The Investment Podcast

Episode 23: The Investment Podcast: Time to allocate to mispriced consumer finance opportunities?

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Romil Patel: Hello and welcome to this episode of *The Investment Podcast*. My name is Romil Patel and I'm joined by Jerome Henrion, Head of Specialty Finance, and Jo Tomkins, an Investment Specialist in the same team at M&G Investments. Welcome to you both, it's a pleasure to welcome you back, Jerome, and wonderful to have you on the podcast for your debut, Jo.

Jo Tomkins: Thank you, Romil, very glad to be here.

Jerome Henrion: Hi, Romil, thanks for having me back.

Romil: Wonderful! Jerome, much has happened since your last appearance on *The Investment Podcast*, back in April. Since then, the UK and Italy have seen a change of leadership, inflation has hit 40-year highs, and Central Banks globally have been tightening monetary policy, with the World Bank warning that the world may be edging towards a global recession in 2023. How does the current scenario differ from March 2020, when Covid was spreading around the world, sending the markets into a tailspin? Indeed, are there any similarities there?

Jerome: I would say some things are very different. Inflation in rates are significantly higher than there were two and a half years ago, obviously, but some things are similar. Mortgage and consumer loans have continued to perform exceptionally well – defaults, or even arrears remain at very low levels, although that will undoubtedly change with the impact that higher rates and the higher cost of living will have on consumers. Secondly, governments continue to provide handouts to consumers. This time, the support has been in the form of energy bill subsidies. Thirdly, I would say unemployment remains at historically low levels and vacancy rates at high levels.

Romil: One thing to note is that the economic outlook has become more challenging. Many believe that loan delinquencies will rise, albeit from very low levels. To what extent is what you are seeing markets price in today different to the global financial crisis (GFC)? To Jo, to what degree is this distorting the perceived risk-return profile of these assets, and which, if any known realities, does it ignore?

Jerome: Some segments of the mortgage and consumer loan markets – be it loans in the private markets or public securities backed by similar loans – now trade at levels that imply defaults and losses higher than what we've seen in the GFC, and not just for one year, but for every year from here on. Imagine a new GFC every year. The market seems to be focused on the fact that it will get tougher for consumers, which will lead to higher default rates. That is clearly our view as well, but it's all a question of magnitude, of what losses end up being versus what one anticipates losses to be. As an example, if you price assets assuming a tenfold increase in losses, and realise losses only increase five times, returns will be excellent, everything else being equal, obviously.

Jo: Just to respond to your second question, Romil. While it will invariably get tougher for consumers, pricing in a GFC event each year may prove to be an overly cautious take on things. As Jerome mentioned before, consumers have been clear recipients of government support measures and subsidies. Others have been able to build up their savings buffers in recent years, particularly during the pandemic. It's also worth highlighting too that the quality of loan origination post-crisis has been much better in light of regulation.

On balance, this is a very different set of circumstances to how things stood prior to the GFC. Also, this time around, and obviously generally speaking of course, the average mortgagee in advanced economies may be better positioned to continue to service their debts. It just might be potentially at the expense of changing spending patterns.

Romil: With all of this in mind, where are you identifying opportunity and deploying capital?

Jerome: Historically, we've been buying in the private market, buying loans, and financing them in the public markets by ensuring public RMBS and ABS. With the market dislocation of the past few months, we've essentially done the reverse recently: we've been investing a significant amount of money in securities, mostly in Mezzanine bonds, that benefit from enhanced credit enhancements and are, therefore, structurally resilient to worsening loan performance.

For the loans that we own, we've been mostly financing them in the private market by borrowing from banks, as the financing conditions we can get from the banks have barely changed in the past few months, unlike in the public markets. The ability of our funds to move from private to public, or public to private, on both the assets purchasing and the financing, is a significant source of value. That combined with the fact that our funds are closed-ended funds that don't use repos, means we can invest when others might be facing redemptions or margin calls.

Jo: I think also what you're seeing in the past few months, or even weeks, is credit markets simply coming to terms with what's changing. There's also a fair amount of uncertainty about the future economic, political, and policy environment baked in too – and understandably so. The moves have obviously been quite extreme in some cases, and this is arguably having a distortive impact on asset prices and liquidity in some areas of the market.

However, for investors like us, who can be nimble in sourcing, analysing and executing on transactions, the current environment has actually presented a number of relative value opportunities, which we've been selectively investing in. This was also the case back in March 2020, when markets became dislocated and largely divorced from fundamentals. We've also been viewing the current mispricing in markets as a means to increase the diversity of our portfolio across both regions and asset classes. These are assets that were, even a few months ago, not nearly offering the same relative value as they are today.

Romil: Before we go, I'd like to ask you for your final thoughts, given the context of today's discussion. Jerome, over to you.

Jerome: Thanks, Romil. Well, if you have the expertise and the data to properly analyse and model these assets, this market is an amazing opportunity to invest in mispriced assets that can potentially generate significant and very stable returns for years to come. The assets are short in duration, highly cash-flowing, and self-liquidating, and should be a valuable addition to most investors' portfolios, I think.

Not only do we think this is an opportune time to invest, given current market dynamics, but a diversification potential of the asset class could be very useful. As allocating to consumer finance assets, like residential mortgages and consumer loans, may actually help investors to balance out their existing traditional risk exposures by introducing alternative sources of risk and return.

Romil: Thanks, Jerome. Well, sadly, that's all we have time for, in today's instalment of *The Investment Podcast*. We hope you enjoyed today's show. It's been an absolute pleasure speaking to you both, Jerome and Jo and thank you indeed for sharing your insights.

Jerome: Thanks for having us.

Jo: Thank you, Romil, and goodbye.

Romil: To you, our audience, thanks, as always, for tuning in. We look forward to seeing you next time, but it's goodbye for now.

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