Insurance AUM Journal
The Industry's Investment Resource
Q4 2020

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BREAKING THROUGH

INTERVIEW

Meet Karyn Williams: The Queen of Risk

Thought Leadership for the Insurance Investment Community

Opportunities within the Structured Credit Universe

Fixed income sector yields are at historically low levels and insurers are feeling pressure to achieve their income objectives. In light of this we interviewed Michael Meyer and Gregory Ward from Loomis Sayles about the structured credit universe and why an expanded opportunity set within the securitized credit market could benefit insurance companies.

Q: You believe insurers should consider broadening their traditional focus on high-quality securitized credit within their investment grade fixed-income reserve portfolios. Why?

We think there are pockets of the securitized market beyond the traditional high quality AAA market that have been overlooked and might help meet insurers' objectives by providing compelling yield potential and relative value. Historically insurers have leaned on their core fixed income manager to access the securitized credit market. We believe that expanding the universe requires a different and more specialized skill set.

The universe is large and diversified. Consider that globally the public portion of the structured credit universe is approximately $15.2 trillion—split evenly between US agency issues and securitized credits (asset-backed securities, commercial and residential mortgage-backed securities, and other types).[1] Private opportunities represent trillions more.

Q: Can you relate structured credit to real assets and its role in the economy?

The structured credit universe is frequently exposed to real assets. These assets can include real estate, autos, equipment (e.g., aircraft, containers, rail cars) and infrastructure. Such assets tend to produce recurring contractual cash flows and provide tangible collateral. They can also provide diversification from other types of financial assets and a potential hedge against inflation.

Structured credit plays an integral role in the movement of capital, enabling issuers to finance business operations to support a broad swath of the economy (including auto loans, aircraft leasing, equipment leasing, residential and commercial mortgages and credit card receivables).

Q: How has the structured credit sector performed in 2020?

Well, like most asset classes so far in 2020, structured credit has had its share of volatility. As the pandemic brought economic activity almost to a halt in March, many investors rushed to sell assets to raise cash. As one might guess, this significantly strained markets.

Corporate spreads were the first to widen. However, a liquidity crunch in securitized assets rapidly drove prices down as investors sought to liquidate assets that had not yet followed corporates wider. As asset prices fell, forced deleveraging by certain market participants (e.g., mortgage REITS) exacerbated the sell-off. Observing the financial markets' challenges, the Federal Reserve (Fed) stepped in to provide support in late March. Sparked by the Fed's actions and fiscal stimulus, sentiment quickly changed and markets generally rebounded sharply in the second and third quarters.

Q: Where do you see investment opportunities in the sector?

With the relative lack of direct Fed support, the recovery in securitized assets has not been equivalent across all sectors and has generally lagged the rebound in corporate credit. For example, travel-related sectors (hotels, lodging, and aviation) have struggled, while consumer-related sectors have benefited from the US government's fiscal stimulus during the spring and summer.

This uneven recovery and the potential for year-end volatility could create opportunities for attractive yields in specific structured credit sectors and classes of securities.

Q: What do you say to investors wary of the risks generally associated with structured credit investing?

The very structure of securitization, which involves the tranching of risk, enables investors to identify and invest at the risk levels where they are most comfortable. At the same time, they have the opportunity to earn a potentially attractive rate of return. Investing in structured credit also allows investors to diversify away from traditional corporate exposures into areas like consumer credit and real estate.

[1] Sources: SIFMA, AFME, Bloomberg Barclays, European Covered Bond Fact Book 2020, as of 6/30/2020.

Q: Is the securitized credit universe skewed toward below investment grade?

No, in fact the tranching of risk creates a large investable universe for insurance companies seeking investment-grade exposure. Below-investment-grade credit represents only 5% to 10% of the securitization market. Frequently, we see higher-rated tranches representing a significant proportion of the deal structures with limited availability of subordinated tranches.

Q: Can you offer an example?

Sure, a recent prime auto deal's AAA-rated tranche represented approximately 96% of the deal structure and the remaining tranches were rated AA, A and BBB. Similarly, a new subprime auto deal consisted of a AAA tranche (63% of the deal structure) with the remainder of the notes split amongst AA (9%), A (11%), BBB (9%), BB (4%) and B (4%) rated tranches. We acknowledge that obtaining an allocation to the subordinated tranches (AA+ to BBB-) can be challenging due to their limited supply. However, investing in less liquid, privately sourced structured credit, backed by real assets, can help achieve insurance companies' targeted allocations.

Q: How would you characterize access to the securitized markets?

It's a complex and fragmented market. For example, it has approximately 40 times more CUSIPs than that of the US corporate bond market. Barriers to investor participation are high.

From an issuance perspective, government-sponsored entities, other regulated institutions and independent finance companies are reliant on the securitization market to finance their operations. In our view, these factors can contribute to securitized spreads being wider than comparably-rated corporate securities.

Of course, understanding the macro environment and what's happening within specific sectors are key components to any investment decision. Investors must be aware that owning securitized credit is a structurally leveraged bet on underlying fundamentals. Additionally, structural leverage can create downgrade risk and binary investment outcomes, particularly in relatively thin classes deep in the capital structure. Analytical sophistication and experience are required in this market. Investors must have scale and relationships with issuers, the sell-side, advisors, and others to originate, analyze, and monitor investments.

What do you want readers to take away from the Q&A?

We believe that an expanded view on securitized credit could benefit insurers. The combination of illiquidity and structural premiums that can be found in the structured credit market can create effective sources of incremental yield to support the overall business of the insurance company.

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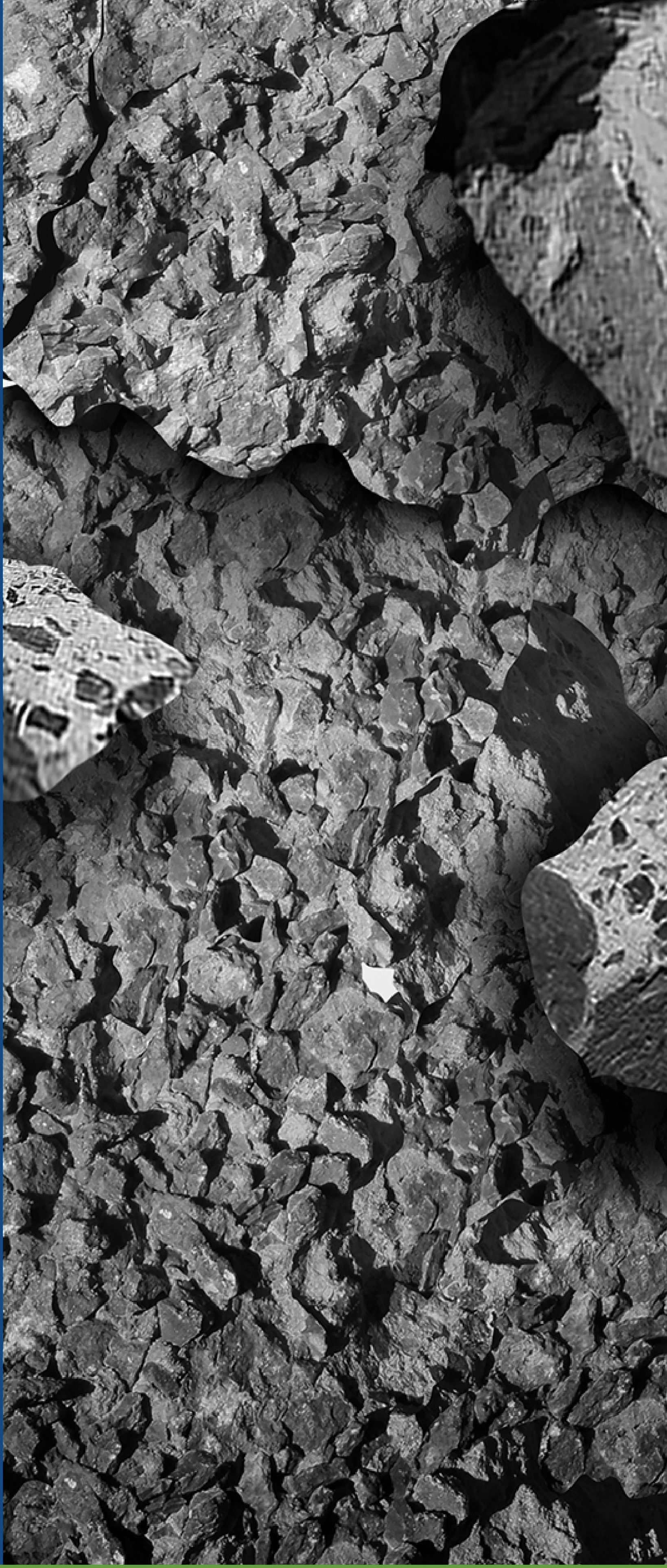

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