**Investment Process, ESG, 2015-17 Mid-Cycle Different**

Add Value 🡪 Calling turning points in economy

Middle of Cycle – Capture positive returns of the market

(25+ years gotten this right)

Macro Side – We have gotten that right this cycle 🡪 Positive on the macro (led by Dan) since 2009

Despite periods of uncertainty (Euro Crisis 2011 & Fear of Global Slowdown 2015-16)

Remained positive on economic growth & kept beta in the portfolio throughout the cycle

Mid-Cycle (this cycle) our performance has been a little disappointing – Spend time on bullet 4

Why Cycle Different / What we recognized / How We Adapted / Joe Example (Responding)

Current Cycle:

Weak Demographics, Significant Excess Capital, Heightened Regulatory environment 🡪 Choppy Slow Growth – Not Accelerating Growth (like past cycles)

Slow growth 🡪 OK but not ideal environment (Rising Tide Not Lifting All Boats)

Caused 🡪 Upward Trend of Poor Sustainable Behavior from Management Teams

Mgmt. Pushing Envelope to provide adequate returns in a slow growth/low return world (ex. Pharma)

* Financial Engineering (GAAP & Non GAAP Earnings; Inversions)
* M&A 🡪 Consolidation 🡪 Raise Prices 🡪 Layoffs
* Manipulate System to Raise Prices
* Governance Issues – Apollo & Caesar’s

Technological Disruption Unprecedented 🡪 Impacted Retail / Autos / Telecom / Cable / Hard Assets

Bigger Idiosyncratic Risks this Cycle – No Major Spike in Defaults in Middle of Cycle

Slow to Recognize (Behind the Curve) 🡪 Adverse Impact on Portfolios

Hard Assets (Best Example of Slow Growth, Excess Capital, Poor Behavior, Tech. Disruption):

Historically 🡪 Hard Asset Bias 🡪 Value Protected Downside

No Major Sell Off w/out major economic slowdown

Slow Growth + Cheap Capital + Tech. Disruption 🡪 Cost to Make Things Cheaper….Cheaper….Cheaper 🡪 Hard Assets Are Now Depreciating Asset

Levering Up Depreciating Assets = Losing Strategy

Shift Focus 🡪 Reoriented Portfolios:

From: Dependent on Accelerating Growth to Grow into BS’s

Hard Assets

To: Growth / Tailwinds

Benefit from Disruption

Sustainably Managing Business

As an aside ESG (as Mike has discussed in the past) has tied into our efforts to:

Identify Change

Get Ahead of Curve

Sustainably Managed Businesses

Joe – Live Examples of How We Are:

Getting Ahead of the Curve

Reorienting the Portfolio

**How Have We Responded?**

Philosophy & Process Still the Same (25 years +):

Bonds 🡪 Limited Upside but big potential downside

Capture Yield of Market by Investing in Stable Quality Credits

Aggressively protect downside

Team & Process Still at Center of Approach

Systematic approach to ESG & SRI issues 🡪 Embedding it deeper into process 🡪 Looking through a Different Lens -- > Identify Change (Business & Industry) (Offense & Defense)

Looking closer for companies to sustainably manage their business (Social, Environment, Governance)

Don’t just look at it in terms of $ & cents

Engage with companies, investors, industry experts, sell side, buy side

Example: Valeant – Switched from developing lifesaving drugs to financial engineering 🡪 Behavior just unacceptable, morally wrong (to jack prices for essential life changing medication), and not sustainable business 🡪 Don’t know where the line is but clearly they breached it

Let Joe walk you through a couple examples but

Already beginning to pay dividends:

Past couple quarters 🡪 Performance has stabilized

Identifying Change & Disruption (Defense):

Transdigm 🡪 Aero Supplier w/2X peer margins, Lever, M&A, Fire People, Sh. Holder Friendly, Leverage, Valuation

Car Rental

Hard Assets 🡪 Less Valuable 🡪 Used to take comfort in hard asset companies (asset coverage to protect downside; but technological change and disruption + cheap capital 🡪 costs are decreasing and asset values for hard assets are as well

US Pharma 🡪 Pricing Practices

Identifying Industries & Companies Benefiting from Change (Offense):

Companies saving money for customers

Contract Manufacturing

Outsourcing

Cloud & Data Storage

Technological disruption Unprecedented:

Computing Power – significant leaps

Data Storage

Predictive Behavior

Caused 🡪 Upward Trend of Poor Sustainable Behavior from Management Teams

* Pushing harder on pricing
* Financial Engineering
* Excessive Industry Consolidation (and Raising prices even further)
* Layoffs…..Layoffs…….Layoffs
* Reduce Pay
* Governance Issues – Apollo & Ceasars
* Inversion deals

Corporate profits % of GDP all-time highs………not sustainable business practices

Think About High Yield – it is the marginal credit – Universe filled w/:

Marginal company

Marginal industry

Good company and/or industry with high leverage

Given business climate increasingly driven by change we needed to do a better job of recognizing & anticipating change in order to continue to provide outperformance

Good ESG Examples: FMG (invest in community, schools, jobs & fair labor), Nike (stopped sweat shops)

Bad ESG Examples: Valeant, Hospitals

**History:**

No Recession BUT This Cycle Is Different:

1. Low ROIC 🡪 Slower Growth (Weak Demographics, Significant Excess Capital, Slower Organic Growth, Heightened Regulatory Environment, Disruptive Technological Change) 🡪 Creating change (some ways unprecedented in post war developed world) 🡪 Not Many Willing to Accept It (especially Management Teams & Investors) 🡪 Management Teams Not Willing To Accept Lower Returns (Pushing Harder and Harder: Raising Prices, Inversion deals (taxes), Financial engineering (EBITDA vs. Adjusted EBITDA), M&A (Consolidate, Cut Costs, Fire People, Try to Raise Prices, Fire People), Increasing Leverage (especially IG))
2. Disruptive Technology 🡪 Revolution of Computing Power & Data Gathering (90% of all data created generated in past 2 years) & 🡪 Creating New Industries (Shale Oil, Data Centers), Market Places (Amazon, Uber), Methods Of Delivery (IPhone, Retail, Facebook, Robotics, TV)
3. Socially Responsible Investing (ESG) 🡪 All about Change 🡪 Systematic Consideration of Relevant & Material ESG Issues to Compliment Traditional Fundamental Analysis 🡪 Transforming the World (Demand Growing b/c Large Corporations & Large Holdings by Fiduciary Investors)

Results:

Mid-cycle 🡪 Rising Tide Has Not Lifted All Boats

Idiosyncratic & Systematic Risks Have Risen

Left Tail Has Been Bigger

Bought of Volatility More Prevalent

Default cycle in middle of economic cycle (Energy, Metals, Steel)

**1st Step = Recognize**

Philosophy & Process Still the Same (28 years running):

Bonds 🡪 Limited Upside but big Potential Downside

Capture Yield of Market by Investing in Stable Quality Credits

Aggressively protect downside through variety of risk control measures

Team & Process at the Core of What We do

And

Process always included ESG factors 🡪 Corporate Governance, Pollution

But

Slow to embrace & appreciate the significance of these changes & the impact on our market & the current economic cycle

Responsible Investing 🡪 All About Change (& Not very different & closely related to low ROIC environment & Technological Disruption)

Political Movement 🡪 NO

Short Term 🡪 NO

Impact on Investing 🡪 YES

Broad based

Organizational structures of responsible investing

Given business climate increasingly driven by change, successful investor must learn to understand & anticipate change

Realization that Responsible investing needs to be ingrained even further into investment process

Responsible investing 🡪 Embracing 🡪 Better Way to Understand Change & Manage Risk

Harmonization with our process

Investment professionals understand priorities of responsible investing 🡪 Using This to Anticipate Change (Company & Industry)

Identify ESG factors most likely to impact business & industry

Need For:

Better Understanding

Anticipating change

What Are We Doing?

Better & More Robust Use of Resources to identify change factors

Foster debate

Direct Additional research

Incorporate conclusion into our credit analysis and portfolio construction

Resources:

Broadened sources of external information:

ESG Research: MSCI, Oekom, Sustainalytics, Bloomberg

Conferences & Seminars: Equity Conferences, Milken Institute, Industry conferences (, Japan Society, Columbia Business School, CFA Institute, Sell Side)

Industry Conferences: Equity, Consumer electronics show, AI, Electric Vehicle, Vehicle of the Future, Telecommunications, Car Rental

Applied existing sources more extensively:

Internal Industry Reviews

Seek out sources

Actively engage management teams, clients, and other investors

Increasing Collaboration with Nordea

Not interested in overall ratings but the reasons why? What weighting would we put on the factors?

Context is warranted 🡪 what is the price & what are the ESG issues 🡪 if not we would own very little fossil fuels & US Pharma

**Results:**

Identify potential pockets of risk resulting from structural change (Hard Asset, Manufacturing, Telecommunications, Car Rental, Auto, Cable, Healthcare)

Identify attractive opportunities: Sprint, Bombardier, Healthcare (outsourcing),

**2nd Step = Acting 🡪 How Have We Acted To Implement Changes?**

Adjusted to New Reality

More Sensitive to Idiosyncratic risks

Focus: Superior products, quality, pricing power, companies benefiting from change

More skeptical of hard asset values as “things” become cheper and cheaper to produce

Advances in technology & demographics…..& society’s response 🡪 Creating change (some ways unprecedented in post war developed world)

Direct impact on multitude of industries and the competitive landscape

Increasingly clear – additional opportunities BUT increased likelihood of materially negative societal effects

Societal risks magnified by business leaders seeking to perform in a low ROIC environment