

Volatility, what volatility?

Jeremy Deacon

Head of ABS and Leveraged Finance



Asset-backed securities

Looking back over the year, 2025 was a strong one for asset-backed securities (ABS) – along with a whole host of other assets. In the ABS market, we typically see spreads move in line with other markets, which have seen tightening throughout the year as demand continues to remain robust. And we see no sign of this demand slowing.

But in our view, the asset class remains attractively priced.

With persistent external noise and some idiosyncratic issues – that generate headlines of an impending downturn in markets – it is hard to see where this potential fallout could come from. While risk remains, it is hard to see the catalyst for what could

set off a major retrenchment. The ABS market has been relatively insulated from the volatility seen elsewhere.

Where is this demand coming from?

In our view, ABS remains relatively cheap versus other parts of the credit market. The market still suffers from a hangover from 20 years ago, where the global financial crisis saw all ABS under the spotlight – despite most of the problems during that period being caused by excessively-levered vehicles exposed to US sub-prime mortgages. And the bad press still lingers. As a result, the asset class remains unloved, keeping bonds cheap as others continue to ignore the solid credit fundamentals.

ABS offers a higher yield for the equivalent risk compared to corporate or government bonds, as investors can benefit from the ‘complexity premium’ that ABS offers, due to the specialisms required to understand both the underlying assets and how they operate within each securitisation. And we believe there is still a lot of money to be put to work in the sector.

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There was a notable development in the market in 2025, with the news around key Solvency II proposals from the European Commission. One of the main outcomes was a reduction in capital charges for Simple, Transparent & Standardised (STS), in line with covered bonds. The reduction is meaningful for non-STS senior tranches, where AAA is proposed to be about a fifth of current capital charges, which improves return on regulatory capital for Collateralised Loan Obligations (CLO) rated AAA significantly and brings it quite close to that for investment grade corporate bonds. On the other hand, the improvement in capital charges is less encouraging for non-STS mezzanine tranches, where the potential for insurers to benefit from the mid-high single digit yields of CLO mezzanine has been curtailed by the still high regulatory capital.



How the market has played out?

While we have seen broad themes play out across the ABS market, the sectors in which we invest each have their own individual stories to tell.

In the autos sector, we have seen what we would consider good value during the year, with the misconception that these bonds would be affected by the consumer finance mis-selling. While the sector did see some negative sentiment, the decision determining that the originator and not the security would be affected, allowed some recovery.

There was some weakness from German, Dutch and Finnish autos, with the consumers in those regions facing a softer economic environment. We expect this to continue to be a factor into next year which could hurt issuance from those respective countries.

In commercial mortgage-backed securities (CMBS) there was strong issuance, but it remains fairly concentrated on logistics assets, which has given us some pause about investing in the sector. Demand has been high, which has seen spreads tighten, but the lack of diversification leads us to favour other sectors. This concentration could see idiosyncratic factors – which would typically be contained – result in wider market weakness. This highlights how important it is for a fund manager to know what they hold and the importance of bottom-up analysis.

In the loan market, we have seen strong performance as corporates looked to secure lending at attractive rates. As in the CMBS market, idiosyncratic factors could remain an issue, but for different reasons however, as cheap lending could lead to concerns around hidden leverage feeding into the system.

When trying to predict how financial markets will behave months or years from now, the original problem usually stems from too much leverage. This is what gives me fear for next year: idiosyncratic issues potentially toppling into an over-leveraged system. We are still seeing heavy CLO issuance, and this is not likely to stop with spreads at their current tight levels, so any fallout will come from widening but, again, what the catalyst will be for that widening is hard to pinpoint.

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Which leads us to residential mortgage-backed securities (RMBS). We have taken a tactical decision to avoid exposure to the US in this sector, as we feel you have to be closer to the originators to properly understand the securities you are buying. There is heavy demand and we feel there could be 'criteria creep'. As demand hits record highs, you could begin to see lenders lower their standards and seek to capture additional returns, or just match previous returns, increasing the likelihood of potential issues.

Outside of the US, we expect to see issuance rise in Europe, following the previously mentioned Solvency II rule changes from the European Commission. This will create demand in the region, perhaps not seen since 2008, as it becomes a good funding source for the EU insurers.

What lies on the horizon?

There is a fear that there is too much credit in private markets, and the opaque nature could lead to problems developing before they can be spotted. So, the key then, is active management. You have to time any move in volatile markets correctly.

Spotting where these issues might come from, however, is a different skill. It is always difficult to know what the catalyst will be for a potential downturn but active management of your portfolio is the best way through it. A portfolio built on bottom-up analysis, where you understand the risk you hold, is the only way through volatile markets.

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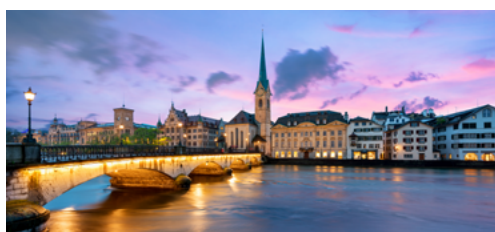
UK

For advisers and wealth managers

bdsupport@rlam.co.uk
+44 (0)20 3272 5950

For institutional client queries

institutional@rlam.co.uk
+44 (0)20 7506 6500



Switzerland

For all investors:

john.parkin@rlam.com
+44 (0)20 3272 5912



Germany

For all investors:

immo.gatzweiler@fundrock.com
+49 151 54 72 5296

FundRock provide EU Management Company services to RLAM.



Spain

For all investors:

mrona@altamarcam.com|
+34 91 290 07 28

Proud to partner with Altamar Capital to serve clients in Spain.



All other EEA investors

For all investors:

arnaud.gerard@fundrock.com
+352 691 992 088

FundRock provide EU Management Company services to RLAM.



Australia

For all investors:

kevin.haran@rlam.com
+61 (0)413 138 055