How pension schemes are flexing ABS

Frank Meijer discusses the attractions of asset-backed securities

For those readers who are unfamiliar with this asset class, asset-backed securities – or ABS – are fixed-income investments secured with reserved asset pools, including car loans, credit card loans, residential mortgages, commercial mortgages and loans to corporates.

At over £1,100 billion, the European ABS market is similar in size to the European investment-grade corporate credit market. As well as being large it is also diverse, offering a broad range of potential allocations across countries and underlying sectors.

ABS portfolios offer institutional investors a structural spread-premium relative to traditional fixed income assets, with comparable levels of credit risk. One reason for the spread premium is that the European Central Bank has bought fewer ABS bonds than other fixed income assets, and so yields on ABS bonds have been much less suppressed. Insurance companies are also much less active in the ABS market due to solvency capital considerations, which makes the ABS market less crowded than traditional fixed income markets. Pension schemes searching for attractive sources of yield are able to benefit from this.

An additional attraction for pension schemes is that ABS has a low, or even negative, correlation with many traditional asset classes. ABS portfolios also offer exposure to direct consumer risk, which is complementary to sovereign and corporate exposure, both of which are typically well-represented within institutional portfolios.

There are various ways in which our UK pension clients have incorporated European ABS within their asset allocation. We summarise these in the table opposite.

Seeking a yield pick-up	Many pension schemes have been drawn to ABS because of the yield pick-up it offers over traditional credit and cash. UK credit yields have been compressed for a long time, while pension schemes have increased their fixed income allocations through LDI, buy-and-maintain and CDI strategies. This has left some clients looking elsewhere for fixed income investments that offer a similar risk profile as investment-grade credit. ABS is helping to meet this demand.
A temporary home before moving into illiquid assets	Many pension schemes are seeking to build allocations to illiquid asset classes, such as private debt and infrastructure, they often need a place to invest the capital before it is drawn-down. European ABS is a relatively liquid alternative fixed income strategy that compares favourably with other potential options such as equites (too volatile) and traditional fixed income (insufficient yield). In some cases clients have set a new strategic benchmark and want an immediate allocation to alternatives, a categorisation which includes European ABS.
Minimising interest-rate sensitivity	European ABS bonds are almost always floating rate, in contrast to the US, where most ABS bonds have fixed-rate coupons. This makes European ABS particularly attractive to clients who do not want to take on additional interest-rate risk.
Diversifying credit expo-sure	At times of stress similar asset classes tend to become highly correlated, including traditional credit markets. As global markets swing between 'risk-on' and 'risk-off', some of our clients have invested in our European ABS fund as a way to diversify their traditional credit exposure to less correlated assets.

For more information, please contact the institutional team of Kames Capital, which distributes Aegon Asset Management's strategies in the UK.

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