

New Investment Option: Corporate Notes

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Introductions

Jeff Schroeder: Speaker

- *Managing Director, PFM Asset Management*



Spiro Hountalas: Speaker

- *Senior Managing Consultant, PFM Asset Management*



James Carter: Speaker

- *Managing Director & Head of Investment Banking;
Melvin & Company*

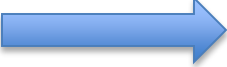


Andy Arndt: Moderator

- *Vice President, Robert W. Baird & Co.*



Agenda

- House Bill 4573  Public Act 100-0752
- Overview of the Corporate Sector
 - Debt obligations issued by private corporations
 - Key segment of the fixed-income marketplace
 - Important component of many high quality portfolios
- Investing in Corporates
 - General Procedures
 - Potential Benefits & Risks
 - Other Key Considerations
 - How Corporate Notes Fit Into a Portfolio

PUBLIC ACT 100-0752

Public Act 100-0752

- Amends the Public Funds Investment Act
- Passed both the House (95-9) and Senate (57-0)
- Signed into law by Governor Rauner on 8/10/2018
- Allows IL public entities to invest in corporate obligations from 270 days to 3 years
 - Previously limited to 270 days
 - Issuing Corporations must be organized in the United State and have assets exceeding \$500 million
 - No more than 1/3 of the public entity's portfolio may be invested in corporate obligations

Public Act 100-0752

- Corporate Note: An unsecured debt instrument issued by a corporation with a maturity of greater than one year and less than ten years
- Why expand the Illinois state statutes to include high-grade corporate notes into the Illinois Public Funds Investment Act?
 1. Diversification: further diversify investment options for Illinois public agencies
 2. To improve overall investment returns
 3. It has been successfully done in other states throughout the country

Revising Your Investment Policy

- Only requires a few minor changes to the existing language that currently allows for short-term corporate obligations

In ~~short-term~~ obligations of corporations organized in the United States with assets exceeding \$500,000,000 if (i) such obligations are rated at the time of purchase at one of the 3 highest classifications established by at least 2 standard rating services and which mature not later than ~~270-days~~ 3 years from the date of purchase, (ii) such purchases do not exceed 10% of the corporation's outstanding obligations and (iii) no more than one-third of the public agency's funds may be invested in short-term obligations of corporations

OVERVIEW OF THE CORPORATE SECTOR

Corporate Notes

- Issuer: Private and publicly owned corporations
- Credit Quality: Varies by issuer
- Term of Maturity: 1 - 40+ years
- Liquidity: Moderate
- Return: Increased return potential relative to other fixed income securities, depends on credit and structure
- Caution: Unsecured promissory note
Credit analysis required

Yield Environment

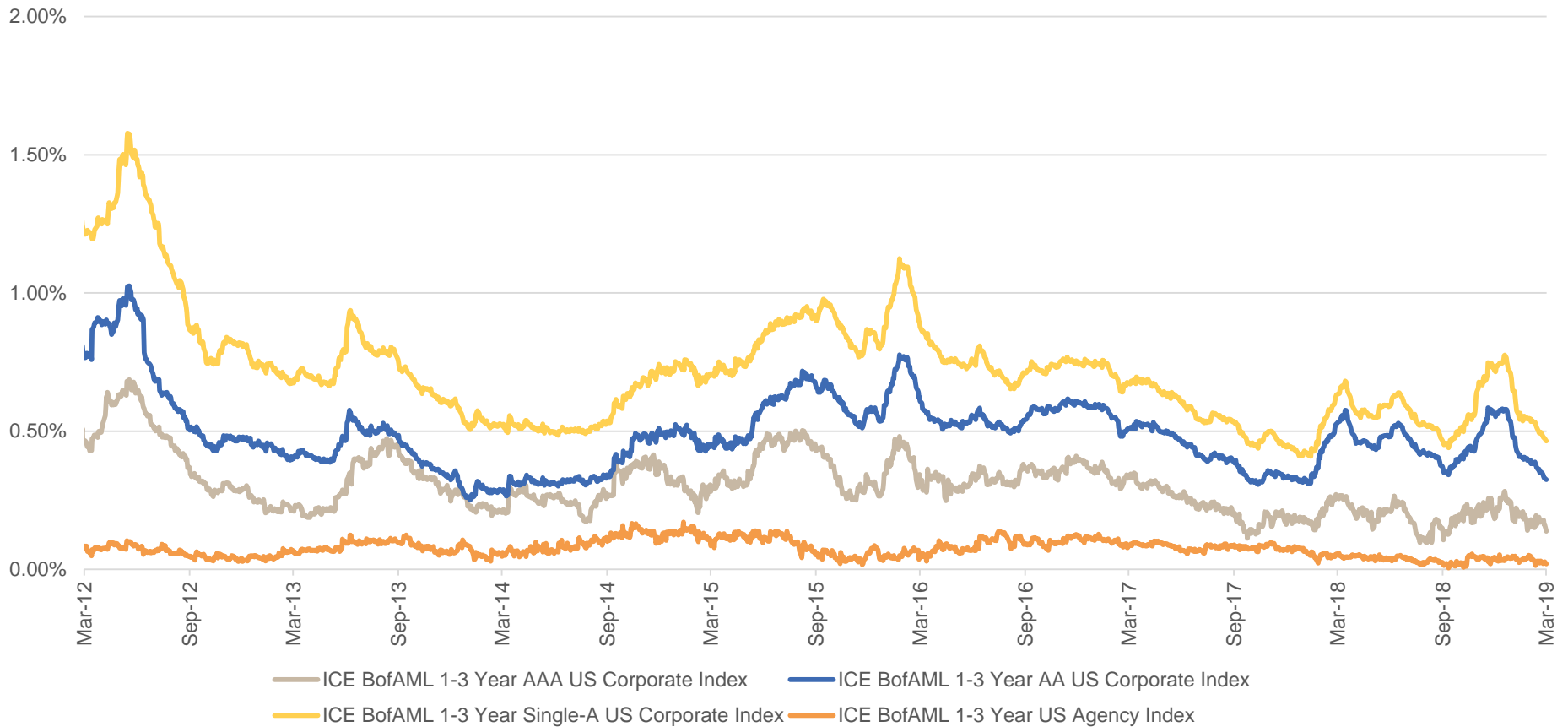
As of April 15, 2019

Maturity	Treasury	Federal Agency	AA Corporate	A Corporate
3-Month	2.46%	2.45%	2.57%	2.68%
6-Month	2.47%	2.46%	2.58%	2.69%
1-Year	2.46%	2.46%	2.61%	2.71%
2-Year	2.40%	2.42%	2.62%	2.76%
3-Year	2.36%	2.39%	2.64%	2.78%
5-Year	2.38%	2.46%	2.79%	2.95%
10-Year	2.56%	2.80%	3.15%	3.46%

Source: Bloomberg BVAL yield curves for Treasury and Corporate. TradeWeb for Federal Agency yields. 3 and 6 month corporate yields from commercial paper; A-1+ for AA and A-1 for A. Yields are for indicative purposes only; actual yields may vary by issue.

Historical Yield Spreads

Yield Spreads (OAS) of Investment Grade Corporate and Agency Indexes



Source: Bloomberg, ICE BofA Merrill Lynch Indices. OAS is option adjusted spread. As of 3/18/2019.

Diversification by Industry

As of January 2019

Composition of the Corporate Universe				
	Financial	Industrial	Utilities	Total
AAA	0.2%	0.9%	0.0%	1.1%
AA	7.1%	5.2%	0.2%	12.5%
A	22.3%	17.1%	2.0%	41.4%
BBB	8.6%	33.6%	2.8%	45.0%
Total	38.2%	56.8%	4.9%	100%

Source: BofA Merrill Lynch 1-5 Year U.S. Corporate Index by face value, as of January 2019 universe.


Corporate Long-Term Ratings Definitions

	S&P	Moody's	Fitch	Definitions (by Moody's)
Investment Grade	AAA	Aaa	AAA	Obligations rated Aaa are judged to be of the highest quality, with minimal credit risk.
	AA	Aa	AA	Obligations rated Aa are judged to be of high quality and are subject to very low credit risk.
	A	A	A	Obligations rated A are considered upper-medium grade and are subject to low credit risk.
	BBB	Baa	BBB	Obligations rated Baa are subject to moderate credit risk. They are considered medium grade and as such may possess certain speculative characteristics.
	BB	Ba	BB	Obligations rated Ba are judged to have speculative elements and are subject to substantial credit risk.
	B	B	B	Obligations rated B are considered speculative and are subject to high credit risk.
	CCC	Caa	CCC	Obligations rated Caa are judged to be of poor standing and are subject to very high credit risk.
	CC	Ca	CC	Obligations rated Ca are highly speculative and are likely in, or very near, default, with some prospect of recovery of principal and interest.
	C	C	C	Obligations rated C are the lowest rated class and are typically in default, with little prospect for recovery of principal or interest.

AAA/AA Rated Representative Issuer List

Top 10 Issuers	# of Issues	Amount Outstanding (millions)	% of Corp Index	Moody's	S&P	Fitch
Apple	16	\$26,500	1.02%	Aa1	AA+	-
Microsoft	13	\$18,500	0.72%	Aaa	AAA	AA+
Toyota Motor Credit	17	\$14,650	0.57%	Aa3	AA-	AA+
Westpac Banking	11	\$13,150	0.51%	Aa3	AA-	AA-
Walmart	9	\$12,545	0.49%	Aa2	AA	AA
Chevron	10	\$12,350	0.47%	Aa2	AA	WD
Natl. Australia Bank	13	\$11,400	0.44%	Aa3	AA-	AA-
Toronto-Dom. Bank	5	\$11,250	0.44%	Aa3	AA-	AA-
Wells Fargo	9	\$11,350	0.44%	Aa2	A+	AA-
Shell International	9	\$11,000	0.43%	Aa2	AA-	AA-

Representative list for informational purposes only; not an investment recommendation.
 Source: BofA Merrill Lynch 1-5 Year U.S. Corporate Index, as of January 2019 universe.

 Denotes foreign issuer

A Rated Representative Issuer List

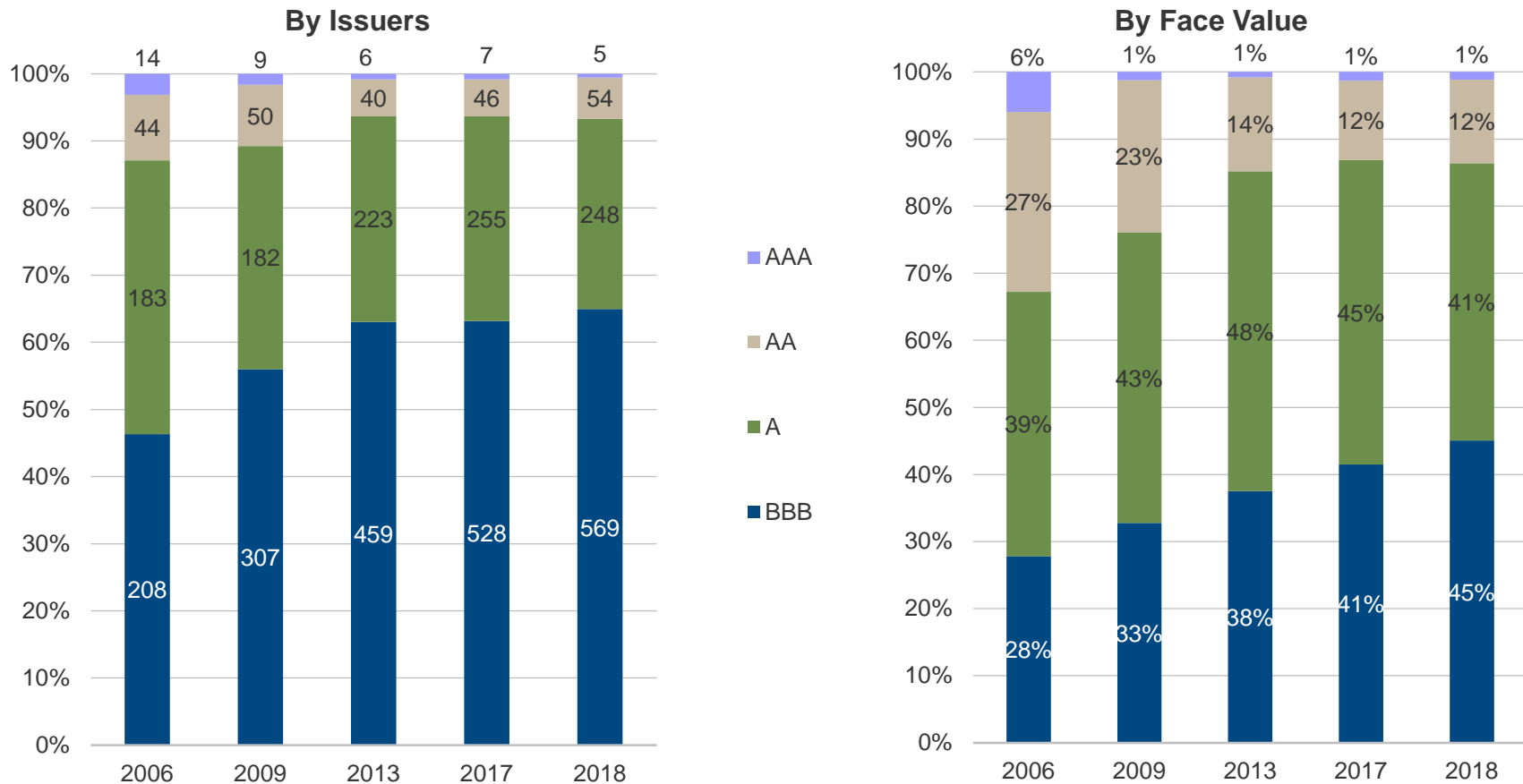
Top 10 Issuers	# of Issues	Amount Outstanding (millions)	% of Corp Index	Moody's	S&P	Fitch
J.P. Morgan Chase	22	\$50,900	1.99%	A2	A-	AA-
Bank of America	21	\$43,569	1.69%	A2	A-	A+
Goldman Sachs	17	\$38,350	1.50%	A3	BBB+	A
Morgan Stanley	13	\$31,082	1.22%	A3	BBB+	A
Wells Fargo	12	\$30,100	1.16%	A2	A-	A+
Citigroup	15	\$27,582	1.07%	A3	BBB+	A
HSBC	10	\$20,900	0.82%	A2	A	AA-
Oracle	8	\$16,494	0.63%	A1	AA-	A
Daimler Finance	17	\$15,575	0.60%	A2	A	A-
BNY Mellon	14	\$13,900	0.54%	A1	A	AA-

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Ratings Landscape Continues to Evolve

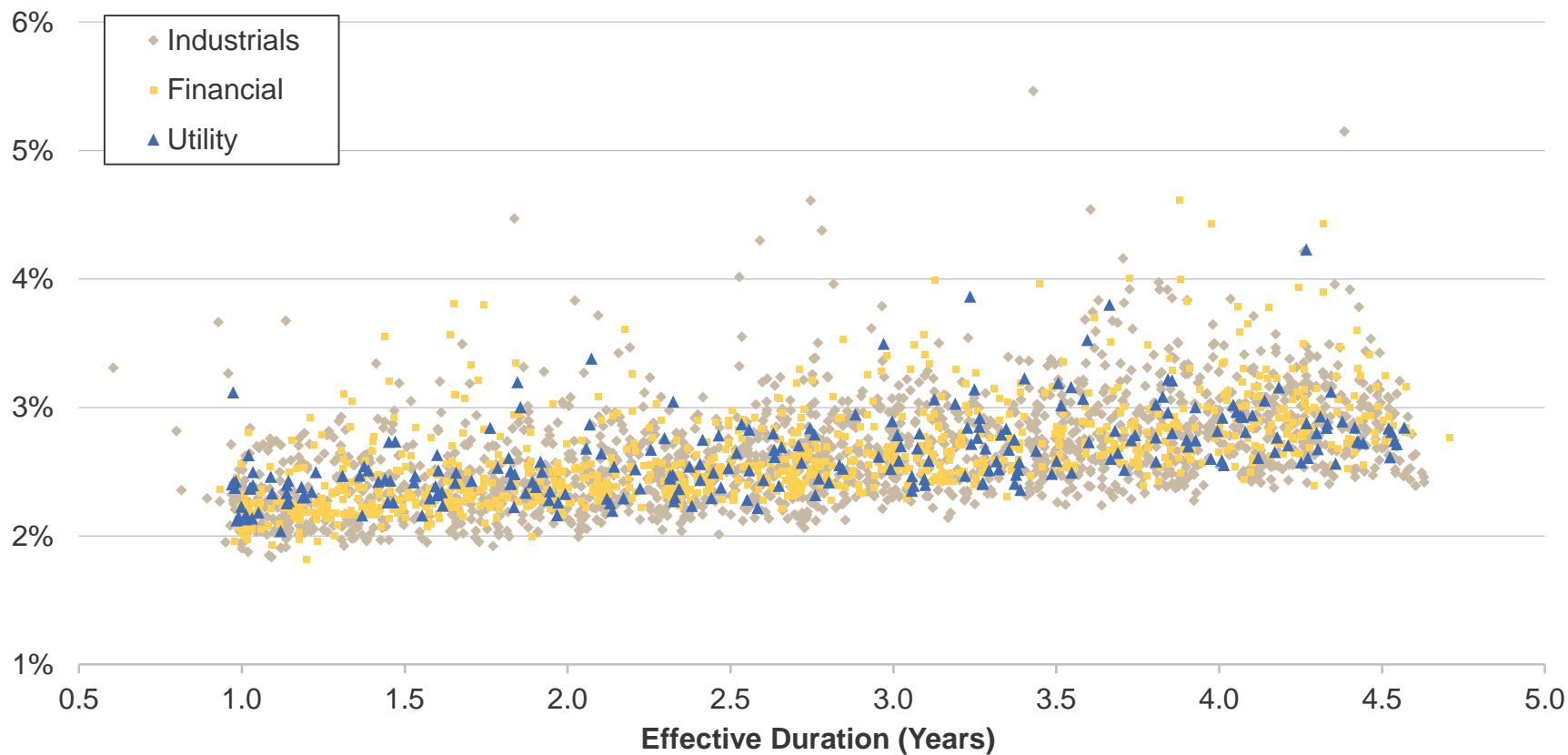
Composition of Merrill Lynch Corporate Index



Source: BofA Merrill Lynch Indices composite ratings, using January 2019 universe.

Finding Yield in the Corporate Sector

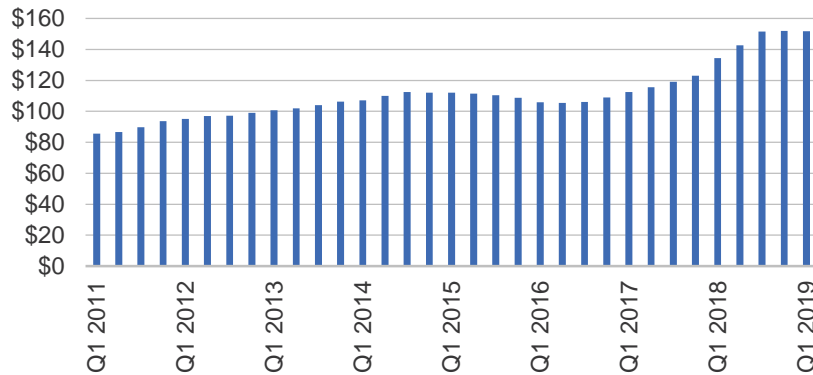
Corporate Yield Curve by Individual Issue
Effective Yield (%)



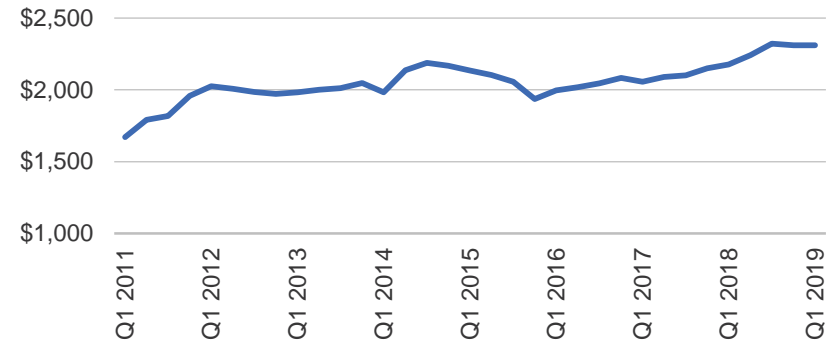
Source: ICE BofA Merrill Lynch 1-5 Year US Corporate Index, as of 12/31/2017.

Corporate Fundamentals Continue to Strengthen

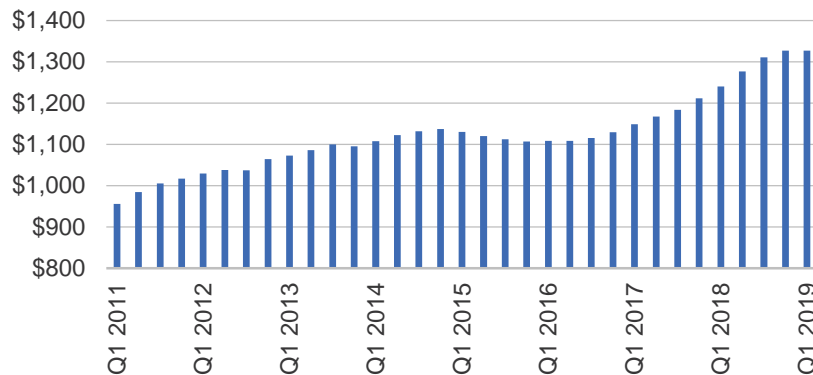
S&P 500 Earnings per Share



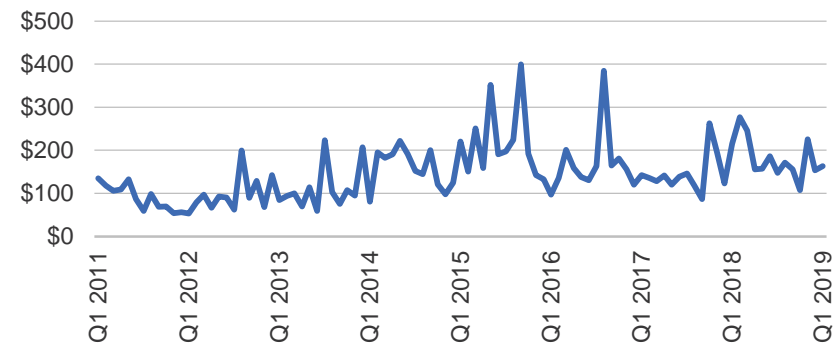
Corporate Profits (billions)



S&P 500 Trailing 12-Month Sales per Share



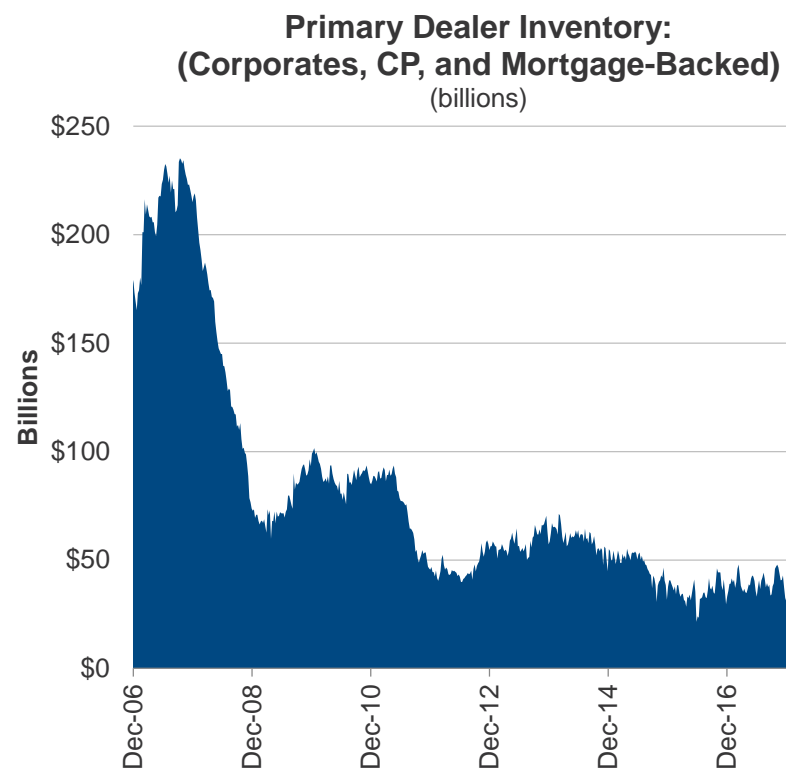
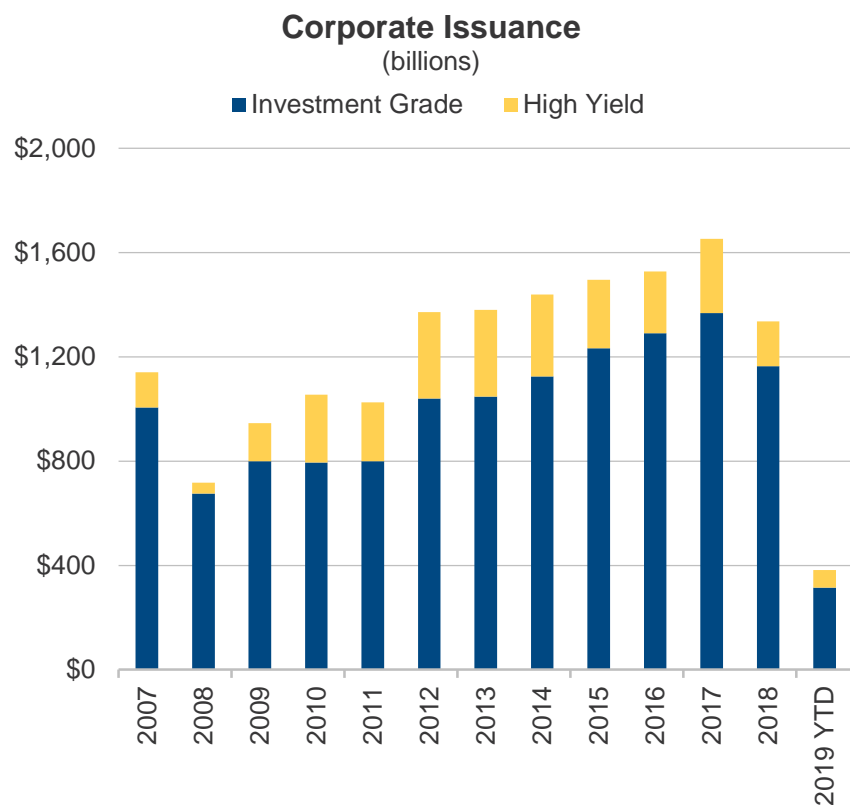
M&A Transaction Value (billions)



Source: Bloomberg, most recent data as of Q1 2019.

Corporate Issuance is Strong, but Liquidity has Shrunk

- While primary market issuance remains robust, dealer inventories are near their lowest levels in at least 14 years.



Source: Corporate issuance from SIFMA. Most recent data as of April 2019. Dealer Inventory from MarketAxess, as of 4/16/2018.

INVESTING IN CORPORATES

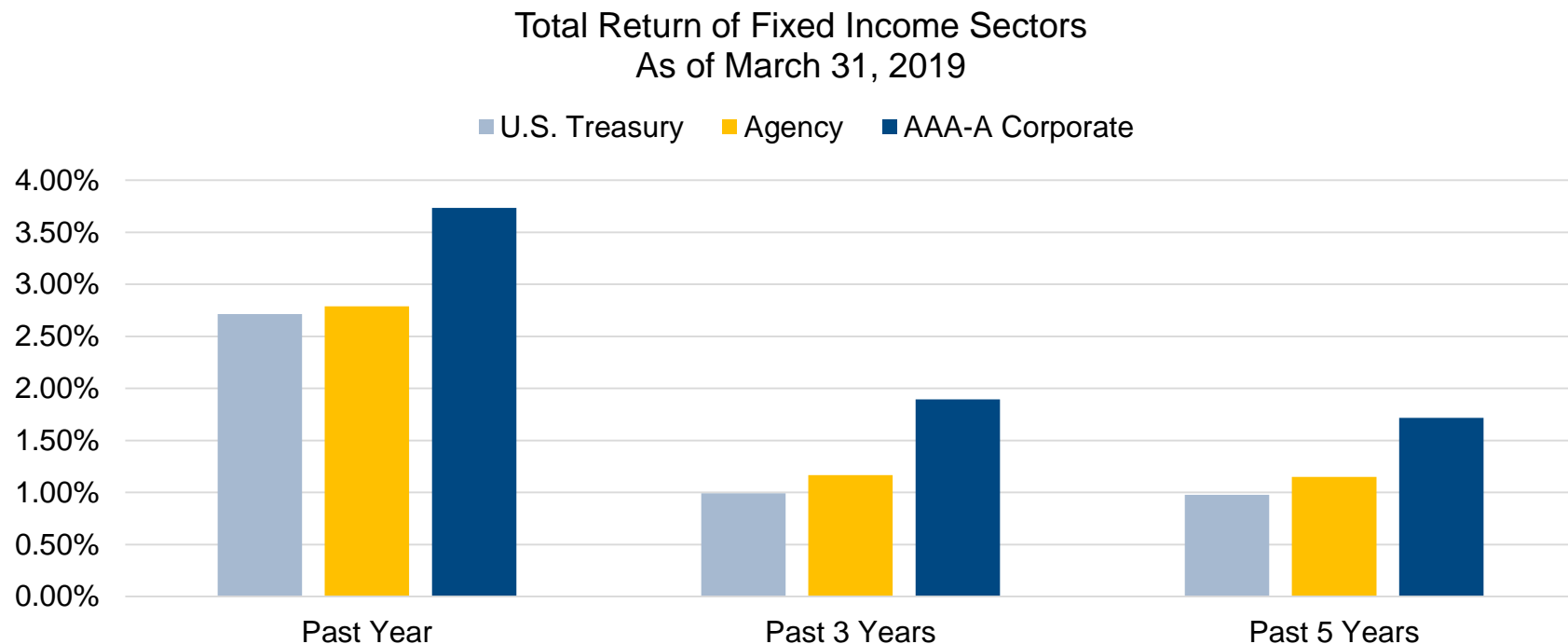
Investing in Corporates – General Principles

Policies/Procedures	Credit Review
	Initial
<ul style="list-style-type: none"> • Understand and follow all applicable laws, statutes and policies • Implement investment and credit policies that reflect organizational objectives, priorities, and appropriate level of risk tolerance • Do not rely on ratings alone, rather include what has been researched and understood. • Ensure prudent diversification (by sector & issuer) • Establish escalation and action procedures in advance of downgrades or other credit problems • Conduct thorough due diligence and document review of issues that have unique complications or structure (e.g. municipals, asset-backed, mortgage-backed, 144A, structured notes, etc....) 	<ul style="list-style-type: none"> • Develop and implement a formal credit review, approval, and monitoring process • Establish clear protocols and lines of authority for credit-related decision making • Work from an established “approved list” that has been fully vetted by the review committee
	Ongoing

Source: ICE BofA Merrill Lynch 1-5 Year US Corporate Index, as of 12/31/2017.

Potential Benefits of Investing in Corporate Securities

- Potential for increased interest earnings and return
- Increased diversity can reduce volatility
- Changing face of fixed income universe



Source: ICE BofA Merrill Lynch 1-3 Year indices from Bloomberg as of 3/31/2019.

Potential Risks of Investing in Corporate Securities

- Credit/Default Risk
 - Risk that an issuer will be unable to meet its financial obligations
- Market Value Risks
 - **Credit spread:** risk of financial loss resulting from changes in credit spreads used in the marking-to-market of a fixed income product
 - **Downgrade:** risk that a bond's price will decline due to a downgrade in its credit rating

Risks can be mitigated with the appropriate procedures, policies, and limitations in place

Investing in Corporates – Key Considerations

Before investing in corporate securities there are several key elements for boards to consider for their investment policy and overall investment program:

- Minimum credit rating requirements (“AAA” or “AA” or “A”) by two credit agencies
 - Balance needs of different levels of sophistication
 - Language to include “based on settlement date”
- Concentration limit on overall portfolio (i.e., current limit on commercial paper investments is 1/3 of the total portfolio)
- Issuer limitation (limit the amount of exposure to any one issuer in the overall portfolio)
- In Depth Credit Analysis
 - Not enough to just look at the credit ratings
 - Consider hiring an outside investment adviser

Going Beyond Credit Ratings

Issuer Analysis	Macro Analysis
<ul style="list-style-type: none">• Balance sheet analysis• Earnings: Actual and projections• Asset quality and impairments• Corporate governance• Price movement of fixed income and equity securities• Monitor credit default swap levels• Trading volume• Analysts' recommendations	<ul style="list-style-type: none">• Industry trends• Competitive environment• Business cycle• Regulatory environment• Rating agency actions• Sovereign credit developments

Investment Advisor vs Broker/Dealer

SEC Registered Investment Advisor

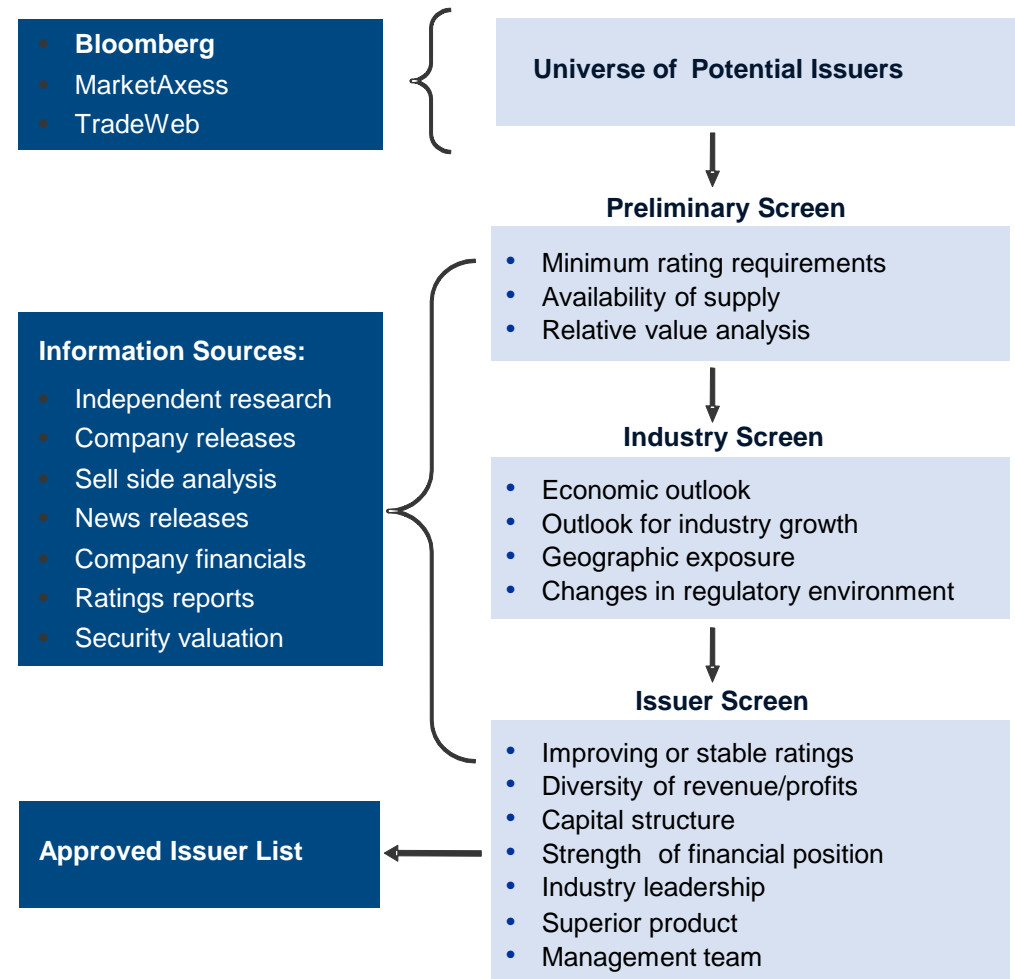
Fiduciary Responsibility	Transparent Fee
Fees are fully disclosed	
Owens no portfolio or inventory of securities	
Fees based on assets under management	
May maintain an Approved List of Corporate Issuers	

Broker/Dealer

Suitability responsibility	Unknown Costs
May be undisclosed fees	
Can set price and sell from own inventory of securities	
Fees based on transactions plus difference between bid and ask price	
Usually does not maintain an Approved List of Corporate Issuers	

Sample Credit Screening Process

- Credit Committee focuses on sectors with positive macro characteristics
- Independent research is conducted to identify issuers that may benefit from macro trends
- Once a potential issuer is identified, a thorough review of the company is conducted
- Credit committee action: approve the issuer, request more data or decline

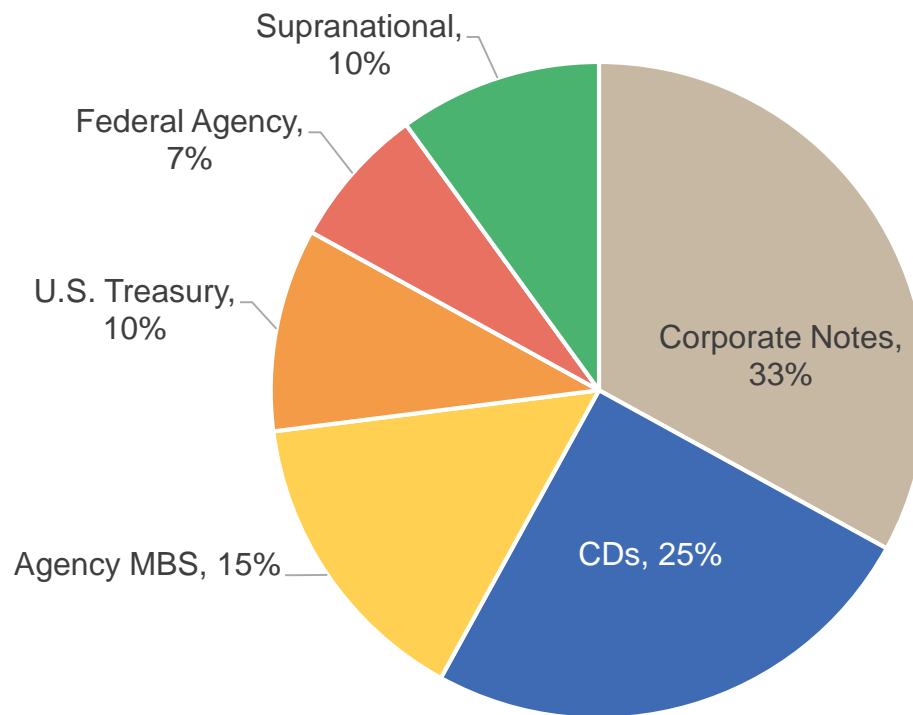


IL Public Funds Investment Act

Sector	Allowed By IL Statutes
U.S. Treasuries	Yes
Federal Agencies	Yes
Certificates of Deposit	Yes
Supranationals	Yes
Municipal Securities	Yes
Commercial Paper	Yes
Money Market Funds	Yes
Agency Mortgage-Backed Securities	Yes
Corporate Notes	Yes

Corporate Notes in a Portfolio

Sample Portfolio of IL Statute Approved Investments



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Conclusion

- Public Act 100-0752
 - Amends the Public Funds Investment Act
 - Allows IL public entities to invest in corporate obligations from 270 days to 3 years
- Potential benefits of corporates:
 - Enhance risk-adjusted returns when used prudently
 - Increase portfolio diversification by sector
 - Wide range of issuers and maturity
- Potential credit risks:
 - Default risk
 - Downgrade risk
- Establish and adhere to prudent credit principles to reduce risk

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Questions and Answers

We thank you for your time!

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