AAM

AAM Investment Roundtable

Rethinking Risk
A CIO Perspective

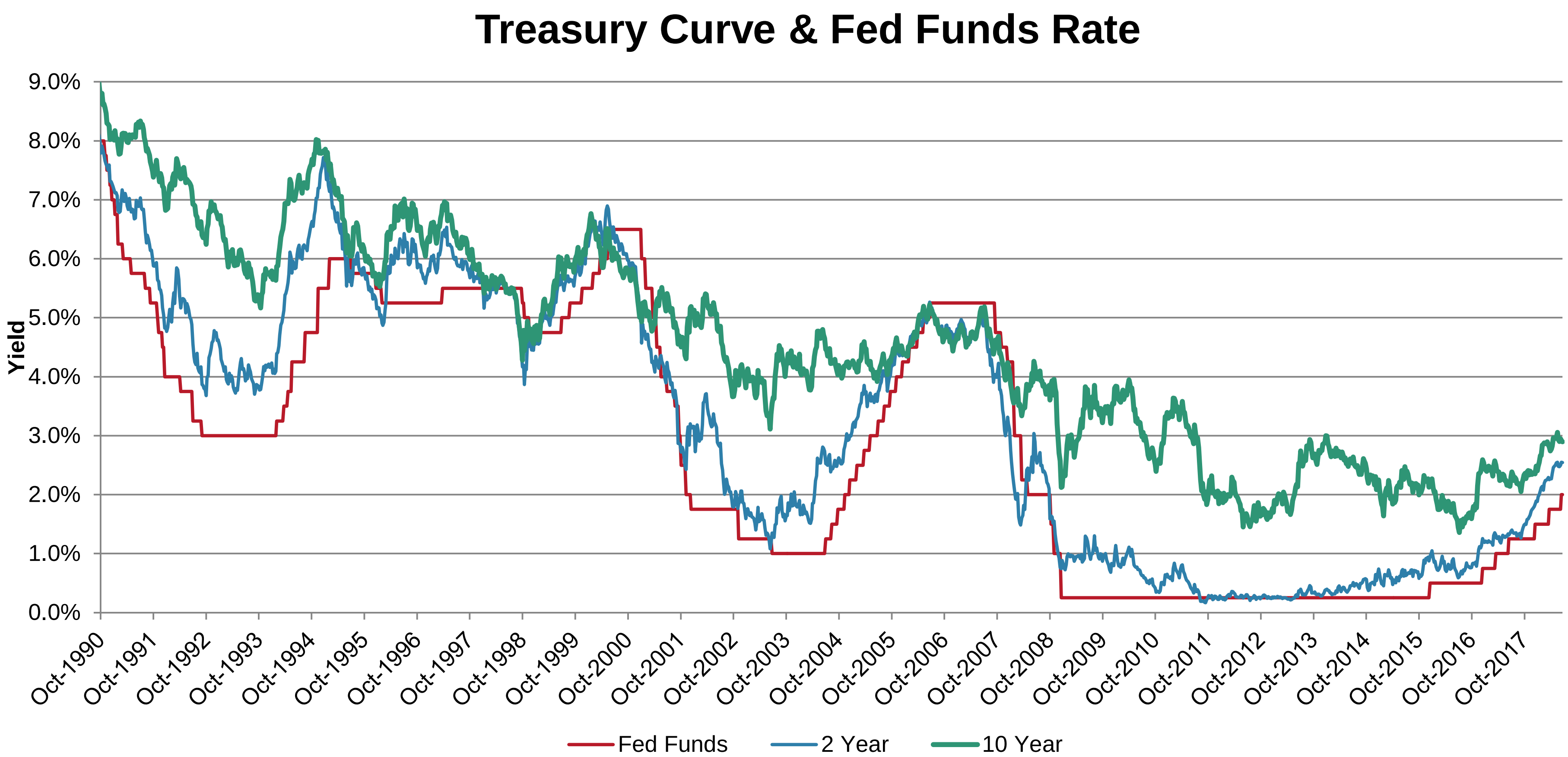
Reed Nuttall, CFA

Chief Investment Officer

AAM

Pensions&Investments BEST PLACES TO WORK IN MONEY MANAGEMENT 2017

Fed Tightening Usually Inverts Treasury Curve



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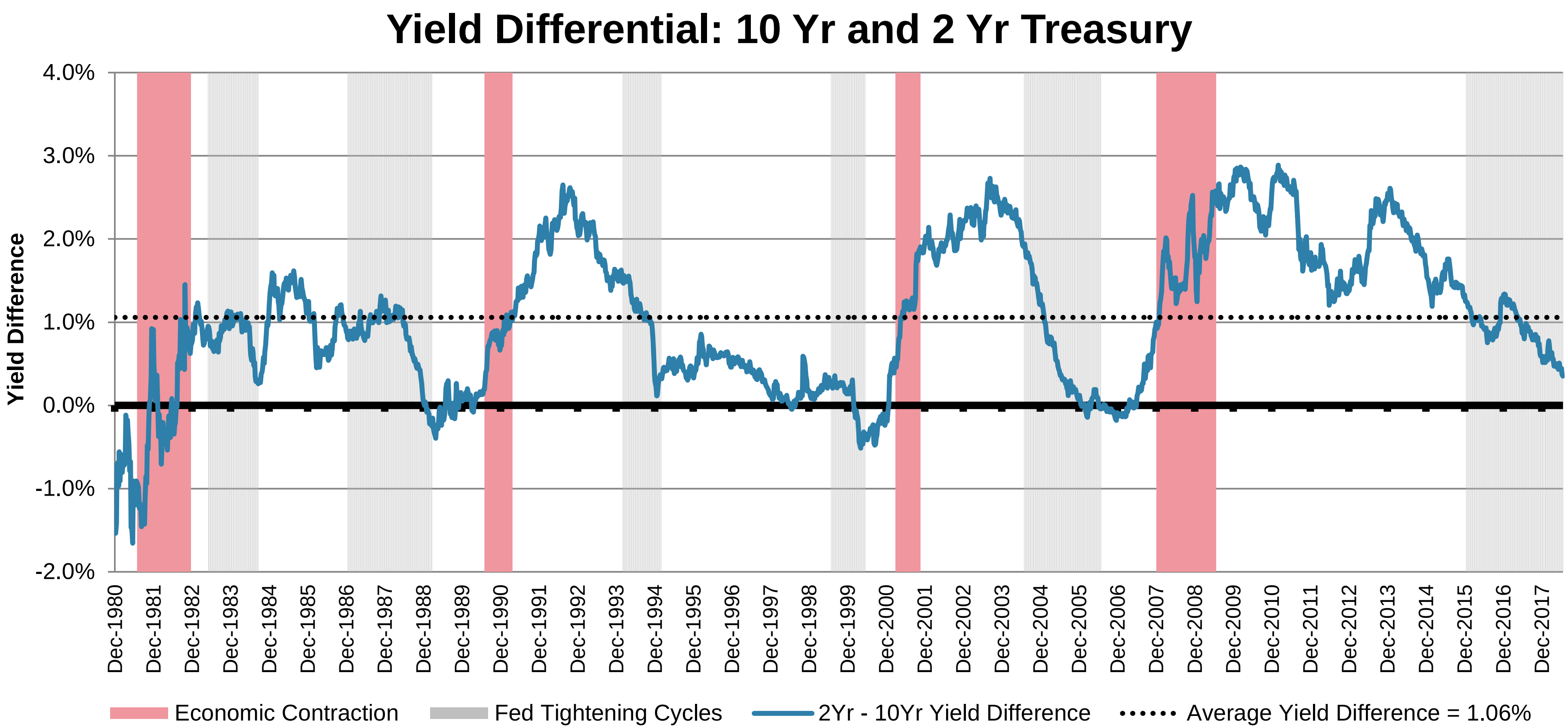
Source: National Bureau of Economic Research, Bloomberg

Inverted Curve Precedes Contractions



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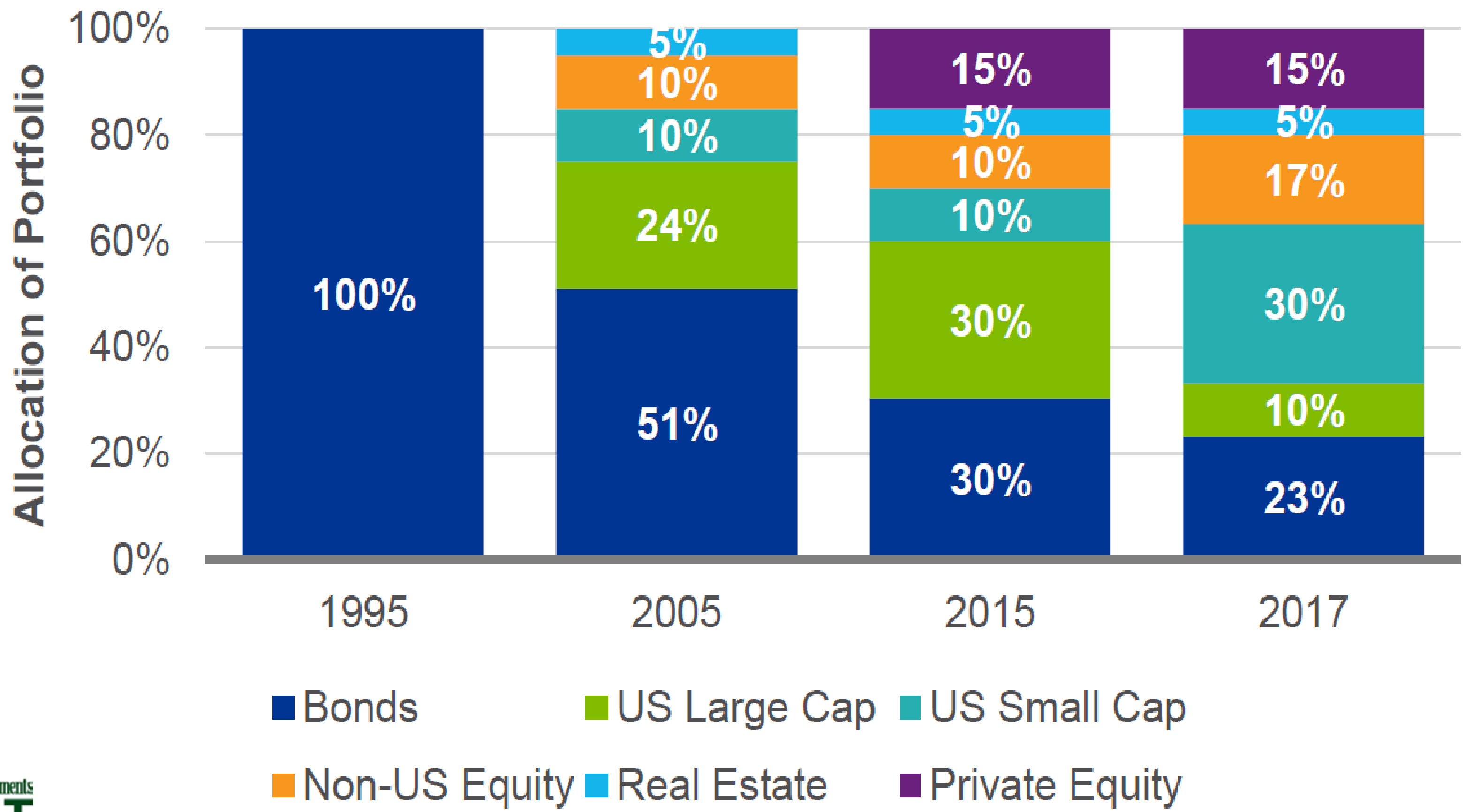
Source: National Bureau of Economic Research, Bloomberg

Reaching for Return Amid Low Rates

Asset Allocation to Generate 7.5% Expected Return



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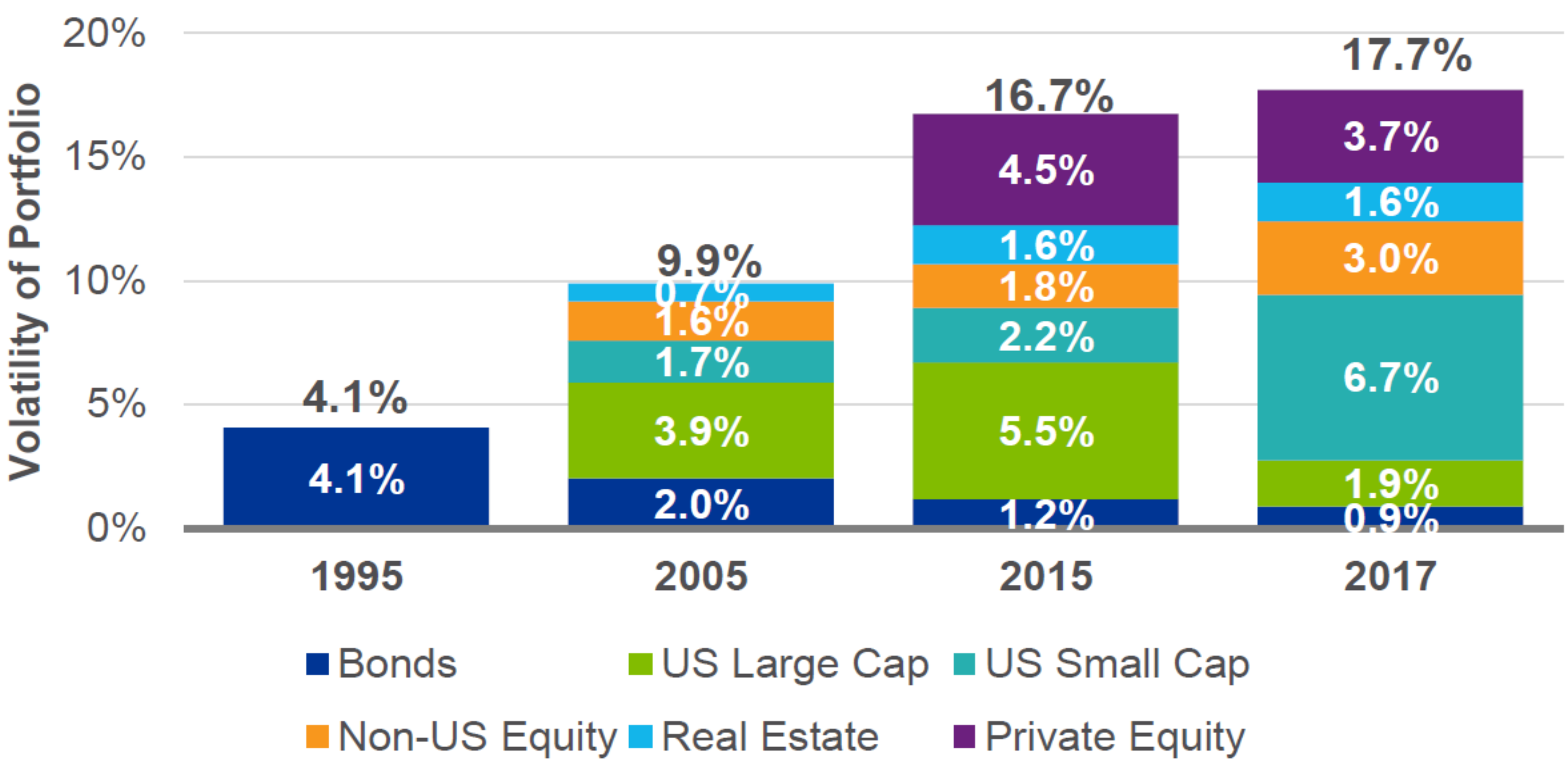
Source: Blackrock

Reach for Return Leads to Increased Volatility

Asset Allocation to Generate 7.5% Expected Return



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Source: Blackrock

Key Market Themes

- Underweight Agency MBS
- Reduce basis in BBBs
- Changes in tax rate cause reallocation to taxable sectors

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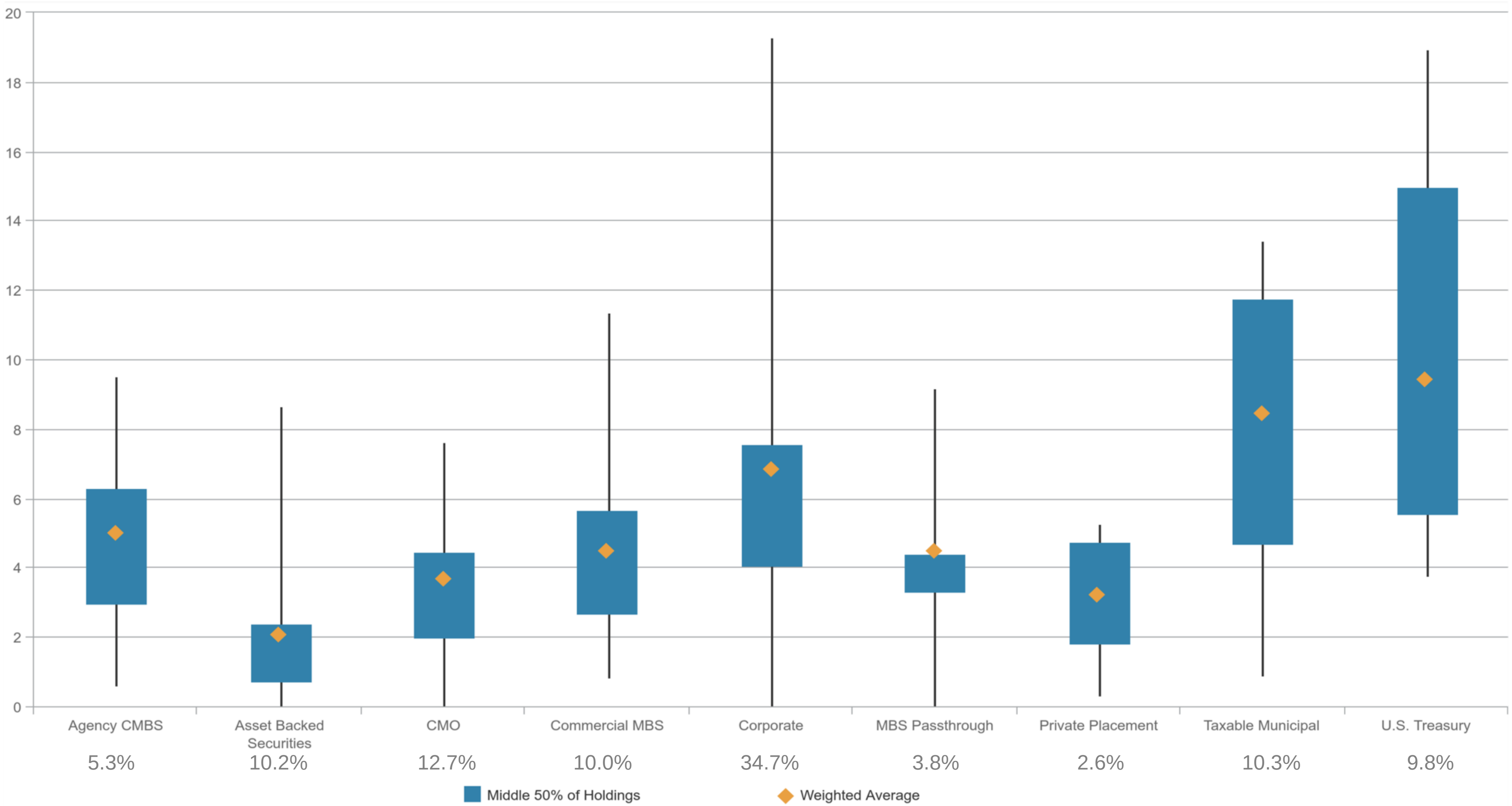
FIXED INCOME DURATION DISTRIBUTION AS OF MARCH 31, 2018

AAM Insurance Investment Management

DURATION EXPOSURE BY SECTOR



Source: AAM / Clearwater Analytics.

Municipal Credit

Tax Reform Effects on Municipal Market Technicals

Greg Bell, CFA,CPA

AAM Principal and Director of Municipal Bonds

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Tax Reform

- Tax rates reduced
  - Individual rates reduced from 39.6% to 37%
  - Corporate rates reduced from 35% to 21%
- Corporate AMT eliminated
- Advance refundings eliminated
- State and local taxes deduction capped at $10,000

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Demand Effects: Changes in Tax Equivalent Yields

	BEFORE	AFTER	CHANGE
10yr Muni Yields	2.46%	2.46%	
Retail Tax-Equivalent Yield	4.35%	4.16%	(.19%)
P&C Tax-Equivalent Yield	3.59%	2.95%	(.64%)
Bank Tax-Equivalent Yield	3.78%	3.11%	(.67%)

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Source: AAM, Thomson Reuters Municipal Market Data

Demand Effects: Tax-Equivalent Yield Spreads to Taxables

	5yr 'AAA' Muni to 'A' Corp	5yr 'A' Muni to 'A' Corp	10yr 'AAA' Muni to 'A' Corp	10yr 'A' Muni to 'A' Corp
Tax-Exempt Yields	1.99%	2.14%	2.46%	2.76%
Retail Tax-Equivalent Yield Spread	(0.05%)	0.20%	0.41%	.91%
P&C Tax-Equivalent Yield Spread	(1.03%)	(0.85%)	(0.81%)	(0.45%)
Bank Tax-Equivalent Yield Spread	(0.89%)	(0.78%)	(0.64%)	(0.26%)

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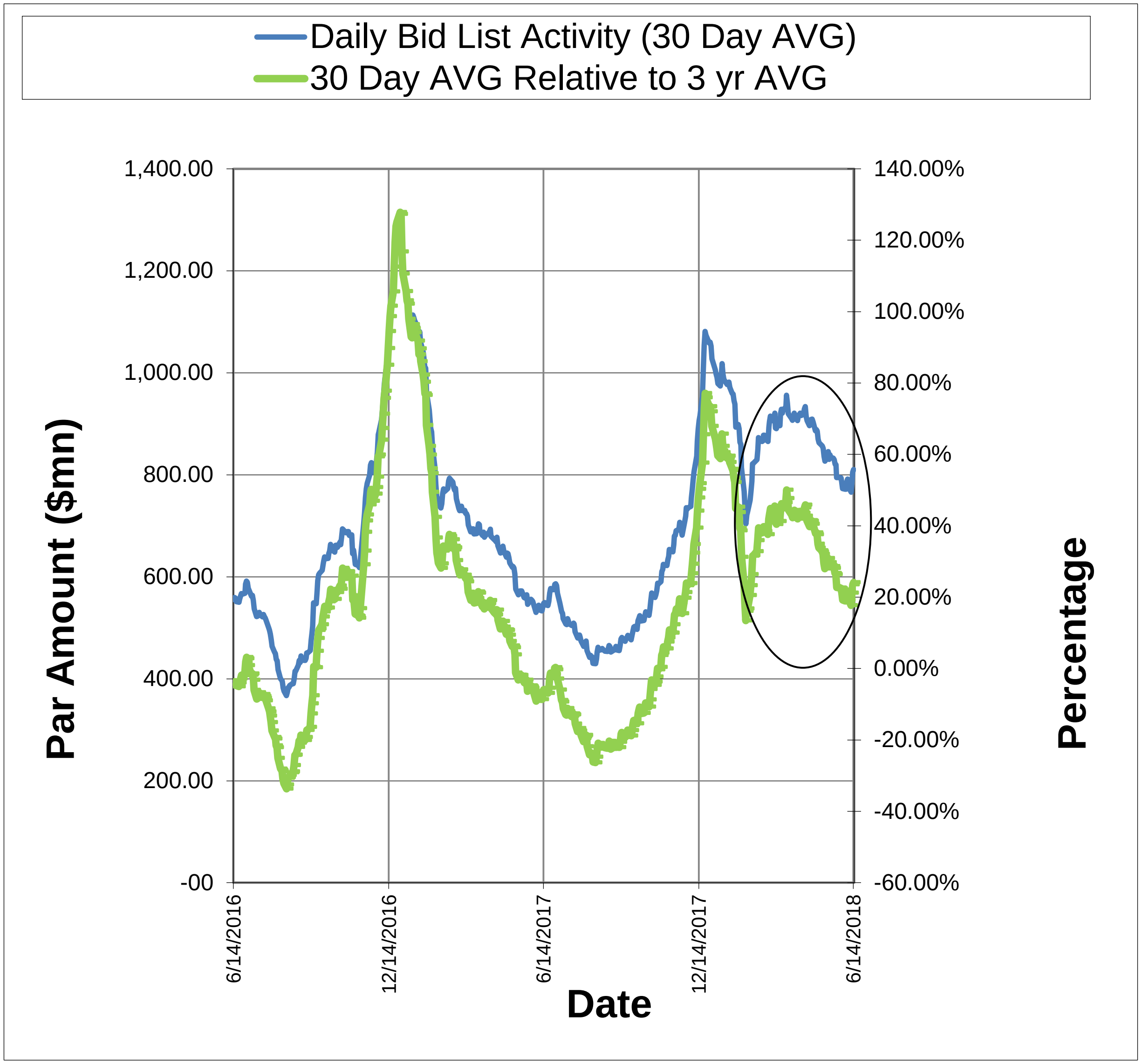
Source: AAM, Thomson Reuters Municipal Market Data, A-rated spreads generated from Northeastern University pricing on 6-20-18

Demand Effects: Changes in Market Concentration

(in Billions)	Q4 2017	Q1 2018	Change
Retail (Household, Mutual and Money Market Funds)	$994.3	$992.3	($2)
P&C	$326.9	$326.9	-
Bank	$570.2	$554.3	($15.8)

Source: Federal Reserve Flow of Funds Data

Demand Effects: Selling Remains Elevated



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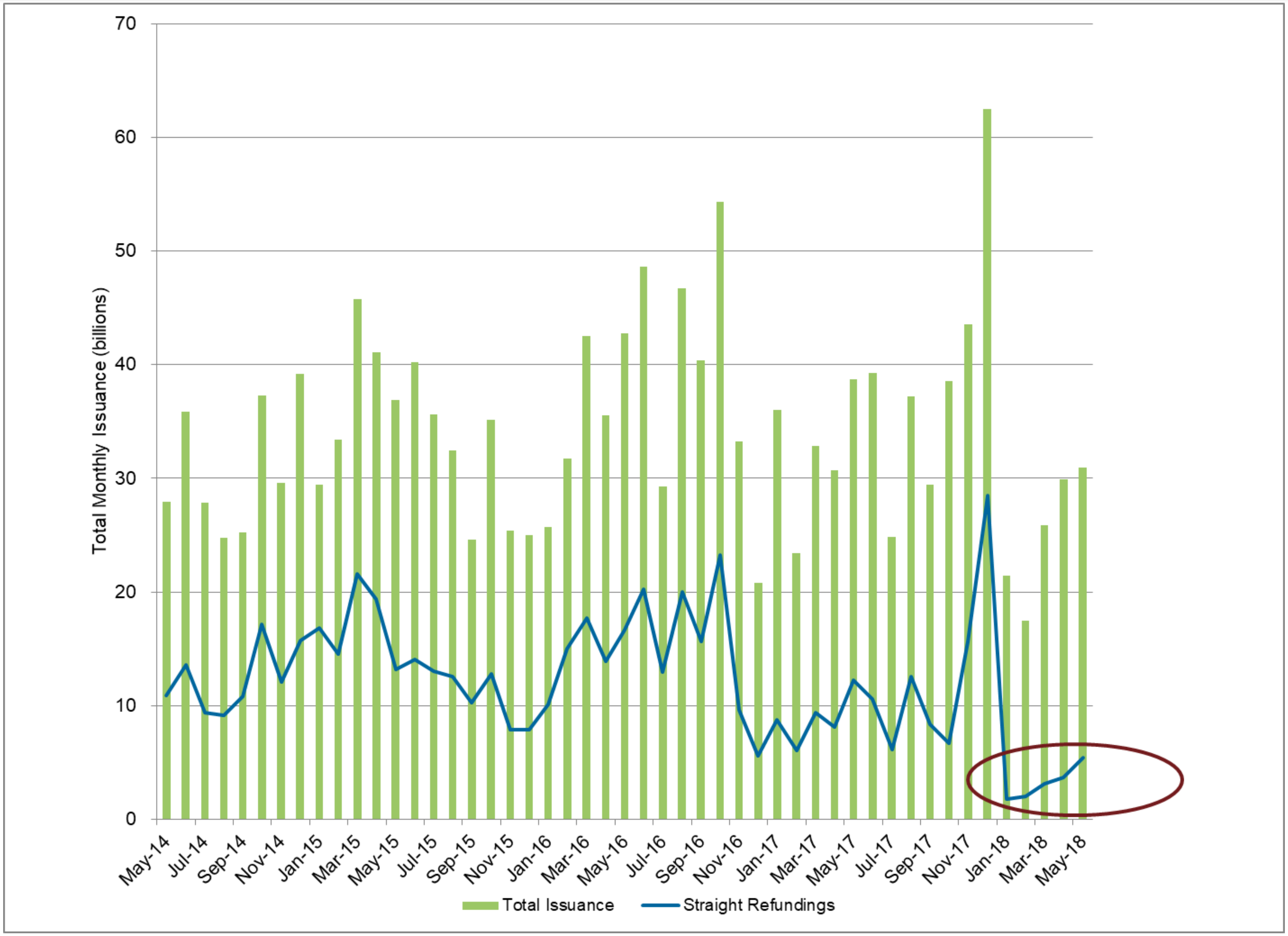
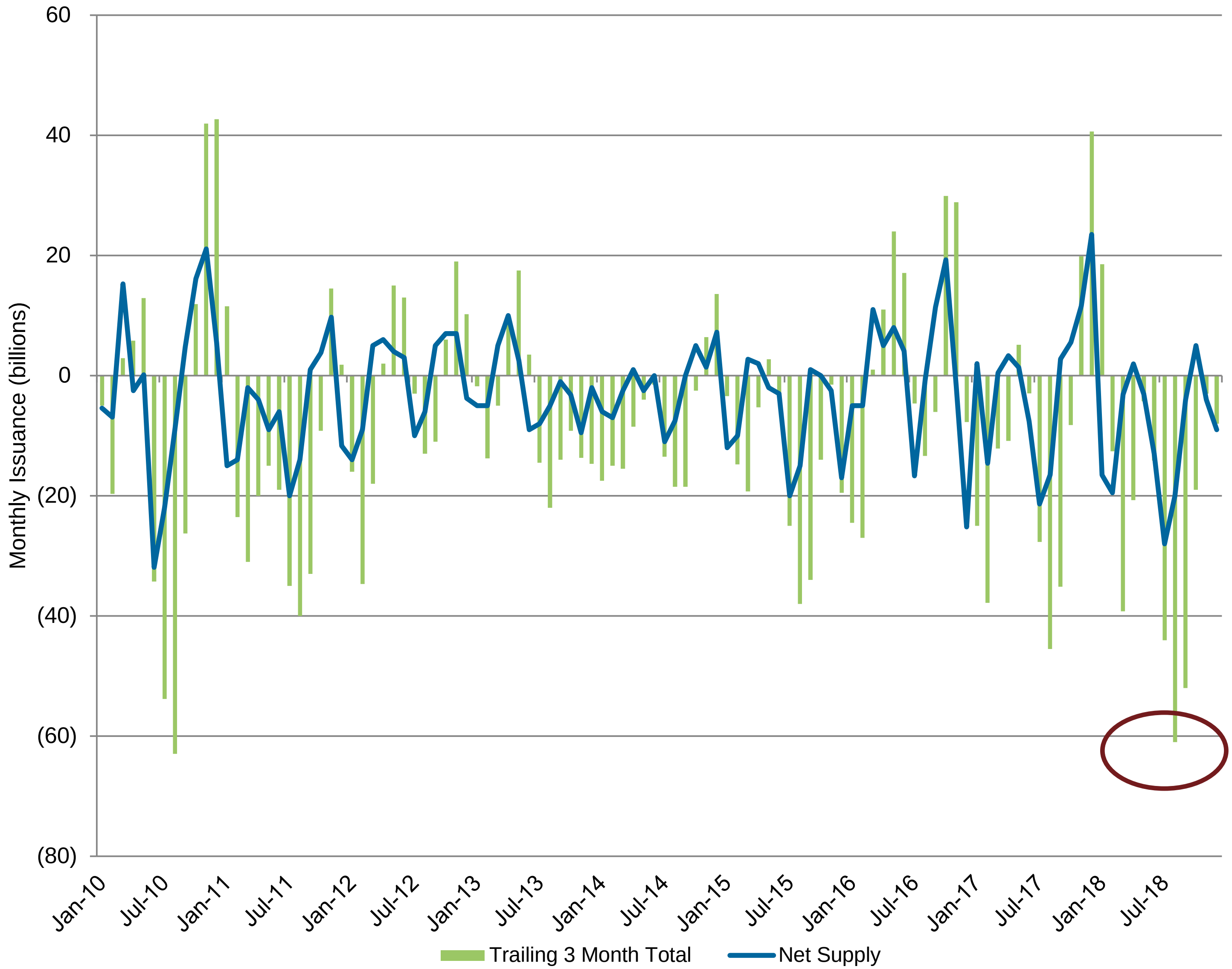
Source: Bloomberg

Supply Effects: Refinancings Have Slowed



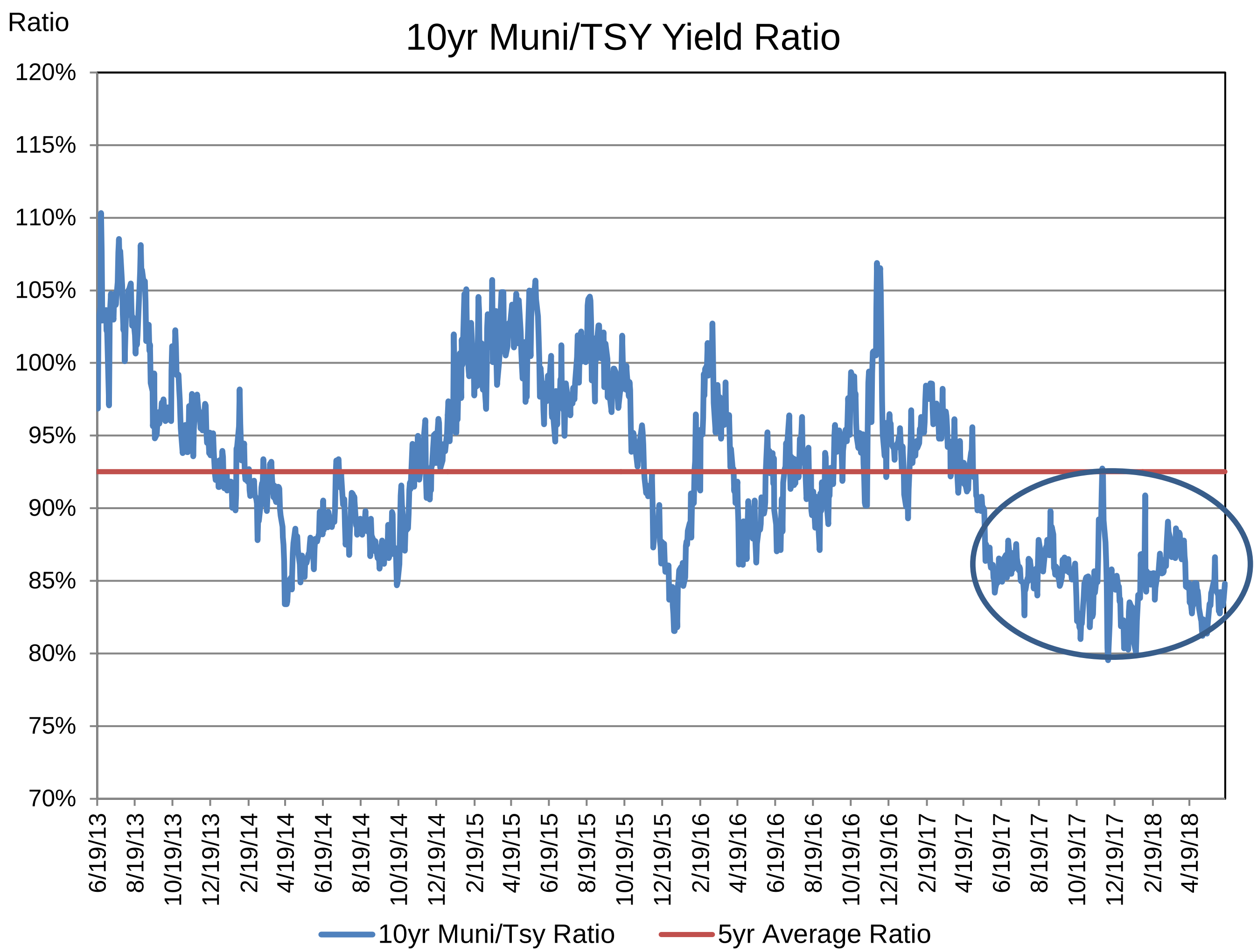
Source: Bond Buyer

Supply Effects: Net Supply Levels Very Supportive



Source: J.P. Morgan

Relative Valuations Should Improve



Source: Bloomberg, Thomson Reuters Municipal Market Data

Potential Headwinds

- Supply accelerates
- Fed raises rates aggressively
- Headline risk or credit deterioration

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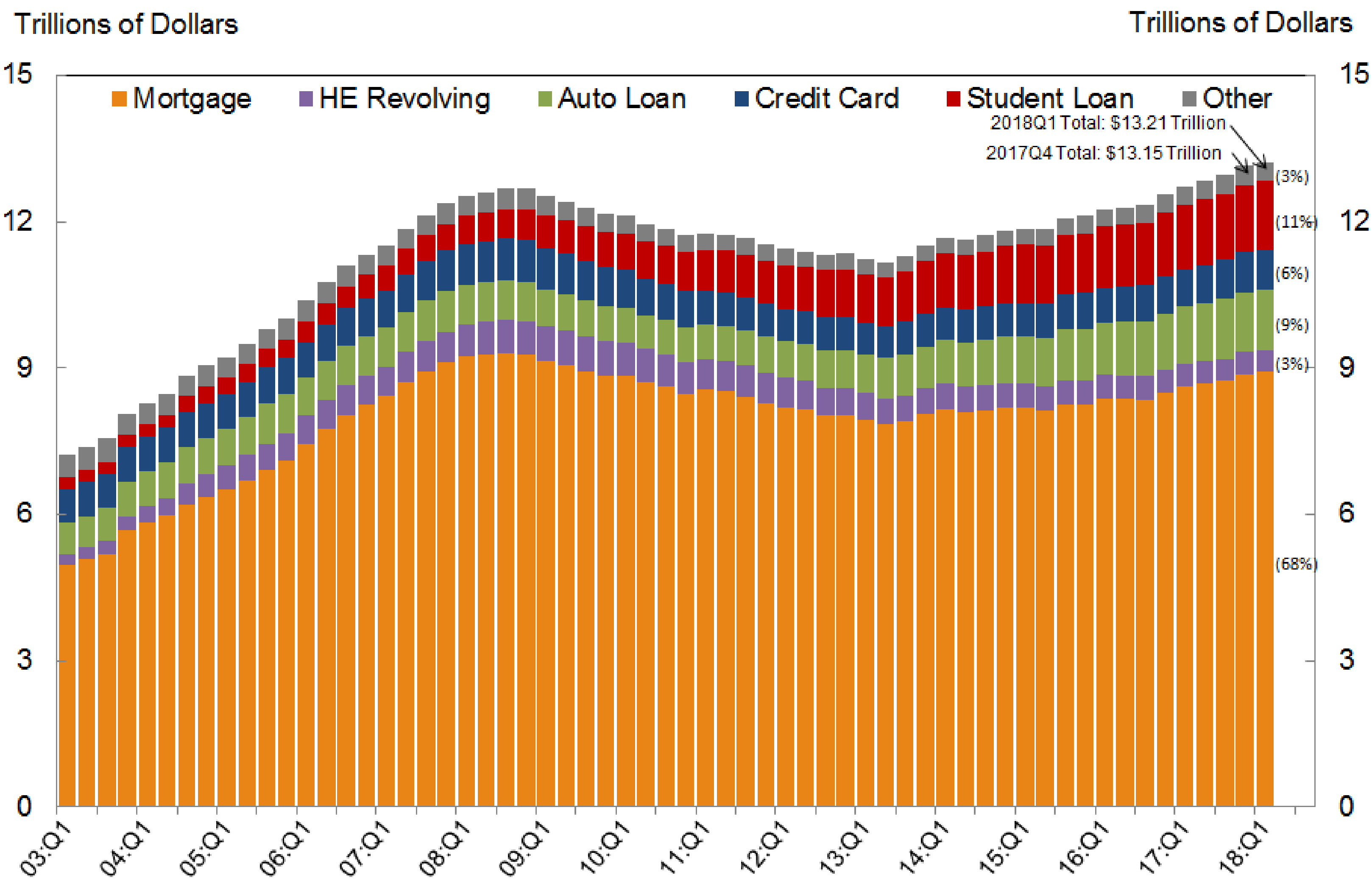
Structured Products || Need a title

Scott Edwards, CFA

AAM Director of Structured Products

Total Debt Balance and its Composition



Source: New York Fed Consumer Credit Panel/Equifax

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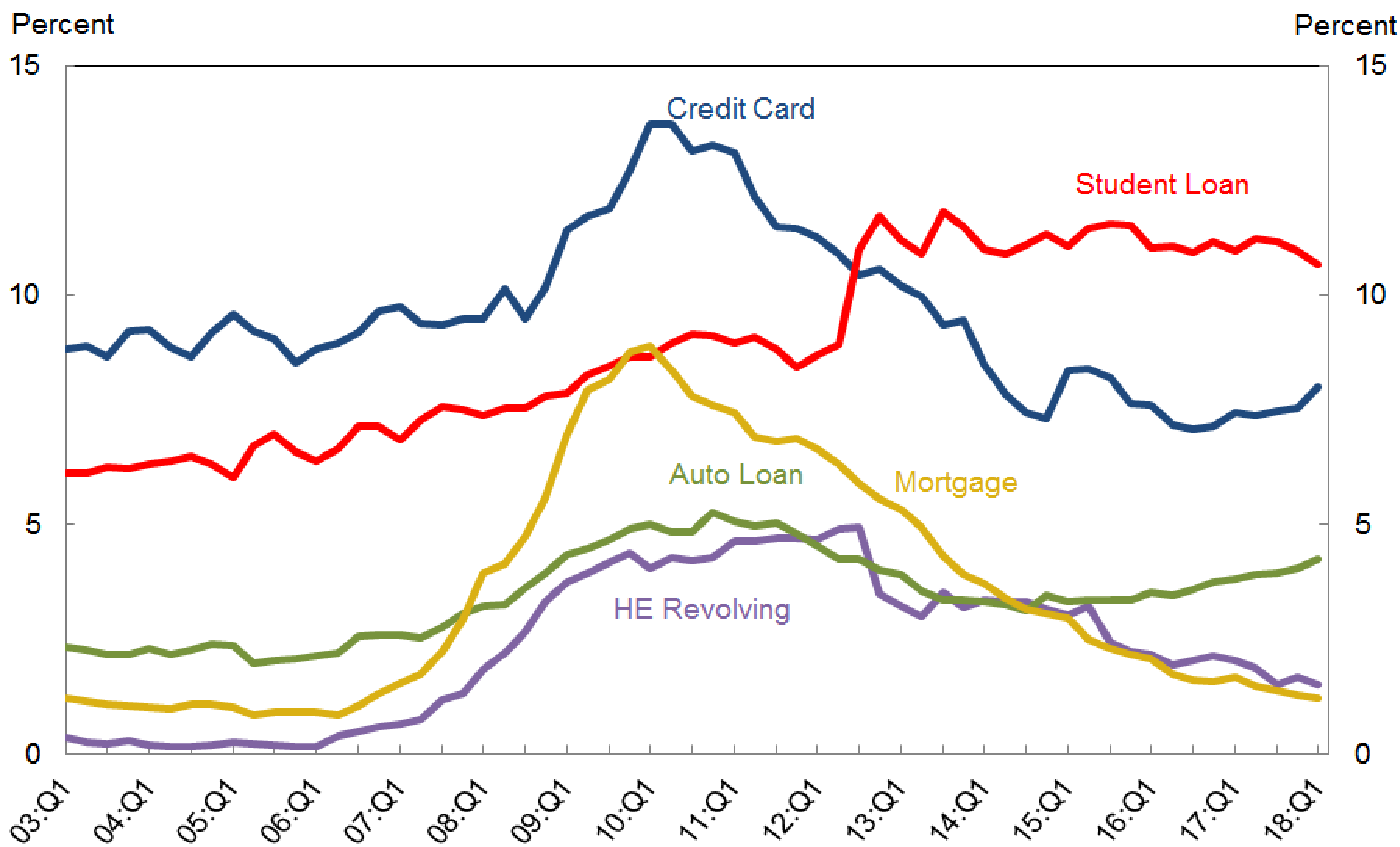
Percent of Balance 90+ Days Delinquent by Loan Type

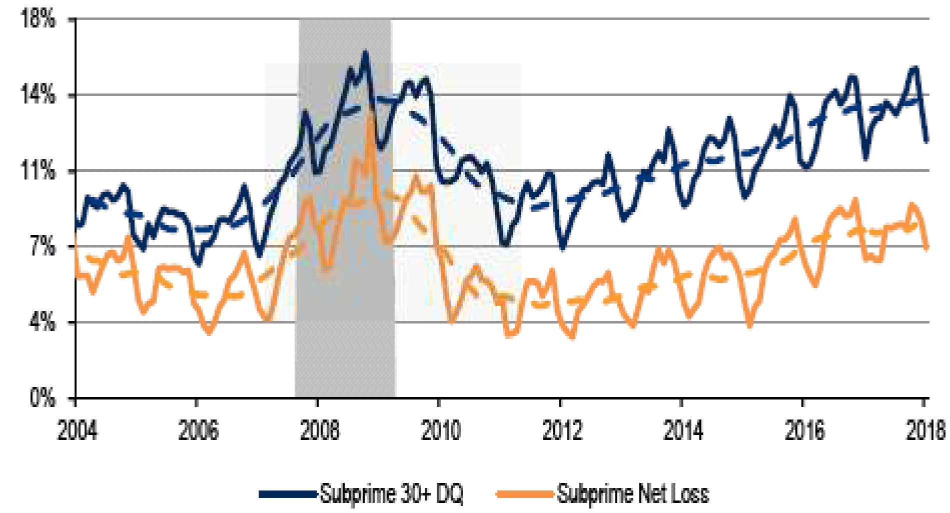


Source: New York Fed Consumer Credit Panel/Equifax

Credit Performance- Auto Loan ABS

Prime Auto Loan ABS- 30+ days Delinquencies, Net Loss

Subprime Auto Loan ABS- 30+ days Delinquencies, Net Loss



Source: Intex, Bureau of Labor Statistics, Bank Of America Global Research

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Retail Turnaround

Del Amo Fashion Center, Torrance, CA

Del Amo Fashion Center is a 2.5 million square feet super-regional mall located in Torrance, California, boasting over 200 retailers, a multiplex, and multiple restaurants. The Mall is owned and operated by Simon Property Group.

- Debt Service Coverage Ratio (DSCR) 2.44x
- Occupancy-85%
- Loan-to-Value-51%

- Major Distressed Anchors include JC Penney (December 2018 lease expiration), Macy's, and Sears
- Macy's Home store replaced by Dick's Sporting Goods and EMC Seafood
- AMC multiplex was upgraded to add IMAX screens
- Nordstrom store was re-located and new Dave and Busters, Marshalls to open in summer of 2018
- In talks with major grocery and hospitality operators for vacant spaces
- Major redevelopment of $423 million being undertaken, with enhanced dining pads and seating, several anchor spaces improved, and addition of multi-level parking

Source: S&P Presales, Morningstar, Servicer Reports

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“Sears. Where Else?”

Seritage Growth Properties is a publicly traded REIT, spun out of Sears Holdings in 2015. They are primarily engaged in re-leasing and redevelopment of 253 Class A multi-tenanted shopping centers, and 28 additional properties through a joint venture with other REITs.

- Since 2015, Seritage has diversified their rental income away from Sears. Sears’ contribution went down from 80% to 45.7%
- In doing so, Seritage also was able to realize 4.1x the rent multiple of income produced by leasing to Sears

Top Tenants

The following table lists the top tenants in the portfolio, including JV Properties presented at the Company’s proportional share, based on signed leases as of March 31, 2018:

(dollars in thousands)

Tenant	Number of Leases	Annual Rent	% of Total Annual Rent	Concepts/Brands
Sears Holdings (1)	167	$ 99,065	45.7%	Sears, Sears Auto Center, Kmart
Round One Entertainment	7	6,821	3.1%	
Dave & Busters	7	6,328	2.9%	
At Home	10	5,896	2.7%	
Burlington Stores	9	5,763	2.7%	
Cinemark	4	4,899	2.3%	
Dick's Sporting Goods	5	4,640	2.1%	
Nordstrom Rack	6	4,385	2.0%	
AMC	3	4,202	1.9%	
Ross Dress for Less	8	4,091	1.9%	Ross Dress for Less, dd's Discounts
Primark	3	3,925	1.8%	
Floor & Décor	3	3,082	1.4%	
24 Hour Fitness	3	2,909	1.3%	
TJX	7	2,849	1.3%	TJ Maxx, Marshalls, HomeGoods, HomeSense, Sierra Trading Post
Petsmart	5	2,391	1.1%	

Source: Seritage Growth Properties Website

Autonomous Vehicles (AVs) || Disruptive & Opportunistic

Afrim Ponik, CFA

AAM Senior Credit Analyst

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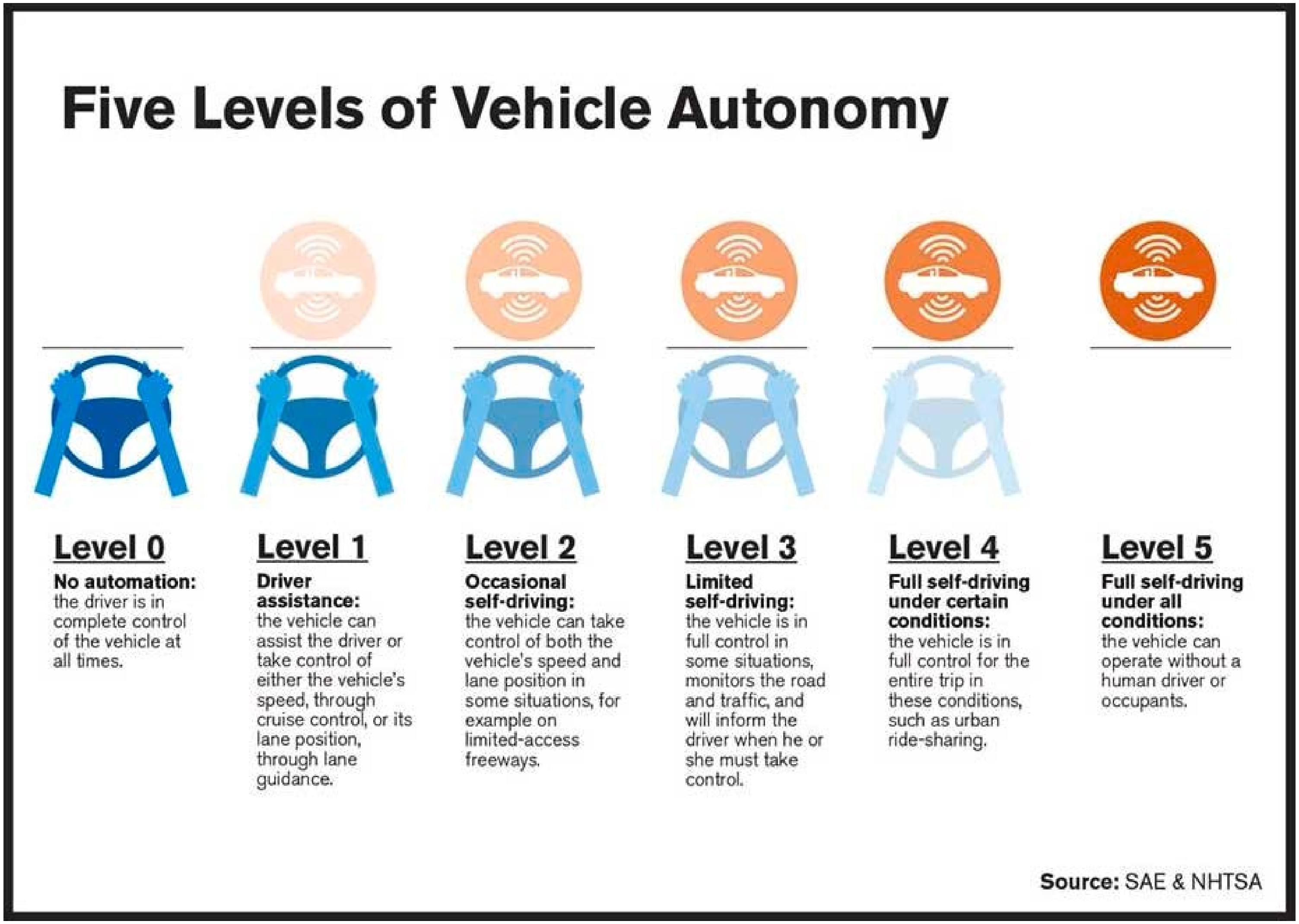
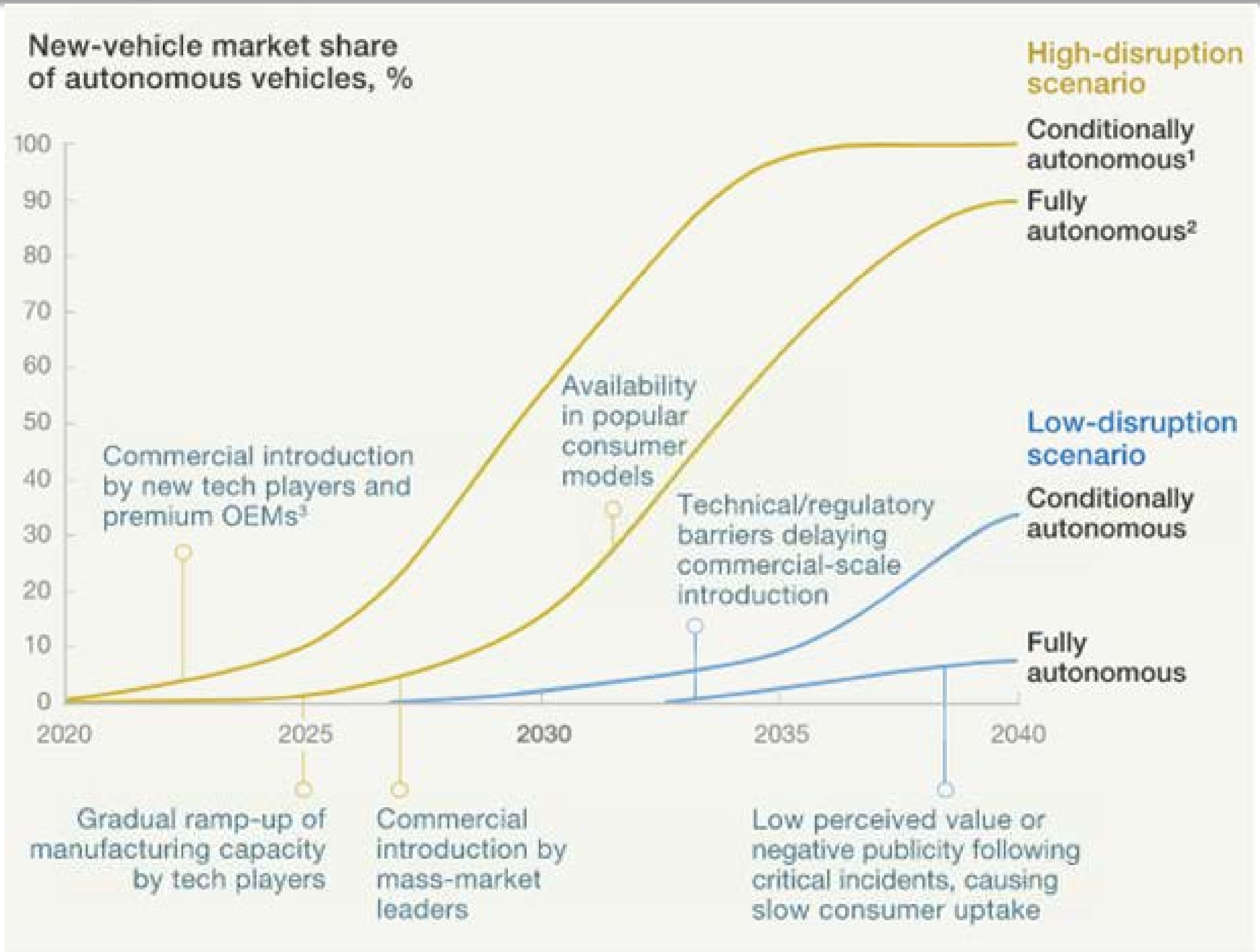
A Natural Shift Driven by Necessity

- 1.2B cars globally to grow to 2 billion by 2040s at current trends
- 90MM of annual sales to grow to more than 120MM if EMs grow at similar rate
- 11 trillion miles driven could more than double in 20 years
- 20 trillion in auto assets being utilized no more than an hour a day
- Disruption is driven by efficiencies, infrastructure, costs, and returns on capital

What Is A True Level 5 – AV?



AV Penetration Is Immaterial Over The Next Decade



Source: McKinsey & Company

Multiple Industries Impacted

Utilities	⊕	Automotive	?
Technology	⊕	Energy	?
Telecom	⊕	Insurance	?
Materials	⊕	Infrastructure	?

- Electric, self driving vehicles a must, to meet globally ambitious emission needs and improve the urban environment
- Autonomous capability will reduce the cost of driving sharply - by improving efficiency, improving safety, and providing billions of hours of leisure time
- Shared networks will reorganize ownership and logistics of the automotive assets to improve efficiency and reduce car population
- These developments will disrupt not just the transportation industry, but the way adjacent industries work

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Utilities - Overall a positive for the sector

Positives:

- Significant load growth from charging stations
- Significant infrastructure build, which means revenue growth
- Push to renewables, also would require new investments, rate growth

Negatives:

- Further development in battery technology/Utility scale battery storage solution there will be little to no demand peak generation, negative for merchant generation
- Car's battery, additional battery storage and solar panels, could increase distributed generation capacity in sunny states

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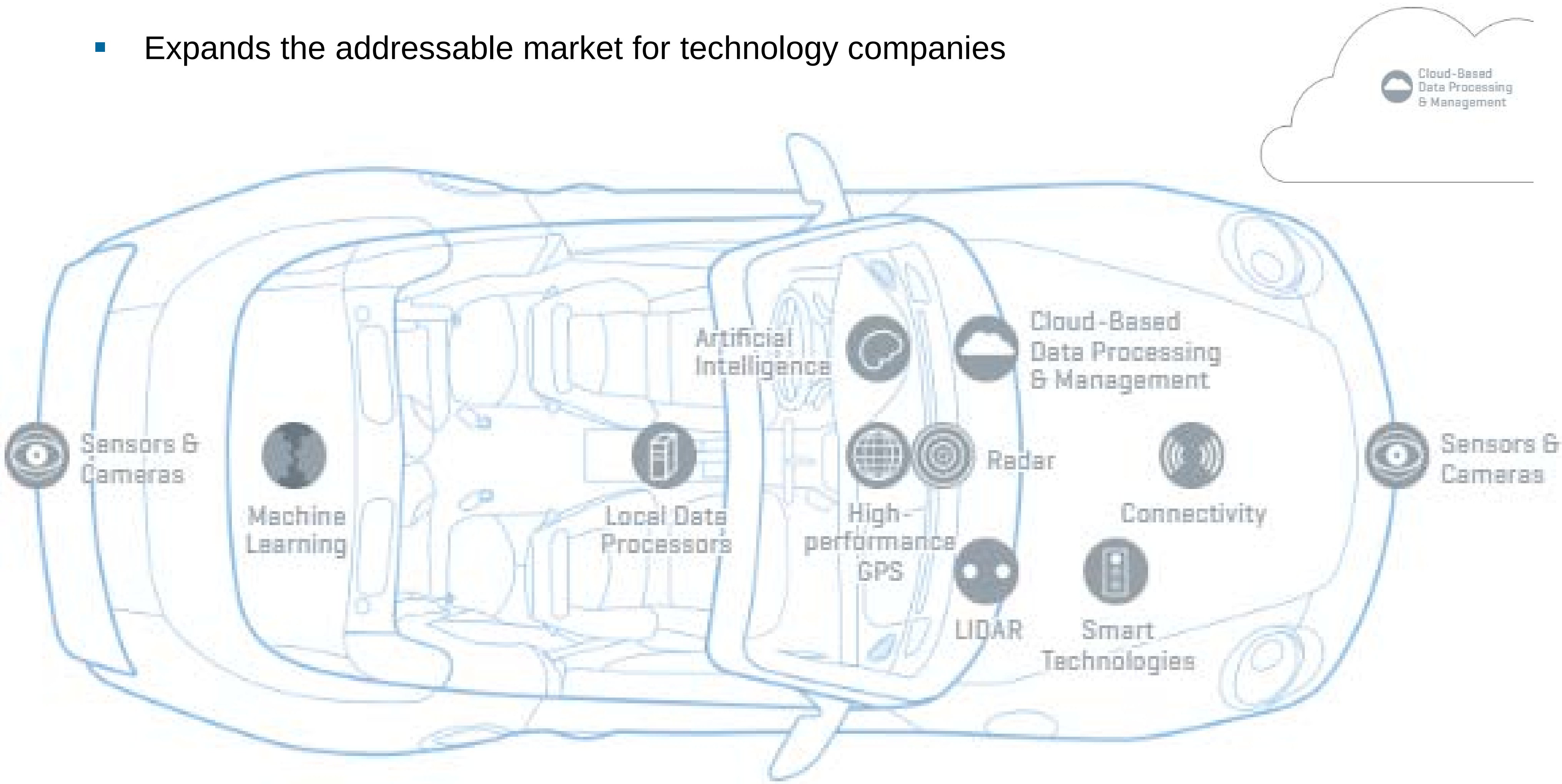
Technology - A Positive For The Sector

- Expands the addressable market for technology companies

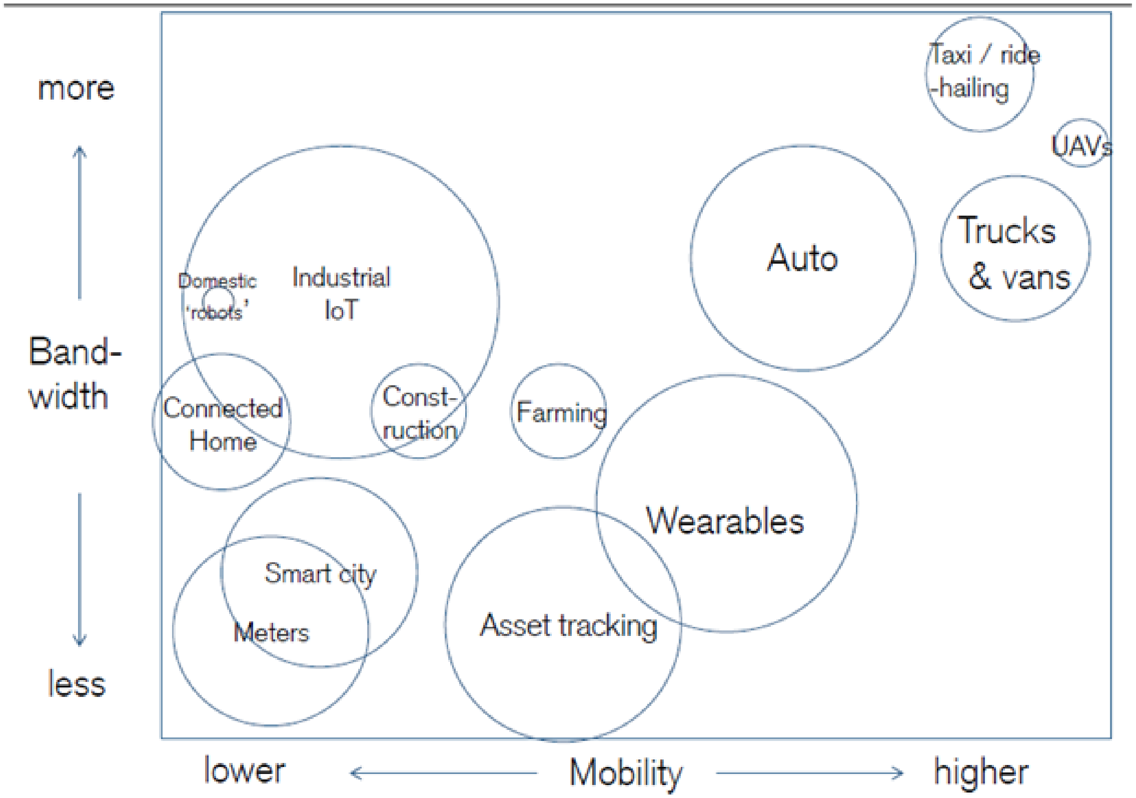


Source: MIT Technology Review 3/12/18

Telecom - A Positive For The Sector

- Cellular adoption remains uncertain
- Would be the largest driver of value compared to other connected devices
- 5G technology use cases are broad

Cellular IoT Connectivity: potential segments – Revenue per use is likely to be higher in high mobility, high bandwidth segments (e.g. auto) vs low mobility, low bandwidth segments (e.g. meters, smart city).



Source: Credit Suisse, Circle size illustrates potential segment size by number of potential cellular-IoT connections. Total IoT segments can be substantially larger, due to non-cellular connections (e.g. Home, Industrial IoT, Smart City)

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Materials - Overall A Positive For The Sector

Positives:

- Battery production will increase materials demand, requiring more Lithium, Nickel, and Cobalt, and Copper
- Infrastructure build out, such as charging stations, communication equipment on roads, additional utility infrastructure, will require more materials

Negatives:

- Reduced car production could impact demand for steel and aluminum
- Perceived increase demand can produce oversupply at times

Automotive – There Will Be Winners And Losers

Positives:

- Significant new revenue streams and potential to penetrate new segments
- At full adaption, margins should be superior
- We could see more vertical integration, example: Tech/Auto in future years

Negatives:

- High R&D and Capex will keep the AVs and EVs unprofitable for a while
- Not all OEMs will be winners in the race to penetrate a new market
- Arguably higher utilization will reduce overall need for vehicles, rental cars

Insurance - Overall A Neutral For The Sector

Positives:

- Time to transition from insuring traditional vehicles
- Accident frequency declines, but severity increases
- The potential new insurance market penetration of the following three new sub-categories:
  - Cyber Risk
  - Software and Hardware
  - Infrastructure

Negatives:

- Insurance is out of the value chain of building AV cars
- Reduction of traditional auto premiums
- Fat-tail risk hard to quantify

Energy - Uncertain for the sector

Positives:

- Consumers preference (SUV market share has increased to 68%)
- Potential changes to CAFE standards
- Demographic changes worldwide should lead to greater consumption in EM

Negatives:

- Current CAFE standards should promote EV adoption
- Battery costs continue to decline
- EV market share continues to grow (1.3% presently)

Infrastructure - Overall A Mixed Bag

Positives:

- While loosing parking demand, airports will gain real estate and revenue streams for access to the airport and reduce congestion
- New infrastructure investment, could mean new revenue sources for toll roads and charging station providers.

Negatives:

- Less need for parking, will negatively impact garages and street parking concessions
- Less cars on the roads and better technology integration will reduce toll road demand
- Less cars being shipped will reduce demand for ports and rails

Corporate Credit Investing || Is The Corporate Market Healthy?

Elizabeth Henderson

AAM Director of Corporate Credit

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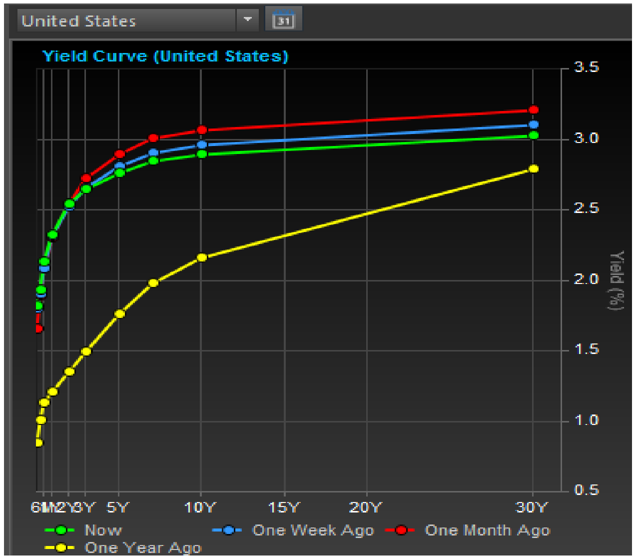
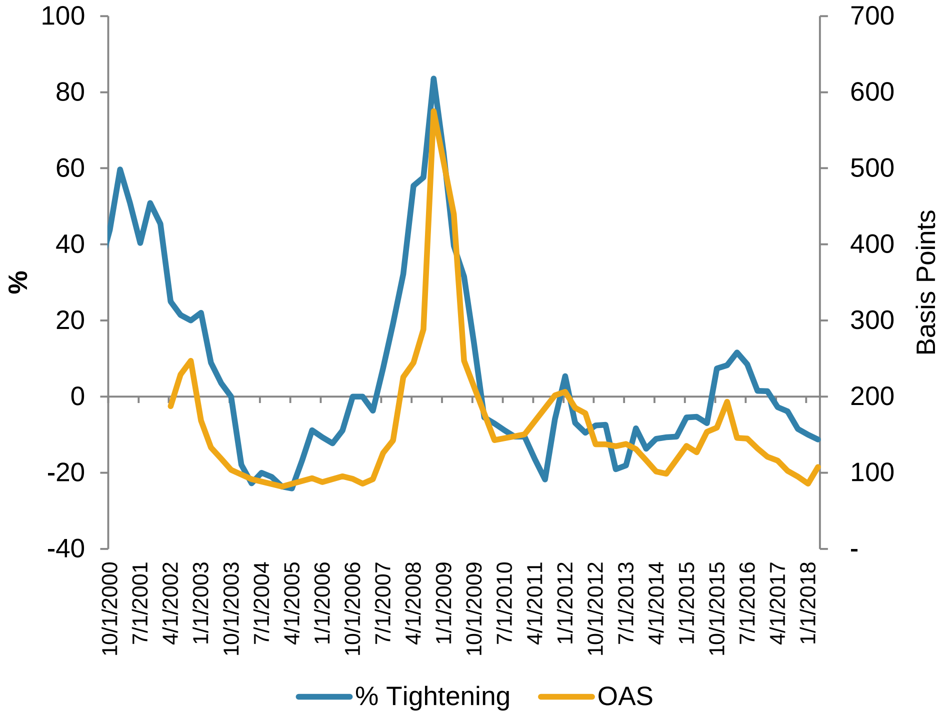
Credit cycle indicators continue to remain supportive but the UST curve is indicating potential trouble ahead

- Bank lending standards remain loose
  - Indicators indicate stability:
    - Credit Managers Index remains above 50 (expansion) and trended positively in 2017
    - GS Financial Conditions Index at 5 year average
- Capital markets are wide open
  - IPO, leveraged loans (second liens), high yield, emerging markets, private equity
- Yield curve is flattening
  - Fed in tightening mode



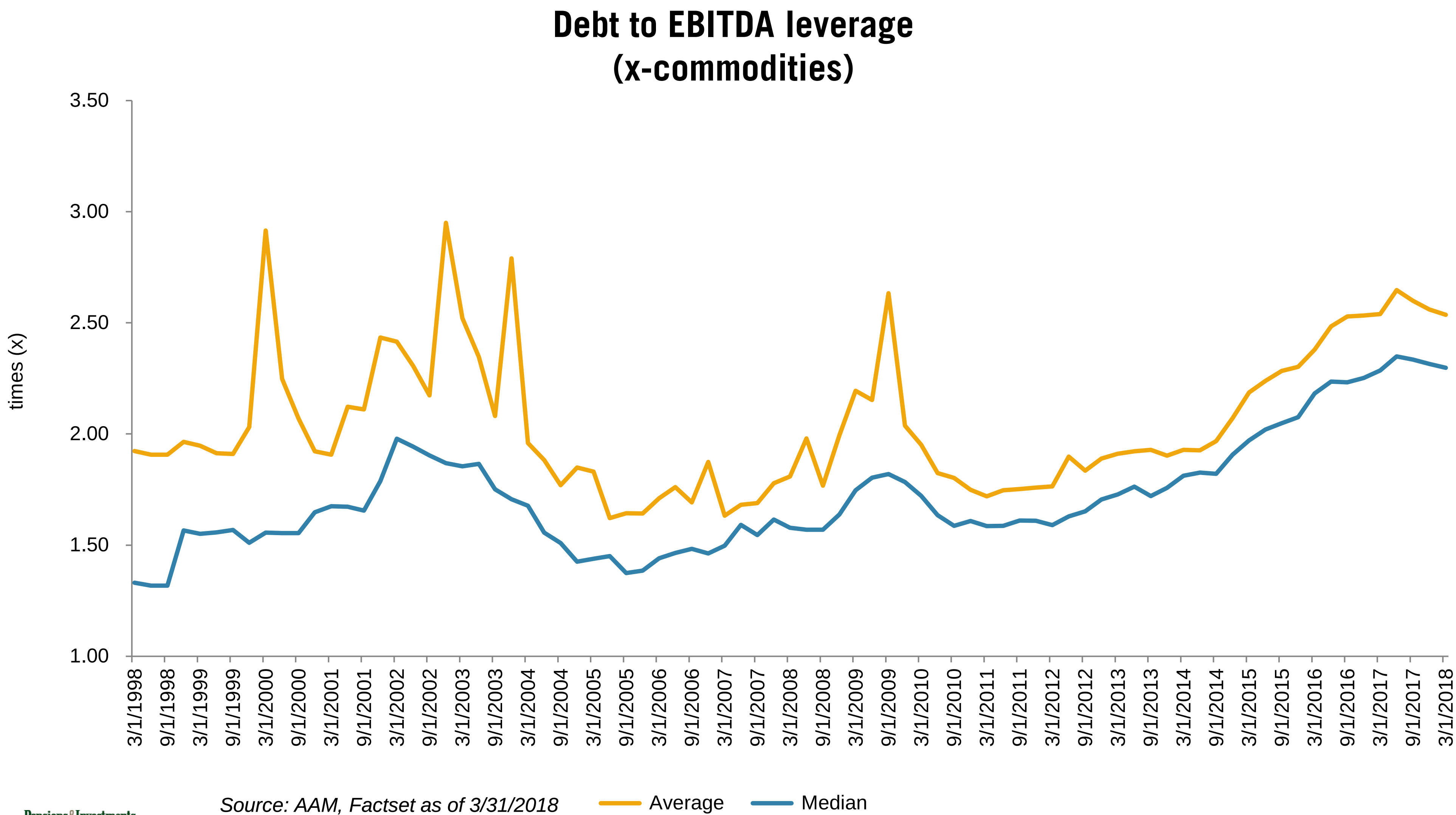
Source: Factset as of 6/19/2018

Net % of Domestic Respondents Tightening Standards - C&I Loans for Large/Medium Businesses



Source: AAM, Bloomberg Barclays, Fed as of 4/30/2018

Debt Leverage at Corporations Remains Elevated



Source: AAM, Factset as of 3/31/2018

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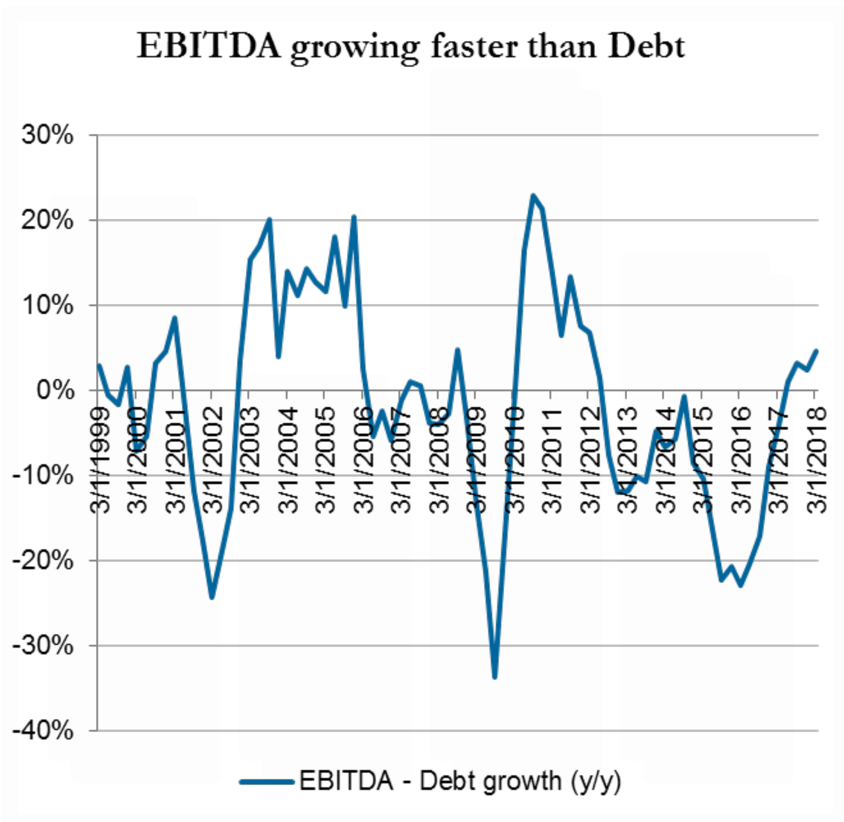
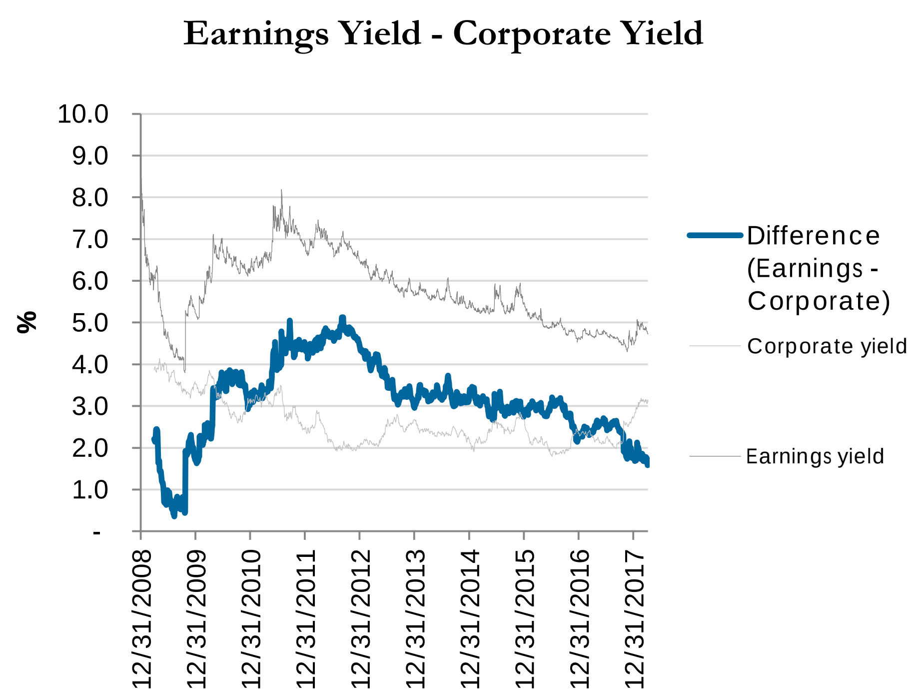
Credit Fundamentals Expected to Improve

Higher yields, a more optimistic outlook for growth and lower tax rates should make it less compelling for companies to increase debt especially to repurchase equity



Source: AAM, Factset as of 3/31/2018



Source: Bloomberg, AAM (Corporate Yields calculated using Bloomberg Barclays Corporate Index OAS plus 10 year Treasury yield multiplied by (1-corporate tax rate); Earnings Yield is for S&P 500); as of 6/11/18

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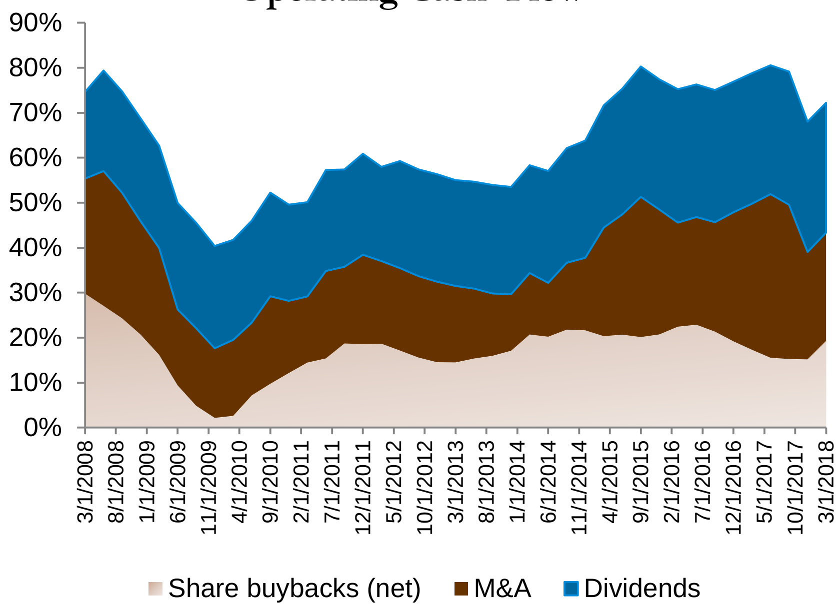
Shareholders Benefited from Tax Reform in 1Q'18

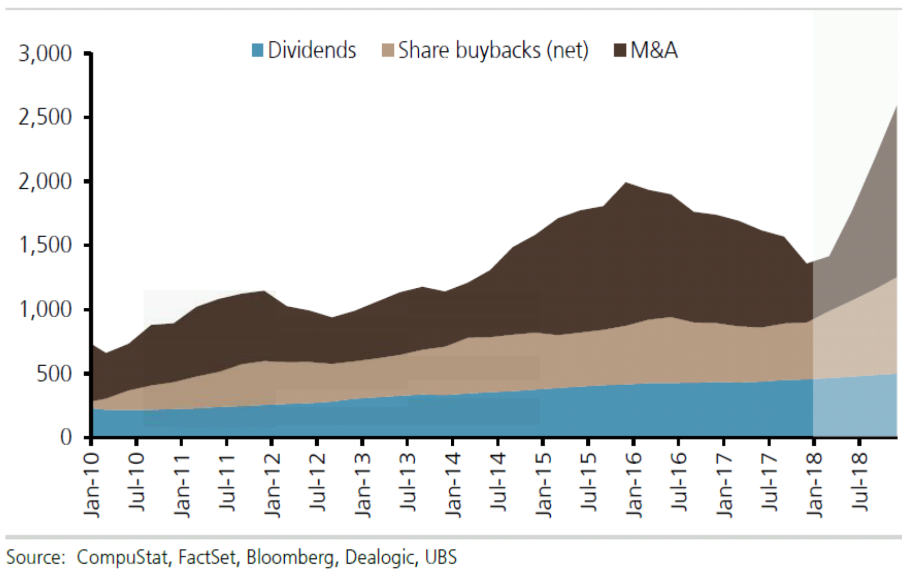
Will companies use the increased cash to reward shareholders or reduce debt?

Shareholder payments as % Operating Cash Flow



Source: AAM, Factset as of 3/31/2018

Shareholder payments ($B) – Expected to Increase



Source: UBS "US Equity Strategy: $2.5tr+ corporate "flow": where is it going?" 6/4/2018

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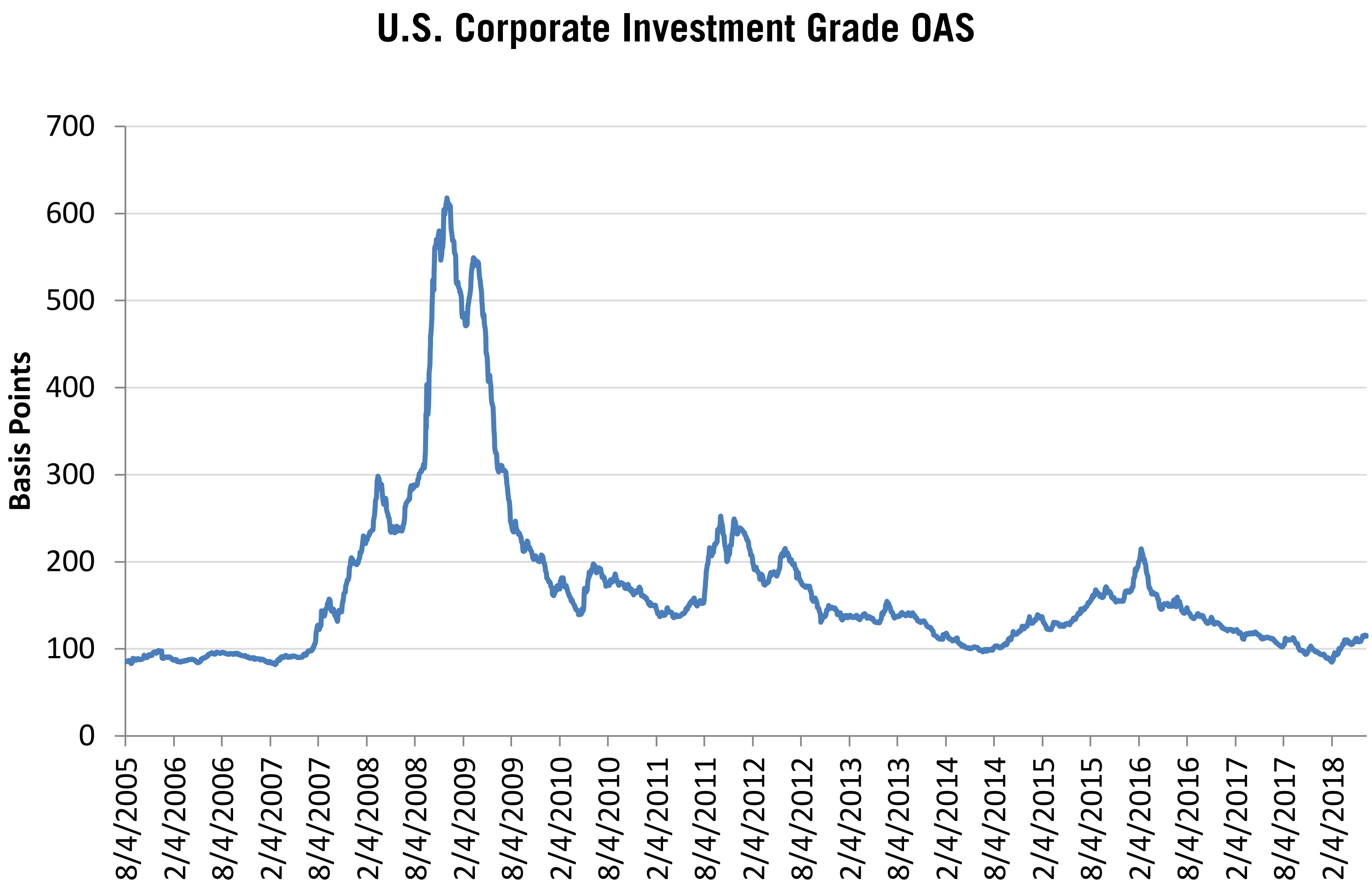
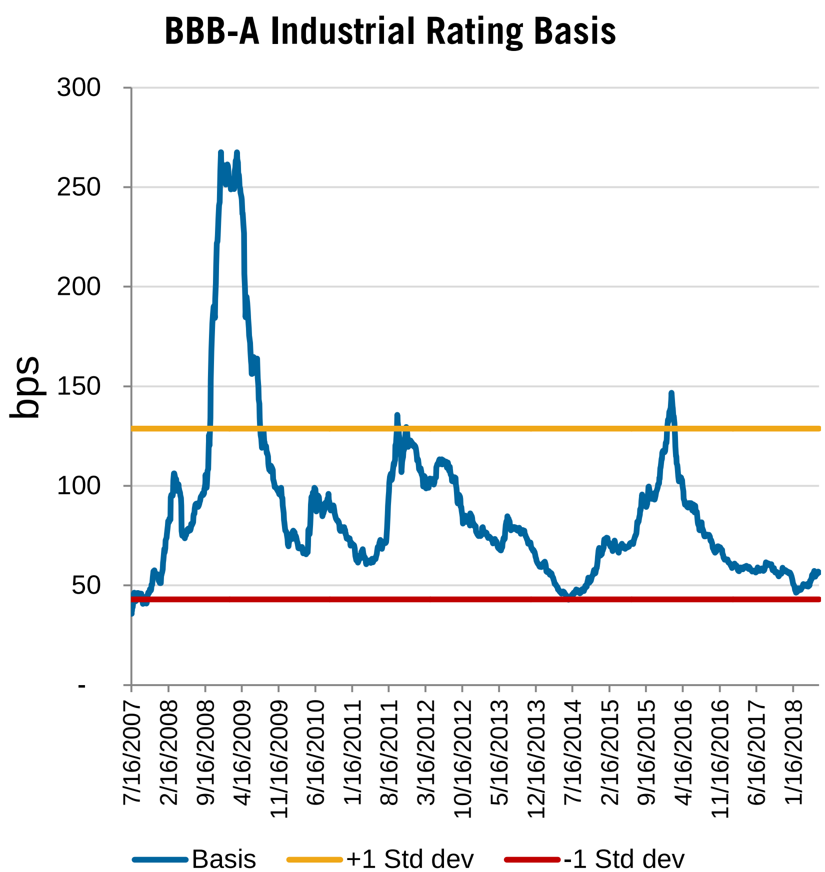
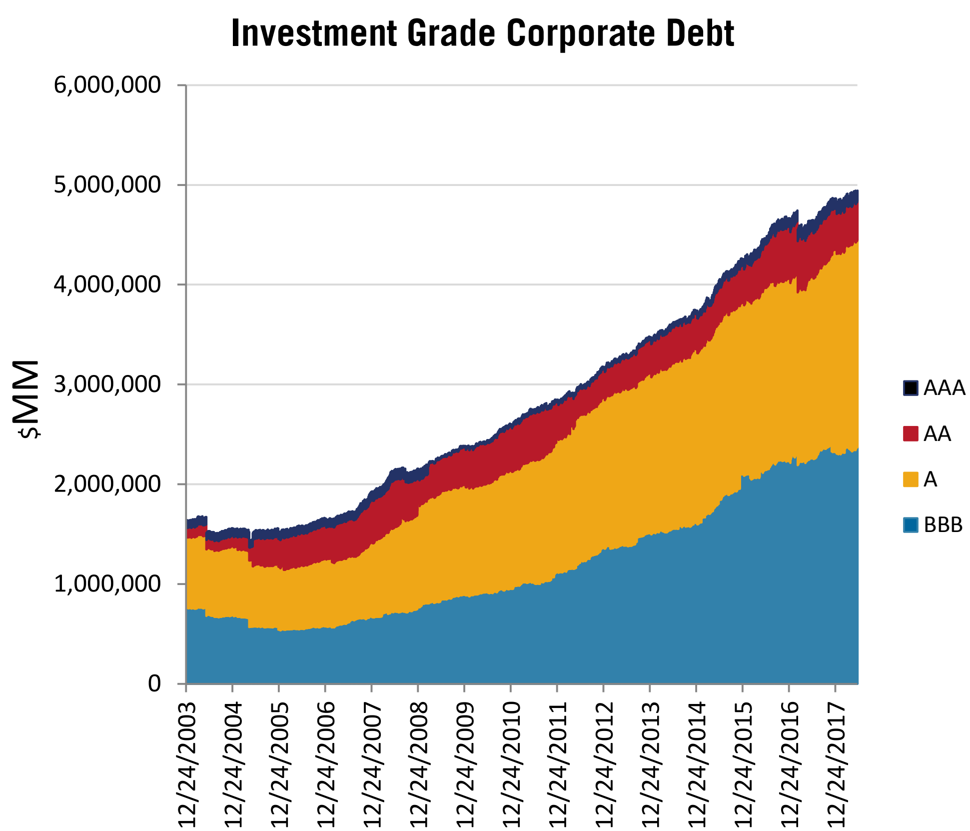
Corporate market OAS is wider YTD with heightened volatility but valuation remains historically lackluster



Source: AAM, Bloomberg Barclays as of 6/14/2018

Reduce Risk in Corporate Credit





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Source: AAM, Bloomberg Barclays as of 6/14/2018