Jean-Marc Breaux

Episode 215: Current Perspectives on Securitized Credit

GUEST Q & A

Stewart: Welcome to another edition of the InsuranceAUM.com podcast. My name's Stewart Foley, I'll be your host. I love fixed income podcasts. I'm a fixed income geek, as most of you know, and we are joined today by Jean-Marc Breaux, who's sector portfolio manager, Fixed Income Division, at T. Rowe Price. Jean-Marc, thanks for joining us, man. I'm thrilled about talking about public securitized today, and welcome.

Jean-Marc: Thanks so much. Glad to be here.

Stewart: So there's a lot of connectivity here. It turns out that T. Rowe Price's securitized piece was our number one ranked piece of content in 2023. There's a lot of interest in this topic. You are going to be a featured speaker at our symposium this coming June, and we're thrilled to have you, and there's a lot to talk about.

So, before we get going too far, though, I want to start this one the way we start them all, which is, I want to know where did you grow up? What was your first job, not the fancy one, and how did you get into managing money for insurance companies?

Jean-Marc: That's interesting. The first question should be an easy one, but it's actually not for me. I moved around a lot growing up, so I called many places home. I was actually born in St. Louis, Missouri, moved around a fair bit after that, before eventually making my way to Chapel Hill in North Carolina, which is where I went to high school so where I really call home at this point.

My first job, I would call my first real job, was in Chapel Hill at the age of 16. Worked at a senior center, retirement community, really, in the restaurant as a busboy. Probably the least glamorous job in the entire establishment, but it was actually great. I got to meet some really interesting people who I really would never have met had I not been working in that service and location.

So how did I end up working in insurance, asset management? So my initial interest in finance was really more on the quantitative side of things, and so out of college, I was looking for opportunities to basically work in quant and also in ways that overlapped with fixed income and investments. I happened to come across a job with Aegon USA, so the parent company of Transamerica. Took a job there back in the early 2000s, really came to enjoy working with the insurance side of the investment management world, which is why I'm happy to still be in touch with that side of the business, while I'm now at T. Rowe.

Stewart: That's fantastic. I think it's always interesting how people got here, and you have real deep insurance chops, so this is good stuff. I want to talk a little bit about ... just high-level about your market. And over the last 12 to 18 months, we've seen a lot of spread compression across public securitized credit sectors. We've seen a similar situation in public credit as well, public corporate credit. Where should yield-oriented investors like insurance companies be focused today, when they're looking to spend the marginal dollar?

Jean-Marc: Yeah, that's a good question. So bit of a history lesson. That's right. We're clearly tighter over the course of the last year or so. I think we would look back to fall of last year as being the turning point where we've been on on a one-directional train since then, after the Fed removed any doubt about future hikes, and instead put in more certainty around future cuts.

What's interesting is that in the first couple months of tightening in the fall of last year, securitized really lagged corporates and it wasn't until this year that we've really caught up in a major way. So I agree now that we are, on the margin, much tighter. The yield has been sucked out of our product, like most other areas. So we, like others, are looking for additional yield in areas like private securitized, but really we're just finding our primary focus is still the public markets. We just think there's still pockets of value across sectors.

Probably the easiest way to break down where we think the opportunity sets are is to just break down the asset classes by the four major food groups. So for us, that's ABS, CLOs, RMBS, and CMBS. If I could just start with ABS, I'd say for the bulk of this year, this has been our primary focus. In large part that's been because this is where the bulk of the supply has been coming from. There are a number of reasons for that. So one, it's just a sign of a healthy economy. We're generating consumer loans, we're generating auto loans. We've also seen some new sectors, or I guess emerging sectors come with more volume into the sector. We've also seen some issuers basically supplanting the regional banks in the lending community and using the ABS markets as their financing source on those loans.

So from that standpoint, the ABS has really been the building block of our core portfolios this year, from the securitized standpoint. A lot of where we're seeing value is actually in the bread and butter senior parts of the auto loan market. Again, that is an area where we've seen a lot of issuance this year and the issuance has kept yields relatively wide, just the technicals there. So it's a good add for us. We've also seen within the auto space some new structures. I think you've probably referenced these before on your program, but credit-linked note structures, basically synthetic transfers, where banks are basically looking to move auto loans off their books and using the securitization market for that. We've been very active in that area. We think it's an area where you can get very compelling yields versus corporates, and also an area where we can leverage our corporate counterparts on the research side to get more confidence in the structure and the banks that are originating the loans.

Let me pivot to the CLO side of things. So this is an area that's near and dear to my heart. I worked in this sector for a very long time, but right now it's just, yields are hard to beat in CLOs, and that's in large part because of where short-term SOFR rates are. I think you can make an argument that from a spread perspective, things have gotten a little bit tight, but the desire for yield is going to be hard to beat here. So it's really a way for us and others to express a view around forward rates.

One thing we are doing on the margin across portfolios is looking for areas to harvest gains in secondary bonds that have now been pricing above par and using those proceeds to rotate out the curve and lock in yield a little bit longer into, call it the primary market. I would say within the CLO market, we have to acknowledge that fundamentals within the loan market are probably trending negatively. We've seen an increase in LME activity, we've seen downgrades, far outpace upgrades within loans, but we believe that the structures are very well insulated from losses and especially the investment grade part of the capital stack is immune from any sort of impairment risk, in even a relatively severe credit environment.

Stewart: You mentioned the term LME. Can you unpack that, please?

Jean-Marc: Oh yeah, absolutely. So LME basically stands for liability management exercises. This is a process that we've seen a lot of sponsors go down over the course of the last couple of years in terms of addressing some unsustainable liability packages. So, their debt financings. Effectively what they are doing is using weak provisions within loan documentation in order to either cram down existing lenders, pull assets away from existing lenders, effectively reducing the recovery value of the existing lending book. It's a clear negative for loans, it's a clear negative for the CLO space, but again, we do think that the structures themselves, the CLO structures, are at least designed to help mitigate against this sort of risk in the long run.

Stewart: And what about, you mentioned RMBS and CMBS. What are you seeing in those two sectors?

Jean-Marc: Yeah, let me start with RMBS. So I would say our activity in RMBS has been opportunistic this year. So until very recently, we thought that yields in that sector were a little too narrow to compensate for the amount of rate-induced volatility you can experience in that sector, similar to what we've been experiencing in the last couple of years. That's changed a little bit on the margin of late, but I will say, where we've been most active is in shorter parts of the market, areas where there's just less convexity risk, where you could still get yields in the 6% area or so.

What's also supportive of that sector is that the fundamentals are just in great shape. So while prepayments are low in many areas, a lot of borrowers are just benefiting from several years of very high HPA. So delinquencies just remain very low. There's very low incentive to not pay your mortgage at this point.

Stewart: So can you just unpack HPA?

Jean-Marc: Oh, sure. HPA is the Home Price Appreciation. So for a variety of reasons we can refer to low rates, lack of supply within the housing market, a lot of that emanating from COVID, and also just the lack of new building activity. Home prices have really seen a tremendous amount of appreciation over the last few years, really outpacing the historical levels of appreciation that we would expect. That's normalizing to an extent here. We don't expect to see a reversal in that, in that we don't expect to see depreciation in home values. We do expect to see a flat-lining in appreciation, but it's going to be difficult for the market to overcome the lack of supply in terms of actually depreciating from here. So we do think that there's a tailwind to the homeowner in terms of preserving their HPA, or their home price appreciation.

Stewart: That's awesome. And you were going to mention, you were heading towards CMBS, I think.

Jean-Marc: I was. Yeah, so I would characterize CMBS as being a bit of the outlier for us. So it's an area where we're just very cautious, still. We've been opportunistic here and there in certain properties where we have a lot of confidence in the outcome, but it's really just, we think, much too early for us to call a turn in the fundamentals here. We've seen a lot of stress in the office sector. We expect that to grow. To date, the stress that we've seen has been largely confined to floating rate structures where the impact of higher rates has been felt immediately. There's a large portion of the universe which is fixed rate, which has to date actually benefited from low rates. But as those loans come closer to maturity, we expect that there's going to be a lot of refinancing pressure. So it just creates a very wide cone of uncertainty around the eventual outcome on some of these loans, and we need more signs that we have a clear path to resolution on a lot of these names and on the refinancing avenue before we can really fully commit back to this sector.

Stewart: That's really helpful. So one of the things I love about Wall Street is the creativity. And you mentioned new-issue ABS as a focus of your team year-to-date. There have been an increasing number of types of collateral, things that folks are securitizing. It used to be, back when the earth was cooling and I was running money, it was pretty much auto credit card, the odd other receivable, but it was fairly strict on the fairway.

Today there's new collateral types popping up as financing evolves. Are there any of these that have piqued your interest as far as the analysts and folks on your team that you think offer good value?

Jean-Marc: Yeah, there certainly are. I would preface it by saying that the majority of the issuance this year has been, as I mentioned before, down fairway, but there are clearly some areas that are emerging that we're spending a lot more time on. I would highlight the ecosystem around digital infrastructure as being an area of growth for us. I think you've spent some time talking about data centers on your program before, so I won't belabor that, but there's a reason for this significant amount of growth behind the sector, a lot of that coming from the transition to 5G, the increase in hyperscale users, and now I guess increasingly the advent of AI. We are active in the data center space. It's pretty clear even though this isn't the new sector for us necessarily, it's a growing sector. What I would focus on a little bit more here is actually the fiber component of it.

So, we have seen an increasing number of fiber companies basically coming to the ABS market over, for instance, the high-yield market. So when we're talking about fiber, we're really talking about just the natural extension of the digital infrastructure ecosystem for us. We're talking about bonds that are collateralized by fiber networks and basically the associated contracts for payment that exist on those networks. So those can be residential contracts, they can be enterprise contracts, they could even be condo or HOA-level contracts. The collateral for these deals is effectively the operating assets of the company. So from that perspective, the approach to the credit is really more an underwriting of the competitive dynamics of the industry and the corporate strategy, which actually makes it much more like a whole business securitization than a traditional securitization where we... If you think autos, et cetera, like you mentioned earlier.

And those are areas where we have a lot of experience. It's also an area where we have experience firm-wide. One of the reasons we like the sector is that if you can get comfortable with the structure and the issuers, and we are picky, you can get high yields for investment-grade rated credit. We expect the sector to grow, so we expect to continue to see opportunities here, so we really are digging in on the opportunity set. We also expect to see what has currently been a residential-focused market really expand to the enterprise market, which will just allow us to diversify our investment footprint a bit within that sector. And then finally, just given what is a pretty complex asset class and structure, we don't think it's going to tighten materially in the near term. So we think there is a longer-term opportunity set here that we're looking to capitalize on.

Stewart: It's interesting because, and my experience is that folks who are first movers into those new segments often are capturing alpha that is later ground away as more and more people come into that space. So I'm not surprised, given the significant fixed income capabilities at T. Rowe, that you're there and you're digging into those sectors. You had mentioned a moment ago that you're able to leverage your corporate and equity resources there for fundamental research. Can you expand upon that just a little bit and talk to us about how you're able to leverage the broader T. Rowe Price resources for your particular segment?

Jean-Marc: Oh yeah, absolutely. So I would say that collaboration between research teams and portfolio management teams is really central to our DNA. It's a big part of how we operate. We are bottom-up and we like to use every component of the platform to direct our decision-making. So, just using fiber as an example, a lot of these companies are migrating to the ABS sector from the high-yield sector. So, looking to refinance their bank debt, looking to refinance their high-yield structures. Our ABS analysts are in constant dialogue with the high-yield analysts that cover both the sector or, in many cases, these specific companies to get a better idea for the strategy behind it. And it's really not exclusive to the sector at all. It's something that permeates the process across other areas, like for instance, CMBS. So, our CMBS analysts are in constant dialogue with our REIT analysts, with our bank analysts, that help us determine an outlook on the appetite for bank lending. We have a large and experienced research platform, and we try to use it as much as possible to basically add alpha in all of our portfolios, in all of our strategies.

Stewart: There's something at T. Rowe that I'd love to have a refresher on, and that's something called whole biz. What is whole biz in your world, and why do you think it's attractive?

Jean-Marc: Yeah, no, I certainly talk about it. It's a sector where we're very active, and I think I mentioned it in the context of being similar to some of these digital infrastructures in that, it's really a securitization that is backed by effectively all the revenue-generating assets of an issuing company. So, in many cases, for us, we see these coming from companies where there's a large part of the revenue is coming from franchise income, franchise fees. So that has largely led the sector down the path of restaurants. So that would include issuers like Domino's, Wendy's, Arby's, even Applebee's. As a matter of fact, you've probably read that Subway was recently acquired, and a large part of the financing program for that acquisition is going to likely come from the whole business securitization market.

A few things that we actually really like about this sector. So, one, if you can get comfortable with the credit, and again, we are very picky on the companies that we like here, it's just another way to get high-yield-like returns from investment grade assets. It also is an area where we can extend spread duration and lock in yield for longer. So a lot of these structures will come with 5, 7, even 10-year maturity buckets, which is not typical of our usual ABS market, which tends to be a little bit on the shorter end of the curve.

And as mentioned previously, we're evaluating the corporate strategy in conjunction with the structure here. So we're working very much with the corporate analysts. So again, it's another area for us to lever the entire platform. And what we find is that generally these are companies with established brands. They have very long operating histories. They have significant brand recognition and brand loyalty, and that usually shows up in the performance metrics for the companies that we're financing.

The last thing I would say on this sector, which is a more recent development, is that it's becoming increasingly diversified. So, I mentioned that restaurants are a large focus here, and that will continue to be the case, but we have seen expansion in areas such as fitness centers, automotive centers, and even some home improvement / repair centers, that again, where a lot of the revenue is based on a franchise model, and really fits the structure well.

Stewart: That's super interesting and I'm learning here a great deal about this space. Is there another area, or are there other areas of ABS that you find particularly interesting right now?

Jean-Marc: Yeah, I think the other area that we're spending a lot of time on right now, because it's growing pretty quickly is the equipment space. So as mentioned earlier, a lot of the regional banks have taken a step back from lending in the equipment space, and some private issuers are basically stepping into fill that void. And they are increasingly using the ABS market to finance their activities. A lot of these issuers are new to us but are not new to the space. These are experienced platforms or companies with experienced management teams that are very well versed in managing equipment books. So we have been able to get comfortable with an increasing number of these platforms, and in these cases we're able to pick up a pretty significant yield premium to some of the more on-the-run traditional sectors like just your liquid equipment financing companies, or also something like auto. So it's an area that's an increased focus for us.

Stewart: That's awesome. So are there areas of public securitized credit that you're avoiding? And I think that this is always something that for insurance companies and particularly fixed income investors, avoiding downside is paramount. So, can you talk a little bit about the sectors that you're not as enthusiastic about?

Jean-Marc: Yeah, I certainly can, and I would echo your view that downside's paramount. The distribution is not normal in terms of the outcome on fixed income securities. So areas that we're avoiding, I mentioned CMBS earlier, that's one where we remain cautious and most of the caution we're expressing there is really on legacy deals that are out there that have been out in the market for a while. But I will say, I will just mention that we've seen some questionable underwriting in some of the new issue deals that we've seen, largely in the floating rate universe, where the ability for the loans to cover debt service on a long-term basis really requires rates to decrease in line with the forward curve, and any flat-lining of rates from here would actually cause some debt service coverage issues on those loans. That's something that we're trying to avoid. Puts us back in the situation we're in today in a lot of these deals.

Another area where we've historically been cautious and remain cautious is marketplace lending. Again, a lot of these platforms are not tested through a full cycle. We've started to see losses creep up in those deals, vis-a-vis other areas of the consumer market at just an increasing rate, would cause us a little bit of concern.

And then I'd say the last area where we've been avoiding is parts of the solar market, really for relative value reasons, but on the loan side of that market, it's a similar issue as what we've experienced within the RESI part of the market. So we see there that pre-payments on solar loans tend to be very highly correlated to pre-payments on mortgages. And so as mortgage pre-payments have decreased, you've just seen an extension in these profiles, and that extension will likely continue for a large subset of the market.

Stewart: And when we're talking about marketplace lending, just for my own benefit, is this a situation where a borrower goes onto a site and fills out essentially a credit app and then that app is shopped to a number of different lenders, and then those loans are securitized? Is that what marketplace lending is?

Jean-Marc: To some degree. So it is a process by which a consumer applies for an unsecured loan. I would say in many cases they're applying directly to one, basically, lender. That loan isn't necessarily shopped, per se. A lot of times the lenders have dedicated money where they're basically stashing the loan. So that's dedicated capital designed to basically house those loans.

But again, the story here is that there's some novel underwriting techniques that have deviated from what we consider to be the long-term proven methods of underwriting credit, which has allowed to maybe expand the box a little bit beyond some of the other areas of lending. Let me just stop there.

Stewart: Yeah, that's fine. I'm reading between the lines that 'novel approaches' to underwriting are not okay. And I think, historically, novel approaches to various things have turned out to be not okay so I get it there.

Jean-Marc: I don't want to overstate it. We have seen losses creep up. It's definitely too early to say that the business model has not worked here. I think they've been quite profitable in many cases. It's just we, from a lender's standpoint, have not seen how this profile works through a cycle.

Stewart: That makes total sense. So I have learned so much about public fixed income securitized today with you, and I really appreciate that. And you've covered a lot of bases, and I want to wrap with a couple of our questions that we ask along the way. So there's two of them. You can take either or both. Lots of our guests take both, no pressure.

The first one is, what piece of advice have you gotten along the way that you'd care to pass along to a 25-year-old Jean-Marc Breaux, or someone like that who's early in their career in the financial services industry? Is there something that you've been taught or told along the way that you think would be helpful to that person?

Jean-Marc: Yeah. I would say this is something I've been told, but it's also something that I've just learned through experience along the way, and that's just ask questions. Don't be afraid to ask questions. It's amazing how many times you'll find yourself in a room full of very smart people and you're afraid to ask the question, and it turns out that half the firm had the same question, was afraid to ask it. And that's ultimately how we learn and become better analysts and better investors, is understanding what we don't know and just having the willingness to go out there on a limb and question things.

Stewart: Shout-out to college students out there. I have made this statement many, many times, at many classes. If you have the question, chances are there's other people in the room that have the same question, so please ask it. It helps everyone.

Jean-Marc: Absolutely.

Stewart: So I think that's good stuff. And the second one goes, you could have a table of four for lunch, you and three others. It could be just you and one other person or up to three. Who would you most like to have lunch with, alive or dead?

Jean-Marc: Alive or dead, okay. All right. I'm going to choose three here. So first, my grandfather who lived in Baltimore where I currently live, was a big Orioles fan.

Stewart: There you go.

Jean-Marc: I'm bringing him back so he can join for lunch and I can basically watch another game with him, because the Orioles are actually good again for once. Second, still alive-

Stewart: It's the only stadium in baseball you can get a crab cake. A good one.

Jean-Marc: Absolutely. Yeah.

Stewart: It's the only stadium I think in baseball where you can get a high-quality crab cake instead of the... In Chicago, you're going to get the hotdog and maybe the Polish, but there's no crab cake as an option. That's what I noticed when I went to the Orioles game.

Jean-Marc: Crab cake, and Baltimore listeners will also tell you that the pit beef is also quite good.

Stewart: There you go. I've actually heard of pit beef, but I've never had it. So, good to know.

Jean-Marc: Worth a shot. All right. Second, I'm a tennis enthusiast. I've always wanted to meet Roger Federer. I'm bringing him to lunch. There is actually a tie into investments here, I think, though, because, what's interesting about Federer is that over the course of his career, he won roughly 54% of all the points he played, but he won 80% of the matches. And I think there's a parallel there to the investment world, which is basically, stay true to your philosophy. Don't worry about the day-to-day, and worry about the long-term outcome.

And then for my third, I'm a little worried that those first two might be a little boring together. So I guess somebody's got to bring fun. I'm going to resurrect David Bowie. He's going to bring some excitement to the table-

Stewart: Wow, there you go.

Jean-Marc: -and we're all going to have a blast.

Stewart: Oh, that's great. I love that. That's a great table. Your grandfather, Roger Federer and David Bowie. That's a cool, eclectic mix. So thanks for being on. We've really had a great time talking about the securitized market, and I just really appreciate you taking the time to educate our audience. So thank you. Thanks for being on.

I just want to bring up that you are going to be, I mentioned at the top of the show, but you are going to be a panelist at our symposium in June. I can tell you, by having spoken with you today, a very approachable and engaging person. So if somebody has questions or whatever that they want to ask you while they're there, I'd encourage you to engage with Jean-Marc while at our symposium this summer. So thanks for taking the time, and thanks for joining us.

Jean-Marc: Thank you.

Stewart: We've been joined today by Jean-Marc Breaux, who's the sector portfolio manager in the Fixed Income Division of T. Rowe Price. Thanks for listening. If you have ideas for a podcast, please shoot me a note. It's stewart@insuranceaum.com. You can rate us, like us and review us on Apple Podcast, Spotify, Amazon, Google Play, or wherever you listen to your favorite shows. My name's Stewart Foley and this is the InsuranceAUM.com podcast.

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