SECURED CREDIT INSIGHT

Janus Henderson
INVESTORS

Finding value in the Covid-19 crisis – an ABS view

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At Janus Henderson we have long seen asset-backed securities (ABS) as a valuable component of diverse multi-sector credit portfolios; typically either instead of, or alongside investment grade corporate bonds. For example, since 2012 we have run a dedicated ABS sleeve within one of our diversified bond funds and the asset class has been an integral part of a multi-asset credit fund launched in the same year.

In this paper we explain our reasons for such allocations, the usual characteristics of ABS holdings and how they have performed through the Covid-19 crisis to date. In a future publication, we will delve into the typical structural features of the holdings and the protections in place to deal with the broad macroeconomic impacts expected as societies globally seek to control the virus.

The basic concepts

To start with, we will address some of the jargon often used when talking about securitised products. Securitisation covers a very broad range of asset types and structures.

The primary asset classes are residential mortgage-backed securities (RMBS), consumer ABS (such as pools of consumer loans, credit card receivables), commercial mortgaged-backed securities (CMBS), collateralised loan obligations (CLOs — typically broadly syndicated leveraged or secured loans, but other types of loans can also be securitised in CLOs) and whole business securitisation (WBS — where securitisation technology has been used to finance portfolios of assets owned by businesses such as large estates of public houses and restaurants in the UK).

When we refer to ABS, to keep things simple, we include all of the above.

We should also point out that European securitisation regulations now effectively curtail the ability of European-based investment managers and institutional investors from investing in ABS originated outside of Europe — unless they have been structured to comply with European regulations, which not many currently do. This piece therefore focuses on European ABS, although it is worth noting the global securitisation expertise that we benefit from within Janus Henderson.

An asset class presenting a variety of differentiating features

Allocations to ABS within our multi-sector portfolios have been a vital ingredient when seeking to optimise the portfolio mix and the required risk and return profile. We view ABS as having a number of differentiating features that can be combined successfully alongside other credit asset classes and sovereigns. These are summarised on the following page.

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- **Fundamental diversification into different risk profiles**
  ABS provides exposure to a range of asset types and structures, within which there are different consumer-driven and 'real economy' risks that impact underlying collateral quality. *This differs from business and management risks associated with corporate bonds and loans.*
- **Attractive relative credit spreads versus equivalently rated corporate bonds**
  ABS typically offers a better spread to other credit asset classes on a comparable ratings basis and has a shorter average spread duration, *reducing potential price sensitivity to credit spread moves in the market*.
- **Strong long-term risk-adjusted returns versus other credit asset classes**
  European ABS has historically provided a lower default rate and an *attractive Sharpe ratio* relative to other credit asset classes.
- **Predominantly a floating rate asset class in Europe**
  Interest rate risk is somewhat negligible, which enables investors to enjoy *credit spread-based excess returns* while managing portfolio's interest rate strategy separately.
- **Resilience through high quality structures**
  The largest portion of the market is senior ranked and secured, *providing additional downside protection*.
- **Broad opportunity set with a range of risk and return profiles**
  The different seniority tranches within ABS offer *multiple layers of risk* providing choice where to invest based on your fundamental macroeconomic view and risk appetite.
- **Amortisation structures promote continuous deleveraging**
  Cash is actively returned to investors and *debt levels are reduced or at least maintained* even during periods of stress.

A working example of the typical characteristics of ABS

Tables 1 and 2 show some of the characteristics of a typical ABS portfolio that we manage and those of an investment grade euro corporate bond index respectively, and help evidence some of the key features we have already discussed. The tables further illustrate the shorter spread duration profile and the higher overall credit quality offered by ABS when compared to investment grade corporates. We have shown data as of end 2019, end March and April 2020 to provide a sense of the overall levels of credit spreads available and the recent moves in the markets.

Table 1: typical Janus Henderson ABS portfolio

Janus Henderson ABS portfolio	End Dec 2019	End Mar 2020	End Apr 2020
Credit spread, %[1]	1.40%	2.70%	2.20%
Spread duration, years[2]	3.2	2.6	2.6
Rates duration, years[3]	0.1	0.1	0.1
Weighted average rating[4]	AA	AA	AA
Senior most class, %[5]	74%	79%	77%
Regions:			
Europe	82%	74%	80%
US	2%	2%	2%
Other	7%	10%	9%
Sectors:			
RMBS	38%	38%	39%
Consumer ABS	13%	13%	17%
CLO	34%	28%	29%
CMBS	5%	4%	4%
WBS	2%	2%	2%
Cash	9%	15%	10%

Source: Janus Henderson Investors, as at 30 April 2020.

Note: The ABS portfolio above represents the dedicated ABS sleeve of our diversified bond fund that has been managed since 2012.

Table 2: European corporate bond index

European corporate index characteristics	End Dec 2019	End Mar 2020	End Apr 2020
Credit spread, %[6]	0.6%	1.9%	1.5%
Spread duration, years[7]	5.2	5.3	5.1
Rates duration, years	5.2	5.4	5.4
Weighted average rating	A-	A-	A-

Source: Janus Henderson Investors, ICE BofA Euro Corporate Index, as at 30 April 2020.

Notes for both tables:

1. Credit spreads are estimated sterling-hedged equivalents versus Libor for the invested portfolio
2. Spread duration is based on modelled base expected average life for the invested portfolio
3. Reset dates used for floating rate investments in calculations for the invested portfolio
4. Excludes cash balance
5. Includes cash balance
6. Credit spread represents asset swap spread
7. Effective duration

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Showing resilience amid the turmoil

While ABS markets were not immune to the broad and deep risk asset sell-off in the first quarter of 2020, their outperformance does stand out; supporting our long-held conviction as to their strong risk-adjusted return potential.

This becomes particularly clear when we compare the performance on an excess return basis, excluding the positive total return impact of declining government bond yields on fixed rate asset classes (chart 1). We have often viewed an allocation to ABS as an alternative way to generate credit spread returns from investment grade assets without any embedded interest rate duration risk (which can be managed separately).

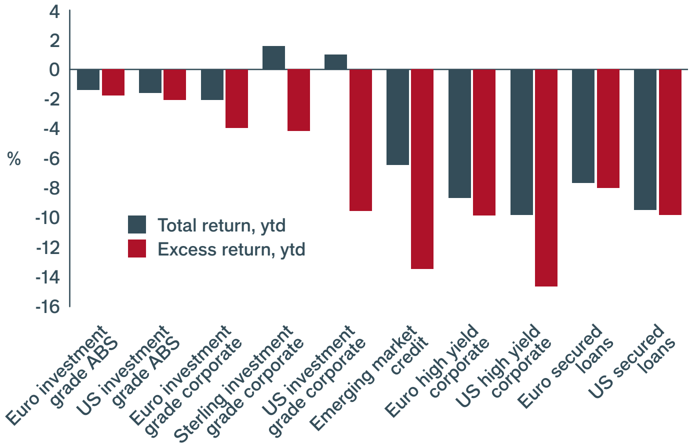
Chart 1: selected credit index returns — Q1 2020

Source: Bloomberg Barclays Pan European FRN ABS Bond Index, ICE BofA Merrill Lynch corporate bond and US ABS indices, Credit Suisse leveraged loan indices, as at 31 March 2020.

Note: returns are hedged to US dollar. Excess returns are versus swap rates for fixed rate asset classes and Libor for floating rate assets.

Given the significant bounce back in risk assets generally during April we thought it useful to also show the year-to-date (to end April data) performance in chart 2. As can be seen, the general picture of a strong relative performance by ABS, particularly on an excess return basis, remains.

Chart 2: selected credit index returns — year to end April 2020



Source: Bloomberg Barclays Pan European FRN ABS Bond Index, ICE BofA Merrill Lynch corporate bond and US ABS indices, Credit Suisse leveraged loan indices, as at 30 April 2020.

Note: returns are hedged to US dollar. Excess returns are versus swap rates for fixed rate asset classes and Libor for floating rate assets.

Performance through a longer-term lens

Table 3 looks at the relative excess returns for the credit indices in charts 1 and 2 through a longer-term lens. We show both 5-year and the approximately eight years since we

Table 3: a more detailed look at excess returns

	5-year returns			SI returns		
Excess returns index data	5-year annual return	5-year volatility	5-year Sharpe ratio	SI annual returns	SI volatility	SI Sharpe ratio
Representative JHI ABS Portfolio	0.99	2.15	0.46	2.17	1.87	1.16
Euro ABS	0.55	1.35	0.41	2.59	1.71	1.52
US ABS	0.02	1.62	0.01	0.64	1.36	0.47
Euro investment grade corporate	0.25	3.65	0.07	1.10	3.01	0.37
Sterling corporate	0.97	6.16	0.16	2.16	5.22	0.41
US investment grade corporate	-0.28	6.25	-0.05	0.63	5.11	0.12
Emerging market credit	-0.01	7.69	0.00	1.24	6.68	0.19
Euro high yield	1.04	7.79	0.13	3.36	6.58	0.51
US high yield	0.04	8.97	0.00	2.12	7.54	0.28
Euro loans	2.03	7.14	0.29	3.65	5.71	0.64
US loans	0.57	6.69	0.09	2.36	5.39	0.44

Source: Bloomberg Barclays Pan European FRN ABS Bond Index, ICE BofA Merrill Lynch corporate bond and US ABS indices, Credit Suisse leveraged loan indices, Janus Henderson Investors, as at 30 April 20. SI = since inception.

Notes: While our representative ABS portfolio has outperformed the index on a 5-year basis, the underperformance since inception was primarily due to being underweight periphery ABS in the early periods of managing the portfolio. This decision was taken in conjunction with the portfolio managers of the overall fund who preferred to exploit the recovery in periphery fixed income markets via other strategies in the fund's portfolio. Since inception (SI): data since the inception of the representative portfolio (March 2012).

started managing the representative ABS portfolio summarised above in 2012 (the since inception returns). This supports our view that despite the recent pick up in volatility, European ABS has continued to deliver strong risk-adjusted returns relative to the broader credit markets.

The European ABS index used in the data is the Bloomberg Barclays Pan European Floating ABS Bond Index. While this is the broadest European ABS index available, it is not without its deficiencies as it does not fully represent all asset classes and rating levels within the securitisation universe. Table 4 summarises some of the key constitutional differences between this index and the investable universe.

Table 4: select index and ABS universe characteristics

Indicator	Index	ABS universe
Size	EUR 69.2bn	EUR 451bn
Overall RMBS exposure	70%	39%
Dutch RMBS exposure	30%	8%
UK RMBS exposure	17%	20%
Spanish RMBS exposure	12%	6%
Auto ABS exposure	21%	11%
CLO exposure	0%	28%
Senior exposure	93%	69%
AAA rated exposure	76%	51%

Source: JP Morgan International ABS & CB Research, Barclays Research, Bloomberg, Janus Henderson, as at 31 March 2020.

It can be seen from the table that the most noticeable absentee from the index is CLOs, which represents around 28% of investable universe. The index is also more concentrated in Dutch and Spanish RMBS as well as auto and consumer ABS compared to the overall universe. Further, the index's focus on senior, AAA-rated ABS is also evident when compared to the overall ABS asset base.

These are important considerations when assessing the performance of an European ABS portfolio versus the index, especially as many of the investments underrepresented in the index offer higher credit spread returns but come with longer credit spread duration and generally higher levels of market volatility.

We have seen this with the representative portfolio that we manage. Year-to-date through the end of March, this portfolio underperformed the index by around 1%, principally due to its CLO holdings. However, by the end of April this had been recovered leaving the portfolio ahead of the index by around 0.3%.

Recent credit spread and price movements within ABS

Table 5 drills further into the relative estimated credit spread moves we have seen across the different parts of the European ABS universe in recent months. It also provides an estimate of the price developments due to the spread changes and how the 5-year realised volatility has been impacted by the events of recent months.

Table 5: spread and price movements in recent months

	Spread, basis points			Implied price change, %		5-year historical volatility	
Name	Dec-19	Mar-20	Apr-20	Q1	ytd	to end of Dec-19	to end of Apr-20
Euro CLO AA	178	425	300	-12.4	-6.1	1.8%	6.2%
Euro CLO A	235	570	390	-18.4	-8.5	3.2%	9.4%
Euro CLO BBB	365	845	705	-33.6	-23.8	7.3%	16.5%
UK non-conforming senior GBP	96	240	175	-5.0	-2.8	1.2%	2.3%
UK non-conforming 2nd pay GBP	155	390	300	-11.8	-7.3	2.6%	5.6%
UK prime RMBS AAA GBP	69	160	115	-2.7	-1.4	0.6%	1.3%
Dutch RMBS AAA EUR	16	55	46	-1.2	-0.9	0.3%	0.6%
Spanish RMBS AAA EUR	113	215	155	-3.6	-1.5	1.2%	1.9%
UK cards AAA EUR	57	160	130	-2.6	-1.8	0.4%	1.1%
Europe auto AAA EUR	15	80	60	-1.3	-0.9	0.3%	0.6%
Europe consumer AAA EUR	50	160	145	-2.2	-1.9	0.4%	1.0%

Source: JP Morgan, Citi Velocity, as at 30 April 2020.

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It can be seen that the ABS universe represents a very broad opportunity set, offering investors greatly varying risk/return characteristics. Within senior ranking bonds, the ABS investment spectrum ranges from prime RMBS, consumer, auto and credit cards offering stable returns with low volatility, to senior non-conforming RMBS and AAA/AA rated CLOs that offer higher return opportunities with still relatively low levels of return volatility.

For investors with higher risk/return appetites, the ABS market offers opportunities in mezzanine, investment grade rated bonds in asset classes such as single A and BBB CLOs and second pay UK non-conforming RMBS (non-prime mortgage portfolios). It is important to highlight however, that these mezzanine bonds can exhibit heightened levels of volatility during market downturns as illustrated previously in table 5. This does not necessarily make them a bad fundamental investment in our view, but is a consideration when constructing portfolios and establishing risk tolerance budgets.

Low volatility linked to limited trading?

Some may have the view that the relatively low volatility data for ABS shown in table 5 was the result of limited trading. Our perspective, looking back over various periods of stress since the Global Financial Crisis (GFC) is that European ABS does tend to be held in 'stickier hands', particularly at the more senior end of the capital structure.

The chart below is based on weekly MiFID trading data from Bloomberg and provides colour around ABS trading volumes year-to-date. It shows that trading volumes remained consistent from the start of the year through to the first two weeks in March, before increasing in multiples over the subsequent weeks. Thus, while the liquidity in the ABS market did become stressed in March, similar to other fixed income markets, it clearly remained open and functional. This challenges the common perception that there is a lack of real trading within the asset class during periods of market stress.

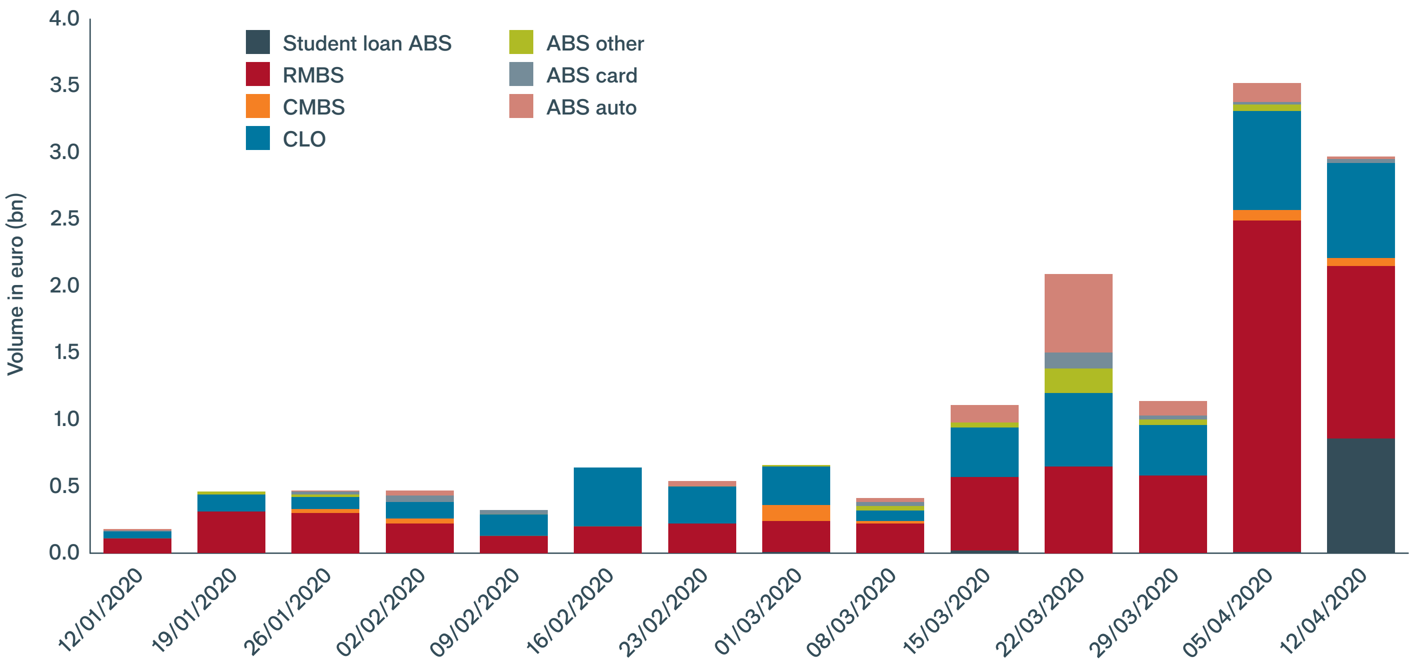
Behaving as expected

Overall, we believe that European ABS has delivered relative performance in line with our expectations to date and through the Covid-19 crisis. Given that we primarily view ABS as a low rate duration alternative to investment grade corporate bonds, the strong excess returns versus the latter asset class has been particularly pleasing.

Having traded thousands of ABS securities since the start of the GFC, we have not had any particular concerns over market liquidity, yet it is still good to see how this held up during a very stressful period.

The next publication from the London-based ABS team will seek to explain why we believe the strong relative performance through the Covid-19 crisis to date has been justified on a fundamental basis, and why we remain confident in the overall long-term fundamentals of the asset class, despite the severe economic challenges that remain ahead.

Chart 3: year-to-date ABS trading volumes



Source: Bloomberg ABS MiFID trading data, weekly, as at 12 April 2020.

Note: this data shows bonds trading to a client account on a 'bid wanted in competition (BWIC)' as two separate trades, but it is the trend that is important.

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Ian holds a bachelor's degree in business administration from Memorial University and an MSc in financial markets and derivatives from London Metropolitan University. He has 20 years of financial industry experience.

Past performance is not a guide to future performance. The value of an investment and the income from it can fall as well as rise and you might lose the amount initially invested.

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