AGL 2020 Market Outlook and Commentary

Dear Friend of AGL,

As 2020 kicks off we are pleased to continue our market commentary discussion initiated in October 2019. There are many viewpoints, issues and questions worth addressing. There also is an underlying theme which characterizes many perceptions of the Private Credit ecosphere. This encompasses many constituencies, including banks in non-investment roles, asset managers, rating agencies, regulators, the press, and others including the general public, but most importantly investors of all types including banks, insurance companies, CLOs, retail investors, hedge funds, pension and sovereign wealth funds. A common theme is that "one size fits all" as it relates to perceptions of different components of the Private Credit ecosphere, and many conclusions are based on aggregate top down statistics plus established story lines, with attendant generalizations. Most situations however are very much "case by case", and leveraged loan investments in particular are highly idiosyncratic. But there are many factors that do affect entire issuer and borrower groups, such as product obsolescence or the implications of social media for service businesses. We try to frame things through a macro and micro lens, as varying degrees of "lens magnification" apply to most everything. This is not to suggest that a two-dimensional approach is enough, and genuine new perspectives on what seems obvious are often the most valuable. Our commentary focuses on Broadly Syndicated Bank Loans ("BSL"), and includes the following subjects and opinions which we hope you find useful:

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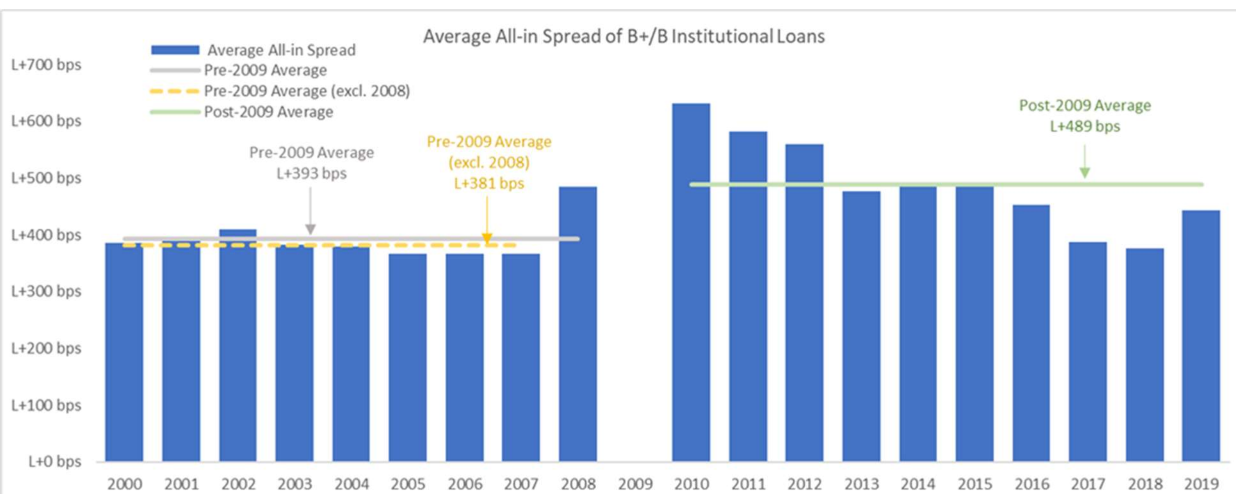
Market Prices as Valuation Lens
Direct Lending

Recap of Private Credit Investment Choices & Summary Comment
Private Credit Asset Classes
Strategies
Leverage
Product
Summary Comment

Expectations for 2020

Macro Conditions- We have a very positive outlook, existential risks and recent events notwithstanding, and expect continued but slow growth in the US, EU and Asia, plus subdued inflation and low interest rates.

Investor Preferences- We see increasing demand for income-based credit spread products, especially BSLs, which arguably have the highest amount of risk adjusted excess spread of any investment product, especially within Private Credit. Unlike other asset classes, BSLs in particular have retained a high level of absolute credit spreads, and compared to prior cycles, these experienced a slight step shift up in 2019. Very attractive in their own right, these are doubly so in the context of the conundrum of very low interest rates and high asset prices. Also redeploying capital into BSLs from realizing gains in equity and fixed income strategies can make sense for many investors given elevated asset prices, and thereby lock-in the earning power of the capital so redeployed.



Source: LCD Comps
Note: Assumes upfront fee is amortized evenly over an assumed three-year life; Upfront fee includes original issue discount. As of 10/5/06, LCD S&P's CCR and Moody's Corporate Family Ratings for rated spread and upfront fee calculations.

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Investor Sentiment- If this can be characterized as a spectrum, with optimism at one end, complacency in the middle and caution at the other end, we see the prevailing direction edging towards caution. Whether it is the recession question, or the effect of lower for longer interest rates, or the increased opacity/algorithmic activity and limited liquidity of public markets, or just TBD surprises, there appears to be increased focus on uncertainty avoidance.

BSL Credit Spreads & Loan Prices- We expect spreads to widen in the coming years, notwithstanding the normal gyrations of new issue and secondary bank loan markets such as we see now with tightening spreads (in contrast to the months before). In "normally" functioning markets, spreads and prices oscillate in response to three forces which adjust, sometimes sharply, the balance between supply and demand. The first is sentiment and is often described as "risk on" or "off", and can be the most powerful, especially if any quotient of fear is involved. So-called market technicals, which should probably be ranked second, often reflect certain assets being popular, usually for good but temporary reasons. Another example are outflows or inflows by certain investor groups, such as retail mutual funds, which in the case of BSL products, typically enter or exit based on interest rate expectations. Third are borrower credit fundamentals, which are reflected in prices to varying degrees and the ultimate driver of loan performance. These are frequently subsumed by the forces of sentiment and market technicals.

The interplay of these three forces changes all the time. However, for the long-term investor, borrower credit fundamentals are key. One can think of credit fundamentals as being similar to gravity, in the sense that when other forces balance themselves, settle down or finish correcting, it is the force that drives actual fundamentals-based performance. It is also the most objective basis for projecting a future performance trajectory, of which there are of course many different potential outcomes. Looking ahead, we see the trend around which these forces oscillate, to be upwards.

The main catalyst will be a cyclical one as the universe of private companies continues to expand in those sectors of the economy that are growing at much faster rates than the economy overall. This is the vital entrepreneurial sector that is financed by Private Credit, and borrows for investment, M&A and Private Equity transactions. Software and cloud-based business enterprise services is one example of a fast growing and multi-faceted sector, and healthcare companies that improve care and reduce costs are another.

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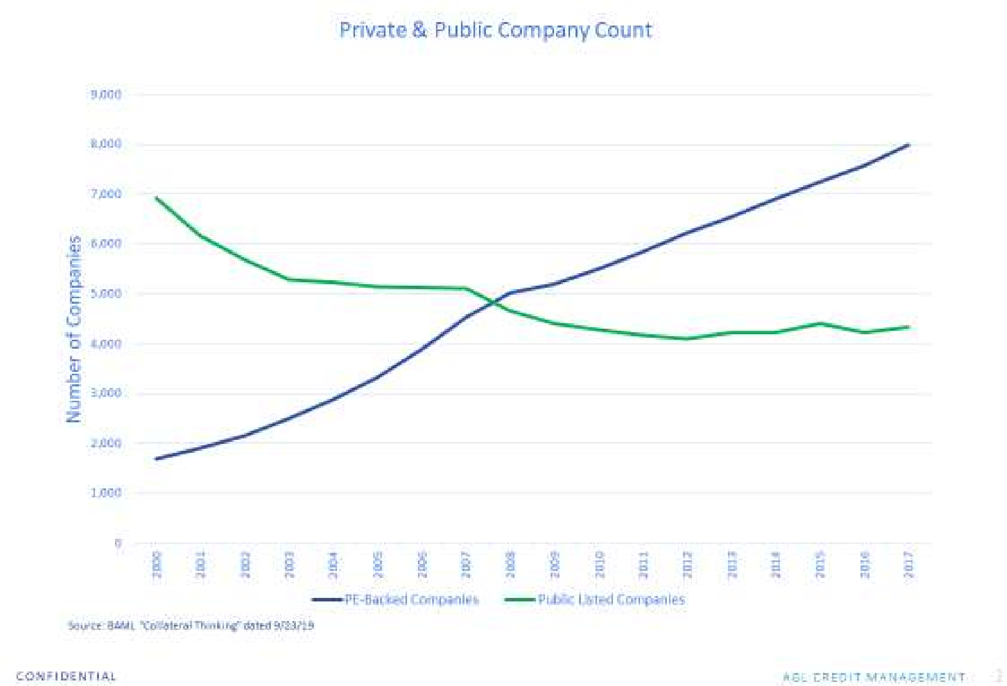

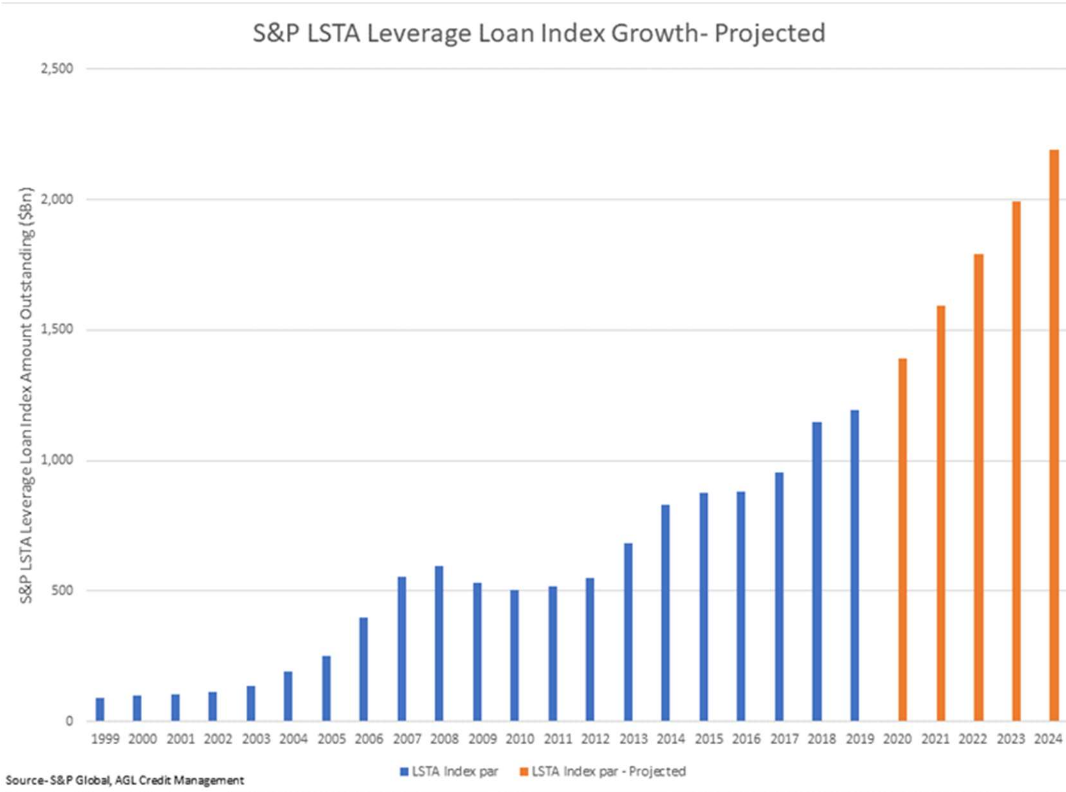

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A countervailing factor will be the attraction of more capital to income-based credit strategies, and BSLs in particular. Increasing investor demand will work to compress spreads and bid up prices. In the rebalancing of increasing supply and more demand, including indiscriminate "search for yield", we expect supply side pressure to dominate over the medium term. The growth of private companies and the demand for Private Credit will likely outpace the growth of investor knowledge of and involvement in the Private Credit asset classes. So, the excess spreads / premiums that exist will both continue and increase. One reason is that Private Credit lacks the degree of standardization and transparency that public securities provide (we note that Direct Lending segment has neither). While BSLs afford even more information than available for comparable public securities, this information access requires tradeoffs (a significant commitment of research resources, and Chinese wall or no securities investing).

Another reason is that Private Credit does not have baselines to frame valuation, as interest rates do for fixed income, or like growth or value classifications do for equities. In addition, there is the fact that these loans are not only private instruments, but individually consist of whatever structure and terms the originating lender and the borrower agree to. This can start with a plain sheet of paper. Unlike other assets, corporate loans need to be understood from the inside out, and this customization has and will likely always command a premium.

It must be noted that in prior cycles the continued growth in loan demand and the associated increased economic activity, whether debt financed or not, resulted in an elevated level of risk. This is both for individual borrowers and in aggregate, including, arguably, not only for most asset classes, but so-called systemic risk. This cycle will likely be no different. The critical point will always be selection, and as part of that, assessing risk adjusted returns.

Separately, a key factor in the return equation for long term investors, are the effects of a traditional recession and/or dysfunctional market volatility (both discussed below), where loan spreads gap out and prices drop. These scenarios are in most if not all medium-term forecasts, and the arrival of such conditions will present more opportunities to invest in BSLs and other assets.

Timing- Asset allocation changes pose an entry point question. Long term investors benefit from the unique fact that BSLs are a "full cycle asset class", as these senior and secured loans are originated and structured by banks to be repaid irrespective of borrower and/or economic adversity. CLOs are likewise intentionally structured to withstand these outcomes, and are designed to both maximize the best attributes of a BSL portfolio, namely a steady stream of cash flow after all deductions for losses (net of recoveries or loan sales) and expenses in a conservative, rigid and transparent structure using debt without any market value or margin call type triggers. This benefits all investors in the CLO's capital structure. The track records of BSLs and CLOs lay this out concretely and impressively.

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Entry point timing does matter from a product standpoint, for while the BSL asset class and CLOs holding them perform predictably over time, albeit differently depending on the leg of the economic cycle, the structures and terms of CLOs and other fund structures are very dependent on market conditions at the time of inception. Interestingly, in the case of BSL based funds like CLOs, the biggest factor over time is usually not the makeup of loans on the asset side, but the structure and terms of the liabilities and capital structure. While the complexion of an actively managed BSL portfolio changes overtime, a CLO or structured fund's liabilities reflect a moment in time.

At present, the technical and cyclical factors of expanding loan supply and increased caution, albeit with "risk of and off" gyrations, are positively aligned for long term investors. Meanwhile very compelling fund structures, including CLOs and other strategies that lock in these features for 6-12 years, are widely available on attractive terms. Timing is favorable and may continue to be for some time.

Other factors- Demographics is the principal cause cited for both low interest rates and economic growth due to higher aggregate savings and less traditional spending. The challenging liability profile of many pension funds (US State funds particularly) and many national government retirement frameworks (i.e. pay as you go) is a concern that is much discussed but appears to be a political third rail almost everywhere. This is prompting more analysis, debate and consideration not only of policy changes, but also a re-think of the asset allocation parameters required to achieve consistent returns of at least 6% required by most programs.

Implications of the above- The demographic issues in particular should put greater emphasis on saving for the long term versus short term investing, which by most definitions is speculative. Availability of robust income-based credit products appears timely, where return of principal is one goal, and not a bet on price appreciation, with the second one a meaningful level of actual earned cash flows. Price appreciation doesn't help unless an investor is in liquidation mode. Greater allocation to credit spread products, especially BSLs, can address this imbalance.

Concerns

Recession- We expect/hope that any downturn will not be a repetition of 2009 where the entire US economy "went over the cliff" due to a complete halt in spending. This was of course caused by the panic induced by the Financial Crisis, not a sectoral problem like the dot.com bubble or the Fed raising rates to shock levels. For a change, this actually was a case of "one size fits all". We expect the future recessionary pattern to be different, and to resemble more of what we been experiencing recently, which is rolling recessions in various sectors. These have been offset by strong enough overall consumer demand to produce the low rates of growth we are experiencing. Examples of mini rolling recessions include many if not all sectors of US

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manufacturing, plus energy and retail. Our concern for the future is an elevated level of such risks (discussed further below).

Credit Risk Part A- There is clearly an elevated degree of financial risk in the form of higher debt levels in every part of the economy including BSLs, which for strange reasons (commented on below), are presented by the press and others as especially high risk and a barometer of frothy markets.

We are concerned about high leverage levels, and other developments like fewer creditor protections, albeit these are risks that are hiding in plain sight. Analysis can determine leverage, whether obscured by so-called pro forma adjustments, or otherwise. Corporate debt is increasing, but it is not "one size fits all", and some companies with seemingly low debt have too much, and others that appear to have high levels can carry more. It should also be pointed out that some investors seek riskier assets. The key of course is to be paid for the risk, or in formal parlance, to get appropriate risk adjusted returns, and presumably within a logical multi asset framework. Financial risk is usually not hidden, and downside projection analysis can forecast the impact of revenue and cash flow reductions and frame a borrower's capacity to handle its debt load or not.

Credit Risk Part B- Our principal concern is fundamental credit risk, not balance sheet based financial risk. We mean this in the traditional banking sense of the term, which is the health of a borrower's business and key factors driving that. These include industry dynamics, customer demand, competitiveness, and critically, management competence plus integrity. Financial risk is important, but this is a transparent balance sheet gearing question, not one of the health of a business. Traditional credit risks are notoriously hard to detect in the early stages but lots of "homework" helps.

A big and growing concern for us are the new developments and changes in consumer behavior, business models and in some cases transformations like the cloud, that in the aggregate may be very positive, but individually are negatively affecting many industries including shrinking some or worse, and many companies in them. These trends, some newly emerging, and some clearly evident for some time, include "digital disruption", carbon avoidance, automation/AI, and possible paradigm shifts like the spending choices of Millennials or future business implications of how social media evolves.

Again, it is not "one size fits all". In this context, for example, what will an acceleration of trends, however nascent, like electric plus driverless vehicles, and the internet of things, do to the global car and truck complex (which puts out 17 million cars every year)? Maybe sub sectors such as tires, batteries and upholstery will be less affected, but this global industry is transforming more dramatically than we can visualize or quantify today. However, a changing and shrinking industry

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does not mean it does not need to exist. Likewise, there are borrowers in these industries that can be investment opportunities.

These fundamental shifts are changing whole sectors, and in ways we don't fully understand, so we perceive that elevated risk is here. Credit Risk Part A is important, but Part B is both more consequential, and unlike the former, hard to discern. For the long-term investor caution is the modus operandi.

It is worth emphasizing that an attractive attribute of long-term investments in portfolios of BSLs is the combination of ample safety and positive returns from assets that are senior secured loans to larger companies, plus the robust consolidated net income stream the loans generate.

Dysfunctional volatility- Another worry is greater and repetitive market volatility that could destabilize confidence and thereby slow down the economy or worse. While sentiment is by definition mercurial, the worry here is not the human factor but surprise market malfunctions perhaps caused by "flash crash" events, or a surprise correlation upset in the opaque derivatives market that causes an avalanche type market chain reaction. Most Income based credit spread strategies such as CLOs are immune from price downdrafts and can buy on "dips" or more dramatic declines. But a market crisis would be problematic on many levels.

Incomplete Narrative on Private Credit

BSLs and CLOs- The press about BSLs, and also CLOs which are BSL's largest investors, has been relentlessly negative, and has created ongoing misperceptions of them. There is news to report, such as elevated borrower leverage or the disappearance of maintenance covenants. As noted above, these developments are largely obvious, and investors can make choices as appropriate. In many cases the infamous search for yield can induce accepting greater risk without greater return. But this is an investment choice.

The problem is the robust positive facts that are not reported, and, by implication, are portrayed as non-existent.

A Clarification- Discussions on BSLs, CLOs, High Yield, etc. often conflate many different facts and relationships. It is key to first distinguish what the assets are and the associated risks these assets have on a standalone basis. If the assets are corporate debt, are the borrowers big or small, is the debt secured and senior, and are these loans or securities? Second is what *asset class(s)?* Are the investments in portfolios of BSLs, High Yield, etc.? This is where the most risk and opportunity reside. Another question is about strategy, such as investing in one or more asset classes- is it short or long term, how diversified are the assets by industry and other criteria, and is it trading gain focused? An important consideration is the use of leverage and how. Lastly, what is the

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investment *product* that holds the investment, such as an open-ended fund or a CLO or some other type of fund?

The most important consideration is the risk profile of the underlying assets, and what does assembling them into an asset class, and employing a specific strategy using a given fund structure do to reduce risk and enhance returns.

To further clarify, a diversified portfolio of BSLs is the asset class, not individual loans. Individual BSLs are leveraged loans originated and structured by banks, using private information, to mid to large to very large non-investment grade, mostly private, companies, and which are both held by banks and distributed to investors the majority of which are CLOs. It is not individual loans but rather portfolios of loans that constitute the asset class providing both the safety of senior secured credit exposure and reliable interest income streams. Assuming good loan selection and management in terms of risk adjusted returns, the net interest income cash flow generated is multiples of what any realized losses may be, whether from recoveries below par from defaults, or sales at a loss.

BSL portfolios managed for cash returns instead of trading gains deliver consistent returns and all of the original principal invested. As such, they are among the safest investment products, and the most reliable generators of consistent cash returns. It is these very attributes that enable well selected and managed BSL portfolios to have returns amplified by leverage including as used by CLOs.

Suitability- A key point in income-based credit spread investing, including in BSLs whether via CLOs or otherwise, is that these are long term investment products. It is over time that diversified portfolios with appropriate levels of risk adjusted returns deliver the streams of cash at predictable levels and the safety of the senior secured positions in borrower assets. As such it is highly questionable for BSLs to be assets in redemption based products like open ended retail mutual funds and ETFs.

Market Prices as Valuation Lens- These provide valuable information but not the complete picture. Market prices, as well as updated fundamental assessments of a borrower's credit condition, are both important and complement each other. Press discussions can conflate these, as when commenting on the possibility of lower future recoveries when loans are held through a default (relying on seniority and security), when in fact most strategies sell loans before a default so to avoid them (relying on price exit). A more helpful discussion or explanation would be whether such reflexive selling is value added or not, and what the tradeoffs may be. Relatedly, significant beneficiaries of holding loans to ultimate recoveries are distressed investors, who are the buyers of loans offloaded by most investors and their managers.

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This is not to say that total return strategies, which are externally price driven, are inappropriate or unattractive. Depending what an investor's goals are, and the suitability question of the short or long-term time horizon, the two strategies and many asset class categories and sub types can complement each other. It should also be pointed out that on a price basis total return BSL strategies have comparatively low volatility and low correlation relative to other asset classes.

The objective of course is long-term wealth preservation and creation, not a moment in time market valuation. The former can be reinvested or distributed in cash, while the latter may or may not reflect what can be realized when an investment is harvested.

Direct Lending- The press has given this asset class a free pass for now. Despite being a mostly new asset class that replaces a regulatory driven pullback by banks from lending to smaller leveraged companies, and the higher risk this entails, press coverage has been positive, and certainly not cautionary. This despite the many risks and issues smaller borrowers have. Small, riskier companies have always had access to financing, and before banks pulled back, this traditionally consisted of a bank asset based revolving credit facility with light leverage, together with traditional unsecured and subordinated "mezzanine" debt which usually had equity warrants. This has now largely been replaced by what is mostly or all senior secured debt with much higher leverage. There are other potential issues with Direct Lending, including zero liquidity, lack of transparency, mostly no track record, adverse selection (conflict of origination motives vs fiduciary obligations), and the fact that the investors in the senior secured debt often invest in the junior capital as well. There is also the notion because these loans typically have covenants, which of course a single or handful of lenders can waive, that this reduces the probability of loss in the event of default. This is highly questionable if not a fantasy given how limited the options are for small companies experiencing adversity. So why, given all the risks and opacity, is there so much interest and growth in Direct Lending? Investor motivations are many, and may include the search for yield, the notion it is a new investment opportunity engendered by a banking "retreat", and one with both low correlation and attractive returns relative to other Private Credit investments. Another point of appeal is that in being illiquid, there can be no "mark to market" and associated ongoing reporting of volatility, so returns are what managers estimate and report them to be which is permitted under the fair value accounting that many institutional investors are required to follow. Last but not least, the constructive role of banks should not be underestimated, or the acumen of new Direct Lending entrants be taken for granted. The Direct Lending narrative still needs to unfold, including its role in replacing the prior financing framework of secured asset-based lending facilities from banks with subordinated mezzanine debt, with a new paradigm using more secured leverage.

The main question concerning Direct Lending is the adequacy of risk adjusted returns. These should have robust credit risk and illiquidity premiums relative to BSLs and High Yield, but mostly do not. Direct Lending should perhaps be renamed "Mezz-Lite. These are generalizations, and

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every Direct Lending situation should be, like BSLs and others, considered "case by case". As an asset class however much remains to be seen.

Recap of Private Credit Investment Choices & Summary Comment

Private Credit Asset Classes- Private Credit is expanding for good reason. The rationale is putting money to work in the old-fashioned sense- That is, investing a $1 (in whatever multiple) and getting the full amount of that principal back at maturity, plus receiving a reliable stream of cash income in the interim. Private Credit asset classes encompass portfolios of many types, such as BSLs, (the largest and most transparent), Direct Lending, various real estate loan portfolios, and a much discussed but the yet to emerge one of infrastructure debt.

Strategies- The strategies can be short term and trading oriented, or long term, and can mix together some of these asset classes, or others such securities, especially High Yield. In addition, some strategies invest in other asset types, including structured investments (more a product type than asset class) such as CLOs and ETFs. Strategies encompassing BSLs, High Yield plus CLO securities, including equity, are common.

Leverage- The core attributes of Private Credit, full return of principal and steady cash income stream if investing long term, support the use of leverage, which of course allowed banks to have high gearing from time immemorial. Leverage is widely used, both on a long-term basis with no market value triggers like CLOs, or subject to a margin call, as in TRS (total return swap) financing. Many strategies are long only but others are long-short, including using credit derivatives which include the iBoxx, which is based on a BSL index.

Products- Product formats generally conform to the specific strategy investing in Private Credit. Many strategies and products are simple, in the sense they invest in one asset class and are long only, such as CLOs. Products can be open or closed end funds, separate accounts, subject to redemptions or not. The more the product format aligns with the underlying asset class, the more it will reflects its attributes, and using leverage will further magnify that. One can think of the product as the protective "vault" intended to preserve the investors' capital and enables the manage to generate returns.

Summary Comment- Private Credit is a leading investment choice when the objective is "getting your money back" plus an attractive cash return. A careful consideration of the asset class(s), strategy, use of leverage or not, and the specific product is warranted. In this universe, BSLs are the most attractive on both a risk adjusted and absolute basis, plus have high transparency and liquidity. BSL based products are suitable however only for long term investors *as the consolidated portfolio's medium to long term income streams are integral to its safety and return performance.* Investing in BSLs directly, with or without leverage, is well established with many

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institutional investors, including insurance companies, pension funds and sovereign wealth funds.

In addition to the high certainty of return of principal and reliable ongoing cash return, BSL investments are a good offset to risky portions of an overall portfolio, and an attractive reallocation choice given the high current market prices of many asset classes. For the long-term investor, the triad formed by BSLs, a sound fund structure, and an experienced manager, is arguably a requisite for all portfolios.

We hope you find this commentary of interest.

Thank you, Best, Peter

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