Insight INVESTMENT

SECURED FINANCE AS A MITIGATING STRATEGY FOR BBB CORPORATE CREDIT RISK

JULY 2019

> Institutional investors concerned about burgeoning risks in the BBB corporate credit market should consider including secured finance as part of a broad-based credit strategy.

BNY MELLON | INVESTMENT MANAGEMENT

EXECUTIVE SUMMARY

IMPROVE RISK-ADJUSTED PERFORMANCE

Investors concerned about rising BBB corporate leverage should consider casting their net wider to include secured finance as part of a broad-based credit strategy. Harnessing the complexity and illiquidity premia available has the potential to meaningfully enhance risk-adjusted returns.

CORPORATE TO CONSUMER

With trade tensions mounting, secured finance offers diversification benefits away from potentially trade-exposed corporate credit into less-exposed consumer- and residential-focused investments.

UNSECURED TO SECURED

Unlike corporate bonds that are mainly unsecured, secured finance investments are backed by collateral and potentially benefit from credit enhancement and other structural protections.

PORTFOLIO STRATEGY

The duration of secured finance public securities can extend out to about 9 years and can be considerably longer for private instruments. For LDI investors, duration can also be extended via overlays, and/or by your completion manager.

ISSUES IN THE CORPORATE CREDIT MARKET HAVE BEEN WELL PUBLICIZED

BBB DEBT HAS GROWN CONSIDERABLY

In our 2018 paper **BBBs: Separating the Wheat from the Chaff**[1], we shone a light on the burgeoning BBB-rated US corporate credit universe. The growth of this segment has far outpaced the broader US corporate debt market and the current proportion of BBBs stands out as excessive relative to historical cycles. While in 2008, 38% of the investment grade (IG) universe was BBB-rated, today over 50% is (Figure 1).

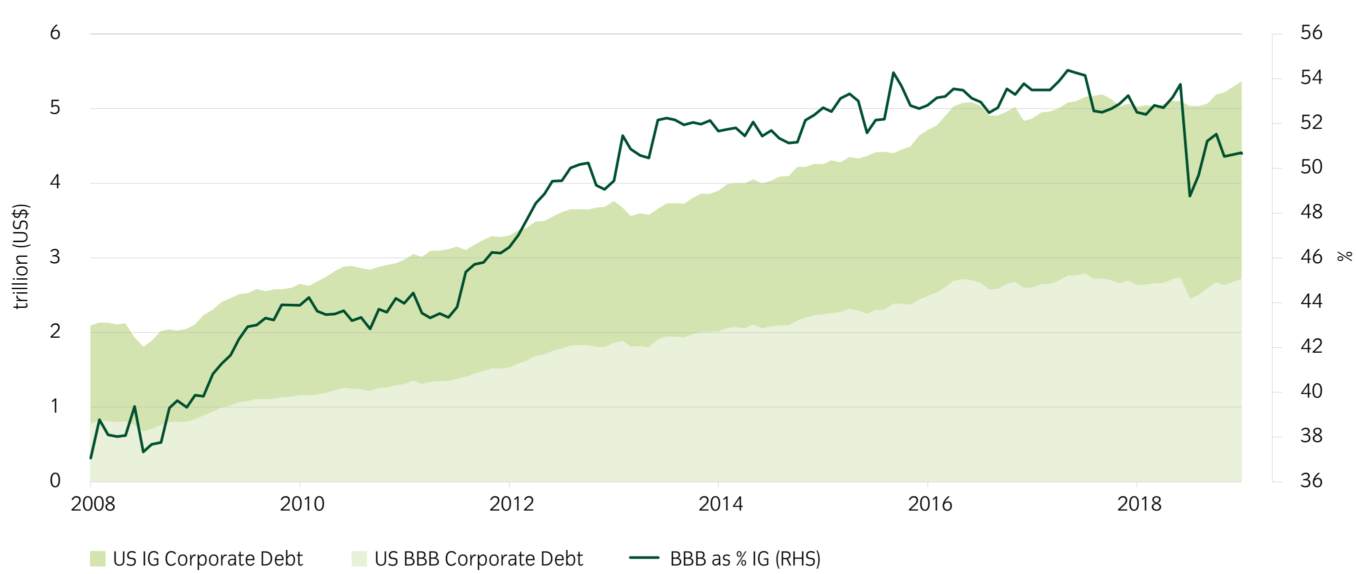
We believe that much of this growth can be explained by downgrades linked to an increase in debt-fueled financial engineering. Essentially, as the economic cycle has matured and organic growth opportunities have diminished, firms have sought to boost shareholder returns through share repurchases, dividend increases and M&A. Much of this has been financed through debt. Additionally, the narrow spread differential between the investment grade ratings tiers has encouraged A and AA rated companies to aggressively re-leverage with minimal additional financial cost. This activity has resulted in pockets of elevated BBB leverage, which in some instances would not look out of place in the high yield universe.

YET BBBs HAVE AN IMPORTANT ROLE TO PLAY IN LIABILITY-HEDGING PORTFOLIOS

While some of the company-specific instances of higher leverage are questionable, on aggregate, the increase in corporate America's leverage is consistent with what has been a period of very robust economic growth. There are, however, understandable concerns from investors that when the current cycle inevitably turns, substantial downgrades and defaults could ensue given the sheer number of credits teetering on the brink of high yield.

Although we sympathize with these concerns, we believe that BBB corporate bonds continue to offer a compelling opportunity for liability-hedging portfolios. They serve as an effective liability hedge, provide additional diversification benefits and offer an enhanced spread cushion. Furthermore, BBB-rated issuers are incentivized to maintain or improve their credit ratings, which A-rated issuers are not to the same extent. Investors just need to be selective. The rapid increase in the BBB universe and associated rise in leverage requires a more discerning approach – investors need to separate the wheat from the chaff.

Figure 1: US BBB corporate credit has experienced rapid growth since 2008[2]



[1] Available at: https://www.insightinvestment.com/globalassets/documents/recent-thinking/na-separating-the-wheat-from-chaff-in-bbb.pdf
[2] Source: Bloomberg Barclays, Insight, 30 April 2019.

STRUCTURED CREDIT AS A MITIGATING STRATEGY FOR BBB CORPORATE RISK

CAST THE NET WIDER

In addition to being more selective, we believe that it is prudent for investors to cast their net wider and consider an allocation to structured credit as part of a broad-based fixed income strategy. Structured credit offers the potential for attractive diversification benefits to corporate bond investors, including the opportunity to rotate out of corporate exposures and into investments that are more consumer-exposed, such as residential and consumer asset-backed investments. Such investments are likely less exposed to the ongoing trade tensions than corporate America.

WHAT IS STRUCTURED CREDIT?

Structured credit is a global asset class incorporating a range of public (e.g asset-backed securities, or ABS, and collateralized loan obligations, or CLOs) and private (e.g asset-backed loans) fixed income investments which have the potential to provide contractual, high-certainty cashflows secured against collateral. While this is a sweeping definition that includes a wide range of potential assets, at Insight we focus on three broad categories of structured credit characterized by the type of cashflow securing the asset (Figure 2). Collectively we refer to the opportunity set as **'secured finance'**.

Figure 2: The three types of structured credit or 'secured finance' assets[3]

	RESIDENTIAL AND CONSUMER	COMMERCIAL	SECURED CORPORATES
PUBLIC SECURITIES	• Prime residential mortgages • Mortgage insurance/Mortgage servicing rights residental mortgage-backed securities • Consumer ABS	• Commercial mortgage securities • Commercial real estate (CRE) CLOs • NPL portfolios	• CLOs • Whole business securitizations • Enhanced equipment trust certificate
PRIVATE DEBT	• Mortgage pools • Bridging finance • Auto/credit card pools	• CRE loans • Multifamily • Aircraft loans	• Corporate loan warehouse • Small medium enterprise pools • Trade finance

[3] Source: Insight. For illustrative purposes only.

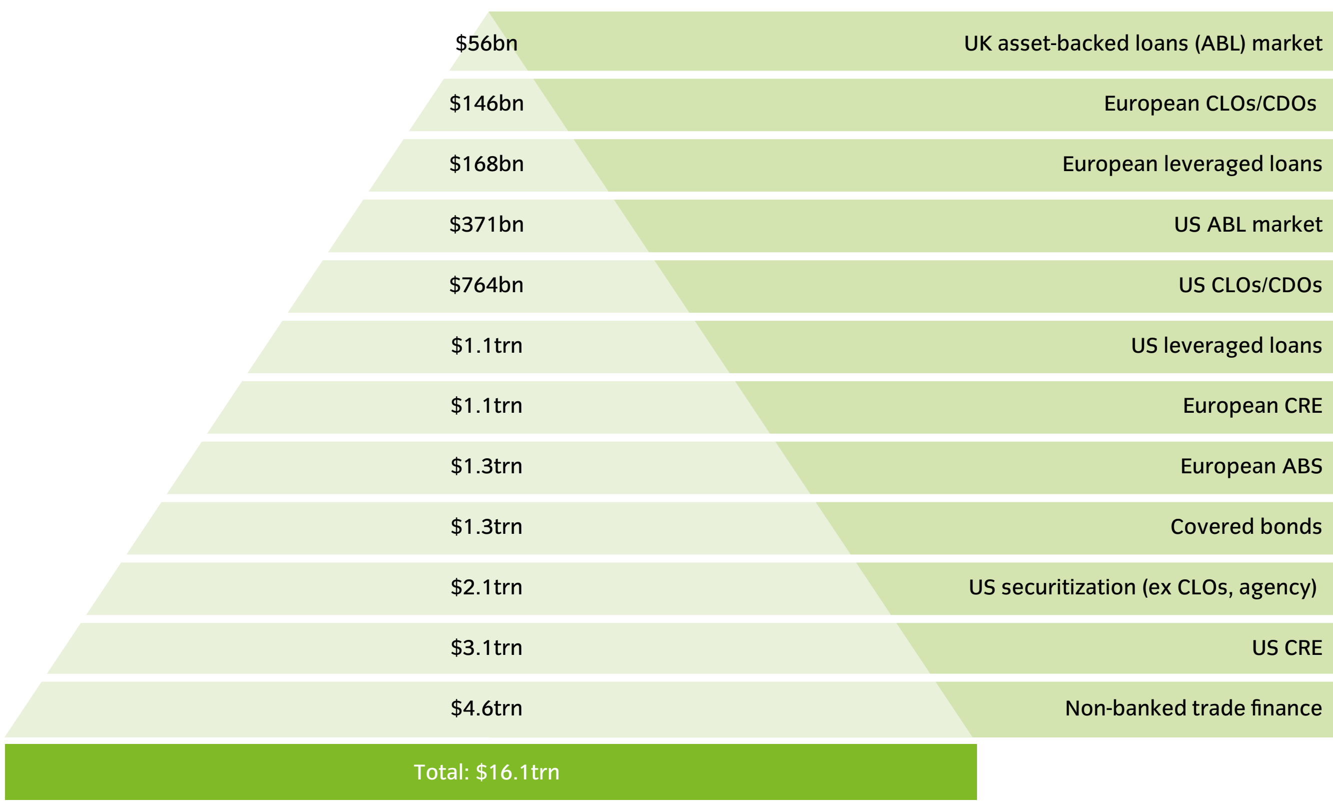
SIZING THE OPPORTUNITY SET

We can put the sheer size of the secured finance market into perspective by comparing and contrasting it with the US corporate bond market.

Using data from Bloomberg Barclays indices, the US corporate universe stands at US$6.6trn, of which US$5.5trn is investment grade rated, US$2.7trn is BBB-rated and US$931bn is classified as long duration BBB-rated (maturity 10 years and above).[4] In contrast, we estimate that the secured finance universe stands at US$16trn, with well over half of this in US dollar denominated assets (Figure 3). This comprises a diverse range of assets from financial securities such as asset-backed securities (ABS), mortgage-backed securities (MBS) and collateralized loan obligations (CLOs) and loans such as commercial real estate (CRE) debt. Secured finance clearly presents enormous diversification benefits for investment grade credit investors.

At Insight, we seek to maximize yield from a diversified portfolio of high-quality secured finance investments and rely upon an asset allocation model to help identify relative value across markets, countries, sectors and credit risks. The output of this process is a qualitative and quantitative framework comparing value across security and lending markets.

Figure 3: Secured Finance represents a US$16 trillion global opportunity set[5]



[4] Bloomberg Barclays, May 2019.
[5] Source: Bloomberg, Insight, World Trade Organization, JP Morgan, SIFMA, AFME, CFA Society, Mortgage Bankers Association, CBRE, UK Finance and S&P Global Market Intelligence. The definition of secured finance excludes agency securitisation, infrastructure debt, direct mid-cap corporate cashflow lending.

THE POTENTIAL BENEFITS OF EXTENDING INTO SECURED FINANCE

Structured credit offers a number of potential benefits to investors. For a given rating, relative to corporate credit, we believe structured credit has experienced lower levels of default and loss given default while offering higher yields and tighter credit standards than corporate credit (where standards have arguably loosened) over the past decade.

Historically low defaults

For many investors, structured credit is synonymous with the global financial crisis of 2008-09. Perhaps less appreciated however, is that outside of US subprime mortgage bonds and collateralized debt obligations (CDOs), the default track-record of publicly traded structured credit is remarkably strong. Many structured credit sectors have never experienced a default of senior or mezzanine tranches (Figure 4). This compares to an average annual default rate of 1.75% for global corporate credit over the last two decades (Figure 5).

The potential benefits of structural protections are perhaps most obvious in comparing the long-term default and loss track record for CLOs at a given level of credit risk compared to similarly rated corporate bonds (Figure 6).

Figure 4: Historical default rates for structured credit sectors (1994-2013)[6]

	Default rate (%)	Recovery rate (%)	Loss rate (%)
UK Prime RMBS (AAA/AA)	0	na	na
UK buy-to-let (AAA/AA)	0	na	na
Dutch/Italian/Spanish RMBS	0	na	na
European CLO (AAA/BBB)	0	na	na
European auto/credit cards	0	na	na
US buy-to-let (AAA/AA)	0	na	na
US auto/credit cards (AAA/AA)	0	na	na
US subprime RMBS	15.86	50	7.93
CDO of US subprime RMBS	21.30	50	10.65
European CMBS	2.52	50	1.26

Figure 5: Global corporate default rate history[7]

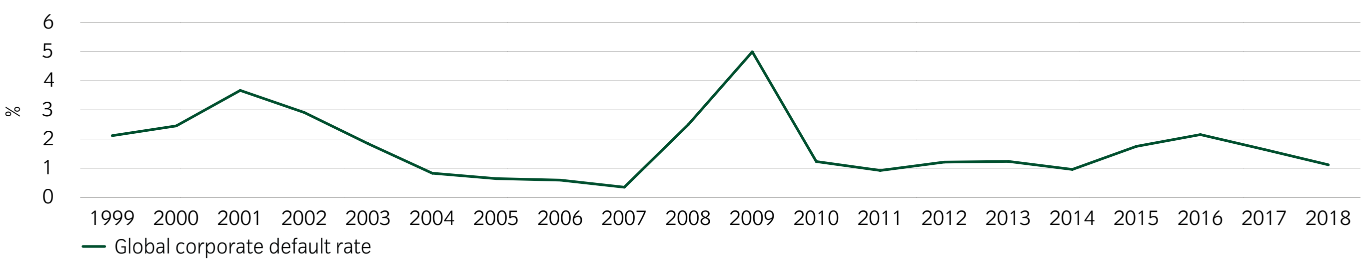


Figure 6: Historical default rates for CLOs compared to corporate bonds (1994-2013)[8]

			CLO		Corporates	
Original rating	Total tranches	Defaulted tranches	Default rate (%)	Loss rate (%)	Default rate (%)	Loss rate (%)
AAA	1,992	0	0.00	0.00	0.00	0.00
AA	1,005	0	0.00	0.00	0.39	0.26
A	1,119	5	0.45	0.08	1.13	0.72
BBB	1,069	3	0.28	0.21	1.82	1.14
BB	841	14	1.66	0.78	8.08	4.75
Total	**6,036**	**22**	**0.36**	**0.04**		

[6] Insight, S&P and Moody's as of December 2013.
[7] Moody's Default Study 2019.
[8] S&P and Moody's as of December 2013.

Additional spread pick-up

The investment environment over much of the past decade has been characterized by easy liquidity and low yields. Investors have had to either accept the lower yields available in investment grade credit, or, to achieve higher yield, assume greater credit risk by moving further down the credit spectrum.

We believe secured finance provides investors with a potentially more attractive option – namely the ability to extract a yield premium which currently sits in the range of ~150-250 basis points[8] (bp) over an equivalent investment grade rated corporate credit portfolio, for a commensurate level of credit risk (Figure 7).

Considering the similar credit profile, investors may naturally ask: what drives this additional yield premium?

In our view, two factors predominate:

Complexity premium: Secured finance investments are structured by definition, requiring additional specialized origination, underwriting, structuring and valuation expertise. Unlike the corporate bond market, where investors can lean on credit ratings and public information, the secured finance market is only open to adequately skilled and resourced investors, resulting in a complexity premium.

Illiquidity premium: The illiquidity premium attached to public and private market secured finance investments results also in part from their less liquid nature. While they trade T+2, ABS and CLO instruments have a smaller buyer base and are heavily structured, resulting in lower market liquidity. Private ABS and asset-backed loans are bilateral instruments by design and liquidity is often limited.

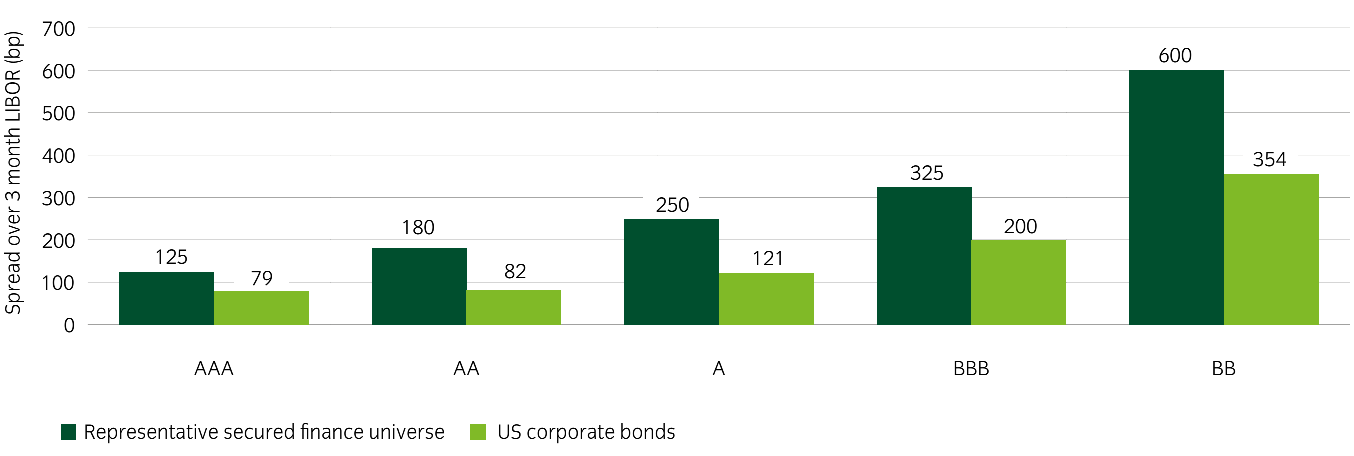
Structured credit rating standards have tightened while corporate credit has loosened

It can be argued that credit rating agencies have been unduly lenient toward companies that have levered up aggressively to fund acquisition or share repurchase activity by giving them far too much flexibility with their deleveraging plans. In an October 2018 research paper, Morgan Stanley notes that 31% of BBB debt is now leveraged at or above 4.0x, while their implied ratings analysis notes that 55% of BBB debt would be rated high yield if based on leverage alone. It would appear that the definition of what constitutes a BBB-rated corporate credit is increasingly being stretched.

Such rating inflation has not been evident in the structured credit markets, quite the opposite in our opinion. Credit rating criteria for structured credit tightened in 2009-2010, effectively a one-off reset, and criteria have not loosened since. A good example is post-crisis CLO transactions, also known as CLO 2.0, as a means of distinguishing them from CLO transactions issued prior to 2008. For a given credit rating, these CLOs are subject to more stringent requirements, for example more restricted collateral eligibility requirements and greater levels of credit enhancement for senior tranches.

At a time when investors are growing concerned about ratings inflation in corporate bonds, structured credit stands out as a compelling alternative.

Figure 7: Structured credit offers attractive risk-adjusted returns[9]



[8] As of June 2019.
[9] Insight as of March 31, 2019. The spreads shown are for illustrative purposes only and are not indicative of the strategy spreads. US corporate bonds used to reflect corporate bonds: BofA Merrill Lynch AAA US Corporate Index, AA US Corporate Index, A US Corporate Index, BBB US Corporate Index & BB US High Yield Index. Representative secured finance universe reflects the global universe of structured credit opportunities plus lending margins in private debt markets where appropriate. Information shown does not reflect any strategy account or fund managed by insight. There could be material differences between the information shown and the strategy.

INCORPORATING SECURED FINANCE INTO A SOLUTION

We have observed that some clients have funded secured finance exposures from within their existing fixed income allocations, in many cases from a corporate bond or core fixed income portfolio.[10] The yield pick-up per unit of credit risk that is currently available together with the strong diversification benefits, greater consumer orientation and structural protections, can add a very attractive dimension to a portfolio.[11] For long duration corporate credit investors who might be concerned about losing duration by selling down their BBB bonds, the duration of public secured finance securities can extend out to about 9 years, while for private market instruments the duration can be significantly longer. Lost duration can be replaced through overlays or by your completion manager.

Maturing pension plans that are cashflow negative and moving to address forced selling and sequencing risks are also incorporating secured finance strategies into their cashflow driven investment (CDI) solutions. Contractual cashflows and strong structural protections make secured finance attractive to CDI programs, while the potential yield advantages can keep the financing 'cost' of the CDI program relatively low.

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Some of our clients fund secured finance allocations from within their existing fixed income allocations

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[10] Each account is individually managed, and could differ from what is presented herein.
[11] Diversification does not necessarily eliminate risk.

INSIGHT'S SECURED FINANCE CAPABILITIES

SPECIALIZATION

- Specialist and experienced Secured Finance Team: $20.1bn[12] in assets under management
- Complementary experience in sourcing, underwriting, structuring, closing and trading
- Integrated into a market-leading fixed income and credit platform

ASSET ALLOCATION

- Robust investment process incorporating top-down credit strategy and bottom-up underwriting
- Proprietary asset allocation model for liquid and illiquid credit across global secured finance markets
- Attractive track record across securitization and collateral based lending

CREDIT UNDERWRITING

- Private Insight credit ratings models
- A history of credit default avoidance[13]
- Risk control by experienced investment committee

SOLUTIONS

- Modeling plan liability profiles and matching with potentially high-quality cashflows
- Tailoring the strategy, credit quality, maturity profile, payout profile etc.

[12] As of March 31, 2019. Insight's assets under management (AUM) are represented by the value of cash securities and other economic exposures, and are calculated on a gross notional basis. Insight North America (INA) is part of "Insight" or "Insight Investment", the corporate brand for certain asset management companies operated by Insight Investment Management Limited including, among others, Insight Investment Management (Global) Limited and Insight Investment International Limited. Advisory services referenced herein are available in the US only through INA. Figures shown in USD. FX rates as per WM Reuters 4pm spot rates.
[13] Past performance is not indicative of future results. Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.

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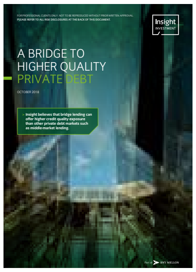
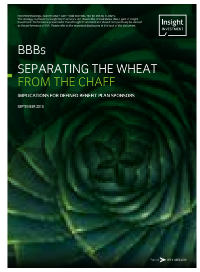


A bridge to higher quality private debt

Insight believes that bridge lending can offer higher credit quality exposure than other private debt markets such as middle-market lending.



BBBs – Separating the wheat from the chaff

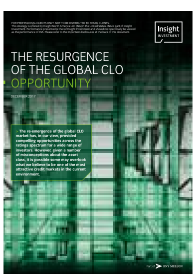
Much has been written recently about the potential risk of US BBB corporate securities given the secular increase of leverage in corporate balance sheets. Insight believes that BBBs provide considerable opportunity for liability-hedging portfolios and should form an integral part of the investment universe.

US subprime auto loans systemic risk or contained weakness?

US auto loan markets have attracted recent attention due to rising delinquencies. However, we believe there is little potential for systemic risk in the structured credit and private lending markets, and we expect market weakness to be contained.

The trillion-dollar trade finance opportunity

The trade finance market is emerging as a compelling private debt opportunity for institutional investors seeking sources of attractive risk-adjusted returns. We look at how they can seek to exploit the growing funding gap faced by businesses worldwide.



The resurgence of the global CLO opportunity

The re-emergence of the global CLO market has, in our view, provided compelling opportunities across the ratings spectrum for a wide range of investors. However, given a number of misconceptions about the asset class, it is possible some may overlook what we believe to be one of the most attractive credit markets in the current environment.

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