Eric Atlas

Episode 194: Residential Debt: A Diversified Income Stream to Write Home About

GUEST Q & A

Stewart: My name's Stewart Foley, I'll be your host. Welcome back. It's so nice to have you and thanks for listening. Today's topic is a good one. It's Residential Debt: A Diversified Income Stream to Write Home About, which I love the title. And we're joined by Eric Atlas, head of US Residential debt at Man Group. Actually, you're part of Man Global Private Markets. Eric, welcome and thanks for joining us. Thanks for taking the time.

Eric: Great to be here, Stewart. Thank you.

Stewart: We are thrilled. This is a great, I was actually talking about this asset class with a friend the other day. Very, very cool. And I want to get into it and I want to talk about Man and everything that you're doing, but before we get going too far, where did you grow up? What was your first job? Not the fancy one. And what makes insurance asset management so cool.

Eric: Great questions. So I grew up in Wayland, Massachusetts, a commuter town around Boston, about 15 miles west, I believe. Great place to grow up. My first job was in high school summers in between grades, I worked at Linens 'n Things in the receiving department. So it was a 6:00 AM to 2:00 PM shift kind of structure, like an assembly line where the boxes were taken off the truck and then they were rolled down a conveyor belt. My job was to stand in the middle of the conveyor belt and slice open the top of the boxes with a knife and then pass them along to the people who unboxed. So yeah, it was a great way really to work in a job where you got your hands dirty and learned that part of the business world. So that was cool.

Stewart: Absolutely. I used to do that at McDonald's. I did the truck in the morning. It would unload food and it would be like frozen fries and frozen whatever, and it just would come down. It seemed like an endless supply of boxes. People just hurling them down this chute, we were in the basement and so they would just fly down there and you just catch them and put them all away. But I mean, it's not particularly glamorous, but it's an essential part of the program, right, mean to get things on the shelves -

Eric: That's right, the boxes never stop coming.

Stewart: That's right. You hope, right? Absolutely. And what makes insurance asset management so cool?

Eric: Yeah, I think something unique about here at Man Group, we manage capital for institutional clients across the board, and today we manage for insurance clients as well. And I really think it's more of a partnership when you're working with insurers with a common goal. So I think that's one. And given the granularity of the asset class too, working with folks who have expertise in the real estate sector is something we think is cool as well.

Stewart: Absolutely. And so Man has a couple of different areas and your particular area is called Man GPM, which stands for Global Private Markets. Can you talk a little bit about, and you are responsible for US residential debt within that group, but can you give us a little bit of background on the group as a whole and what all you're up to? And then I want to get into this residential whole loan asset class that I think is really compelling.

Eric: Yeah, definitely. So Man Group is a global investment manager with approximately 161 billion under management. And GPM, the global private market business is, surprise, the private market engine within Man Group. So as you noted, I'm responsible for residential credit within GPM and looking at credit from Man's perspective, we're a key pillar of a $25 billion credit offering and credit platform. So we've been in residential credit for over 10 years. We've financed over 30,000 properties for an aggregate value of 20 billion. And again, that's part of the broader kind of Man credit platform.

Stewart: That's really helpful. And so there's been some talk about this asset class, let's talk about the value proposition of why residential private credit is attractive period, and then why for insurance companies? And there's some really interesting characteristics about this asset class that make it compelling, I mean to me, very compelling, but give us a lay of the land there.

Eric: Yeah, yeah. Great. So I think there's three things to highlight that we can all keep in mind as we continue through the conversation. The first is the asset. What are the assets we're talking about? The second is specific to insurance companies, capital treatment for those assets and the ability to finance those at the insurance company level. And then the third is really how to structure those relationships with insurance companies given there are many benefits of granularity, but it's been very important to logistically structure these relationships where the administrative burden is placed onto me and my team as the asset manager rather than on the insurance company side, given just the amount of line items in resi land, which again provides the diversification but also the challenge to make it as seamless as possible.

So starting with the asset, we're talking private market credit and we'll get into that a little bit more later I'm sure. But there's a pickup in yield private market versus public market. That's a trend we're seeing across the board. And when we're specifically talking about granular residential assets, you also get diversification through exposure to a healthy underlying fundamental housing market. So that is different than other parts of real estate and we think a diversifier both within the asset type itself, but also in an insurer's investment portfolio.

So the second is the capital treatment and whether it's a residential mortgage or a commercial mortgage backed by residential properties, the capital treatment is very attractive and something that has been a reason why insurers have been focused on this as of late. We're talking in the one to 2% range depending on the type of asset. Once those assets are owned by the insurer, that then qualifies generally for federal home loan bank financing, which is a very attractive way to finance those positions. So some positives on the asset itself. And then the capital treatment and financing with those low capital charges are something that insurers are focused on as well.

And the third is the structure and given the line items, the granularity of it, we have insurance clients today, but a big part of that and what we think we're good at is structuring those relationships where the accounting burden and the asset management burden are on us as the investment manager. And we have teams on the accounting side and on the asset management side that have been doing this for a long time and it's their bread and butter and we want to be able to provide this exposure to the asset class in an easy insurance friendly way, which we think we've been able to achieve.

Stewart: And the asset class is something that insurance companies have owned forever in a day, right? They've owned them in different ways but if I understand this right, so if I'm buying a straight mortgage pass through, agency pass through the underlying collateral in that security is essentially the same as if I'm holding that particular mortgage directly on my balance sheet, it just does not have the agency guarantee. But essentially is it the same ultimate collateral, a mortgage on a residential home in the US that meets underwriting standards and so on and so forth? And then that line item actually resides if I'm an insurance company, that actual line item resides on my balance sheet, right?

Eric: Yeah. So all of what we're talking about and everything you just mentioned is exposure to US housing, first lien exposure to US housing. And then there's the agency world and the non-agency world, which is where private markets are more focused. But at the end of the day you have exposure to US housing in a first lien position and we're focused on the senior exposure to those assets as well.

Stewart: And I don't want to put words in your mouth, but I just want to kind of, if I'm buying agency, whatever, I'm getting haircuts all along the way. So from a private residential mortgage perspective, my realized yield is going to be significantly higher for the same collateral. Is that a fair assessment of the exposure?

Eric: Yeah, I think if we're talking about agency pass-throughs themselves, obviously the credit is guaranteed by the government. And if you go to non-agency world, there's the concept of credit risk. So because of that, non-agency tends to generally speaking, offer wider yields to accommodate the additional risk without the government guaranteeing the credit of it. So that's where it really comes into play. What does the underlying housing market look like and what are we focused on as investors to have low leverage, higher yielding exposure to US real estate?

Stewart: And given the breadth of residential investments at Man, what are your thoughts on credit versus equity in today's environment?

Eric: Yeah, that's a great question. So within the private market business, we have what we call the equity side of the house and the credit side of the house. The equity side of the house being single family rental from an institutional perspective. So buying portfolios and one-off houses, aggregating them together, sometimes you put financing on those positions depending on what the investor wants sometimes you don't. But as a lot of folks listening probably know pre covid and certainly during covid when housing was up so much SFR and single family rental was a very popular, let's say acronym and rightfully so, right? We were in a world where you could buy houses and generate attractive cap rates or yields, and with rates being so low, the financing was very attractive on that as well. So rightfully so it was an asset class that garnered interest and performed well for many investors. And here at Man, that was something we were focused on as well during that time period.

Flash forward to inflation rearing its head and rates moving off of zero to in the fives. If you look at the housing market, we're actually above the peak now nationally from last year. So housing is up this year. What that means, if you're an institution, you can't buy assets at a higher yield than you could have a year ago because the homeowner bid, which is 97% of the market, dominates it and they've been driving that up. So the yield you get on the equity side is similar, but what has happened is when inflation happened, rates happened, the cost to finance skyrocketed. So now we're in a place where generally speaking, the cost to finance your single family rental may be higher than the yield that you're getting on the house itself. So there's dilutive financing.

So for that reason, some investors are slowing down and kind of waiting to look at what happens with rates given that backdrop. But the exact reason why single family rental equity is challenging is the reason why we love credit, because the house prices have been stable because the fundamentals are healthy, but our investments, floating rate or short rate fixed, have moved with the rate move. So now credit is much yieldier, and if you have residential exposure, you have yieldier exposure to that healthy market.

Stewart: And so can you talk a little bit about the general lending environment and the trends that you see in bank and private market lending? And I think it's a pretty well covered story where banks are pulling back and insurers in particular are filling that void, providing capital in ways that I think have, it's compelling because I feel like the ALM is more aligned with the insurers than with the banks as it is. So what can you share with us about the general lending environment right now?

Eric: Yeah, great question. So yeah, I think the backdrop is what you said. I think banks have continued to be in risk-off mode with certain types of lending and the private markets and often partnering with insurance is really filling that void. So high level, I think that means when something moves public to private, there could be an additional yield pickup there with what we think is still a safe risk profile to those assets. So why are banks retreating? We had the regional bank failure last year. Capital requirements are increasing. Basel III kind of building on that post GFC trend. We have higher interest rates and flatter curve deposit outflows. And if you look at banks' existing portfolios, there's probably more risk there than there was a year or two ago. So all of that really has banks in a risk off mode from a lending perspective.

Where are they retreating? They're retreating in spots where we're really focused. So over the last year we've really had access to more loans and even reverse inquiry for our loans than we had prior to that, whether that's in commercial real estate, non-agency residential loans to different types of sponsors, consumer lending, et cetera. We're seeing that shift over. And the punchline really is private markets can offer more attractive returns at similar risk profiles potentially in exchange for illiquidity that may even match the liabilities that insurance companies have. So it's a good match and it's yieldier match with the healthy underlying asset class.

Stewart: Yeah, it's very compelling. I mean with the capital charges, the ability to finance it qualifies for FHLB financing. There's a lot of good there. The private credit market has been very hot for insurance companies. And given that attractiveness, what are the characteristics of resi credit in particular, which is your focus? What makes that stand out to you right now?

Eric: Yeah, so I think there are two things to focus on. Historically I think it's fair to say insurers have been overweight, if you will, commercial real estate to residential real estate. Some larger groups have in-house teams that directly originate commercial loans, but really haven't had resi exposure in the same way. And certainly a trend we've been seeing the last five plus years is as insurers look at that and want to diversify their exposure, US housing being that exposure, they've partnered with third parties like us, investor managers, who have that residential know-how in terms of selecting what assets to purchase and how to manage those assets. So we're seeing a shift from kind of purely commercial exposure to commercial exposure that it's underperformed versus resi with some resi exposure there. And the question is how do you do that?

And given it's different, and we're talking $500,000 loans here, not 50, 100, 500. So it really does help to have experts as a partner to give you that exposure. And real estate is such a large asset class, all insurers should have exposure there, and it's just that balance of commercial versus resi and the trend there. So while yields on paper tend to be higher on the credit side, whether it's resi, whether it's commercial, whether it's corporate, I think you can really look at, and I mentioned this a few times before, the underlying fundamentals of the US housing market are healthy and that is different than what we see in commercial real estate and depending on your view, potentially corporate exposure as well. So talking about the US housing market for a second, I mentioned that we're up nationally on the year and we're above the peak from 2022.

So let's talk about why that is. Mortgage rates actually are sub seven now for the first time in a while down from their prior peak in the eights, I think a month or two ago. But rates are significantly higher, no doubt about it. From sub 3% they're double, a little bit more than double, where they were. House prices have gone up and housing is less affordable, it's less affordable to own a house than it was pretty much anytime over the last 30 years. So you have that which is putting downward pressure on house prices. If that happens in a bubble, house prices should go down. But there's an equilibrium because of the lack of supply in the housing market. So depending on who you ask or what you read, there's about six million houses that we need to build in order to meet the existing demand for housing. So there's a historical lack of supply in the face of this worsening affordability that's creating this equilibrium where our view on housing is that it's going to be flat to up in the near medium term. I think that's the view of a lot of my colleagues out there.

So you compare that to commercial real estate where it's really dominated by investors, or institutions rather, over two thirds of multifamily even is institutional versus resi where it's driven by the homeowner. Resi doesn't need to trade on cap rate and you have 30-year mortgages where people are locked into that. So as long as the job market's healthy and people can pay their mortgage, there's no margin call that's going to put downward pressure on housing.

So it's really that to sum it up, it's the lack of supply has been creating an equilibrium in this heightened unaffordability world. But as we know now, inflation has been improving, mortgage rates are over a hundred bips lower than their peak. And if you look at the forward curve, the base case expectation is that that will continue next year, which will be good for volume and performance as well of resi.

Stewart: So does that pretty much sum up your outlook for 2024 as we're moving forward here? I mean it's toward the end of December, just to timestamp this for our listeners. Is there anything else on 2024 that you want to add before we move forward?

Eric: Yeah, so I think going into 2024 and even 2025 our expectation is that the housing market will be range bound flat to potentially up. And we've seen that the fundamentals perform well in the face of raising inflation and rates because of the lack of supply, and we expect that to continue even as rates are projected to go down.

Stewart: Yeah, it's really interesting. I mean, you've had that supply chain shock out of Covid that really boosted the cost of building materials. And I know even in our own neighborhood, one of our neighbors had to downsize the size of their house because the cost of what they designed, they couldn't afford to build. So I think the way that you're stitching that together makes sense, at least from my experience.

So when you look at residential credit fitting into an insurance company portfolio, how does your team help with that and provide value? We know that there are a fairly significant number of line items in this asset class, and you had mentioned earlier that the onus for that accounting and administration really resides with you and your team. Can you talk a little bit about how you're working with insurance companies and making these allocations? Because as we've touched on the capital treatment and the financing possibilities make it very compelling as does the yield, the outright yield. So talk us through some of the pain points there.

Eric: Yeah, so I think it's from an insurer's perspective, you want it on your balance sheet to be able to get that capital treatment and access the home loan bank financing we talked about. But there are a couple of different ways to do that. And I think the two most important reasons to do that, one is the asset management side. When something goes wrong with a loan in granular residential space, loans go delinquent. And how do you deal with that? So the onus should be on myself and my team, the asset management team, to resolve those issues that are all part of our underwriting and normal course, not the insurer.

And then there's the accounting of that asset class, which may be something new. From a real estate perspective, the focus has been on a hundred, two hundred plus million dollar loans. So it's how do you structure the relationship such that asset management and the accounting as much of that as possible is handled by the investment manager. And so there are structures where you can purchase assets directly onto insurance balance sheets. There are trust structures that you can use with reference lines. There's also the world of rating. So there's a handful of different ways that this has been done and with our insurance clients we've spent a lot of time on digging in there and coming up with the best solutions for our insurance partners.

Stewart: So just to get a little bit more granular, what types of residential credit investments are you currently focused on?

Eric: Yeah, great question. Let's dig in there a bit. So you mentioned as a comp thinking about agency mortgages and pass-throughs where credit is backed by the government and there's really not that much additional yield pickup versus risk-free rate on a lot of those products. What we view as our goal is to provide solutions to insurers where there is a yield pickup, where we underwrite a potential yield pickup, from our residential exposure compared to those agency mortgages and the return there. So we like to focus on areas of residential credit with high barriers to entry that are structurally senior with low attachment points but are in more fragmented parts of the mortgage space. So an example of that and something we've been spending a lot of time on recently is a focus on loans that finance property investors, whether it's for a renovation or for a rental property, financing those loans, which again you have the same exposure in terms of US housing, but now you have a professional property investor either renovating or holding and lending that holding and renting that property out.

So you kind of have that commercial aspect. So these types of loans are actually structures, commercial loans with residential collateral. So there's a business purpose affidavit that goes with that, and correspondingly it goes into CM2 if it's below a certain LTV threshold given its commercial backed by residential. But that's an area where we're seeing delinquency remaining historically low and really a spread pickup and return pickup through our underwriting compared to more generic mortgages. So it's senior first lead exposure to US housing focused on fragmented market that provides that additional yield pickup, but you still get similar capital treatment and federal home loan bank financing on the backend.
Stewart: That's really helpful. And as I mentioned, just one person's opinion but compelling. So I've learned a lot about this today and I really appreciate it. If you could give us two or three takeaways that our audience should take with them when they stop listening to this podcast, what would those three be?

Eric: Yeah, I'd probably circle back to the three we started with to come full circle here. I think the asset, it's differentiated in a granular source of income with attractive returns and exposure to a healthy underlying market. So healthy market, we're underwriting an additional yield pickup versus other types of resi and other types of real estate. Two is the attractive capital treatment of those assets and the inexpensive federal home loan bank financing that you're afforded when you have exposure to these assets as an insurer. And then C is given A and B is an attractive opportunity for insurers, how can we partner with insurers best to structure a relationship where the management and accounting is on the investment manager? So it's create a seamless way for insurers to get exposure to that pickup and yield and diversification with the capital treatment and financing options.

Stewart: Thanks so much. It is a great wrap. I got a fun one for you out the door if you're interested. I typically put some optionality on this, but I kind of want to just get to it. If you could have lunch with anybody alive or dead, who would it be?

Eric: Oh wow.

Stewart: That's a good one, right?

Eric: Yeah.

Stewart: Is there anybody, are you a sports guy?

Eric: Yeah.

Stewart: Anybody there that you'd want to grab lunch with?

Eric: Bill Belichick there, but I don't know how well that's going to go over these days.

Stewart: Wow. Okay. There you go. That would be a fun lunch, especially right now, right?

Eric: Yep, yep, yep. Should we do that?

Stewart: Obviously you're a Pats fan, so did you grow up a Pats fan?

Eric: I did, yeah. I grew up a Pats fan.

Stewart: That's awesome. I didn't appreciate the level of competitiveness, if that's the right word, between Boston and New York until I moved to Connecticut. I just didn't appreciate how it is far more intense than any other sports rivalry outside of the Northeast Corridor, at least in my opinion. I don't know. I may be wrong.

Eric: Oh yeah, for sure. There's a definite Boston, New York intensity that we all love. When you're at those games too, the percentage of passive versus active fans is unlike anything I've ever seen, so makes it ever the more enjoyable. Hopefully the Patriots can compete in the coming years. I guess the same can be said for the Jets.

Stewart: Yeah, no, exactly. That's good stuff. Now, I've learned a lot today. I really appreciate you being on. We've been joined today by Eric Atlas, head of US Residential Debt at Man Global Private Markets, otherwise known as GPM, which is part of the Man Group. Eric, thanks for taking the time. Thanks for being on.

Eric: Thanks so much, Stewart. Take care.

Stewart: Thanks for listening. If you have ideas for podcasts, please shoot me a note at podcast@insuranceAUM.com. Please rate us, like us and review us on Apple Podcasts, Spotify, Google Play, Amazon, or wherever you listen to your favorite shows. My name's Stewart Foley, and this is the insuranceAUM.com podcast.