INVESTMENT INSIGHT

Janus Henderson INVESTORS

The case for asset-backed securities (ABS)

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Key takeaways

- The ABS universe represents a very broad opportunity set, offering investors greatly varying risk and return characteristics. It can offer diversification to core fixed income portfolios and the amortising structures and shorter durations can help reduce overall credit and interest rate risks. It can also complement the construction of cash flow aware portfolios.
- Investing in ABS requires not only a unique and broad insight into the dynamics of the structured debt markets but also an ability to understand and analyse the risks in a securitisation transaction. For those that have the capability to perform the requisite analysis, ABS can offer the opportunity to earn attractive risk-adjusted returns.

The basics

Securitisations cover 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). For simplicity in this paper, the term ABS includes all of the above.

A variety of differentiating features

ABS have a number of differentiating features that can be combined successfully alongside other credit asset classes and sovereigns within a fixed income portfolio:

- **Fundamental portfolio 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.
- **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.
- **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 the portfolio's interest rate strategy separately.
- **Resilience through high quality structures**
  The largest portion of the market is senior ranked and is 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 fundamental macroeconomic views and risk appetite.
- **Amortising structures promote continuous deleveraging**
  Cash is actively returned to investors and debt levels are reduced or at least maintained even during periods of stress.

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A range of opportunities

From an investor's point of view, ABS can appeal to both conservative and less risk-averse investors through the wide variety of investment opportunities available. ABS can also be a valuable component of diverse multi-sector credit portfolios; typically instead of, or alongside, investment grade corporate bonds.

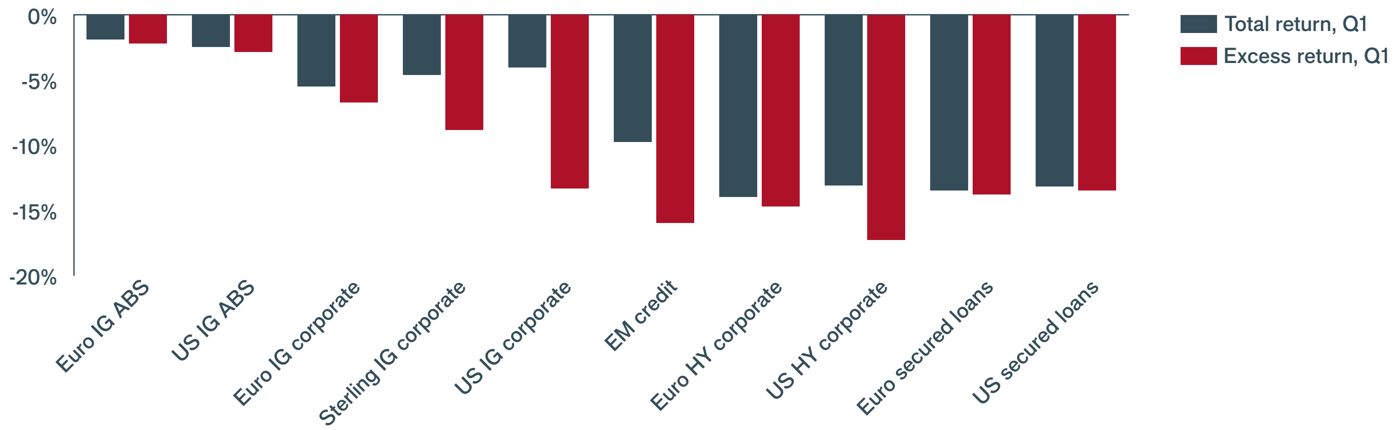
ABS offers greatly varying risk/return characteristics. Within senior ranking bonds, the investment spectrum ranges from prime RMBS, consumer, auto and credit cards offering stable returns with low volatility to senior non-conforming RMBS (non-prime mortgage portfolios) and CLOs that offer higher return opportunities with greater relative volatility, but still strong fundamental resilience.

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.

Performance showing resilience

The Covid-19 crisis has been a good litmus test for the asset class. While ABS markets were not immune to the broad and deep risk asset sell-off in the first quarter of 2020, their outperformance has stood out over the period, supporting their strong risk-adjusted return potential. This is shown in figure 1 – despite the pickup in volatility due to the Covid-19 crisis, ABS held up well relative to broader credit markets.

Figure 1: selected credit index returns in Q1 2020



Past performance is not a guide to future performance.

Source: Bloomberg Barclays Pan European FRN ABS Bond Index, ICE BofA Merrill Lynch corporate bond and US ABS indices, Credit Suisse leveraged loan indices, 1 January to 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. IG = investment grade; HY = high yield and EM = emerging markets.

Performance through a longer term lens

For a broader comparison over a longer period, the table in figure 2 looks at the relative excess returns, volatility and Sharpe ratio for various credit indices and the Janus Henderson ABS representative account over the past five years. As can be seen, ABS has delivered strong risk-adjusted returns compared to major fixed income credit sectors.

Figure 2: a longer term, more detailed look at excess returns

	5-year returns		
Excess returns data	**5-year annual return**	**5-year volatility**	**5-year Sharpe ratio**
Representative JHI ABS Portfolio	1.40	2.17	0.64
Euro ABS	1.07	1.38	0.78
US ABS	0.65	1.67	0.39
Euro investment grade corporate	1.07	3.67	0.29
Sterling corporate	2.14	6.14	0.35
US investment grade corporate	1.47	6.40	0.23
Emerging market corporate	2.62	8.01	0.33
Euro high yield	2.84	7.91	0.36
US high yield	3.06	9.30	0.33
Euro loans	3.36	7.32	0.46
US loans	2.42	6.96	0.35

Past performance is not a guide to future performance.

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 31 August 2020. Notes: The JHI ABS portfolio above represents the dedicated ABS sleeve of a diversified bond fund to demonstrate the fund managers' performance track record and is for illustrative purposes only. The fund managers have been running this portfolio sleeve since March 2012.

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Ability to withstand stressful economic environments

Securitisation transactions are typically structured to absorb high levels of collateral portfolio default through varying degrees of credit support for the different tranches of the notes issued. Credit support takes various forms including:

- **over-collateralisation**, which provides protection to all tranches of notes
- **subordination of more junior notes**, to provide protection to more senior notes in the structure
- **reserve funds**, designed to cover note interest shortfalls and losses in the collateral pool
- **excess spread**, being the interest earned on collateral pool, net of note interest and expenses

The amount of overall credit support typically available to various tranches of notes within a structure are examined in the following sections with a focus on UK RMBS and collateralised loan obligations.

Prime and non-conforming RMBS

Prime RMBS transactions – securitisations of high quality prime borrowers – typically comprise a senior tranche and a subordinated tranche. Non-conforming RMBS (NC RMBS) transactions, unlike prime RMBS, comprise mortgages that do not conform to high street prime origination criteria (this does not necessarily mean that the borrowers are of much poorer quality or are non-performing). These structures typically include multiple tranches, offering investors varying risk profiles.

Figure 3 shows the general levels of overall credit support available to each tranche of prime and NC RMBS structures. It can be seen that typically, credit support for a senior tranche of NC RMBS is around 26% versus 14% for a prime transaction, which reflects the fact that the former mortgages are somewhat more risky, with a higher risk of defaulting.

Figure 3: credit support levels for prime and non-conforming RMBS transactions

Tranche	Typical rating		Typical credit support*	
	Prime	Non-Conforming	Prime	Non-Conforming
A	AAA	AAA/AA+	14%	26%
B	-	AA/A+	-	21%
C	-	A	-	17%
D	-	BBB	-	14%
E	-	BB	-	12%
F	-	B	-	10%

Source: Janus Henderson Investors, as at 1 July 2020.

Note: *Including excess spread and reserve fund. Prime RMBS average reserve fund: 1.6%, Non-conforming RMBS average reserve fund: 1.8%.

European CLOs

CLOs are securitisation transactions primarily backed by 100-150 BB/B rated secured loans and floating rate bonds. Similar to other securitisations, CLO structures include multiple tranches offering varying degrees of risk. Typical levels of overall credit support by tranche are detailed in figure 4.

Figure 4: typical credit support levels for European CLOs

Tranche	Typical rating	Typical credit support*
A	AAA	42%
B	AA	29%
C	A	23%
D	BBB	18%
E	BB	12%
F	B	9%
Sub debt	NR	-

Source: Janus Henderson Investors, as at 1 July 2020.

Note: *Including excess spread and subordination.

How do the structures fare under stress analysis?

While any transaction needs to be analysed based on its specific characteristics, we have conducted simple stress analyses to help to illustrate the typical inherent protections that are available.

Firstly, for prime and non-conforming RMBS, we compare in figure 5 the worst observed general market losses over the Global Financial Crisis (GFC) period against the credit support typically available for various tranches. We then conduct similar analysis for CLOs and selected other asset classes.

It can be seen in all instances that the multiples of coverage available are substantial (it being lowest for single A CLOs at a still healthy 3x).

It could be argued that losses within different asset classes will turn out to be worse than that experienced during the GFC as the world seeks to control Covid-19. While this is not our base view due to a range of factors, including the aggressive policy action that has been taken by central banks and governments, it can be seen that the credit support coverage provides substantial cushion for more negative macro outcomes.

This is perhaps best illustrated through a simple example focusing on prime UK RMBS. In mid-July we estimated that average payment holidays or mortgage deferrals requested across prime UK RMBS mortgage pools was around 20%. If we assume that all of these borrowers eventually default (not our expectation, but to keep things simple) and assume a 70% loan recovery rate on default (a reasonable assumption based on historical recovery rates), then cumulative losses would be around 6% (versus the 1% level seen post the GFC). Even under this extreme scenario AAA credit support provides over 2x coverage.

Figure 5: credit support levels and coverage versus historical losses

	Typical credit support	Worst historically observed losses *	Credit support multiple for historically observed losses
Prime RMBS AAA	14%	1%	20x
NC RMBS AAA	26%	4%	6x
NC RMBS AA	21%	4%	5x
CLO AAA	42%	8%	5x
CLO AA	29%	8%	4x
CLO A	23%	8%	3x
Prime UK auto ABS AAA	30%	1%	30x
Prime European auto ABS AAA	12%	1%	22x
Near-prime auto ABS AAA	44%	5%	9x

Source: Janus Henderson Investors, Moody's, selected individual transactions from investor presentations

Notes:
* Worst historically observed losses:
- CLOs – based on worst 5-year cumulative defaults for the period between 2007-20, based on Moody's speculative grade default data and long-term recovery rate of 65%
- Prime and non-conforming RMBS – based on cumulative losses for the period 2007-19
- Prime auto ABS – based on Moody's 5-year cumulative loss data on deals up to 2013, capturing the Global Financial Crisis period
- Near-prime auto – based on selected individual transactions worst vintage cumulative defaults and 40% recovery rate.

Assessment of expected maturity profile

One of the unusual characteristics of ABS is that the maturity profile will typically vary based upon the macro environment and the performance of the underlying collateral. To assess the expected maturity profile we need to consider the specifics of underlying collateral (eg, borrower type, loan terms) and how the macro environment may impact the speed at which they repay the loan (eg, scheduled or early repayment, forbearance offered, refinancing available) or the levels of underlying defaults.

When investing in an ABS trading materially above or below par, the realised speed of repayment can have a material positive or negative impact on the return achieved. Changes in the general market assumed pace of repayment can also bring about increased mark-to-market volatility.

With our in-depth expertise and resources to perform the requisite analysis on the collateral, structure, and servicer in any ABS transaction, we can identify the risks, but also the opportunities. For example, buying a bond that the market prices to an assumed 4-year weighted average life (WAL)* which repays within two years, can realise material additional return (as the bond is bought below par and it pulls back to par far more quickly than assumed).

* WAL: a measure of spread duration, which the market uses to price amortising bonds.

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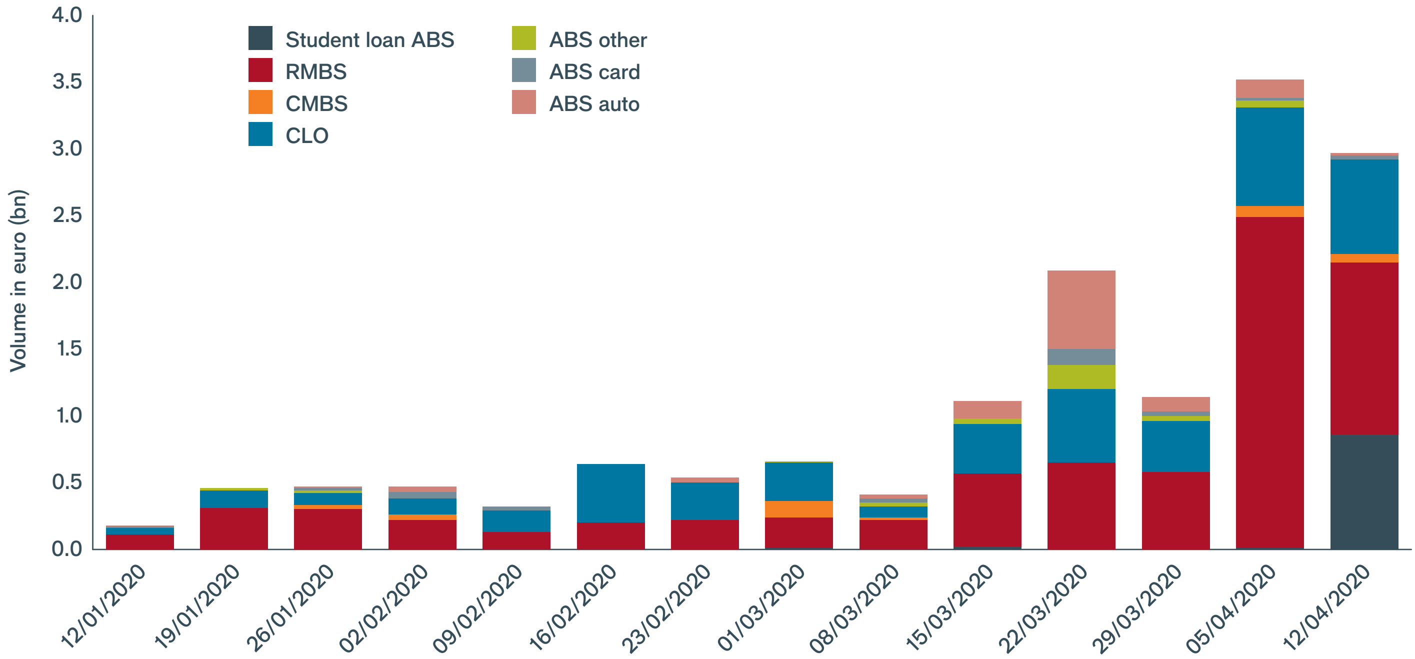
A note on liquidity of ABS

Some may have the view that the relatively low volatility data for ABS is the result of limited trading. Our perspective, looking back over various periods of stress since the 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 in figure 6 is based on weekly MiFID trading data from Bloomberg and provides colour around ABS trading volumes year-to-date to mid-April 2020.

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 due to the Covid-19 crisis, 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.

Figure 6: 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.

An attractive yet relatively under-utilised asset class

ABS is a specialist asset class where experience and expertise are well rewarded. Investors in these securities face a different set of risks to those in conventional bonds, the analysis of which requires a broad insight into the dynamics of structured debt markets as well as the ability to understand the risks in any transaction.

While attractive as a standalone investment strategy, ABS can also offer portfolio diversification for core fixed income portfolios, as its amortising structures and shorter durations help to lower credit and interest rate risk in the portfolio.

We believe that European ABS has delivered relative performance in line with our expectations to date. 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.

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Investment team

Colin Fleury
Head of Secured Credit

Colin Fleury is Head of Secured Credit and co-manages the Multi-Asset Credit, Asset-Backed Securities and Short Duration strategies managed by the Secured Credit team at Janus Henderson Investors. Prior to joining Henderson in 2007, Colin held secured credit portfolio management roles at Deutsche Bank AG and Abbey National Treasury Services plc. He also has secured debt structuring, underwriting and advisory expertise from roles at Shell International, where he was a senior advisor on the M&A and financing team, and at Credit Suisse, where he was a vice president in the global project finance group. Colin's early career also includes experience in secured UK real estate and SME corporate lending and spans multiple jurisdictions in Europe and worldwide.

Colin is an associate of the Chartered Institute of Bankers and a graduate of the Credit Suisse Corporate Finance and Capital Markets Programme. He has 34 years of financial industry experience.

Ian Bettney
Portfolio Manager

Ian Bettney is a Portfolio Manager on the Secured Credit team at Janus Henderson Investors and co-manages Asset-Backed Securities and Short Duration strategies managed by the team. Prior to joining Janus Henderson in 2005, Ian held roles at STA UK, Ltd, EIS and Enron Metals and Commodities, Ltd. He started his career at NEIA as an international business development assistant.

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.

Denis Struc
Portfolio Manager

Denis Struc is a Portfolio Manager on the Secured Credit team at Janus Henderson Investors, and co-manages Asset-Backed Securities and Short Duration strategies managed by the team. Prior to joining Janus Henderson in 2010, Denis was an analyst at Moody's Investors Service in the structured products department. He began his career in 2005 with HBOS, where he was working as a surveillance analyst in the structured credit and investment risk group.

Denis received a BBA degree from Academy of Economic Studies of Moldova and an MSc in finance and investment from Brunel University. He holds the Investment Management Certificate and has 15 years of financial industry experience.

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