan prices drop in the summer, but now they have been coming back nicely even though we're not seeing meaningful inflows into loan funds. It seems like macro issues are impacting the portfolio so we have to be very focused on managing around those risks rather than the Fed's decision on interest rates and the impact on retail investors getting into or leaving the loan asset class.

SL: It looks like between the beginning of June and the end of July 2011 you reduced the amount of leverage at the Fund by almost 13%. What is the leverage structure used by the Fund?

Yarrow: We have both a line of credit and auction rate preferred shares (ARPS). Right now, we have $200 million auction rate preferred shares outstanding and an ability to borrow a total of $300 million under the line of credit, with $170 million outstanding at this time.

SL: It looks like the auction preferred number of shares stayed steady, so you reduced leverage through the line of credit?

Yarrow: Right, because once you redeem auction rate preferred shares you cannot replace them, while with a line of credit you can borrow up and down so we make short-term changes in leverage, using the line of credit. We have been reducing the auction rate preferred shares over time, as back in early 2007 we had $700MM ARPS outstanding.

SL: Can you discuss the Fund's historical use of leverage?

Yarrow: Prior to the financial crisis, the leverage in VVR, as it was with virtually every closed-end loan fund was high. VVR had 45% leverage up to 2007 compared to a maximum of 50%, because

Invesco Van Kampen Senior Income Trust (VVR)
Total Return Performance Data as of 3/21/2012

		3-Month	6-Month	1 Year	3 Year	5 Year	10 Year	Inception
VVR	Price	12.41%	18.94%	2.61%	34.85%	-3.33%	3.75%	2.65%
	NAV	4.91%	9.33%	3.79%	30.04%	-3.41%	1.89%	2.12%
Group*	Price	0.60%	17.25%	0.26%	32.06%	0.75%	4.80%	3.45%
	NAV	5.57%	9.67%	3.74%	27.63%	0.43%	3.81%	3.53%

		Year-to-Date	2011	2010	2009	2008	2007	2006	2005	2004
VVR	Price	15.30%	-2.97%	18.67%	82.35%	-58.79%	-13.54%	23.42%	-0.90%	2.08%
	NAV	4.69%	2.86%	15.00%	89.02%	-6.94%	-2.87%	7.27%	5.98%	8.20%
Group*	Price	11.12%	-4.57%	18.47%	84.43%	-48.62%	-10.06%	19.21%	-3.80%	0.64%
	NAV	5.35%	1.54%	14.99%	76.30%	-51.37%	-0.50%	8.82%	5.66%	6.67%

*Group indicates Peer Group Average

Source: Morningstar

of the stability of loans during that period. What changed in 2007 and 2008 is this massive increase in volatility, and that's why we, along with all the other closed-end loan managers, have reduced leverage in the Fund. We currently operate the Fund with substantially more cushion against the maximum allowed leverage ratio because it is clear that loan assets today are more volatile than you would think they would be based on fundamentals alone.

SL: In the fixed income sector, there are many choices. I'm curious how you deal with balancing the need to diversify the risk of default and loan recovery and at the same time add the value of a research and management team, seeking to outperform an index or your peers?

Yarrow: Typically in this Fund we're going to have 300 different issuers plus or minus 20-30. We believe this is a more than adequate number to achieve the diversification we are looking for within the portfolio. Having a number of names substantially greater than this level leads to some very small portfolio positions. From both a time management and portfolio perspective, we would prefer to eliminate the very small positions and focus on the names where our analysts have the most conviction.

SL: What is the one issue you find most commonly needing an explanation for Senior Loan funds?

Yarrow: Tom has touched on this, but the senior secured nature of the asset class makes it a lot less risky than the high yield bond asset class. As we're investing in non-investment grade companies, often referred to as "junk", people view this as a very risky asset class. It is not without risk, but Senior Loans are clearly not as risky as investing in unsecured bonds or equities.

Ewald: This is a very broad question. At times, I feel like the answer is almost everything. Often people don't understand the assets that make up our portfolio. The example that I always give is that we finance leverage buy-out opportunities (LBOs). We're lending against a company, and as long as the enterprise value of that company is greater than the senior secured loan, we should be okay. Some people hear these are bank loans and think we're making loans to banks, which is clearly not true. They hear that we're senior secured and think that we are receivable-based lenders or we're lending against bales of copper wire in a warehouse, and that's not true either.

We're lending to companies that in some cases have revenues of $20-$40 billion dollars. We lend to some very large companies as well as smaller companies. One easy example that has now paid off was Wrigley's, the gum company. They had 105 years of uninterrupted revenue growth and the Mars family who owns M&Ms and Mars wanted to buy Wrigley's. They bought the company, Warren Buffett was a subordinated lender in that deal, and we provided the senior secured loan.

SL: VVR is currently trading at $4.79, under $5 a share. Is this a concern for the Fund from your perspective? Are there any plans to try and get it comfortably above $5?

[**Editor's Note:** Out of the 632 current closed-end funds, 24 (3.8%) trade below $5 a share. Most custodians or broker/dealers don't allow margin to apply to securities trading under $5 a share. This can potentially reduce interest in the Fund from some investors.]

Yarrow: Our primary concern is the overall performance of the Fund. We really don't have concerns about the specific share price; we are very focused on our overall performance and how we're performing versus our peers.

SL: With regards to the dividend policy for VVR, what decisions drive changes in this policy?

Yarrow: We have a monthly meeting where the portfolio managers, fund administration and tax group go over what the income of the Fund is, and from there we decide on any changes to our dividend. Our primary goal is to keep our distribution in line with our current income. Any recommended changes to the dividend will go to the Board of Trustees for their review and approval. Also, at the quarterly Board meetings, we'll discuss the strategy of the Fund, and dividends will be part of that discussion.

SL: Can you give us some commentary about what happened in pre- and post-2008 financial crisis to your portfolio management process?

Ewald: Prior to 2007, the leveraged loan market was enormously stable for two reasons. One of them was loans should be stable. The reason loans should be stable goes back to what I mentioned earlier – that as an investor in a loan fund you're not taking duration risk, you're only taking a modest amount of credit risk because recoveries in the asset class are typically so high. Loans should inherently be a very stable asset class. The other reason that they were so stable during this period had to do with technical factors. New Collateralized Loan Obligations (CLOs) were constantly being issued and were providing a continual demand for new loans. In the period immediately prior to the financial crisis, over two-thirds of all loan buyers were CLOs.

The financial crisis really started in June 2007 when subprime mortgage spreads started to widen. This led to an almost complete halt in the issuance of new CLOs. The climax was reached at the end of 2008 where we had a near complete financial collapse, precipitating the government passing TARP in order to prevent the large investment and commercial banks from going under. These banks were holding fairly substantial amounts of Senior Loans. Prior to the financial crisis, they were providing warehousing facilities for new CLOs. With the issuance of CLOs suddenly at a standstill, the banks were left holding the warehoused loans that had rapidly dropped in price. Additionally, leading up to June 2007, the banks had a huge pipeline of underwritten deals that they planned to syndicate to the market. With now no demand for those new syndicated loans, the banks were "hung" with them. The banks were forced to be large sellers of Senior Loans into a depressed market which put further downward pressure on prices.

At that time, you had a vehicle called the market value CLO that had been constructed around the idea that the vast majority of a company's loans would remain stable around par value. Loans trading below 95 cents on the dollar were considered stressed, and below 90 cents on the dollar they were distressed. When those vehicles were built, it never occurred to anyone that the average loan prices of the entire market might fall below 80 cents on the dollar. As loan prices started to fall, market value CLOs had to reduce leverage in an effort to avoid liquidation which created even more selling. Open-end retail funds and hedge funds received redemptions calls, forcing them to sell, and even closed-end funds were forced sellers as the drop in asset values in the funds threatened their maximum leverage tests.

SL: How far down did the loan market get on a market price basis?

Ewald: This all reached a crescendo where loan prices were barely above 60 cents on the dollar. Given that the average recovery on loans has historically been around 70 cents on the dollar, the market was essentially pricing-in that all loans would default. Loan prices collapsed below any reasonable fundamental value and well below any level that any market participant could have possibly imagined.

Since then, loans have come back strong, but they still remain cheap today. Volatility remains high. Prior to June 2007, loans were an incredibly stable asset class. You could add in 10%-40% leverage, really not worry about it and just keep clipping the coupon.

Today the correlation between loans and other asset classes is much higher which means that when equities fall, loan prices fall. They don't fall nearly as much, but there still is correlation. That's one of the things that investors have to be more thoughtful about. You simply have a higher level of volatility than you had before, and the reason for that higher level of volatility is that a lot of the new buyers of loans are crossover investors.

Many high yield bond fund managers and hedge fund managers are investing in loans today. Through their dealer desks, the investment banks have substantially reduced their holdings and typically will only buy loans if they know they have a seller on the other side. Previously if prices began to back-up and dealers felt it was a temporary back-up, they had the capacity to buy loans onto their balance sheet, which helped to stem price declines. There's much more volatility in the loan market today than we historically had. Ironically, investing in a closed-end fund is probably a good thing because if you're willing to be a long-term investor and willing to take some leverage; it creates the potential for handsome returns.

SL: In your monthly financials, I noticed a tax-adjusted undistributed net investment income (UNII) balance, in addition to UNII. Can you explain the difference and why you no longer show tax-adjusted UNII?

Yarrow: There are some differences in the way we account for our assets on a book basis versus a tax basis. You have both a book UNII balance and a tax-adjusted UNII balance. As an example, the timing of when you write off the principal and interest on a loan or stop accruing interest on a default loan differs from a tax perspective to a book perspective. This doesn't have an impact on the value of the assets as we mark all the assets to market, but it impacts whether you book gains or losses on the assets as income or as capital gains/losses. That's why you end up with differences between the two. When we're looking at setting the dividend, we look at the tax-adjusted UNII balance because tax accounting drives paying excise taxes if we don't distribute enough of our income or we pay out return of capital if we distribute more than our income.

Regarding why we don't show tax-adjusted UNII anymore, Invesco's policy is to not show it monthly because there are often tax adjustments that are made after the fact so any monthly numbers that we show may not be accurate because they are subject to change.

SL: The UNII balance was negative for a while, understandably because of what we talked about from May 2007 through October 2011. Obviously, all else being equal, a positive UNII balance is better than a negative one, but I think it more important to see a UNII balance trending higher versus trending lower, indicating a cushion that you can maintain a distribution through market noise. What was the impact of the Fund's downward UNII balance on the Fund?

Yarrow: It actually had no impact whatsoever because that was a book basis UNII balance and on a tax-adjusted basis, the balance was positive as we constantly strive to reset our dividend in line with our income. As I mentioned previously, the tax-adjusted UNII balance drives our dividend decisions, and there can be differences between the tax and book UNII balances.

SL: Closed-end funds average about a 7% total distribution yield, and income typically is a big focus for individuals buying CEFs. Although we recognize yield isn't worthwhile if it doesn't match up with long-term total return performance for the portfolio, as of March 9, 2012, the average closed-end Senior Loan fund was showing a forward-looking market price yield of 7.1% versus VVR's 6.6%. When you're buying for the portfolio, how do you blend the need for "X" cents per share to stay yield-competitive and the need to buy for an upward trend on a total return basis?

Yarrow: We focus primarily on performance from a total return perspective. You do make a good point though that a lot of investors are in our Fund for the yield, so we do pay attention to it. As long as our yield is in the general range of what our peers are offering, we are going to be less concerned with generating additional yield and more focused on making decisions that maximize the total return in the Fund. Obviously, if our yield for some reason is lagging our peers, we'd be doing an analysis to figure out why and what the impact is on the Fund.

Ewald: A normal way to look at this asset class is "I'm going to get paid 7% and going to lose 2% from capital losses giving me a total return of 5%, that's pretty good. I'll take it". What's unusual about this asset class starting middle of 2007 through today is that you can buy into the discount, so rather than talking about expected capital losses you can talk about expected capital gains. If you bought in 2008 – obviously the ideal time to buy this asset class – you would have hit the low to buy 60 cents on the dollar. If you were buying Senior Loans, you don't care about current income. You're buying it because you're expecting to get 50% return on capital appreciation. The environment that we have right now is much more current income than capital appreciation. The fact that there's any capital appreciation is very unusual and should be attractive to investors.

SL: You previously touched on return of capital (ROC) and understandably had a small return of capital in 2008 and 2010. Would you comment on this?

There are three ways we look at ROC. First, from the accounting measure, which is often Master Limited Partnerships, Real Estate Investment Trusts and Option Premiums. Second, from return of capital that's caused by a portfolio manager delaying a transaction because he doesn't want to take a gain or change the distribution policy, and then there's destructive ROC where you're eroding net asset value and paying true investor principal. It doesn't appear that's what you're doing with the Fund as it has good NAV growth.

How would you classify the Fund's use of return of capital, a hot topic in the closed-end fund space?

Yarrow: We typically try to avoid having any return of capital, but, from time to time, there are going to be things that happen that might cause ROC, and 2008 and 2010 were examples of this. In 2010, we had tax adjustments that were related to the Invesco/Van Kampen transaction that occurred in June of that year, which caused the Fund to move from a slightly positive UNII balance to a slightly negative UNII right near the Fund's fiscal year end (July 31st at that time). Rather than dramatically cut the dividend one month just to increase it again the next month to avoid the return of capital, we felt that investors would prefer us to keep the dividend stable and have the small return of capital.

In 2008, we had some small fiscal year-end tax adjustments that caused the balance to again go slightly negative, and we took the same approach of keeping the dividend stable. We constantly strive to keep our distribution in line with our income and the UNII balance at a very small positive level. Building too large of a positive UNII balance, however, puts us at a greater risk of not paying out 98% of our income in the calendar year and thus subjecting the Fund to excise taxes, so it is a bit of a balancing act with UNII.

SL: Regarding your monthly "average days to loan" reset figure, it looks like it's been as low as 32 and as high as 67. What is driving that change?

Yarrow: It's primarily related to the timing of when companies lock in LIBOR and how long they're locked for. Typically you have a couple of months where the average days to reset is high, then it drops down for a month and bounces back up for a couple of months and so on. This makes sense as the vast majority of our companies lock-in LIBOR for 90 days. Once they are locked-in, you see a fairly high average days to reset, and then as they get closer to the end of the 90-day period it goes down and will jump back up again when they reset for the next 90 day period.

SL: It looks like you just posted the January 2012 Fund figures, posting updates about five weeks after the month-end. Is that a normal schedule for investors looking for the updates?

Yarrow: Yes, that's right.

SL: The final portfolio question concerns the future. Is there anything you see in the Senior Loan market in the next few years that you would like to share with our readers?

Yarrow: Our view is that we are in a slow growth environment at the moment, and a slow growth environment is actually fine from a Senior Loan perspective. Over the next two years we should be in a relatively low default rate environment. Credit losses are going to be quite negligible. Eventually the Fed is going to start raising interest rates, and as it does, it will have a positive impact on yields for Senior Loan portfolios. However, the impact will be somewhat muted because approximately half the loans in the market today have LIBOR floors, typically in the 1%-1.5% range. We get paid the higher of the current LIBOR (or the floor) and will not see a boost in yield on loans with LIBOR floors until LIBOR increases to a level above the floor. As interest rates rise, investors who are in very low duration portfolios such as Senior Loan funds, are going to feel quite good because they're not going to be suffering the interest rate losses on a market value basis that longer duration portfolios will likely experience.

SL: Fascinating. To finish up, do either of you have a favorite recent book that's shifted the way you think of things in the portfolio? I'm currently in the middle of *Black Swan,* a little long but an interesting read for understanding high impact, low probability events.

Ewald: I'll give you one. I am reading a book right now on World War I.

SL: Interesting. Are you a history buff?

Ewald: The reason it's interesting is that it helps keep things in perspective. People are talking about how bad things are right now with Greece, the uncertainty and everything else. But people and investment managers are usually too focused on the near term. They lack historical perspective, and I think that leads to all sorts of mistakes. That's one reason I like to read history; it helps to keep me grounded.

Yarrow: The last book I read was *Moneyball,* which shows you can still do well with less, if you spend your money wisely.

SL: Both great points to keep in mind. I really appreciate the time you've given me this afternoon in order to help our readers understand your Fund and the Senior Loan sector.

Ewald: Right, John. Thanks again and wonderful questions.

Yarrow: Thanks a lot. ■

About Invesco Ltd.

Invesco Ltd. is a leading independent global investment management firm with $667.6 billion in assets under management of which $12.2 billion is in closed-end funds. The firm is listed on the New York Stock Exchange under the symbol IVZ. Additional information is available by calling 404-439-4605 or by visiting their web site at www.invesco.com.

Disclosure: Clients and family members of Closed-End Fund Advisors do not hold shares in VVR but currently hold shares in its sister fund, VTA. The firm will wait 72 hours after the date of this interview's release before making any additional purchases or sales in either fund.

Portfolio Managers' Reviews

"This year's green shoots promise to bloom," says The Kiplinger Letter, "with the economy gaining strength over the course of the year." In short, the chances of a self-sustaining recovery have improved. We are allocating our portfolios accordingly.

Diversified Growth, Growth & Income and International Equity Models, In the first quarter, we sold one of our U.S. small cap funds to put more money into large cap equity funds, such as Adams Express and Central Securities. The markets have cooperated, and many funds have strengthened and narrowed their discounts.

We also sold some of our global bond funds, especially those that were selling at or near premiums such as Templeton Emerging Markets Income which was selling above its net asset value. We retained the better performing global bond funds however, because we like their frequent cash distributions.

As the quarter moved forward, we allocated more of our resources into Asian funds as these markets have been beaten down to bargain levels. We favored larger funds because they pay out more in distributions, but we also chose to invest in two smaller Asian funds with growth potential.

We added to shares of Templeton Emerging Markets Fund because we saw that the emerging markets were recovering. This Fund invests across the entire sector in as many as 40 markets.

Hybrid Income, Balanced/ Foundation and Conservative Diversified Models. We added First Trust Finance in order to add business development company exposure to client accounts. We swapped Wells Fargo Advantage Dividend Opportunity (EOD) for Eaton Vance Tax Advantaged Global Dividend on a significantly reduced discount than our purchase and Eaton Vance Tax Managed Global Fund on the day it announced a dividend cut, avoiding the widening of the discount from -12.5% to -15%. We decided to buy EOD because it had reduced its portfolio's exposure to peripheral Europe, resumed trading at a 4% discount and had a very attractive distribution level.

For Master Limited Partnership Exposure, we purchased shares of Kayne Anderson MLP Investment Co. near a 4% premium, after the secondary offering and just before the small but beneficial dividend increase. This Fund has a solid track record of sustaining a 10% premium. We did not feel the dilution of the secondary offering would impact the Fund's NAV performance and income production as significantly as the market reacted.

We increased our global equity holdings with an overexposure to metals, mining and oil and gas sectors with Nuveen's Global Value Opportunity whose discount has widened over 7% compared to a one-year average of -3.4%.

In the Conservative Diversified Model, we added ASA Gold and Precious Metals Fund and iShares Gold Trust – one of the few ETFs we use on occasion for clients – to help capture gains if markets resume their interest in gold and precious metals.

Cohen & Steers Closed-End Opportunity Fund, a fund-of-funds that we hold in many accounts, announced that, as required by its charter, it will submit a proposal to convert from a closed-end to an open-end fund when its shares traded at an average discount of -7.5% or more over a period of 75 consecutive days. This will be considered at a special meeting of shareholders of record as of March 19. All shareholders will receive a proxy to vote on this change. As we like discounts and prefer the closed-end fund format, we are voting against it. Each of you will have to make your own decision on whether you want to keep a closed-end fund.

We will continue to make changes to help our clients reach their investment objectives. ■

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