

## IMPORTANT NOTICE

This overview is being provided for informational purposes only. This document does not constitute an offer to sell or the solicitation of an offer to purchase any securities or investment product. Collateralized Loan Obligations are complex products and investments therein are subject to numerous risks not discussed below. For more information about any particular Collateralized Loan Obligation, investors should consult the applicable offering documents.

## CLO OVERVIEW

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### What is a CLO?

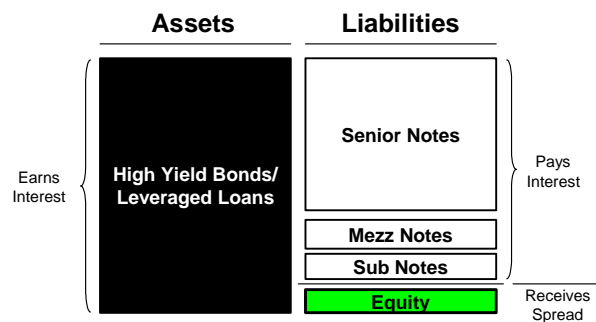
Collateralized Loan Obligations (CLOs) are structured finance products designed to securitize diversified pools of leveraged loans. The purpose of a securitization is to repackage and redistribute risk, and the act of securitization is the process of converting assets into securities backed by those assets.

CLOs finance the purchase of their portfolios of loans by issuing debt and equity. The debt is issued in ranked classes with higher ranking classes having priority of payment over lower ranking classes and all the debt having priority of payment over the equity. Consequently, each class of CLO debt has a higher credit rating than the average credit rating of the portfolio of loans and the CLO can borrow at a lower rate than it earns on its portfolio. The difference, or “spread”, between the relatively high yielding assets and the lower yielding (lower cost) liabilities is paid to the CLO’s equity investors.

The CLOs discussed in this summary are *Cash Flow* CLOs. Cash Flow CLOs are managed principally to maximize the risk-adjusted returns on the portfolio over the life of the CLO. In contrast, *Market Value* CLOs are structured to generate equity returns from profits earned from the trading of assets and are managed principally to maximize trading gains over the life of the CLO.

### How Does a Cash Flow CLO Work?

The securities issued by the CLO are tranching into several classes of senior notes (Rated AAA to A), mezzanine and subordinated notes (Rated BBB to B), and equity. In the case of GSC Investment Corp. CLO 2007 the financing is structured with 74.0% senior debt, 18.5% mezzanine and subordinated debt, and 7.5% equity. The rating of each class is a function of the relative seniority of the class’ claim on, and the relative quality of, the CLO’s assets.



The CLO allocates the interest and principal proceeds generated by its loan portfolio on periodic distribution dates according to a payment waterfall. Payments of interest and principal to the various note classes issued by the CLO are made sequentially, in the order of their subordination. The equity receives the difference between the interest earned on the portfolio and the interest paid on the CLO notes (as discussed in the following section) provided certain collateral quality tests are met. If these collateral quality tests are not met, the residual interest proceeds could be diverted from the equity to purchase additional loan collateral or prepay principal on the notes. Any losses realized in the portfolio are borne by the classes in reverse order of seniority, with the equity bearing the first loss.

### Where is the Arbitrage Opportunity for the Equity Investor?

The subordination of equity to debt and junior debt to senior debt in a CLO concentrates the risk of loss in the unrated equity and allows the CLO debt to be issued with higher ratings and a lower interest rate than the CLO portfolio would otherwise support. As a result, the CLO borrows at a lower rate than it earns on its assets. The positive “spread” between the interest earned on the portfolio and the interest paid on the CLO’s debt creates the arbitrage opportunity for the equity investor. The equity investor’s leveraged

investment in the CLO portfolio allows for higher possible returns than an unleveraged investment in the same portfolio, but with commensurately greater risk of loss.

### **What Variables Affect CLO Returns? How are Those Risks Mitigated or Managed?**

In addition to the cost of the liabilities and yield on assets, the key variables that affect the return to CLO equity investors are default rates, timing of defaults and recovery rates on the portfolio collateral. CLO expected returns assume average default rates and recovery rates or “net default rates” (net defaults after recoveries) for the classes of assets in which they invest. These defaults are assumed to occur evenly over time. The degree to which the timing of and rate of defaults deviates from the expected rate or timing (such as, for example, higher than expected defaults or lower than expected recoveries) will determine the degree to which the return to the equity investor is affected.

The cost of CLO debt is fixed at the time the debt is issued. The yield on the portfolio of loans, however, varies over time as loans are paid and new loans purchased. When the market price for loans decreases, borrowers often use the proceeds from new, lower-priced borrowing to prepay existing, higher-priced borrowing. This decreases the arbitrage of the CLO and, consequently, the returns to equity. On the other hand, when loan prices increase, the rate of prepayment of lower-priced loans decreases, and the CLO may be unable to fully exploit the improved arbitrage opportunity.