Diversified ABS:
a truer exposure to asset backed securities?

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One of the problems with credit markets is classification conventions. If you look at sterling credit index methodologies, you will see a lack of consistency between providers on bond and sector categorisations. Asset Backed Securities (ABS) reflect this perfectly.

At RLAM we extensively use secured bonds to enhance return or reduce risk in client portfolios. However, not all these bonds will be termed asset backed securities. The industry – asset managers, banks, and index providers – have deemed ABS to cover only a sub-set of secured bonds. Our Diversified Asset Backed Securities Fund helps to illustrate the key points of difference between our approach and the narrower designation.

ABS conventions

There are two broad ways to get exposure to bonds with enhanced collateral: securitisations and secured corporate bonds. It is the former that most ABS funds focus on. In securitisations, debt is raised against a specific pool of assets held within a special purpose vehicle (SPV). Examples include auto loans, residential mortgages, student loans, and credit card loans, and these are generally concentrated towards consumer-related sectors. Tranches are issued which reflect priority of claim on cashflows and underlying assets; there is no recourse to the sponsor if things go wrong. Most securitisations are issued as floating rate notes, referenced to a variable market interest rate, e.g., Sterling Overnight Interbank Average (SONIA).

Secured corporate bonds are fundamentally different, although clearly falling within a definition of being asset backed. Secured bonds are issued by companies, who pledge assets as collateral. Typically, these bonds are fixed coupon, with maturities of five years and more. Covenants are generally in place so that if the value of the collateral falls below a threshold (x1.5 or x1.6 the value of bonds outstanding) the issuer is obligated to pledge more collateral.

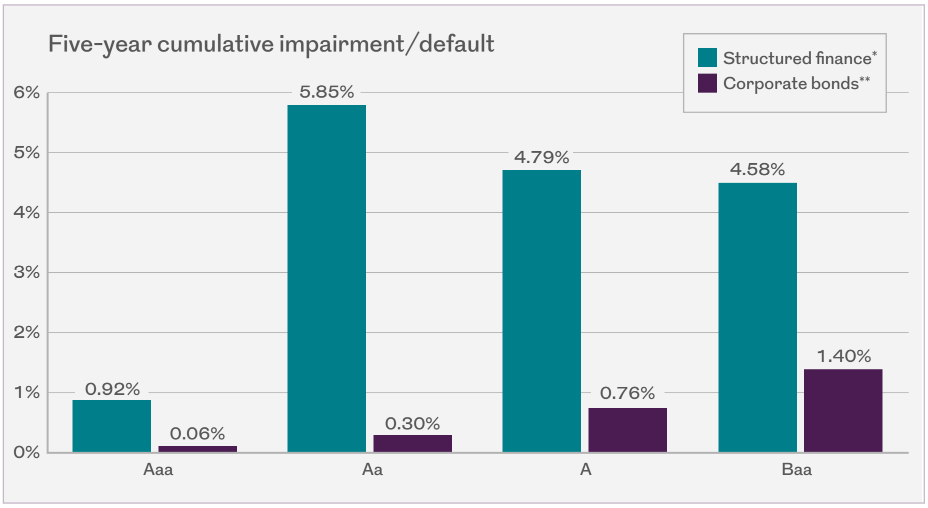
In our Diversified Asset Backed Securities Fund we offer clients exposure to both securitisation and secured corporate debt, with a focus on being a senior lender. We have a rich heritage in both areas, having been investors in the first sterling residential mortgage-backed securities (from Lloyds and Santander) and the first sterling covered bonds (issued by Leeds Building Society, secured on prime mortgages) after the Global Financial Crisis. Post crisis, banks had to offload assets via securitisations – we were well placed to look at these structures given our significant experience in secured corporate bond investing.

Diversified ABS

Our approach significantly widens the asset backed universe, bringing in housing associations, covered bonds, investment trusts and infrastructure issuers. To further improve diversification, we can also hold non-secured corporate debt up to a maximum of 20%.

In this way we avoid pitfalls of over-concentration on certain sectors such as credit cards, residential mortgages, and auto loans. A challenge is duration management, given that secured corporate debt is generally longer dated. To address this, and to align with our benchmark (SONIA), we use a range of simple derivative instruments to hedge out interest rate risk. What we are left with is a corporate bond fund, heavily skewed towards asset backed bonds in the widest sense, with little or no interest rate risk. This allows us to pick the best of both worlds: secured corporate bonds and securitisations.

The principal risks our clients are exposed to are credit spread widening and default; the latter is mitigated significantly through our focus on senior secured debt, which maximises recovery in a deteriorating credit environment. On a daily basis, the fund will reflect movements in credit spreads, and volatility will reflect the maturity profile of the credit bonds held. However, the



Past performance is not a reliable indicator of future results.

Source: Moody's as at December 2020. For illustrative purposes only.

* Data is from 1993 to 2020 (EMEA)

** Data is from 1983 to 2020 (Global)

downside protection is superior, relative to securitisation focused strategies, due to the greater diversification and the quality of our lending position. From a liquidity viewpoint our focus on senior debt tranches means we largely avoid exposure to junior securitisation tranches – the area that can become most illiquid at times of stress.

Moving down the ratings hierarchy in securitisations isn't inherently bad. Clearly yields are higher, but it's important to know what risks are being taken. The average rating of second pay (slightly junior) securitisations is typically high at AA, reflecting rating agency methodologies. However, this can give false comfort, as AA rated securitisations have historically significantly worse cumulative impairment/default losses compared to AAA rated securitisations and AA rated corporate bonds. This reflects the cliff-edge risk introduced by tranche structures – in our opinion credit ratings don't tell you everything.

There is another advantage to our approach: buybacks. Many secured corporate bonds have clauses that allow the issuer to buy back bonds but only at government bond yields (i.e. no credit spread) or at small yield premiums. Why would an issuer want to do this? It may be that the interest cost is too high, that the debt is no longer required, or the issuer wants to do something with the encumbered assets. Whatever the reason such buybacks can be a nice surprise – not something you usually get in bond markets!

When compared to AA corporate (unsecured), the default/impairment statistics in the graph show a significant improvement in loss risk for AA unsecured corporates relative to AA rated junior securitisations. Our approach allows us to pick the best unsecured bonds (for a small proportion of the fund), while maximising the benefits of secured bonds, namely: undervaluation of seniority and the enhanced recovery available; the diversity of opportunity (by maturity, cashflows and economic exposure); and the higher spread available due to rating methodology, complexity and regulation. Unsecured bonds are often targeted towards diversifying, return-enhancing areas such as highly regulated financial and utility debt.

A differentiated fund offering

The Diversified Asset Backed Securities (DABS) Fund falls within our sterling credit range, with most bonds being sterling denominated. A key attraction is that our bonds are generally governed by English law, an important advantage as other jurisdictions tend to have weaker protections for secured bondholders. For pension investors, it is unlikely that there will be consistency in what constitutes an asset backed bond. Within the Royal London DABS Fund, we have been clear that our horizons are wide and we believe that this has served our clients well over the longer term. Whether used as a cash plus generator for liability-driven investment (LDI) portfolios, or as a diversifier against generic corporate bonds, we think the DABS Fund is a differentiated offering in the sterling market.

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Investment risks

The value of investments and the income from them may go down as well as up and is not guaranteed. Investors may not get back the amount invested.

Credit risk: Should the issuer of a fixed income security become unable to make income or capital payments, or their rating is downgraded, the value of that investment will fall. Fixed income securities that have a lower credit rating can pay a higher level of income and have an increased risk of default.

EPM techniques: The fund may engage in EPM techniques including holdings of derivative instruments. Whilst intended to reduce risk, the use of these instruments may expose the fund to increased price volatility.

Exchange rate risk: Changes in currency exchange rates may affect the value of your investment.

Interest rate risk: Fixed interest securities are particularly affected by trends in interest rates and inflation. If interest rates go up, the value of capital may fall, and vice versa. Inflation will also decrease the real value of capital.

Liquidity risk: In difficult market conditions the value of certain fund investments may be difficult to value and harder to sell, or sell at a fair price, resulting in unpredictable falls in the value of your holding.

Counterparty risk: The insolvency of any institutions providing services such as safekeeping of assets or acting as counterparty to derivatives or other instruments, may expose the fund to financial loss.

Government and public securities risk: The fund can invest more than 35% of net assets in different Transferable Securities and Money Market Instruments issued or guaranteed by any EEA State, its local authorities, a third country or public international bodies of which one or more EEA States are members.

Leverage risk: The fund employs leverage with the aim of increasing the fund's returns or yield, however it also increases costs and its risk to capital. In adverse market conditions the fund's losses can be magnified significantly.

Contact us

For more information about our range of products and services, please contact us.

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