ROYAL LONDON
ASSET MANAGEMENT

Harnessing the inefficiencies in ABS investing

Shalin Shah, Senior Fund Manager and Martin Foden, Head of Sterling Credit Research, explore the inefficiencies, risks, and opportunities that elude many investors in the securitisation market.

Shalin Shah,
Senior Fund Manager

Martin Foden,
Head of Sterling Credit Research

How do you define ABS investing?

Martin: I think since the financial crisis, the definition of Asset Backed Securities (ABS) has become narrowly focused on the securitisation market. However, our definition is broader and encompasses any security that has asset backing to support the interest payments and realisation of principal.

As a result, we invest across secured corporate bonds blended with securitisations to utilise the best of both worlds. Our RL Diversified ABS Fund is the purest form of that and will have the highest allocation to ABS bonds, covering both those asset classes.

What do you look for when investing in ABS?

Shalin: We look to harness the significant inefficiencies we have noticed in the credit markets. For instance, a typical corporate bond fund index is largely an unsecured index.

Based on our experience, by looking wider you can embed secured bonds into a fund without necessarily sacrificing yield. That's because rating agencies, which remain the key determinant of credit allocations in the market, typically focus on more limited aspects of creditworthiness, such as probability of default, rather than looking at how much money is returned in the case of a default. This means you can often pick up additional yield without compromising on downside protection.

Martin: With the right approach and focus we can find higher yielding bonds where not only do we have that secured claim on assets, but also strong covenants that provide more dynamic protection (before default). For instance, we can lend so that if at any point the value of collateral drops below a certain trigger level, the company will be required to put more assets into that position to enhance our clients' lending position.

We don't have a perfect crystal ball and by building in these pre-emptive controls, we materially improve control over companies we lend to, giving visibility of how that credit will evolve over different economic, corporate, and management cycles.

How did the Royal London Diversified ABS (DABS) strategy cope with the LDI liquidity crisis we saw in September and in a bear market generally in 2022?

Shalin: The DABS strategy outperformed a range of peers within the ABS space. This was particularly pleasing given the higher spread duration than a typical ABS fund. The reason for the outperformance stemmed from structural weakness in a range of peer funds compared to the DABS strategy, which have much larger exposures to junior securitisations. The forced selling of junior tranches would have led to extreme price moves. In part this was due to the lower liquidity in the smaller sized junior tranches (with often only one owner of a tranche). This was made worse by their higher correlation to a weak macroeconomic environment, where lower asset prices and higher interest rates increase the risk of bond extension, which, when coupled with the higher subordination can lead to very low recoveries. As discussed, the DABS strategy does not typically own these types of bonds.

The LDI crisis which was led by a generally higher macroeconomic risk and a higher yield environment meant

that even without the forced selling of credit, junior tranches of securitisations were highly susceptible to significant price falls, as there is little buffer for error in these securities.

How do you look to ensure the strategy is best positioned to perform in both a rising and falling rate environment?

Shalin: The strategy has hedging in place. Interest rate swaps, gilt TRS (total return swaps) and futures are some of the tools employed so that overall interest rate duration is maintained close to zero. This means that there is more scope to select a wider range of bonds across multiple sectors and tenors rather than being a forced buyer of a narrow range of ABS. This laser-like focus on adding incremental value through selecting the right securities and cashflows, should create a higher chance of positive performance over the medium term. The fund performed relatively well over 2022, given most asset classes fell markedly as yields rose. The portfolio returned -0.37%* over the period, largely reflecting strong positive stock selection, which offset the large credit spread widening witnessed in markets – by way of contrast, the total return on all-maturity investment grade credit indices was close to -18%.

(*Net returns for Z share class for calendar year 2022. 5-year annualised net returns of 2.17%. Past performance in not a guide to future performance.)

Can you take comfort from credit ratings within the higher-rated securitisations?

Martin: There are some very clear latent risks within securitisations that investors must be aware of as economic conditions deteriorate. Certain superficial characteristics that may be sought don't really provide any downside protection at all. You can buy an investment grade securitisation, but the fundamental reality is that unless you buy the senior AAA tranche, which often doesn't meet the yield requirements of dedicated ABS funds, you're buying a subordinated junior part of that capital structure.

The reality is because borrowers are trying to maximise their leverage and minimise their cost, the first senior piece tends to be very large. So, you are not only subordinated, you are very subordinated. As securitised asset values start to fall, junior tranches can go from full recovery to full loss in the blink of an eye. Given typical ABS funds' yield targets, it's not unusual for them to have more than 50% of their exposures across these subordinated bonds. Our more diversified approach, embracing the inefficiencies across sectors, allows us to stay senior, minimising this subordination risk.

Shalin: There is concentration risk as well. A lot of these securitisations are concentrated on the consumer; so that's credit cards, automobiles, and residential mortgage-backed securities. When you look at those three key areas within the specialist ABS funds out there, the big issue is that a lot of the underlying consumers might be unable to meet their obligations – this is especially true with the present cost of living crisis. As a result, despite potentially looking like a diversified portfolio, many funds are actually just different iterations of consumer finance.

Extension risk in junior bonds is also significant. There is a perception that securitisations are short-dated but if bonds pass their expected maturity date, which is starting to happen, there will be an extension that can last years. The market reaction to this can be quite severe as credit exposure increases at the worst possible time. From an investor standpoint, they may think they're getting a high yield, but the reality is the achieved yield may be much lower should these bonds not mature at that first expected call.

It's a different outcome for secured corporate bonds with hard maturities and cash flow schedules and for the senior securitisation positions, where cash tends to get diverted if deals aren't called. These products provide much greater security and cash flow clarity as you're the first claim on assets.

Martin: The critical point is securitisations have very specific characteristics and the headlines don't always give you a true reflection of the underlying risks. It is critical that you are able to maintain selectivity; by taking a diversified approach you don't have to buy every deal and you don't have to be down the capital structure to achieve a certain portfolio yield.

How do you undertake ESG (Environmental, Social, Governance) analysis for ABS?

Martin: The short answer is ESG integration within the ABS area is no different to our ESG integration within the wider sterling credit approach. Anything that will undermine sustainability of cash flows or balance sheets, we must be aware of within our evaluations.

The challenge, but equally the opportunity, is that external data isn't great. Off-the-shelf scores, ratings and labels don't tend to handle ESG nuance particularly well so it's hard to delegate that to third party systems. We have a really experienced and effective in-house responsible investment team that collaborate with our analysts to enhance our risk identification.

Shalin: Our focus on control in lending also allows us to dampen the impact of poor management. In fact, one of the key reasons we build portfolios around secured bonds is for an enhanced governance structure and the benefit that control brings to advancing our ESG priorities too.

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Investment risks

Past performance is not a guide to future performance. 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.

Royal London Asset Management
55 Gracechurch Street
London EC3V 0RL.

For institutional client queries
institutional@rlam.co.uk
020 7506 6500

For advisers and wealth managers
bdsupport@rlam.co.uk
020 3272 5950

www.rlam.com

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For more information on the fund or the risks of investing, please refer to the Prospectus or Key Investor Information Document (KIID), available via the relevant Fund Information page on www.rlam.com

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