Five ways in which UK pension schemes are using ABS

Frank Meijer discusses the attractions of asset-backed securities

Over the past two years we have welcomed a growing number of UK pension clients into our European ABS strategy, managed by our specialist team in The Hague. In this article we discuss the attractions of asset-backed securities, before highlighting the different ways in which our UK clients are incorporating them within their portfolios.

For those readers who are new to this asset class, asset-backed securities are fixed income investments secured with reserved asset pools, such as residential mortgages, consumer loans (credit card and auto), commercial mortgages and loans to corporations.

The European ABS market is large and diverse. At over £1.1 trillion, it is comparable to the European investment-grade corporate credit market and offers a broad range of 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 much 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 market less crowded than traditional fixed income markets. Pension schemes searching for attractive sources of yield can benefit from this.

A further 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 well-represented within institutional portfolios.

It has been interesting to see the different ways our UK pension clients are incorporating European ABS within their asset allocation. Below are five of the most common themes.

1. Seeking a yield pick-up

Many 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 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.

2. A temporary allocation

Many 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 draw down. European ABS is a relatively liquid alternative fixed income strategy that compares favourably with other potential options such as equities (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 that includes European ABS.

3. 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.

4. Diversifying credit exposure

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 ABS as a way to diversify their traditional credit exposure to less correlated assets.

5. Accessing consumer risk

The cashflows produced by ABS bonds are typically generated by the underlying consumers paying their mortgages, car loans and credit cards. These tend to follow a different cycle to sovereign and corporate markets, providing a different return profile for portfolios.

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

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