

GLOBAL STRUCTURED DEBT INSIGHT

Welcome to a new publication from the Janus Henderson Global Structured Debt Team. It will become a regular means of communication to share thinking from across the team on key themes impacting structured debt markets. The team, led by Colin Fleury and John Kerschner, would be delighted to discuss any of the topics in more detail.

This edition explores:

- ▶ value in securitised products and secured loans, in both Europe and the US
- ▶ a new ESG linked margin ratchets trend in secured loans
- ▶ how to analyse carbon emissions in mortgage-backed portfolios, using the UK as a case study



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Why we see value in structured debt

We believe securitised markets across the developed world offer compelling yields (income) for investments with relatively short maturity profiles, strong fundamental performance expectations and relatively low exposure to interest rates. In an environment of low absolute yields and potentially rising interest rates, such investments deserve a much closer look.

A look at the value in the US

In our view, securitised products in the US look relatively attractive, in part because they have lagged their corporate counterparts in the rally from the lows of 2020. The US Federal Reserve was quick to announce programmes to buy agency mortgage-backed securities (MBS) and government bonds, including the historic corporate bond buying programme. But in securitised products (outside of traditional MBS) its only focus was AAA rated securities – a segment of the market few were worried about, if only because they already carried a credit rating higher than the US government.

When corporate bond spreads surged in the final quarter of 2020, securitised products were more subdued, lagging their corporate counterparts. This year, the relative tightness of both investment grade and high yield corporate bond spreads is a multiple of most securitised products. As an example, figure 1 shows the relative value in US collateralised loan obligations (CLOs) versus corporate bonds.

Figure 1: the relative value in US CLOs



Source: JP Morgan, Bloomberg, Janus Henderson Investors, as at 28 May 2021.

Note: US CLO: JP Morgan Data Query – CLOIE CLO Indices Data, investment grade, discount margin; Bloomberg Barclays US Corporate Statistics Index – OAS spread to swap.

The lag in securitised products may also be due to the lack of exchange-traded index products such as the Markit credit default swap index (CDX) and iShares iBoxx \$ High Yield Corporate Bond ETF (HYG). For investors quick to conclude that the world's outlook is getting better, buying investment grade or high yield corporate bond exposure has been relatively easy through ETFs. However, the securitised market generally lacks these more uniform products, precisely because it is a more diverse, nuanced and technical

market and securitised products demand bottom-up fundamental and quantitative analysis. That said, in 2020, Janus Henderson successfully launched a AAA CLO exchange-traded fund, allowing retail investors to access the market.

A similar story in Europe

European securitised markets have had a similar experience to the US, with the European Central Bank only buying AAA rated and vanilla securitised bonds since 2014 and spread compression recently lagging corporate bonds. To demonstrate the relative attractiveness, the chart in figure 2 shows spreads from a representative high credit quality European centric ABS strategy versus a broad corporate bond index.

The average rating of the ABS portfolio is AA+ versus A/BBB+ for the corporate bond index and the spread duration is around three years versus five. Despite its higher credit quality and shorter duration, the current average spread of the ABS portfolio is around 0.2% higher, making the asset class more attractive from a valuation point.

Standard deviation metrics of the two spreads provide further evidence – while the ABS spread is around the median of its 5-year history (neither wide, nor tight), corporate spreads are actually tighter versus history (around one standard deviation below their mean). Relative to each other, the ratio of 1.2 (over one standard deviation above the mean), also signals that ABS spreads offer better value than corporate bond equivalents.

Figure 2: relative attractiveness of securitised products in Europe



Source: Janus Henderson Investors estimates, Bloomberg, JP Morgan and Citi Velocity, as at 6 May 2021.

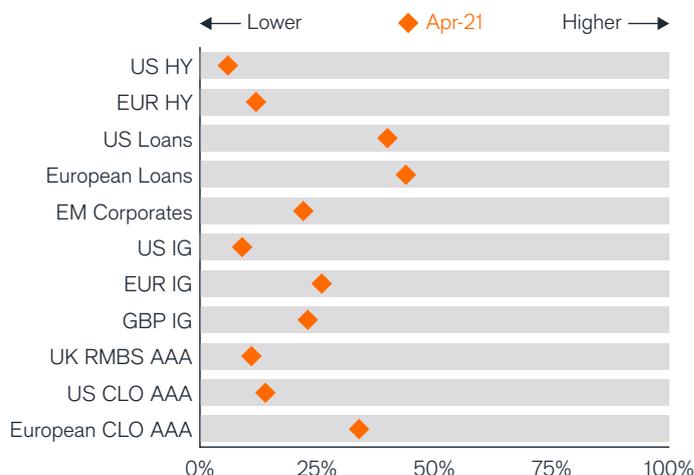
Note: European ABS Strategy spread data estimated based on representative account, as of 31 March 2021. Composition: broadly 40% RMBS, 32% CLOs, 23% consumer ABS and 5% other. The corporate index is the Bloomberg Barclays Euro Aggregate Index.

Past performance is not a guide to future performance

Value in secured loans too

Loans also screen relatively attractive based on the 20-year spread data shown in figure 3.

Figure 3: relative valuation between asset classes (spread ranges, current versus history)



Source: Janus Henderson Investors, Bloomberg, Credit Suisse, JP Morgan, as at 30 April 2021.

Note: Data for European CLO AAA and UK RMBS AAA is from 2006 to date, US CLO AAA is from 2011. All other data over a 20-year time period. Indices used: Credit Suisse Western European Leveraged Loan Index, Credit Suisse Leveraged Loan Index, JP Morgan UK RMBS AAA 5y GBP, ICE BofA US High Yield Index, ICE BofA European Currency Non-Financial High Yield 2% Constrained, ICE BofA US Emerging Markets Liquid Corporate Plus Index, ICE BofA Sterling Corporate Index, ICE BofA US Corporate Index, ICE BofA Euro Corporate Index. US CLO: JP Morgan Data Query – CLOIE CLO Indices Data.

Index data is for illustrative purposes only and not indicative of any actual investment.

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Furthermore, we see three primary reasons that will likely contribute to the continued attractiveness of the asset class:

- Loan structures in both Europe and the US have a minimum Libor floor (eg, set at 0% in Europe), which boost the effective spread available to loan investors.
- Issuance levels are elevated year to date (loan volumes backing buyouts represent c.75% of 2020 volumes and 60% of 2019*), ensuring a balanced supply/demand environment and reducing the possibility of a compression in spreads where investors chase a limited pool of assets.
- As the CLO market forms a significant buyer of loans, this is placing a floor on how tight loans can price, given that it would impact the CLOs' spread arbitrage (difference between the cost of funding and income from loans).

With default rates expected to remain very low through 2021 the already attractive spread being paid on loans looks even more compelling.

*Source: LCD, as at end April 2021

ESG trends in leveraged loans – margin ratchets

As environmental, social and governance (ESG) criteria become increasingly influential in investment decisions within financial institutions, European secured loans are the latest asset class to embrace ESG.

Loan agreements in Europe invariably incorporate a margin ratchet, which allows the borrower to benefit from a lower cost of funding based on improving credit metrics (and vice versa) – typically two to three steps of 25 basis points (bp) based on leverage.

The new kid on the block

The inclusion of a margin ratchet linked to ESG related key performance indicators (KPIs) is a relatively new phenomenon. To our knowledge, only three transactions included an ESG mechanism prior to 2021 but the trajectory of travel is clear with an additional seventeen transactions completing through to the end of April 2021.

There is no market standard as yet in terms of what is being measured and who is responsible for the measurement. Some documentations specify that the test is performed by an independent auditor or ESG rating specialist while others rely on attestations from the company management. In all cases the KPIs are measured annually and result in a modest discount (or premium) to the prevailing margin – 5-10bp (non-cumulative).

The most frequent KPI seen to date has been greenhouse gas (GHG) emissions. Other measures have been quite varied and some highly specific to the relevant company including employee satisfaction and diversity, patient experience, installed base of wind power generation capacity and share of green products, raw materials and recycling. Some recent examples are set out in the table.

Key performance indicators used in margin ratchets for European loans

Issuer	Key performance indicator (KPI)	Ratchet	Verification
Company 1 – distribution	GHG emissions	+/- 7.5bp	Annual auditor
Company 2 – retail	ESG agency rating	+/- 5bp	Annual ESG Agency
Company 3 – services	(i) ESG rating (ii) GHG emissions	+/-5bp	Company attestation
Company 4 – healthcare	(i) Patient experience (ii) Waste reduction (iii) Employee satisfaction	+/- 7.5bp	Annual auditor
Company 5 – packaging	(i) GHG emissions (ii) Use of recycled product (iii) % senior women	+/- 7.5bp	Annual auditor
Company 7 – manufacturing	Installed wind power capacity	+/- 10bp	Company attestation

Source: Janus Henderson Investors, as at 12 May 2021.

Striking a balance between positive momentum on ESG and investor returns

It goes without saying that providers of debt should be encouraging corporates to improve their ESG profile as part of the fight against climate change and to drive positive change in society. Management teams that focus on improving the ESG profile of their business should be creating a more sustainable and investible business, which should ultimately be reflected in a lower cost of funding. The implementation of the ESG margin ratchets into loan agreements recognises this development. Given the broad range of criteria that have so far been adopted as ESG KPIs, there is a risk that without proper oversight they are not sufficiently stretching or specific. As such they may not drive measurable improvement in the ESG profile of the business to justify the lower cost of funding, even if they are a welcome development in terms of improved ESG disclosure.

Ultimately there is a balance between encouraging positive momentum on ESG issues while still ensuring that the return being offered rewards investors adequately for the risks being taken. So far, as evidenced above, the margin ratchets have limited overall impact on the total return for investors. The market does need to be diligent and ensure that any proposed reduction in economics does not run ahead of the change in risk profile brought about from improved ESG measures.

Carbon footprints in UK mortgage-backed portfolios

With the current focus on climate risk in the economies by governments, companies and individuals, the process of carbon reduction or decarbonisation is increasingly becoming a part of investment policies, as investors look to integrate climate risk within their investment considerations. The recent raft of government policies and regulations around the globe also make this a necessity, such as the requirement for UK pension schemes to identify and assess climate risk in their portfolios.

Relevance of housing stock in combating climate change

With over 27 million residential properties in the UK producing an estimated 64 million tonnes of CO₂ as of 2017, UK residential housing stock is one of the largest contributors to the overall emission count in the country. According to the report published by the Committee on Climate Change in February 2019, heating and hot water for UK homes make up 25% of total energy use and 15% of the country's greenhouse gas (GHG) emissions. A further 4% of GHG emissions are the result of electricity used in the home for appliances and lighting.

A large proportion of residential housing stock ownership is financed by residential mortgage loans, with a total of £1,541.4 billion loans outstanding at the end of 2020. The securitisation market provides some £150 billion of funding to mortgage lenders in the form of residential mortgage-backed securities (RMBS) transactions.

In addressing the path to the decarbonisation of the residential housing sector, each party including governments, regulatory bodies, independent agencies, mortgage lenders and investors will have a part to play. As an active investor in RMBS transactions, we start by attempting to measure carbon emissions associated specifically with the properties that underlie the RMBS transactions we invest in.

Calculating the carbon footprint for UK RMBS exposure

Over the course of 2020 we engaged with the Partnership for Carbon Accounting Financials (PCAF) and a number of UK mortgage lenders to discuss their approach to measuring the carbon emissions profile of a mortgage loan portfolio and the challenges it presented, particularly around the low quality and availability of mortgage loan and household energy efficiency data.

The maps in the image below represent the output of our exploratory analysis. We took publicly available energy consumption (electricity and gas) figures along with Energy Performance Certificate (EPC) data, to view the regional exposure to high CO₂ output across the UK, as estimated by the EPC or high gas and electricity consumption usage.

The colour scale in the charts corresponds to the level of energy consumption in a region, with a darker colour symbolic of regions with the highest consumption. We then overlaid our weighted UK RMBS exposure to each region by aggregating available loan level data for current RMBS holdings. This is represented by the blue dots, with a larger size denoting higher exposure.

This initial step gave us transparency around average energy consumption per UK household and our exposure to these regions within our portfolio, which can then be translated into a carbon footprint.

One way to calculate the actual carbon footprint for RMBS transactions would entail the use of the level of CO₂ that is associated with producing one kilowatt (1kW) of energy across the UK from different energy sources. This data is then overlaid on the existing electricity and gas consumption estimates that we mapped, to calculate the overall CO₂ emission. By focusing on the proportion of bonds that we own over the total debt in the RMBS deal, we can then estimate the CO₂ emissions specific to our portfolios.

While this analysis alone does not necessarily provide a key insight into how to reduce carbon risk, as a first step, it allows us to make single issuer comparisons and broadens our active engagement with mortgage originators. Most importantly, it strengthens our ability to influence plans to reduce the carbon footprint of RMBS and other asset-backed securities (ABS) deals.

*The analysis used Environment Agency data licensed under the Open Government Licence v3.0. derived from Open Postcode Geo, which is derived from the ONS Postcode Directory, licenced under the Open Government Licence and the Ordnance Survey OpenData Licence. UK electricity data for the year 2016 published on 28 March 2019; <https://www.gov.uk/government/statistics/postcode-level-electricity-statistics-2016-experimental>. Gas consumption data published 2019: <https://www.gov.uk/government/statistical-data-sets/gas-sales-and-numbers-of-customers-by-region-and-local-authority>.

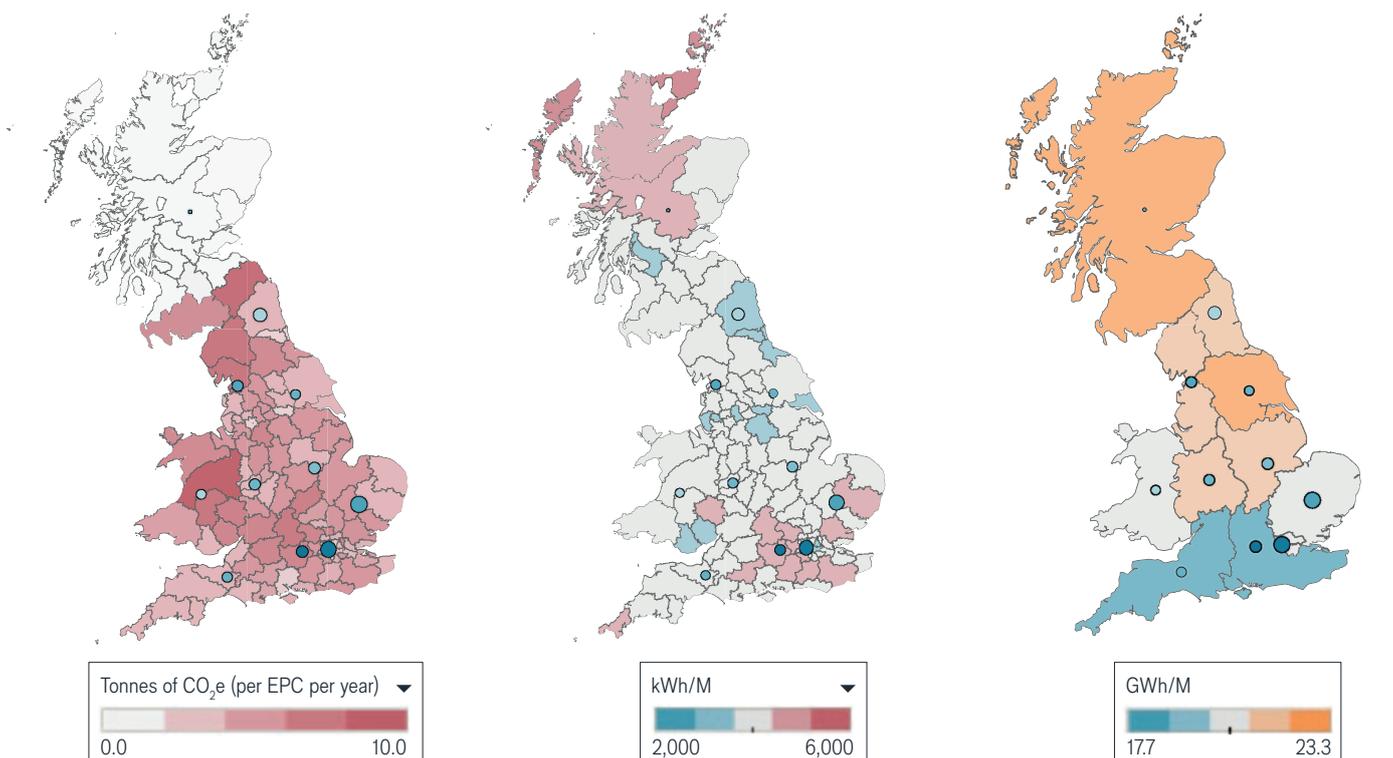
Note: circles represent the weighted allocation of our UK RMBS portfolio to the region. EPC data provides estimates for annual tonnes of CO₂ emissions per certificate, per year, which can be aggregated at the postcode level. Electricity and gas consumption are based on average annual kilowatt hour per meter (kWh/m) within that area.

UK RMBS portfolio exposures versus energy consumption levels

EPC CO₂ emissions

Electricity consumption

Gas consumption

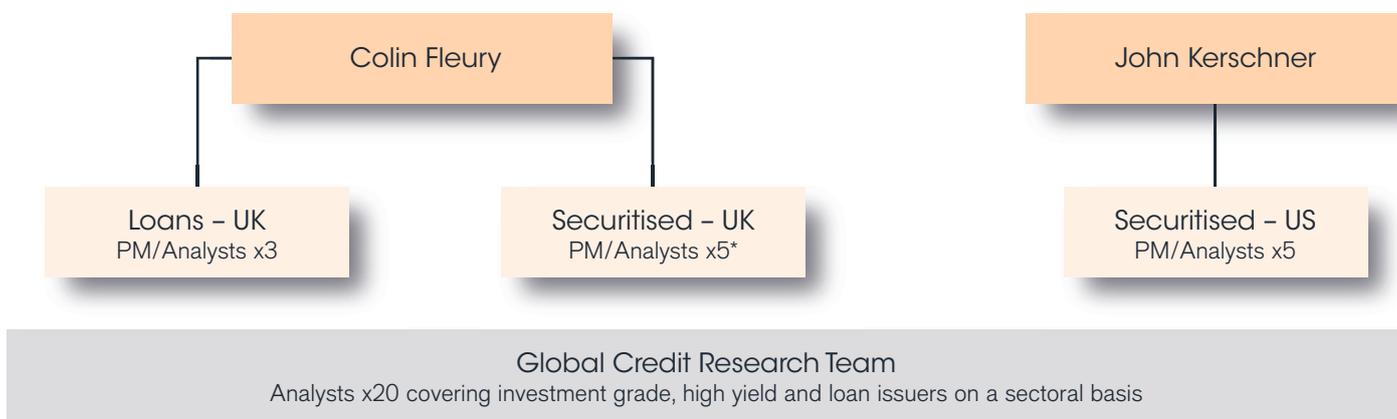


Source: Janus Henderson Investors as at December 2020. See notes for further detail.

Team overview

The Janus Henderson Global Structured Debt Team applies global, asset class wide expertise to offer actively managed solutions to help clients meet their investment objectives. The team, led by Colin Fleury, Head of Secured Credit, and John Kerschner, Head of US Securitised Products, is UK and US-based and made up of 15 investment professionals. Team members have a range of specialisms, with average industry experience of 16 years and an average tenure with Janus Henderson of eight years. They manage tailored mandates for institutional clients, assets within multi sector strategies and mutual and exchange-traded funds. Overall structured debt assets under management at Janus Henderson exceed US\$16bn.

Asset class expertise includes all major securitisation markets including residential and commercial mortgage-backed securities, consumer credit and collateralised loan obligations, covered bonds and secured corporate loans and bonds. The team merges qualitative and quantitative skillsets while working closely with industry sector specialist analysts within the broader Global Credit Research Team. The Global Structured Debt Team represents an integral part of Janus Henderson's global Fixed Income platform, collaborating with experts in global investment grade, high yield and government bond markets.



* includes a portfolio analyst supporting both Loan and ABS specialists

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