Securitised credit: Unlocking the pension opportunity in 2024

High interest rates, sticky inflation and weaker economic growth have combined to create a challenging environment for traditional fixed income investors. Securitised credit strategies could offer an attractive alternative for pension fund investors

This article reviews the key features of securitised credit, highlighting its potential diversification benefits. This includes the **floating rate** nature, where the opportunities lie, the potential to reduce credit risk via **credit enhancement**, common misconceptions surrounding securitised credit and its potential role in liability-driven investment (LDI) strategies.

Why should investors allocate to securitised credit?
As interest rates have risen, traditional fixed-income investments have incurred losses during this period, whilst securitised credit has been one of the best relative performing fixed income asset classes. Securitised credit is predominately floating rate and coupons increase in line with interest rates, limiting interest rate risk.

The investable universe provides ample opportunity for diversification across various market segments, with the distributed part of the global market representing around $4 trillion of mainly floating rate securities (excluding agency mortgage-backed securities).

Securitised floating rate characteristics can also prove beneficial, given low correlations versus traditional fixed income, adding asset class diversification. Securitised credit pays a higher rate of income when compared to equivalently rated corporate bonds, as the asset class benefits from complexity and illiquidity premiums – as this is an over the counter (OTC) traded marketplace, offering a higher spread level. Investors benefit further from credit enhancement – put simply; a cushion against potential cashflow losses.

How will the 'higher for longer' scenario impact securitised credit?
A 'higher for longer' interest rate environment is the perfect scenario for securitised credit, allowing high income levels to continue to drive returns. Interestingly, whilst coupons are high, spreads in the asset class remain at historic wides. A mild recession is expected (particularly in the US) in the middle of 2024, with central banks subsequently expected to gradually lower interest rates. In this scenario, returns would continue to be predominantly driven by income, with associated spread tightening providing another layer of returns, via capital appreciation.

How can investors allocate within securitised credit?
The securitised credit market is global in nature, with the US a large component of the opportunity set. When combining the US and Australia, these markets account for over 80 per cent of the global distributed market, whilst Europe and the UK less than 20 per cent. The US market

is more diversified, with all segments having large weights and typically offering superior liquidity. Opportunities within securitised credit markets move frequently over time, across regions and sectors. Therefore, making a global, dynamic and active relative value approach is most likely to extract value. Yet some investors are missing this wider opportunity set.

Those securitised credit investors focusing only on Europe could benefit from broadening their geographic portfolio reach and allocating more dynamically. Including the US may provide the following benefits:

- Improved liquidity profile
- Access to attractive US-only segments - including single-family rentals (SFRs)
- Improved diversification, leading to more resilient portfolios
- Capable of delivering more stable investment returns

What are the risks associated?

High-quality securitised credit investments have demonstrated resilience during periods of market stress. Not all securitisations are equal and individual security selection remains key. However, key risks that must be evaluated are:

1. **Credit spread risk**
2. **Default risk**

We see limited credit spread risk within the current environment. Spreads are at historic wides, reflecting a lack of spread compression compared to investment grade corporates post multiple market events. This opportune spread backdrop may present investors with an attractive opportunity.

Whilst default risk clearly remains, defaults are currently low (and are expected to increase as we move through the cycle) – yet are not anticipated to increase above the long-term averages. Securitisations utilise special purpose vehicles – separate legal entities used to ring-fence and orient the risk of the securitisation towards the underlying pool of collateral. This structure creates opportunities for credit enhancement, with multiple debt tranches available at various seniority levels. Investors should only incur losses if total losses exceed the amount of credit enhancement behind the selected tranche. Credit enhancement refers to structural features which provide a cushion against collateral losses. Credit enhancements include cash reserve funds, over-collateralisation and excess spread.

Investor perception vs reality

When some investors hear 'securitised credit,' flashbacks of the global financial crisis are never far away. However, from a default perspective, most securitised sectors remained relatively robust to perceived defaults and recovered (outside of an initial risk-off credit market shock). Areas such as sub-prime residential mortgage-backed securities (RMBS) and collateralised debt obligations (CDO) experienced significant losses during this tumultuous period, yet the whole sector has been unfairly tarnished.

Since then, there have been significant developments and improvements within the securitisation market:

1. Securitisation regulations require originators to retain 5 per cent of origination exposure, known as 'skin in the game' – symbiotically aligning investors' and issuers' interests together
2. New regulations, which require extra disclosures with respect to affordability and credit ratings transparency, further protecting investors
3. Securitised credit is more liquid than one might think. The US market which is the deepest and most liquid, trades with c.$5 billion daily volume

Don't go chasing waterfalls

The LDI crisis of September 2022 is still fresh in investors' minds. The importance of pension funds having an allocation to low correlated liquid assets was highlighted. Many pension schemes did not have sufficient liquidity to meet their provider's urgent collateral calls and were forced into selling the most liquid assets. During this period, the securitised market provided liquidity to those that needed it.

High-quality securitised credit demonstrates a stable liquidity profile subject to market trading costs. Meaning, LDI strategies can continue to utilise securitised credit to meet their liquidity requirements, alongside other liquid asset classes.

Summary

- An alternative or complement to traditional fixed income.
- A higher-for-longer environment could generate high relative income for investors, with potential for capital appreciation through spread tightening.
- Securitised credit offers complexity and illiquidity premiums in the form of higher yields versus equivalently rated corporate debt, and investor protections via underlying credit enhancement.
- LDI strategies could benefit from liquid allocation to securitised credit.

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