Quarterly Investment Perspective

Taking Too Much Credit

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Chief Investment Officer

Executive Summary

- Different types of credit analysis figure prominently in Bessemer's investment process
- This summer, the credit rating of the U.S. may come back into question as politicians debate the debt ceiling
- We are also focused on late-cycle credit dynamics around municipal bonds and U.S. corporate debt, the latter an important signal for equities
- While a recession does not appear imminent, we are using pockets of equity strength to incrementally reduce portfolio risk, preparing for a slower global economy in the year ahead

Credit means different things to different people. It's a score that determines if a young couple can afford a mortgage for a new home. It's a piece of plastic that allows college students to pay for spring break vacations. It's a corporate decision on how to manage a balance sheet and drive growth. It's a large and complex asset class. It's a measurement of financial health for companies, cities, states, and even countries.

In this edition of our *Quarterly Investment Perspective*, we share three examples of how we incorporate credit in investment decisions. Specifically, we discuss the relevance of country credit ratings — the U.S. in particular in light of the political debate likely to erupt this summer over the government's debt ceiling. We also share how we conduct credit analysis on municipal bonds and why such research is critical for managing risk and uncovering attractive opportunities. Finally, we explain why we are wary of U.S. corporate credit — and why trends in this asset class matter for equities. While different, all three examples show the important role that credit plays as we construct client portfolios.

As usual, we conclude with thoughts on recent performance and our market views. Following an extremely strong start to the year in equity markets, we decided in mid-February to incrementally reduce our equity exposure, shifting capital to fixed income. As the year progresses, our intent is to use periods of equity strength to further de-risk portfolios, as we believe that 2020 is unlikely to be as supportive for risk assets.

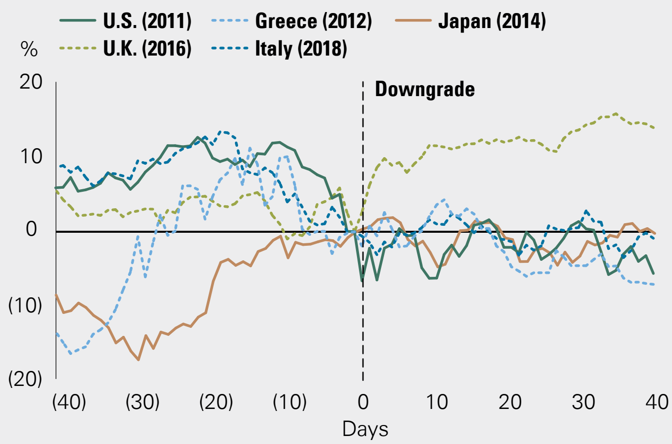
The Debt Ceiling and Sovereign Downgrades

Country credit assessments, issued by rating agencies such as Standard & Poor's (S&P), Moody's Investor Services, and Fitch Ratings, are meant to assure investors of sovereign financial stability and ability to repay debt. Those sovereign credit ratings are building blocks for valuations of other assets in the respective country. Most directly, they influence the country's government bond yields (lower credit ratings usually push borrowing costs higher, as investors demand more return for the greater risk that they will not be paid back). Ratings also impact other types of debt issued in the respective country; indeed, the main rating agencies have a "ceiling" that prevents corporate debt ratings from exceeding that of the country's debt. More generally, sovereign ratings can be inputs as investors decide how much they want to allocate to a given country.

Sovereign ratings are based on a handful of key variables, including per capita income (more tax revenue increases a government's ability to repay debt), economic growth, the amount of total public debt, and inflation. Default history, sovereign debt held by foreign investors, and political stability are also considered.

Exhibit 1: Equity Performance 40 Trading Days Before and After a Sovereign Credit Rating Downgrade

Key Takeaway: Typically, equities have tended to come under pressure prior to sovereign debt downgrades.



As of 2019. Equity performance is measured in local currencies and reflects changes in the price level. Equities are measured using: U.S. (S&P 500), Greece (Athens Exchange), Japan (Nikkei 225), U.K. (FTSE 100), Italy (FTSE MIB). Country (credit rating agency, downgrade, and date of downgrade): U.S. (Standard & Poor's, AAA to AA+, August 5, 2011), Greece (Moody's, Ca to C, March 2, 2012), Japan (Moody's, Aa3 to A1, December 1, 2014), U.K. (Standard & Poor's, AAA to AA, June 27, 2016), Italy (Moody's, Baa2 to Baa3, October 19, 2018).

Source: Bloomberg

Credit ratings are reviewed regularly; in the case of S&P and Moody's, they range from AAA (the best rating among what is considered investment grade) to D for default (a rating of C suggests a country is highly vulnerable to default). Countries are put on "watch" by agencies if a rating change is likely in the near term. Such announcements can move markets significantly, although quite often, the market adjustment to a rating change comes ahead of the change itself as investors note the trends in relevant key variables. Indeed, a look at some sovereign rating downgrades in recent years found that while equities tended to fall after a rating was lowered, in many cases the markets were already under pressure before the news of the rating change (Exhibit 1).

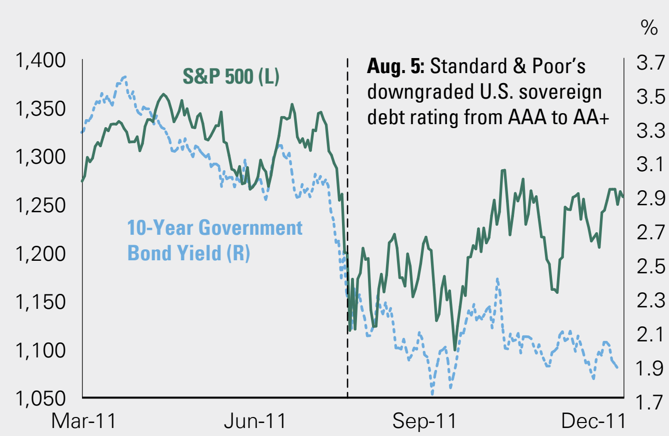
We expect that the U.S.' sovereign rating will come back into focus this summer as Congress faces increasing pressure to raise the debt ceiling (the limit on the amount of federal debt that the Treasury can accumulate). The ceiling was hit in March and is now being extended through "extraordinary measures." Lifting the ceiling (currently around $22 trillion) requires legislation and the president's signature.

Given the dysfunctional nature of U.S. politics today, we cannot rule out a repeat of 2011, when Congress fought over the debt ceiling and fiscal policy to the extent that S&P cut the U.S. credit rating on August 5 (the first time in history that the U.S. had a sub-AAA rating). In that instance, even though the other major rating agencies did not follow with their own downgrades, U.S. equities fell ahead of and following the rating change: Between early July and early October 2011, the S&P 500 lost about 15%. In addition, the U.S. General Accounting Office (GAO) estimated that delays in raising the debt limit in 2011 led to an increase in the Treasury's borrowing costs of about $1.3 billion for that fiscal year.

Interestingly, and in contrast to the pattern seen in most countries, the 2011 U.S. downgrade resulted, at least for a period, in *lower* U.S. government bond yields and a *stronger* currency. Despite the fact that U.S. debt was deemed riskier, investors wanted the perceived safety and liquidity of U.S. bonds, buying dollars in the process (Exhibit 2).

Exhibit 2: S&P 500 and Bond Yield Changes Before and After U.S. Sovereign Debt Downgrade

Key Takeaway: In the U.S., 10-year government bond yields dropped significantly after the August 2011 downgrade as investors moved away from risk assets and into U.S. bonds.

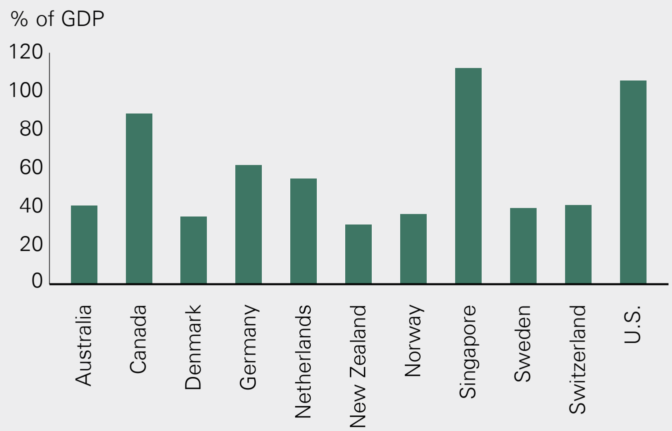


As of 2019.

Source: Bloomberg

Exhibit 3: Gross Public Debt of AAA-Rated Countries

Key Takeaway: The U.S.' gross public debt is the highest of triple-A rated countries except Singapore, which primarily issues debt to ensure a deep bond market as opposed to using it for budgetary needs.



As of 2018. Percent of GDP is average 2017–2018.

Source: Bloomberg, International Monetary Fund

Today, the U.S. remains triple-A by Moody's and Fitch and AA+ by S&P. Compared with other AAA countries, the U.S.' rating looks a bit shaky. Gross public debt is the highest among the triple-A club with the exception of Singapore, where public debt is not required for budgetary needs (in contrast to the U.S.) but rather is issued primarily to ensure a deep local bond market (Exhibit 3). The U.S. also stands out with respect to debt held by foreign investors (around 28% of total debt) — Japan and China are the largest single foreign holders of U.S. government paper, mainly via respective central bank reserves.

Equally significant, the rationale for the 2011 downgrade again appears in place. Back then, S&P officials noted "that the effectiveness, stability, and predictability of American policymaking and political institutions have weakened at a time of ongoing fiscal and economic challenges...." The same can certainly be said today, with a budget deficit of 4.4% of GDP (despite an unemployment rate at multidecade lows) and consensus expectations that the deficit will widen toward 5% of GDP in the coming years, not to mention an incredibly polarized Congress, as was seen during the early 2019 government shutdown.

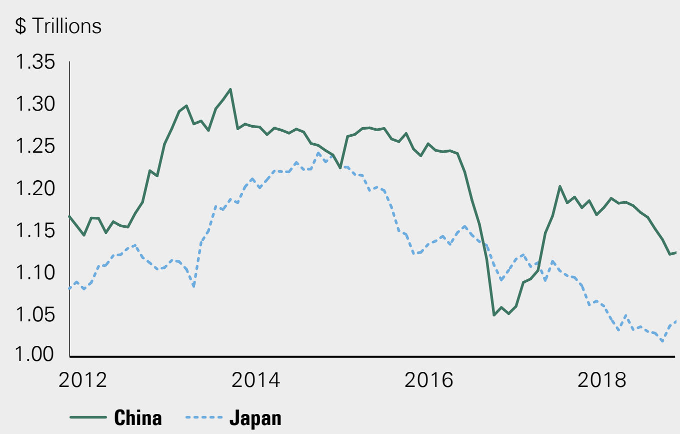
Even if the debt ceiling is ultimately increased, avoiding default and potential further U.S. credit downgrades (our base case), a "game of chicken" into the final deadline would likely unnerve investors, pulling equities lower. While this reaction would probably be short-lived, there could be a longer-term consequence, with foreign holders of U.S. bonds increasingly searching for alternative defensive, liquid assets; currently only 8.3% of the 133 countries rated by S&P have a triple-A grade, down from 16% triple-A a decade ago (Exhibit 4). A structural shift in the perceived safety of, and demand for, U.S. Treasurys would increase America's borrowing costs, ultimately weighing on growth.

Municipal Bonds: The Credit Details Matter, a Lot

Bessemer Trust trades tens of thousands of municipal bonds each year on behalf of clients. Municipal bonds can help diversify a portfolio and protect capital in market downturns, while also providing tax benefits (the vast majority of municipal bonds are exempt from federal income taxes and, in certain instances, from state and local income taxes as well). Munis are truly

Exhibit 4: China and Japan Holdings of U.S. Treasurys Declining

Key Takeaway: Debt-ceiling drama could lead foreign investors to further reduce Treasury holdings.



As of December 31, 2018.

Source: Bloomberg, U.S. Treasury

unique within the investment universe — each bond, like a fingerprint, is different. The town or state, the source of funds to pay off the debt, the time frame of the debt in question — these and other special attributes make deep, thoughtful credit analysis on each bond imperative.

So how does Bessemer go about such research? We do not start with bond credit ratings. While we respect the agencies doing this work, we prefer to do our own bottom-up analysis, only comparing our view to what the rating agencies have to say at the end of our process. Indeed, for some municipal bonds, there is no credit rating at all; they are not required and sometimes are viewed by issuers as not worth the up-front investment versus the amount of capital being raised.

Our credit research team studies a number of factors for each muni bond considered for purchase:

- The economic outlook for the area in question (employment base, government policies, quality of infrastructure, etc.)
- The area's revenue base (economic diversity, revenue catalysts, etc.)
- Any constitutional, statutory, or regulatory limits on the issuer's ability to alter the revenue or expense base
- Governance (demonstrated long-term budgetary/capital planning)
- Scope/nature of services provided (full-service municipality versus a water/sewer enterprise)
- Legal provisions of the bond (nature of pledge, revenues securing the bonds, and leverage constraints)
- Issuer financial disclosures (are they timely/transparent/thorough)

Conventional wisdom suggests the safest munis to own are bonds issued to finance essential governmental infrastructure, in contrast to projects such as multipurpose arenas or hotels (even in a recession, municipalities will try to make sure residents have water and working sewers). Refunded bonds are also attractive from a credit-quality standpoint. Similar to refinancing a mortgage, a municipality will issue bonds at a lower interest rate in order to prepay bonds issued at a higher rate. Until the redemption date, the refunded bonds are fully secured by escrow accounts most often invested in U.S. government and/or government agency securities. Comparative returns may be attractive as well. For example, a refunded California public higher education bond recently traded at a 1.50% yield versus a comparable AA+ rated California school district bond with a 1.36% yield.

Further, investors tend to lean toward states with sound governance, healthy reserves, and well-funded pension plans because deteriorating state finances can trickle down and impact local government operations and credit quality via reductions in the payment of state aid. Illinois provides a good example here: As of January 2019, the state reported that it had some $8.06 billion in unpaid bills and an estimated year-end deficit of $1.6 billion — in addition to massively underfunded pension liabilities. Moody's and S&P give the state a credit rating of Baa3/BBB-, respectively, both one grade above "junk" status.

While many investors would (understandably) shy away from all Illinois munis for now, given the state's very challenged finances and the risk that slower economic growth could also weigh on municipal credit quality, we take a different view. While we do not concentrate holdings in financially challenged states by any means, we believe there can be opportunities everywhere — with sufficient due diligence and in-depth credit research.

Consider bonds issued by a major Illinois public university. The university is nationally ranked and research-focused, with three campuses. It has a broad array of highly regarded graduate and professional programs — with substantial interest from out-of-state students. The university has shown strong governance, with consistent, positive operating cash flow margins, even when state funding was delayed or reduced.

Because of the university's home in Illinois, these munis traded (as of mid-March) at a 2.28% yield — 32 basis points above similarly rated (single-A) "out-of-state" muni bonds with the same maturity (2025). We believe that this is a case of "the baby being thrown out with the bathwater." The university's ability to pay these bonds, in our view, is strong and not materially at risk by the state's overall financial picture.

As of the first quarter of 2019, clients held municipal bond portfolios comprised of high-quality bonds with a strong average rating of AA. The portfolios are structured with a greater average duration (price sensitivity to yield changes) than usual because we expect U.S. economic growth to moderate in the coming quarters. Slower economic growth tends to dampen inflation expectations, driving yields lower (and bond prices higher), so we believe the positioning of the portfolios should benefit from this trend while also generating a higher portfolio yield. Credit spreads are historically narrow, with the spread between highest-quality AAA-rated and lowest investment-grade BBB-rated bonds at only 0.82%, down from 3.54% 10 years ago (Exhibit 5). This means investors are hardly demanding any additional yield to hold these riskier assets. If the economy moderates, we expect investor sentiment to change quickly and materially. As a result, we do not think it is a good idea to "stretch" for yield when investors find that today's miniscule credit spreads of lower-quality munis can easily be more than offset by a loss in relative value when credit spreads eventually widen.

Exhibit 5: Municipal General Obligation Yield Spread — BBB-Rated vs. AAA-Rated

Key Takeaway: Municipal bond quality spreads are at historical lows.

As of March 18, 2019. Bps stands for basis points.

Source: Municipal Market Analytics (MMA)

U.S. Corporate Debt: BBB Buzz

While credit comes into play across asset classes and in different ways, the term is most frequently used by investors when speaking about the U.S. corporate debt market. Including loans, bonds, and other debt securities, this market tops $14 trillion, larger than similar markets in France, Japan, the U.K., and Germany combined. The size of the U.S. credit market in part is a function of the large American economy, though it is also a reflection of a cultural acceptance of borrowing through financial markets rather than only the banking system.

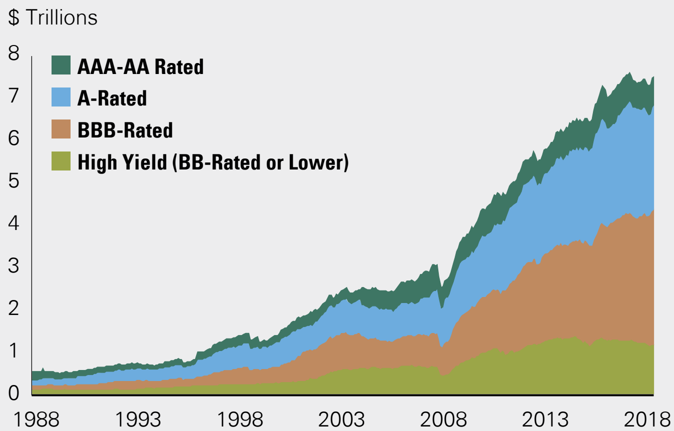
The last decade has seen explosive growth in U.S. corporate debt issuance — nonfinancial corporate debt today stands at 74% of GDP, a record high. The growth shouldn't surprise anyone — after all, the Federal Reserve, through quantitative easing (QE), made borrowing extremely attractive. Ten-year U.S. Treasury yields since January 2009 have averaged 2.5%, versus an average of 5.8% over the previous two decades. Many firms looking to expand would have seen better value in issuing debt versus equity over this last business cycle.

Two corners of the U.S. credit market stand out today, presenting material risks to cyclical assets more broadly when either growth and earnings slow or interest rates rise: lower-tranche investment-grade bonds and leveraged loans.

As noted earlier, bonds can be rated investment grade (higher credit quality) or non-investment grade, also called high yield or "junk." As many investors insist on only owning investment-grade debt, corporations may try hard to ensure their financials qualify them for investment grade, as the stamp of approval can get them greater investor interest, which in turn can help keep their debt-servicing costs low. Anecdotally, it seems this cycle has seen a lot of firms push to cross that threshold, achieving BBB credit ratings — the lowest rung on the investment-grade credit ladder. Currently, more than 45% of nonfinancial investment-grade bonds are rated BBB, up from 33% at the end of 2008. For BBB-rated corporations themselves, leverage has increased from 2.2 times earnings in 2008 to nearly 3.4 times in mid-2018.

Exhibit 6: U.S. Corporate Bond Market Credit Rating Breakdown

Key Takeaway: In the last decade, the size of the BBB-rated segment of the corporate credit market has grown markedly as companies have pushed to achieve investment-grade status.



As of February 28, 2019. U.S. corporate bond market is measured using ICE Bank of America Merrill Lynch U.S. Corporate Index.

Source: Bloomberg, Bank of America Merrill Lynch

Downgrades and Disruption

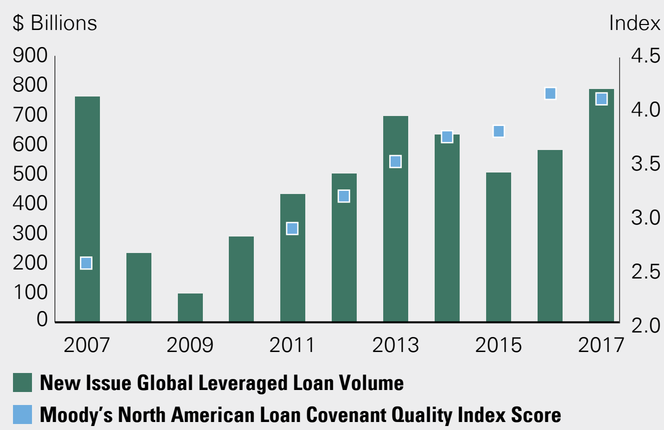
In addition to avoiding certain bonds within the BBB space, we consider the risk that a large number of downgrades could be disruptive to the markets overall, debt and equity alike. This is a valid concern, in our view, because of the probability that the economy may slow in the coming quarters, making it more difficult for companies to pay off or refinance their debt, and likely causing ratings agencies to downgrade credit ratings. The volume of BBB debt dwarfs the high-yield market today, at 2.5 times the size. Investment mandates are often delineated between investment grade and high yield, implying there would likely be forced sellers of downgraded investment-grade bonds and not sufficient appetite from high-yield investors for such a large influx of supply (Exhibit 6). We note that the market would likely react ahead of actual downgrades, with spreads on lower-rated investment-grade bonds likely to widen alongside concerns regarding the economy, before credit ratings agencies react.

In addition to the risks around lower-quality, "just barely" investment-grade debt, we also highlight similar risks around another corner of the credit market: leveraged loans. These loans, usually made to relatively riskier firms with already large amounts of debt on balance sheets, are often used to refinance existing debt or finance mergers or acquisitions. Global issuance of leveraged loans reportedly hit a new record last year at well over $700 billion, with new debt providing fewer protections for buyers (what is often called covenant lite [Exhibit 7]). In our view, this reflects investors' search for higher yields in a world where government bond yields have remained unusually low. Leveraged loans are often packaged and sold as collateralized loan obligations, or CLOs, and are attractive for their floating rates (a hedge against rising Treasury yields).

For all types of corporate credit, we note that despite growing volumes of debt outstanding, trading liquidity has declined over recent years — in part following post-crisis regulatory changes. A less liquid market is not an issue when there are plenty of yield-hungry buyers. However, when investors decide to lighten exposure to this part of the investment world, perhaps because of expectations that earnings will slow, this lack of liquidity can exacerbate price declines — potentially increasing broader investor anxiety in the process.

Exhibit 7: Leveraged Loan New Issuance and Loan Covenant Quality Index Score

Key Takeaway: Global leveraged loan issuance continues to expand while covenant protections have grown weaker.



As of 2017. The Moody's Loan Covenant Quality Index score is a yearly average; data are unavailable from 2008 to 2010 due to lack of rated leveraged loan issuance. A higher Covenant Quality Index score represents weaker covenant protections (scale is 1 [strongest] to 5 [weakest]).

Source: International Monetary Fund, Moody's

Importance of Active BBB Management

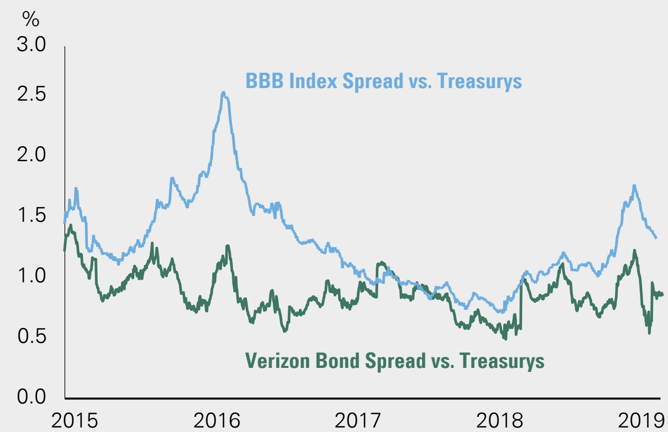
Even though there are concerns regarding the overall deterioration in credit quality and the growth of the investment-grade bond market, it is important to remember that not all investment-grade bonds (just like municipal bonds) are created equal. The growth in BBB corporate bonds has been driven, in part, by strategic corporate actions aimed at creating shareholder value. Some companies sacrificed their A ratings and increased their debt levels in order to fund acquisitions, dividends, and share buybacks. Management teams made these decisions in light of a low-interest-rate environment and a historically low cost of debt relative to equity.

Active portfolio management and credit selection help minimize risk and maximize return when investing in BBB corporate bonds. In general, Bessemer mandates have not found value in the debt of companies that have overly relied on leverage rather than adjusting business models amid market pressure. For example, a number of companies in the consumer staples sector have suffered as Amazon and other direct-to-consumer models have taken market share. Increasing leverage without directly addressing this market shift is unlikely to be a successful long-term strategy, in our view, and we have avoided many names in this area.

On the other hand, Verizon Communications, a large telecommunications firm, is an example of a company whose bonds are rated BBB+ but still offer relative value given the impact of the company's fundamentals on its credit profile. Verizon made the strategic decision to take on more debt in order to buy Vodafone's wireless assets. Its leading market position and significant cash flow allow the company to manage its BBB+ rating. Although in 2017-2018, Verizon's yield advantage over Treasurys merely paralleled the broader BBB index, most recently those supports were on display, helping Verizon's spread to widen less than those of its other BBB peers.

Exhibit 8: BBB Index Spread to Treasurys versus Verizon Bond Spread to Treasurys

Key Takeaway: Verizon's financial wherewithal in managing its BBB+ rating is visible in its spreads relative to U.S. Treasurys, which have widened less than the broader BBB index relative to Treasurys.



As of February 28, 2019, for BBB index spreads; as of March 15, 2019, for Verizon bond spreads.

Source: Bloomberg

That gets us to the linkages between credit and equity markets. If debt service becomes difficult for a company, it may be forced to take steps such as cutting back on research and development, capital expenditures, or return of capital to shareholders. These initiatives can impact future growth potential and, in turn, equity prices. Not surprisingly, then, equity investors at times interpret weakness in credit markets as a sign that equity valuations are too elevated.

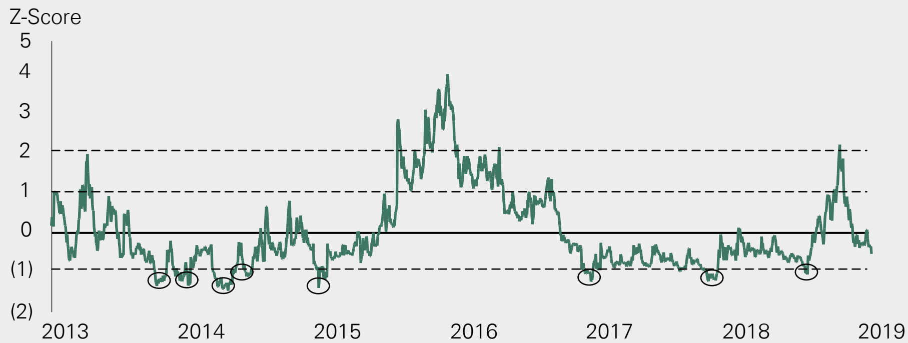
On the other hand, exuberance in high-yield credit markets relative to investment-grade credit can signal that investors have become too complacent regarding the risks associated with higher-yielding assets. Historically, when the difference, or spread, between the junk bond credit default swap (CDS) index and the investment-grade CDS index narrows (moves lower, see Exhibit 9), this indicates that investors may be taking excessive risk. Conversely, when this spread widens (moves higher, Exhibit 9), this tends to indicate that investors are favoring quality companies over higher-yielding names. (Credit default swaps are financial instruments used as a type of insurance against the risk of a bond default.)

When the high-yield versus investment-grade CDS spread widens aggressively, there are likely larger macroeconomic factors at work. For example, with energy companies comprising the largest weighting (15%) within the U.S. high yield credit index, a sustained move in the price of oil can be a primary driver of this spread. The spread widening between

The first quarter of 2019 started with a bang. In part because of the extraordinary end-2018 selloff and subsequently lower valuations and cleaner investor positioning, the stage was set for a bounce.

Exhibit 9: Spread Between the U.S. High-Yield and Investment-Grade Credit Default Swap Indices

Key Takeaway: Too much exuberance in the high-yield market can signal investor complacency regarding risk. When the spread shown below moves lower, investors may be taking too much risk, and on the flip side, as the spread moves higher, investors are tending to favor higher-quality names over higher-yielding ones.



As of March 20, 2019. Reflects z-scores, which measure the number of standard deviations from the mean a data point is. Reflects the Markit CDX North America High Yield Index and the Markit CDX North America Investment Grade Index.

Source: Bloomberg, Markit

the first quarter of 2015 and the first quarter of 2016 as well as the widening that took place in late 2018 was largely driven by falling oil prices.

First-Quarter Review and Look Ahead

The first quarter of 2019 started with a bang. In part because of the extraordinary end-2018 selloff and subsequently lower valuations and cleaner investor positioning, the stage was set for a bounce. That bounce was triggered in large part by two factors: increased hopes for a resolution to the U.S.-China trade war, along with a much more dovish Federal Reserve. As we wrote in our March 2019 *A Closer Look,* "Beyond the Deal," both U.S. and Chinese leaders seemed more inclined to reach a compromise as the year-end threatened much slower growth and weaker respective equity markets — the change in rhetoric was followed in early 2019 by a series of trade negotiations both in Beijing and Washington. Meanwhile, the Fed also changed its tone around year-end, noting tighter financial conditions and weak growth overseas to help rationalize a pause in monetary tightening. As 2019 got under way, this pause was reinforced by two other Fed factors. First, officials increasingly discussed the potential to end balance-sheet reduction (so-called quantitative tightening) later in the year. Second, they increasingly introduced the possibility of a new inflation framework that would target an inflation level "on average" over the course of an economic cycle, implying more room to let inflation run above target for a period of time — and, in turn, keeping policy looser to allow that inflation overshoot.

While global growth softened in the first quarter versus late 2018, equities climbed higher, helped by multiple expansion that, in turn, was driven by expectations for low-for-long borrowing costs and a better global trade picture.

We took advantage of those early 2019 gains to incrementally reduce our equity exposure, in favor of fixed income, in mid-February. Even moving to a very modest equity underweight, performance of portfolios remained solid into the end of the quarter, helped by security selection in some mandates as well as regional exposure (overweight the U.S., close to neutral on emerging markets, and notably underweight developed Europe). As of March 29, preliminary returns on a 70/30 "Balanced Growth" portfolio were 9.8% versus 9.1% for the benchmark in the quarter.

As we look ahead, we believe equities can appreciate further near term, but that upside is growing more limited. A U.S.-China trade resolution, with subsequently stronger growth sentiment and rising wages, could put a Fed hike back on the table — creating a source of market volatility as higher interest rates are no longer discounted by investors. Meanwhile, other risks still lurk — from (a delayed) Brexit to the U.S. debt ceiling to other trade worries (including global autos).

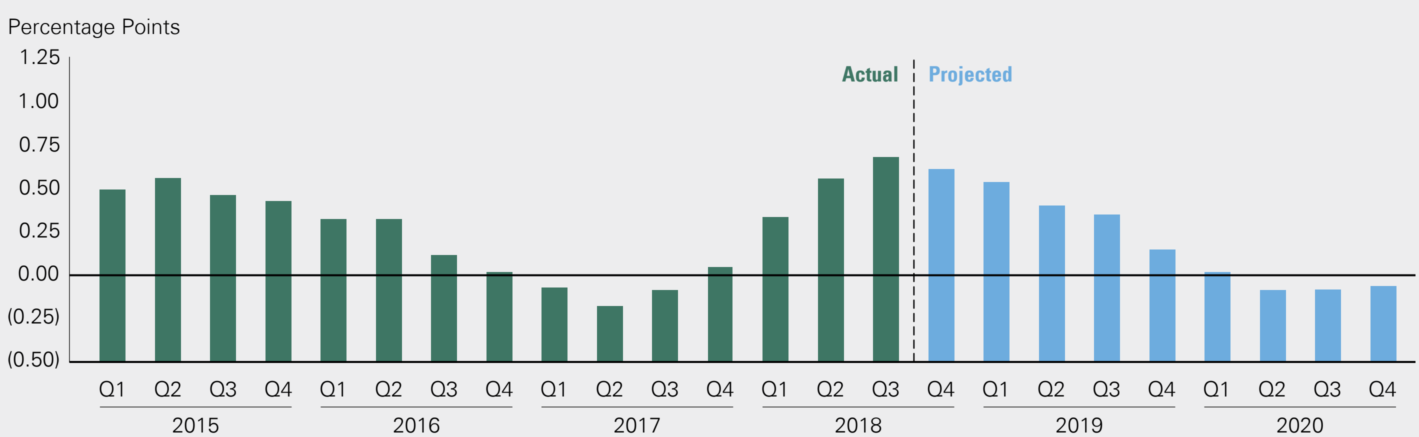
Our intention is to continue using periods of equity strength to again reduce portfolio risk. We expect global growth to moderate into 2020 — in part as U.S. fiscal stimulus turns into a fiscal drag and weighs on the world's current engine of growth (Exhibit 10). That, in our view, will leave the global economy, and corporate earnings, more vulnerable to shocks.

With special thanks to J.P. Coviello, Phyllis King, Holly MacDonald, David Rossmiller, Bree Sterne, and Bruce Whiteford for their contributions.

As we look ahead, we believe equities can appreciate further near term, but that upside is growing more limited.

Exhibit 10: Effect of Fiscal Policy on U.S. Real GDP Growth

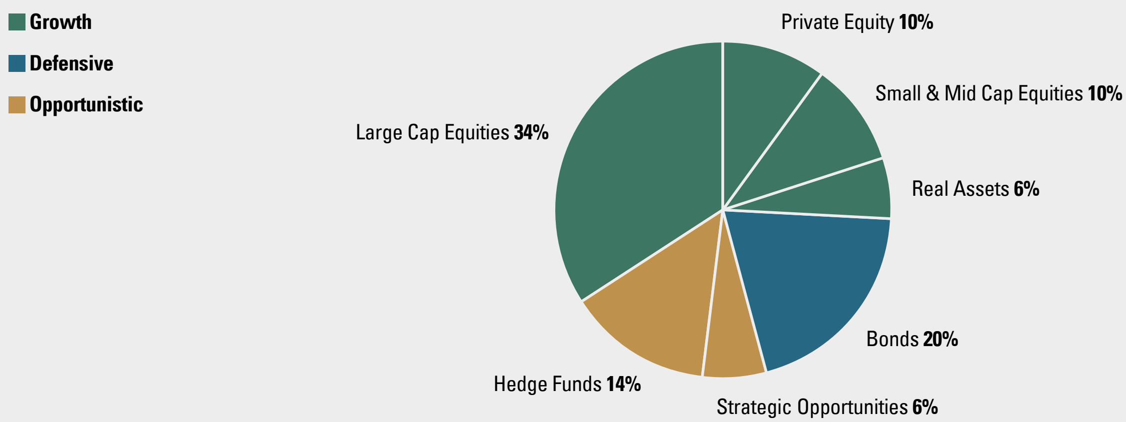
Key Takeaway: U.S. fiscal policy has been a boost to GDP growth but is expected to become a drag in 2020.



As of March 2019. Reflects three-quarter centered moving average.

Source: Bloomberg, Goldman Sachs

Bessemer's Positioning (70/30 Risk Profile with Alternatives)



Positioning as of April 1, 2019. This model displays Bessemer's Balanced Growth with Hedge Funds and Private Assets target portfolio allocation guidelines. Each client situation is unique and may be subject to special circumstances, including but not limited to greater or less risk tolerance, classes, and concentrations of assets not managed by Bessemer, and investment limitations imposed under applicable governing documents and other limitations that may require adjustments to the suggested allocations. Model asset allocation guidelines may be adjusted from time to time on the basis of the foregoing or other factors. Alternative investments, including Bessemer private equity, real assets, and hedge funds of funds, are not suitable for all clients and are available only to qualified investors.

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