BlueBay
Asset Management

Structured credit: Direct from the desk

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AUTHOR
Luka Miodragovic
Portfolio Manager

Structured credit has gone through a significant evolution over the past 10-years to emerge as a stable, well-regulated and, in our view, attractively priced asset class. With a more defensive profile than corporate credit, combined with compelling premiums, the asset class has notable appeal in today's ultra low-rate environment.

Sector-specialist Luka Miodragovic provides a deep-dive into structured credit, what it can offer investors today and what he's learnt from over a decade dedicated to its intricacies.

Luka, what was your journey into structured credit (SC) investing?

I started at BlackRock in 2008 in the analytics department. At that time, BlackRock had won mandates from several central banks to help analyse and unwind stressed mortgage portfolios during the global financial crisis; this is when I got roped in and had my first exposure to the structured credit asset class and where I've remained ever since. I moved from analytics into fund management in 2010.

> The asset class is young and always changing, with new deals and products popping up all the time. Broadly speaking, most of the post-crisis regulatory changes have been implemented. Indeed, we are starting to see some relaxation in Europe in reaction to extremely conservative initial policy responses.

Is there a piece of wisdom you've learnt during your investment career that you still lean on today?

I was arguably lucky to start working with mortgage-backed securities (MBS) at the most interesting time in the history of the asset class, although the ride has been a rough one. It's taught me a lot about investing overall, but particularly how much cashflows matter – the cashflow of the underlying loan is what counts above anything else, including price noise. It's also given me great exposure to central banks, which really makes you feel part of the big economic movements at pivotal times.

Structured credit is an evolving asset class; seeing it go through its first crisis was a big learning curve for everyone involved. Happily, it's bounced back as a more stable, regulated and attractively priced market.

How large is the structured credit market and how is it split per collateral type? Which area is growing the most or is likely to grow over the next few years?

The market totals approximately USD2.5-3 trillion in the US and around USD500 billion in Europe. There are some smaller subsidiary markets, such as Australian residential mortgage-backed securities (RMBS), but the US and Europe make up the core. The bulk of the assets are in residential and commercial mortgages. RMBS takes the larger share in both the US and Europe. Collateralised loan obligations (CLOs) comprise around 25% of the total size and is one of the fastest-growing sub-sectors.

Elsewhere, auto loans (personal loans secured against your vehicle) have displayed notable growth in the US, surpassing mortgage loans for the first time in 2013. Alongside CLOs, auto loans are the only major sub-sector to have grown to exceed its pre-crisis size. Aircraft lease asset-backed securities (ABS) are a notable emerging sector, which we've seen grow quickly over the last couple of years.

What's the appeal of ABS for investors?

We believe ABS has several benefits over corporate debt, having a generally more defensive profile. A key feature of ABS is that you are only tied to the performance of the collateral, not the issuing institution. For example, if a bank originates mortgage loans and packages them into an ABS, the ABS investor is only exposed to the performance of those specific mortgages, whereas a corporate debt investor who buys the bank's debt is exposed to the entire performance of the bank. If the bank becomes insolvent, the ABS can be sold to another entity and, as long as the underlying borrowers continue to pay their mortgages, the investment goes unscathed.

Conversely, the corporate bond bank investors are at risk of getting a write-down on their investment. Hence ABS are considered to have 'bankruptcy-remote' status.

A good example of this is that, to this day, we are still investing in UK RMBS originated and issued by Lehman Brothers, with all deals expected to be repaid at par as homeowners repay and refinance their mortgages.

In addition, aside from a couple of sectors, the majority of ABS are fully amortising. Whereas a traditional corporate bond might be issued for say, five years with no repayment due until the end of the term, ABS start deleveraging with repayments from the day they are issued. This actively de-risks the transaction from day one.

Some ABS are also backed by collateral that can appreciate in value, such as property. This reduces the risk of the investment over time as the rising value of the asset can be used to repay the loan should the original payment source fail for any reason.

Also, investing in ABS allows investors to capture a spread premium over other credit assets with comparable ratings and duration. This is how we have approached our investments in the portfolio currently, focusing on higher credit-quality assets with attractive risk-adjusted spreads.

How active is trading in this space?

Trading volumes really vary across the sectors, from high-liquidity markets with a large number of market participants, such as US conduit CMBS, to thinly traded markets such as Australian non-investment-grade RMBS.

Do any ABS securities have Libor floors?

Outside of CLOs, only newly issued European CMBS have Euribor floors since the underlying loans tend to be tied to Euribor as well. Most consumer-facing loans are either fixed rate or tied to the lender's standard variable rate, so there is a mismatch with the bonds that makes a floor on the total coupon instead of Euribor a more natural fit.

Additionally, it is generally not viewed favourably to restrict consumer-facing assets, such as residential mortgages, auto or consumer loans, to having non-zero interest rate floors. Spanish mortgage floors were ruled illegal and an 'abusive practice' by the European Court of Justice and if you cannot put floors on the loans other than to say they cannot go below zero, by proxy you cannot have floors on the bonds that are backed by those same loans.

What are the biggest challenges to investing in this asset class?

Structured credit is still evolving, therefore a primary challenge is that the structures and loans that are being originated are constantly changing. With MBS, rather than monitoring the health of one company, you're also exposed to how a large pool of people pay their mortgages. This exposes you to credit, macro and prepayment risk, which brings with it variability in cashflows and risks compared to more straightforward corporate bond structures. Structures also change in reaction to risk-on/risk-off sentiment, where they can also become more conservative to match the mood of the market.

The other main challenge is regulation – it's constantly changing both at the broad asset class level and in relation to all the industry sectors that we invest in. For example, in cities and countries that are looking to institute bans on diesel cars, the value of these may be far lower than projected and this may affect the credit performance of auto loans and leases in these jurisdictions.

Do you believe that investing in investment-grade structured credit can help de-risk a fixed income portfolio?

In my view, yes – it's a relatively defensive sector backed directly by observable collateral. Investment-grade securities typically benefit from substantial structural subordination that provides a significant cushion to a pick-up in losses in the underlying collateral. Furthermore, the spread durations in ABS and CLOs are relatively short. In Europe for example, the bulk of ABS is less than three years in spread duration and CLOs are typically four-to-six years in spread duration. The outcome is typically lower price volatility than corporate credit. ABS also does not follow the wider moves of the market unless it's a sustained sell-off or rally, so can help to reduce portfolio correlation on a shorter-term basis. For example, in July and August we saw a 15bps peak-to-trough widening and then equivalent tightening into September in the iTraxx Main corporate credit index while European ABS saw no major spread movement over the same period.

Do central bank interest rates impact the structured credit market? If so, how does this influence your positioning?

Central banks have a big influence on this market; both the US Federal Reserve and European Central Bank have had ABS and MBS purchase programmes (the ECB one is still active). They view the market as a way to directly implement monetary policy – they can opt to lower interest rates to ultimately reduce mortgage rates, or they can directly bulk-buy mortgage bonds to lower supply so lenders are forced to lower their rates.

A recent example of the impact of central bank action is the large spike we've witnessed in US mortgage prepayments recently, as consumers switch lenders penalty-free to take advantage of ultra-low rates. The impact for us is it becomes harder to buy US RMBS trading above par given the uncertainty about timing and quantum of cashflows.

Is the market cyclical like other fixed income asset classes?

A recession would ultimately affect the structured credit market, with the impact varying based on the sector. We view SME corporate-facing ABS/MBS as the most vulnerable sub-sector, which would likely see consumer job losses result in lower consumer and business spending and thus more business bankruptcies (impacting small and medium-sized enterprise ABS) and fewer commercial property tenants (impacting CMBS).

In a more severe or prolonged downturn, consumer-facing ABS, such as mortgage-backed ABS or auto loan-backed ABS, could see a spike in defaults as unemployed borrowers may, for example, no longer have the ability to repay their car loans, since they no longer have a job to drive to, or keep paying the mortgage once their savings have dried up.

Structural protections in ABS are designed to mitigate against these effects and we saw this play out during the 2008-2009 downturn, where losses were relatively muted across asset classes and jurisdictions, with the notable exception of US sub-prime and CMBS.

Are there any notable events on the horizon for the asset class in terms of its development?

The asset class is young and always changing, with new deals and products popping up all the time, such as more recently with solar panel loans and venture capital debt. Geographically, the market remains predominantly focused on developed economies. Broadly speaking, most of the post-crisis regulatory changes have been implemented. Indeed, we are starting to see some policy relaxation in Europe (designed to stimulate growth) in reaction to extremely conservative initial policy responses.

Are geopolitical issues like the trade war a concern or is the asset class less impacted by sentiment changes than other fixed income sub-sectors?

We believe the trade war ultimately affects everything on a macro level, and structured credit will sell-off if everything else is declining, albeit with the usual notable lag. The one main exception is container ABS, which relies on container leases as

a cashflow source. So, if world trade slows down, there will be less demand for shipping containers to transport goods around the globe, which may affect the credit performance of the ABS backed by these leases.

How do you think Brexit will impact the UK ABS space?

In my view, if the UK sells off because of a significant period of risk-off in UK assets, then UK ABS won't be immune and we are likely to see spread widening. For example, if people start to spend less, then smaller businesses will be affected, which will put a negative outlook on SME ABS from the likes of peer-to-peer lender Funding Circle. We are already seeing stress in commercial retail property and the CMBS that backs that, and while this is a direct impact of the shift from bricks and mortar to online shopping, I believe the negative Brexit-related sentiment will only exacerbate the trend.

The core markets of RMBS and auto ABS should have a more muted effect as people prioritise paying their mortgages and car loans. While delinquencies and defaults will likely increase in these types of debt, they are unlikely to be of much credit concern to bondholders, in my view, especially in the investment-grade tranches.

Looking ahead, what do you think is the biggest risk to the ABS market?

I'd say regulation is actually the biggest 'risk' for us. While improved underwriting standards have transformed the asset class and made it stronger, there are cases where well-intended regulatory moves risk damaging the market.

For example, the Irish parliament proposed a law that could impact the ability of banks and lenders to sell mortgages into special purpose vehicles (SPV) unless the borrowers give their consent, which would leave the lender without a funding source if the borrowers say no. The Central Bank of Ireland, Department of Finance, Attorney General, the Banking & Payments Federation of Ireland and European Central Bank have all come out against the proposal but it continues to be debated in parliament.

Should it pass, it could effectively kill off the Irish securitisation market – something that even the large property crash that led to credit impairments in Irish MBS failed to do.

How do you manage risk?

We primarily manage the risk in our investment-grade strategy through spread duration and the capital structure; ABS is available at every stage of the capital structure from AAA down to single B. Different asset classes have different durations – CLOs tend to have longer duration while auto ABS tend to be typically one-to-three years. If we want to position conservatively, we can go higher up the capital structure and in shorter-duration products and vice versa if we want more aggressive positioning.