Tortoise QuickTake Energy Podcast

Tortoise

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Welcome to the Tortoise QuickTake podcast. Thank you for joining us. Today, senior members of Tortoise provide a timely update on trending topics in the market.

Welcome to the Tortoise Credit weekly podcast. I am Jeff Brothers, Senior Portfolio Manager for Tortoise. I would be remiss if I didn't mention the significance of today's date and remember all who were lost on September 11th.

Despite the outstanding U.S. economic performance, highlighted in last week's strong employment report, dark clouds seem to be circling the financial markets. It is hard to keep up with the laundry list of worries, which include escalating trade tariffs, emerging market stress, wobbly credit markets, a chaotic Trump administration and uncertainty regarding the Federal Reserve. In these volatile times, we wanted to highlight in today's podcast the opportunity in the auto ABS sector as a potential safe haven from the current market turmoil.

The asset-backed securities (ABS) sector is a unique fixed income asset class with bonds secured typically by consumer-related collateral, such as auto loans, credit card receivables or student loans. Within the ABS sector, we believe auto ABS in particular offers a compelling combination of high quality, short maturities and strong liquidity. The sector has historically provided attractive risk adjusted returns and yields currently range between 3.0% and 3.75% depending on the issuer, maturity and rating. Auto ABS can be collateralized by auto loans or leases, with loans to prime or subprime borrowers and are issued by a variety financial entities such as Ford Motor Credit or GM Financial.

We believe the case for auto ABS starts with the positive consumer fundamentals. Consumer credit trends are primarily influenced by the strength of the labor markets, which are generating solid job gains, record low unemployment and modest wage improvements. In addition, increases in household net worth from stock gains and home price appreciation further support consumer balance sheets. The recent tax cuts also provide additional disposable income to service auto loan debt. The fundamentals for auto ABS have also been helped by the upward trend in used car prices, which are up 5.1% over the past year according to the Manhiem Used Car Index. Finally, while corporations have increased leverage since the financial crisis, consumers have actually de-levered as reflected in healthy debt-to- income and financial obligations ratios.

The solid consumer fundamentals have translated into stable credit trends for auto ABS. Prime borrower ABS shelves like Ford, Honda and Toyota have performed extremely well since the financial crisis with very low levels of delinquencies and losses. The subprime sector, an area much maligned with the association to the mortgage crisis, has also seen stable performance, well within the underwriting expectations. Auto ABS issues have benefited from consistent underwriting standards, with subprime auto in particular tightening underwriting following some modest credit deterioration in 2015. Another sign of issuer discipline, is the share of subprime auto loans relative to the total auto loans outstanding has held steady around 30%, well below the pre-crisis levels of 47%.

The strength and time-tested support provided by the ABS structure is also an important positive factor for the sector. Auto ABS structures held up extremely well through the very stressful great recession period. Even in subprime auto ABS, bonds rated AAA and AA experienced no principal loss during the crisis and investment grade bonds, according to Moody's, have a historical impairment rate of only 0.1%. The bond structures utilize robust credit enhancement to protect investors against potential principal loss. The credit enhancement required by the rating agencies has actually increased for both prime and subprime relative to pre-crisis levels. The sequential payment in auto ABS, which allocates principal cash flows to the most senior bonds first, also rapidly builds the credit enhancement as the security ages.

Lastly, we believe the positive supply and demand technicals and attractive relative value favors the auto ABS sector. The overall supply in the ABS market has been modest, especially relative to the heavy new issuance in the credit markets. With signs that auto sales have peaked, we would expect auto ABS issuance to level off. Despite the strong performance over the past year, particularly in lower rated subprime issues, we still believe there is room for the sector to grind higher.

With positive fundamentals, attractive relative value and well-tested structures, auto ABS may be a good choice to reduce the list of worries.

Thank you for listening, and we'll talk to you again next week.

Thank you for joining us. And stay tuned for our next cast. Have topics you want covered or other feedback to share? Write us at info@tortoiseadvisors.com.

The Manheim Index applies statistical analysis to its database of more than 5 million used vehicle transactions annually. Manheim has developed a measurement of used vehicle prices that is independent of underlying shifts in the characteristics of vehicles being sold.