Asset-Backed Securities

An Attractive Option for Growth and Income

For Professional Clients Only

Amid volatile markets and economic uncertainty, asset-backed securities provide investors with some welcome alternatives.

The extreme financial market volatility in both bonds and equities may now be behind us, but the medium-term outlook for many assets remains less certain than it has been for many years.

The likely pace and depth of central bank interest rates cuts is unclear and while inflation has receded it is proving more stubborn than had been hoped and bond market volatility is likely to continue. While equities have enjoyed a strong run, the gains have been highly concentrated in a handful of companies and the wider economic outlook across markets remains mixed.

In these circumstances, high quality asset-backed securities could provide the characteristics that many investors are looking for including:

- Growth
- Low volatility
- Income and cash flow
- Higher credit spreads than equivalent risk corporate credit
- Diversification

In today's market, growth, income and low volatility are the key attractions of asset-backed securities making this an asset class that can compete with and compliment traditional equities and bonds — including investment grade corporates.

Asset-backed securities are sometimes regarded as a complex financial instrument, but in essence they are remarkably simple.

Delivering Cash Flows

Underlying any asset-backed security is a pool of loans, these may be mortgages (residential or commercial), car loans, student loans and many others. These loans are typically secured against assets or future income and are naturally cash flow generating as borrowers are contracted to repay the principal on their loan plus interest.

Converting these underlying loans and the collateral attached to them into a tradeable asset is the process of securitisation.

The originator of the loans pools many of the underlying loans or mortgages and places them in a special purpose vehicle (SPV).

Investors can buy securities issued by the SPV that give them the right to the cash flows generated by the underlying debt assets. Those cash flows are typically floating rate meaning very little duration risk and yields are much improved in a higher interest rate environment.

The securities are sold in tranches, which are rated in the same way as traditional corporate or sovereign bonds from AAA, AA and so forth. Higher-rated tranches offer lower risk because they are the first to be repaid and the last to incur losses from any defaults from the underlying loans. Asset-backed security tranches have consistently offered higher credit spreads relative to equivalent-rated corporate credit.

When added to higher base rates, high quality asset-backed securities offer investors the prospect of strong growth returns too meaning they are a compelling alternative to traditional growth assets.

Despite the obvious attractions of asset-backed securities, some investors may be wary because of their association with the global financial crisis. However, the asset class since the early 2000s has been improved through increased regulatory scrutiny following the crisis. The rating of tranches is now more strictly regulated and there is significantly more credit enhancement or security for investors. Importantly, the originator of an asset-backed security must retain an economic interest in the securitisation which aligns the interest of the originator with the end investors.

This greater security, combined with the range of risk/return profiles, means asset-backed securities can play a wide range of roles in any institutional portfolio and a combination of different asset-backed securities can be part of a multi-credit strategy.

Diversification

As well as offering a diversification away from traditional corporate equities and bonds, asset-backed securities are themselves a highly diverse and liquid market. Most obviously, the underlying loans cover a range of markets — for example residential mortgages, commercial mortgages or car loans.

The outlook for different underlying loans and markets is varied. Some parts of the commercial mortgages market, for example, are under strain in the current economic climate and the long-term effects of the pandemic, while residential mortgages in many markets have proved resilient even through the recent rate tightening cycle.

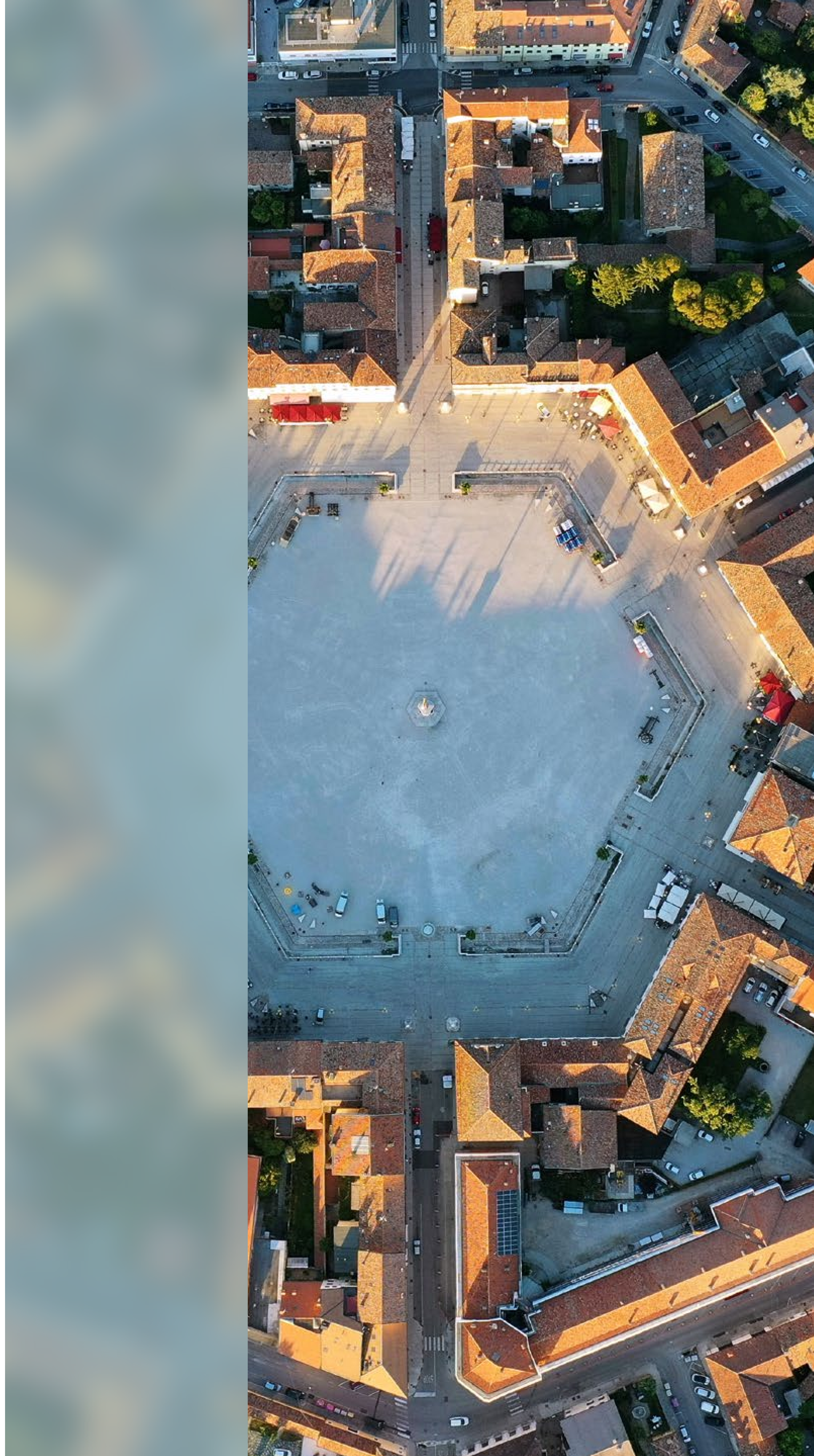
There is also the potential for geographical diversification, providing exposure to different consumer economies. This is of growing significance as different economies and markets — the US, UK and Germany, for example — are no longer moving in lockstep.

The market is also expanding into other sectors, including more social and green issuance, such as solar farms, and the diversity of underlying assets looks set to grow.

Given this diversity, investing in ABS does require sophisticated credit and market analysis and managers will, for the most part, integrate assessment of ESG risks into their portfolio construction process.

The asset class is highly accessible to any type of institutional investor and strategies are available across sectors, geographies and risk profiles.

In the search for growth, low volatility and income, high quality asset-backed securities present an attractive opportunity for investors looking for alternatives to traditional equities and bonds.



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