



ABS – Actual Bond Security

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As fears of a sovereign crisis intensify, equity markets sell off and credit markets shut down for new business, there are obvious parallels between the current market backdrop and the '2007 vintage' credit crunch. However, there is one very obvious difference for fixed interest investors: the relative stability of secured or asset backed securities (ABS). Here, we examine why ABS performed poorly during the credit crunch and, crucially, why it is faring much better during the current market volatility.

But first, what are asset backed securities? Quite simply, as the name suggests, these are bonds which benefit from security over assets. In the case of default or financial distress, the claim investors in these instruments have over clearly defined assets typically places them in an advantageous position compared to other unsecured creditors of the company. The collateral used can be as diverse as buildings, specific income streams such as government contracts, or financial assets, for instance loans and mortgages.

Everything else being equal, the magnitude of credit enhancements that ABS enjoy compared to unsecured corporate bonds implies that they have a materially lower overall credit risk. We would therefore expect that ABS should exhibit less volatility than unsecured bonds. However, these protections did not prevent significant underperformance from the sector between 2007 and early 2009. In part this was due to the perceived complexity of these bonds at a time when a number of banks, which had been significant buyers of these bonds for their low risk liquidity funds, were forced to sell assets into an extremely unreceptive market. At the same time, the misuse of the securitisation process in the US sub-prime mortgage market further affected investor sentiment towards this area.

The indiscriminate nature of this underperformance produced a large number of relative value opportunities. Perversely, asset backed debt, secured against appropriate assets with acceptable leverage and enhancing structures, was trading at materially greater yields than unsecured corporate bonds. By way of example, in the summer of 2009 Tesco issued a senior bond secured against its supermarkets, paying 3.3% above government bond yields. At the time this was a 1.7% greater yield than could be achieved by holding similarly rated unsecured Tesco debt.

The recovery in corporate bond markets in 2009 was coupled with a strong rehabilitation of secured bonds. However, crucially, as markets began to sell off in May 2010, the fundamental attractions of this asset class, including security over tangible assets, seniority and protective covenants, have seemingly now been recognised by investors and these bonds have outperformed sharply. Furthermore, the largely non-cyclical nature of these bonds and their low correlation to European sovereign debt has proved supportive.

Up to 40% of a typical RLAM corporate bond fund will be in bonds that benefit from security over the issuers' assets and it is important to note the high quality of the assets that these bonds are secured against. Within our ABS holdings, a large proportion is issued by utility companies such as National Grid and Yorkshire Water and public related entities including PFI companies and infrastructure operators such as BAA. The remainder tend to be secured bonds issued by blue chip consumer/industrial companies including Tesco plc, J Sainsbury plc and Land Securities plc. Most of these bonds are rated, benchmark constituents and liquidity

in this sector is broadly consistent with similarly rated unsecured corporate bonds. Our funds also hold unrated mortgage debenture bonds which tend to be issued by asset rich investment trusts and real estate companies.

As fears over global economic growth and corporate funding resurface and with the investment grade asset backed benchmark currently offering credit premiums to government bonds of 2% compared to the unsecured investment grade industrials index at 1.7%, we firmly believe that there is a real opportunity to lock in extremely attractive credit spread levels from a sector that should continue to exhibit materially lower fundamental credit risk and volatility.

Source: rlam as at 20th June 2010 unless otherwise stated.

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