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High yield structured credit

Ripe conditions within the European market

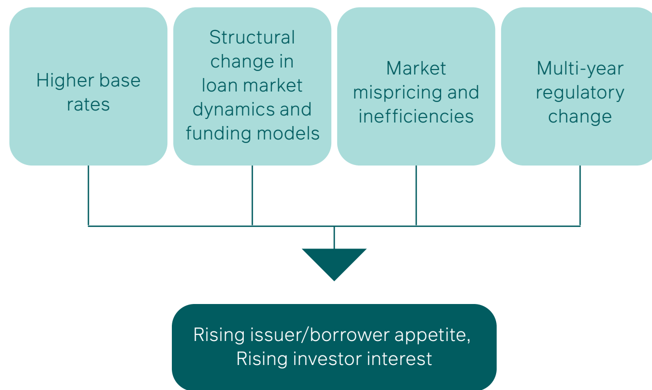
The value of investments will fluctuate, which will cause prices to fall as well as rise and investors may not get back the original amount they invested. The views expressed in this document should not be taken as a recommendation, advice or forecast. Past performance is not a guide to future performance.

Executive summary

Today's structured credit market is characterised by a diverse range of asset types and instruments. These can be accessed through both public and private markets. The array of options include asset-backed securities (ABS), collateralised loan obligations as well as Significant Risk Transfer (SRT) transactions and other forms of private asset-backed finance such as specialty finance – two key investment areas emerging from the wake of the Global Financial Crisis (GFC). Several long-term structural themes have propelled these five verticals' forwards in recent years. These themes look set to shape their development and evolution ahead as the asset class enters its next phase of growth.

For investors, the increased deal flow and scalability across the broad opportunity set which we see in European structured credit today, bodes well for capital deployment. We believe conditions are ripe for investment in Europe due to a confluence of factors including higher base rates, an evolving regulatory landscape, changing market dynamics and funding models, as well as inherent market mispricing and inefficiencies. Taken together, this is leading to growing demand for private and structured credit solutions from an increasing number of issuers/borrowers – as well as investors.

Figure 1: Conditions are ripe for investment due to a confluence of factors



Source: M&G Investments, May 2024.

We believe high yield-focused credit investors should continue to have the potential to generate double-digit 'equity-like' returns from the asset class. Further, we believe there is potential for excess returns relative to traditional fixed income, along with the strong structural protections inherent in these investments, with the perceived complexity and less-understood nature of structured credit transactions upholding the relatively higher barriers to market entry.

This is an asset class requiring a particular skillset. Investors must be able to understand how to analyse and value the underlying assets together with the structuring expertise and levers to generate alpha. This could be achieved through asset sourcing, less competition and leveraging of market inefficiencies, or harvesting complexity/illiquidity premiums.

In this paper we delve further into the individual dynamics shaping the investment landscape for structured credit. Starting with a brief history on the evolution of the asset class, we then explore where potential opportunities lie for investors, discuss how to source deal flow and finally consider the key criteria when selecting a structured credit manager:

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- Key growth drivers for the asset class
- A growing investor base
- The opportunity set: five interconnected verticals
- Manager selection: the success factors.

Structured credit: development and expansion of the asset class

A rapidly growing and evolving asset universe

Structured credit has gained significant momentum due to several supply and demand-side factors. The investable universe has grown exponentially in terms of scale and diversity of options now available to investors.

Although the market has existed since the first collateralised mortgage obligation was issued in the US in 1983, the combination of modern securitisation structuring techniques, improved modelling and risk quantification, as well as greater data availability, has enabled a wider variety of asset types to be utilised as underlying collateral backing securitisations and asset-backed financing structures. This is so long as the pool of loan assets (revolving or static) generates the cashflows used to pay the interest and principal back to investors according to a defined waterfall and payment structure, secured by physical or financial assets to provide security.

...Private asset-backed finance offers institutional investors access to core performing loans on bank balance sheets.

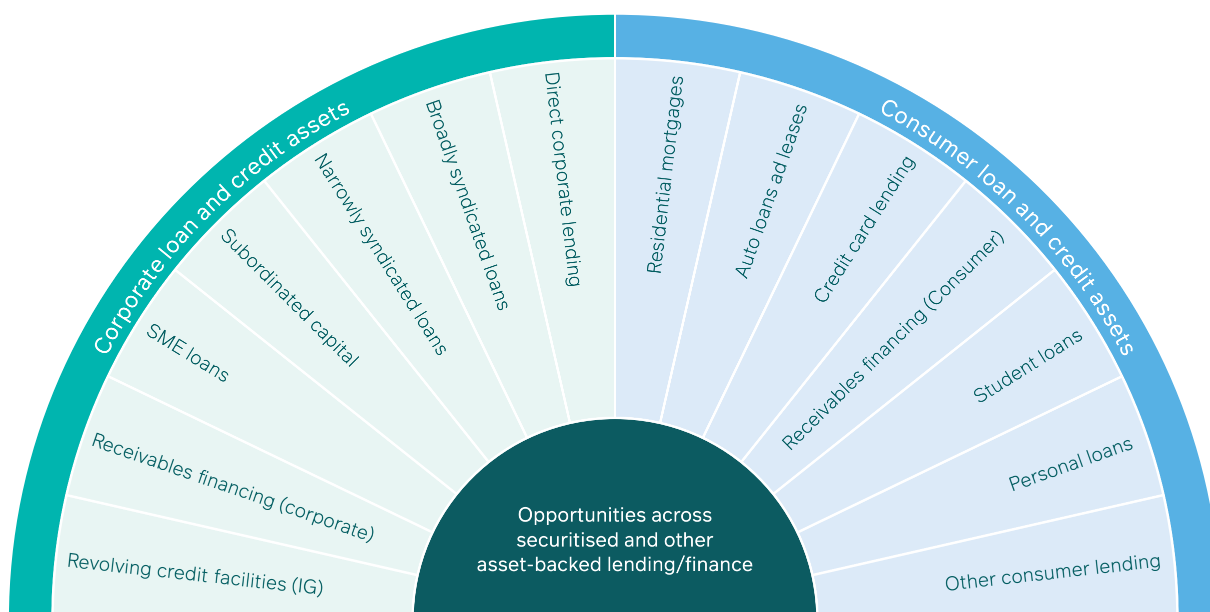
Since the GFC, SRT transactions and other forms of private asset-backed finance, such as specialty finance, have emerged as focused routes for institutional investors to access the core performing loans held on bank balance sheets. This has been done via synthetic or cash 'true sale' securitisations or whole loan asset/portfolio sales respectively. These transactions tend to be structured as junior tranches (either first-loss or second-loss mezzanine positions in the capital structure) and are backed by the loans and credit originated and typically serviced by a retail bank.

Asset-backed financing structures and securitisations have also moved to private pools of capital. The accelerated pullback of banks from certain lending segments has created financing gaps and given rise to the entry of innovative, non-bank lending platforms and speciality finance companies. In turn, this is fuelling a range of potential private asset-backed lending opportunities in the real economy for patient capital providers.

The investment opportunity – financing the real economy

At the core, the broad and diverse potential investment opportunities that comprise the structured credit universe focus on loan and credit products that help provide an integral source of funding for the real economy. These span various forms of consumer and corporate lending, including loans, leases and mortgages to homeowners, as well as receivables financing, funding facilities and bank capital and other capital solutions.

Figure 2: Corporate and consumer lending spans the investment universe



Source: M&G Investments, May 2024.

The market is as wide as it is deep, presenting a broad array of options for investors, each offering different risk and return profiles that can be securitised against many different types of assets.

In our view, the asset class can provide an attractive way for investors to gain exposure to the returns of granular and diversified consumer and corporate loan assets originated by bank and non-bank lenders. As many of the asset opportunities, such as SRT and specialty finance, cannot be accessed through traditional asset allocations, the asset class potentially offers important diversification benefits for many investors' fixed income and credit portfolios, which tend to be heavily weighted towards government and corporate bonds.

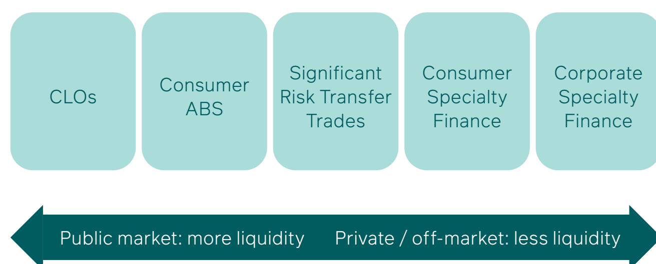
Moreover, each potential investment opportunity is backed by a portfolio of assets containing hundreds, if not thousands, of individual loans, leases or other forms of credit: residential mortgages, auto loans, loans to small and medium-sized enterprises (SMEs). These span different borrowers/issuers, credit profiles, and geographies.

Investing across the liquidity continuum

Importantly, the key asset collateral types can be accessed through public or private markets. As collateral types get more esoteric and deal structures involve greater complexity and negotiation between an issuer/borrower and investor(s), there is typically a greater reliance on private/bilateral processes. Cash securitisations, for example, can be executed in quite a private format and transactions are typically not widely syndicated.

Structured credit assets we typically invest in all have certain common characteristics. However, their liquidity profile can vary significantly depending on a variety of factors, including whether they are technically public or private. Rather than labelling an asset as 'public' or 'private' and therefore 'liquid' or 'illiquid/less liquid' we tend to view and evaluate structured credit assets on a continuum of liquidity in practice. This can of course vary over time and the liquidity situation in public and private credit markets can converge during times of market volatility.

Figure 3: High Yield and Private Structured Credit opportunities – Our five interconnected verticals



Source: M&G Investments, May 2024.

Key growth drivers for the asset class

Long-term secular trends favour private credit

There are several reasons why we believe the growth and expansion of the asset class is set to continue, particularly on the private side. Not only is the demand for private, non-bank financing increasing, but, in our opinion, the addressable asset universe will conceivably evolve from here, particularly as banks in Europe retrench further from certain lending markets and jurisdictions. With bigger and more varied financing gaps emerging across the real economy, that could enable us as investors to step in and fill the void as either the provider of debt capital or the buyer for those loan portfolio assets.

Several long-term secular trends are at the core of the growing asset-backed opportunity that we see in Europe today. The opportunity has grown, in part, due to the pullback of retail banks from certain areas of lending to the real economy due to stricter regulatory capital requirements that have been brought in since the GFC. In addition, the disruption in the global banking sector primarily driven by higher interest rates has put the spotlight on bank balance sheets once again.

...the addressable asset universe will evolve as banks in Europe retrench further.

European investment opportunities abound

As part of their strategic recalibration, European banks are having to ration capital which means exiting or hedging capital-intensive and arguably non-strategic businesses, curtail new lending and explore alternative asset solutions to achieve regulatory capital relief such as selling loan portfolios to trusted, institutional investors.

Along with the ongoing disintermediation of traditional bank finance, other interconnected drivers like technological innovation have spurred this rapid growth in recent years. In our opinion, these secular drivers or 'megatrends' have plenty of room to run in Europe and look set to dominate the landscape going forward.

The great bank retrenchment – filling the financing gaps

In Europe, banks are the main providers of credit to the real economy, accounting for around 75% of lending as a share of GDP[1], yet the entry of non-bank lenders and specialist finance companies in recent years is steadily helping the transition to a more 'market-based' lending ecosystem in Europe, akin to the US.

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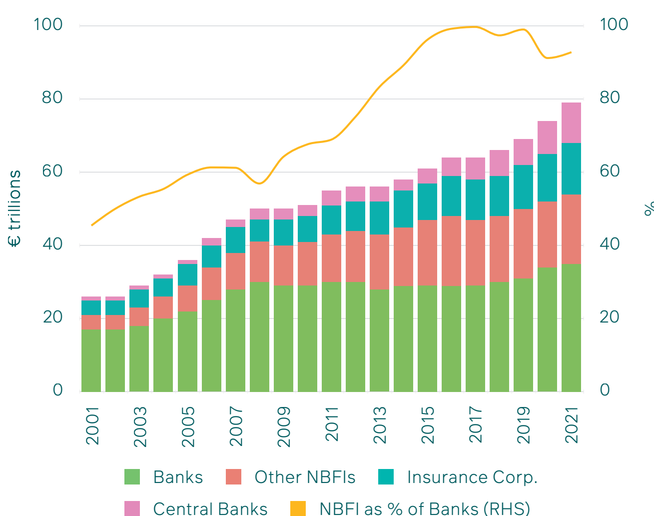
Figure 4: European Financial Assets



Source: Eurostat EU27 national sector balance sheet data, August 2023.

[1] Committee on the Global Financial System, 'Structural changes in banking after the crisis', 2018.

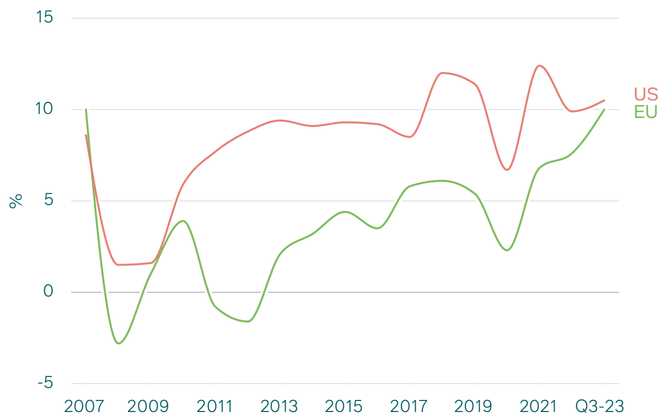
Europe's private capital markets are not as deep or as developed as they are in the US where c.77% of corporate funding is provided through capital markets[2]. Consequently, there is still some way to go in Europe in terms of non-bank lenders becoming a greater part of the lending landscape.

Many believe that European bank balance sheet deleveraging remains critical to addressing regulatory capital issues and boosting profitability in the coming years

EU banks have long struggled with historically low returns on equity (RoE) and declining profit margins as well as significant cost/operational inefficiencies versus their US peers. While higher net interest margins (NIM's) have bolstered profitability more recently, European banks still trade well below their book value while price-to-equity (P/E) multiples have widened further and are close to all-time lows relative to US banks.

[2] Oliver Wyman paper citing SIFMA, 2022, 'Our Markets'.

Figure 5: Return on equity

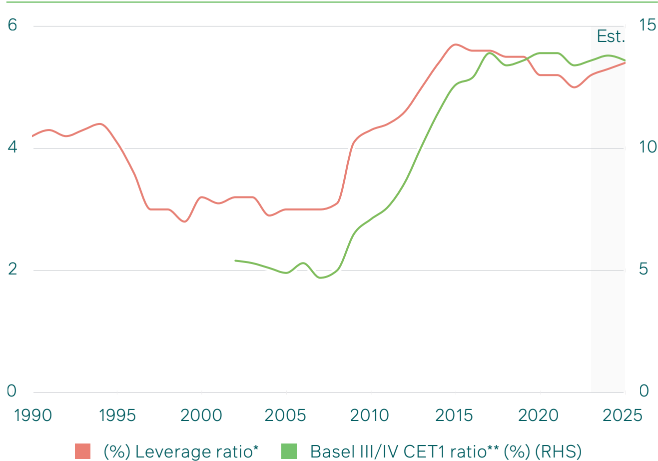


Source: ECB Statistical Data Warehouse (data updated to Q2 2023 for comparison purposes), FRED 'Banks' Return on Equity United States' World Bank (data updated to Aug 2020) and Federal Reserve Bank of New York 'Quarterly Trends for Consolidated U.S. Banking Organizations Third Quarter 2023'.

Banks have reduced access to traditional funding and capital to the real economy, particularly for SMEs, private equity (PE) sponsors and other commercial lending activities. This has created potential funding opportunities for alternative (non-bank) lenders, and also given rise to risk-sharing transactions and other capital market-based financing solutions.

A stringent regulatory environment – focusing on mechanisms for capital relief

Figure 6: Basel III/IV: Capital requirement increase



Source: ECB, Company data, Autonomous Research estimates. * Tangible common equity/adjusted assets. **Estimated prior to 2011 based off Basel I and Basel II ratios.

Global regulators have required retail banks to fund themselves with more capital by imposing stringent capital rules post-GFC, including but not limited to i) tighter and more onerous capital requirements (Basel III); ii) incorporation of forward-looking provisioning requirements (IFRS 9); and iii) new rules for banks' risk-weighted assets (RWAs) under Basel IV (also referred to as the 'Basel III Endgame') via the implementation of the Output floor.

Many believe that European bank balance sheet deleveraging remains critical to addressing regulatory capital issues and boosting profitability in the coming years.

Technological innovation – supporting the emergence of new lending models

Changes in technology and customer behaviour has facilitated the emergence of new lending models via new tech-enabled lending platforms together with the emergence of third-party servicers. These Fintech platforms modernised their product offering and lending service to create a competitive differentiator, utilising big data (eg, ecommerce, behavioural data) to enhance their credit underwriting models and gain a better understanding of customer needs.

Following the COVID-19 'mini-boom', non-bank origination platforms and speciality finance companies in Europe have faced challenges consistently finding alternative sources of capital to fund the assets they originate and/or are looking for higher advance rates than banks can offer which is creating interesting potential financing opportunities for patient capital providers.

Figure 7: Innovation in the lending sector

Pre-2008

- Traditional lending models
- Manual loan management and servicing
- One-size-fits-all loan products

Post-2008

- Tech-enabled lending products driven by non-bank and specialty lenders
- Growing use of third-party servicers

Post-pandemic

- Hyper-personalised loan products and enhanced UX design
- Automated loan management

Source: M&G Investments, May 2024.

Maturity transformation – renewed bank balance sheet focus amid higher rates

The banking crisis that unfolded in the first few months of 2023 exposed the mismatch in term funding horizons and the drawback of funding long-term assets with (flighty) short-term deposits. For 'buy-and-hold' investors, this maturity mismatch is non-existent as assets are always financed to term, thereby mitigating refinancing risk.

Figure 8: Average maturity gap and share of long-term loans across the Euro area

Note: Synthetic Transfer only, does not include cash SRT. Source: Citi, December 2022. *M&G proprietary SRT system ('Carta'), January 2024.

Further, there is a growing recognition from policymakers that because of the maturity transformation that banks must do, they are arguably no longer the best 'natural owners' and over time we could see a growing transitioning in long-term assets from bank balance sheets to long-term holders.

In addition, with bank's cost of capital increasing and bank's availability of funding being tested, this is encouraging banks to double-down on efforts to optimise their balance sheets.

Finally, renewed balance sheet deconsolidation, together with ongoing regulatory and structural profitability challenges, is propelling the shift by traditional lenders away from capital-intensive, esoteric/ niche or operationally complex assets and towards 'safer assets (eg, senior positions).

A growing investor base

Why is structured credit interesting to investors?

We believe structured credit markets can offer a compelling opportunity for investors seeking higher risk-adjusted returns derived primarily from contractual cashflow and high current income. Also, those investors looking to diversify their portfolios by gaining the ability to access differentiated and compelling asset exposures not typically found in traditional fixed income and credit allocations.

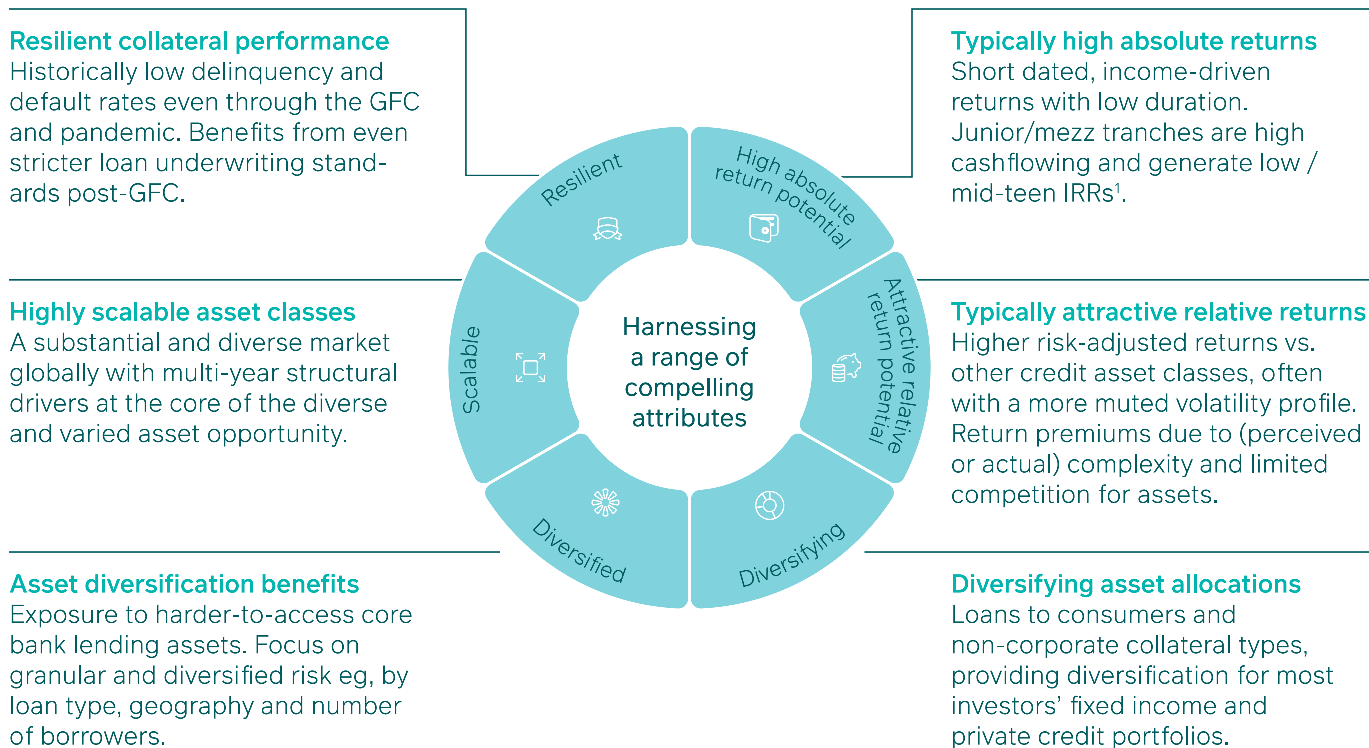
Moreover, investors can potentially harvest the varying complexity and illiquidity premiums on offer due to asset sourcing, underwriting, and by exploiting market mispricing and inefficiencies while building in downside mitigation, which remains ever important in light of macro and market uncertainty and often volatile environments.

High yield and private credit structured credit asset classes, whether accessing investment opportunities through a dedicated strategy, focusing on certain scalable market verticals, or by taking a diverse, relative value-based approach across what is a growing and multifaceted universe, can potentially offer investors a way to bolster and scale their allocations to private credit best serving their long-term investment goals.

The projected returns above are forward-looking, do not represent actual performance, there is no guarantee that such performance will be achieved, and that actual results may vary substantially.

Figure 9: High Yield and Private Structured Credit – Why allocate to the asset class?

Past performance is not a guide to future performance



Source: M&G. [1]IRR examples are for illustrative purposes only and not a guarantee of future returns.

The opportunity set: five interconnected verticals

At M&G, we focus our investments across five interconnected asset sourcing areas or market verticals within Structured Credit:

1. Significant Risk Transfer (SRT)
2. Consumer specialty finance
3. Corporate specialty finance
4. Collateralised loan obligations (CLOs)
5. Residential mortgage-backed securities (RMBS) and consumer asset-backed securities (Consumer ABS).

Here we take a closer look at these focus areas and explore the key asset origination / sourcing themes which sit at the core of each area.

Figure 10: Sizing the addressable market opportunity

Different asset classes offer a combination of return and asset availability

Access point		Return range (USD)	Average Return (USD)	Approx. Outstanding Market Size (US$ billions)	Expected Credit Duration (Years)	Next 12 months Pipeline (US$ billions)	Average Ticket Size (US$ millions)
Category	Sub-category						
Capital relief	Corporate SRT	10-20%	15%	50	~[3 – 5]	15	150
Significant Risk Transfer Trades (SRTs)	Other SRT	10-15%	13%	10	~ [2 – 7]	2	75
Securitisations (public and private)	European CLOs (junior tranches)	10-30%	20%	25	~ [3 – 4]	1	15
	European Public ABS (junior tranches)	8-18%	13%	15	~ [1 – 3]	0.5	10
	Private ABS/ABL (Non-bank platforms)	13-20%	16%	2	~ [2 – 3]	0.5	50
Asset / Portfolio sales	Whole loan asset portfolios / Financing structures	15-25%	20%	20	~ [2 – 7]	10	75

Source: M&G, May 2024. USD returns shown are approximate. *The expected WAL/duration of investments will vary depending on the nature of the investment/refinancing ability and the underlying collateral type.

The projected returns are forward-looking, do not represent actual performance, there is no guarantee that such performance will be achieved, and that actual results may vary substantially.

There is no assurance that any such pipeline transactions will be consummated.

1. Significant Risk Transfer

The SRT market has historically come into its own in recent years, we believe, as regulatory capital trades have become an integral tool in helping banks manage their RWA exposures by transferring the credit risk on a portfolio of assets to third-party investors, so that they obtain regulatory capital relief on that portfolio.

Banks securitise exposure and buy protection on the first or second-loss tranche in the capital structure from investors (predominantly on a synthetic basis), resulting in a lower risk weight for the assets. Equally, by hedging a portion of their balance sheet risk through these ‘risk-sharing’ transactions banks free up capital which enables them to continue lending. Often SRT deals are focused on assets that are difficult to sell or where the bank wants to retain a direct lending relationship with core/strategic customers.

...The SRT market is evolving quickly, and this is leading to a greater diversity of underlying collateral types and geographies.

The composition of the SRT market tends to be weighted towards largely Investment Grade corporate credit, while European banks tend to dominate issuance due to regulatory and market reasons. However, the SRT market is evolving quickly, and this is leading to a greater diversity of underlying collateral types and geographies. In our opinion, prime mortgages and consumer loans, for instance, are likely to lend themselves to SRT transactions in the coming years given changes in the RWA calculations associated with Basel IV (Basel III Endgame).

Figure 11: Number of SRT transactions (by asset type) 2021-2023*/**

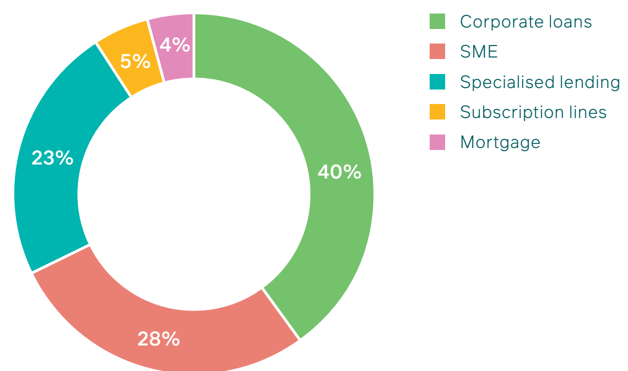
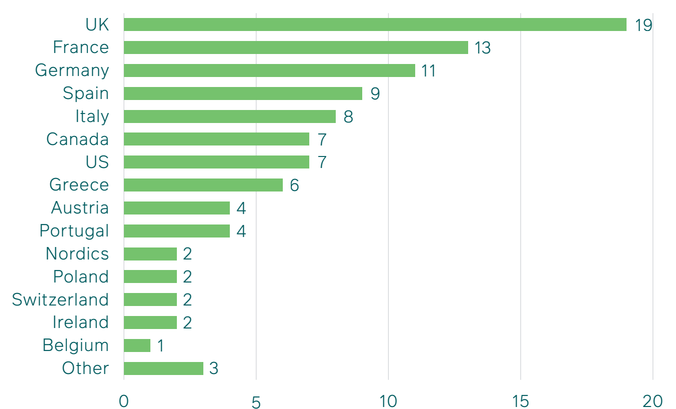


Figure 12: Number of transactions (by originator country), 2021-2023*/**



Source: Citi, December 2022. *Source: M&G proprietary SRT system (‘Carta’), January 2024. **Synthetic Transfer only, does not include cash SRT.

Equally, as the clock ticks down ahead of the Basel III Endgame implementation deadline (1 July, 2025), the US SRT market has potential to be quite meaningful size-wise. This comes after much-awaited clarity by the US Federal Reserve on how banks may use CLNs – a common practice in Europe – to transfer credit risk to investors through synthetic securitisation and, importantly, recognise the capital relief benefit.

Many expect US regulators will 'significantly reduce' the Basel capital burden on large US banks given the pushback since the rules were announced in early Q3 2023. Currently the proposal is estimated to result in an aggregate 16% increase in common equity tier 1 (CET1) capital requirements for affected US banks vs. a 9.9% increase in the EU and 3% in the UK.

2. Consumer specialty finance

Specialty finance remains a key growth area within structured credit and is often referred to as a form of private asset-backed lending or 'asset-based financing' (ABF). We seek to focus our investments in the most scalable and secured areas of the current asset universe. In our opinion, these include residential mortgages and consumer finance, and investments with higher cashflows offering a clear yield pick-up relative to other credit asset classes. These refer to pools of performing loans or receivables backed by consumer risk, and often a hard asset eg, homes, cars. Most assets are also secured against (have full recourse to) the borrower and cashflows are linked to the performance of the underlying collateral.

Multi-year structural themes are driving a proliferation of specialty finance investment opportunities, in turn, offering exposure to structurally-levered granular asset portfolios backed by mortgages and consumer loans originated by banks and non-bank lenders.

Figure 13: Established European/UK markets

Sizeable and diverse market globally with an estimated +$29 trillion of loan balances

Key themes	IRL	GBR	FRA	DEU	NLD	SWE	ITA	ESP	GRC
Bank funding / liquidity / capital management through asset solutions (eg, to manage pressures from higher RWAs / internal risk limits)	✓	✓	✓	✓	✓	✓	✓	✓	✓
Consumer lending: Rising origination in specialist / non-bank lending sector, New products and receivable types		✓	✓	✓		✓			
Legacy NPLs deleveraging creating RPLs opportunities & banks deleveraging effort shifting towards Stage 2 assets	✓	✓			✓	✓	✓	✓	✓

Source: M&G Investments, April 2024.

Similar to SRT, European bank deleveraging is at the core of the asset class opportunity. By engaging in core performing asset/portfolio sales, banks are typically looking for risk limit headroom or to increase their 'capital velocity' and are increasingly selling pools of typically seasoned and performing loans to selected institutional investors in either a whole loan or through a full securitisation. Usually the first-loss and/or mezzanine tranches are retained by investors after senior financing.

Specialty Finance also extends to include non-bank lending to consumers or businesses with private capital growing in importance for non-bank specialty lenders looking to either diversify their funding sources away from traditional lenders, free up their lending capacity or pursue a capital-efficient originate-to-distribute business model.

In particular, we have seen an observable pick-up in demand from non-bank lenders that want to retain their receivables and need asset capital and/or higher advance rates than banks are willing to offer which has presented a range of interesting mezzanine financing opportunities in private ABS warehouses at attractive risk/return levels.

3. Corporate specialty finance

Opportunities in this part of the universe involve performing corporate lending portfolios (such as SMEs and larger corporates). These are typically sourced from non-bank originators that lack traditional sources of funding and capital available to fully-scaled bank lenders, and products which may be operationally complex or where non-bank lenders have a differentiator; eg, working capital (receivables finance), trade finance, invoice-backed loans and other forms of asset finance.

Prospects in this market are entirely private, being largely inaccessible via publicly-traded markets and capital can be deployed during various stages of a platform lender's lifecycle, from 'early-stage' (start-up), to significant growth thereby generating a larger financing requirement and thus creating a mezzanine financing opportunity to platforms that have built up several years track record and are attracting institutional capital.

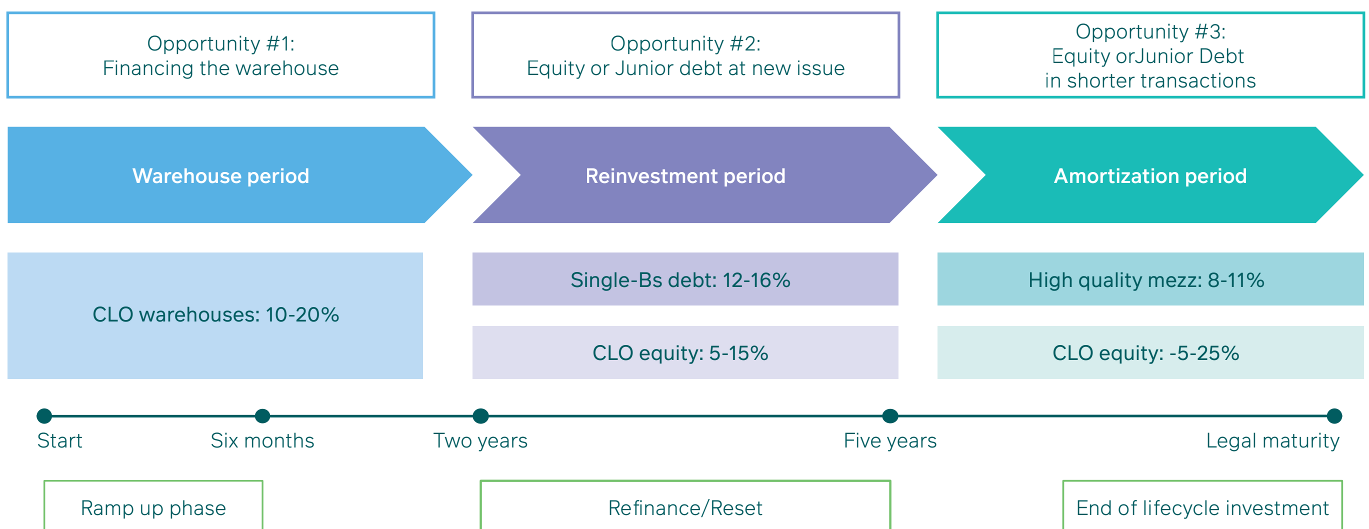
4. Collateralised loan obligations (CLOs)

The varied lifecycle of a CLO offers different types of potential opportunities. Early-stage investments can provide access to a diversified pool of loans and quick repayment for noteholders. Alternatively, end-stage CLO lifecycle investing during the amortisation period gives greater certainty of the overall risk profile of the security based on a static pool of assets (given the manager's inability to trade) and a shorter, non-flexible maturity date.

While not all CLO opportunities are created equal and timing can be key, there are a number of key themes evident in junior debt, CLO equity and CLO warehouses. We tend to focus on the cleanest underlying asset portfolios and favour short-dated credit risk, for instance, buying post-reinvestment period debt and very high cash-flowing equities, in order to help mitigate the inherent mark-to-market volatility of CLO tranches. Warehousing and rolling can also be a beneficial strategy in a variety of markets.

Within a broader structured credit portfolio, CLOs can potentially offer true liquidity, high cashflows, short duration and attractive risk-adjusted returns – and alpha generation potential for those investors that focus on relative value and have the track record in exploiting the intrinsic inefficiencies of the European CLO market in both primary and secondary markets and within the CLO capital structure.

Figure 14: Opportunities to invest across the CLO lifecycle



Source: M&G, January 2023. Yields in €.

5. Consumer ABS

These consumer and residential mortgage loan public securitisations potentially offer attractive short-dated income returns with low duration. Both RMBS and consumer ABS generally benefit from sequential amortisation which increases credit enhancement for junior bonds over time. The underlying collateral pools are typically highly diversified given the large number of loans backing the pools and the wide range of borrowers within them.

...Market dislocation can create compelling value for consumer-backed transactions.

Frequent bouts of market dislocation have created compelling value for consumer-backed transactions with pricing dynamics still largely out-of-kilter with the credit fundamentals. Primary ABS markets continue to offer strong supply, although the fast-changing nature of liquid markets means that the relative value of consumer ABS and RMBS paper will inevitably fluctuate. However, pricing for junior and non-IG mezzanine tranches generally remains attractive for the risk taken, in our view. It is important to have a wide read across credit markets, assessing relative value and allocating to where the most attractive value is at any given time.

Sourcing opportunities: the M&G Structured Credit approach

Within the high yield and private structured credit universe, M&G seeks to source attractive investment opportunities across five market verticals:

Figure 15: How M&G source compelling asset opportunities

Asset class focus area	Key asset types	Our asset origination / sourcing themes	Asset sourcing routes / Investment types
1. Significant Risk Transfer (SRT)	• Corporate loans (large corporates, SMEs) • Specialised lending • Mortgages and consumer finance • Esoteric assets (eg, capital call facilities, social housing loans, agricultural loans and project finance, trade finance)	I. Bank deleveraging and capital relief: Primary motivation for bank issuers globally is to achieve capital relief	Predominantly synthetic securitisations but can also be 'true sale' securitisations
2. Consumer specialty finance	• Residential mortgages • Auto finance (loans, leases) • Unsecured personal loans • Credit card balances • Mobile handset loans • Residential solar panel loans • Student loans • Buy now, Pay later (BNPL) • Bridging finance • Other consumer receivable types (eg, point of sale)	I. Bank deleveraging and capital relief: Bank funding / liquidity / capital management through core asset solutions (eg, to manage pressures from higher RWAs / internal risk limits) II. Diversification of funding sources: Mortgage and consumer loan originators: Rising origination in specialist / non-bank lending sector, New products and receivable types coming to market III. Asset sales 2.0: Legacy NPLs deleveraging creating RPL opportunities and banks' deleveraging effort shifting towards Stage 2 assets	• Whole loan portfolio acquisitions/ Financing structures – legacy or core loans (back books) • Private asset-backed loans (mezzanine) • Forward flow (new origination) • Securitisation (often privately-placed)
3. Corporate specialty finance	• Corporate loans (large corporates, SMEs) • SME loans • Leases (eg, equipment leasing) • Short term receivables • Other esoteric receivables	Diversification of funding sources: Select opportunities to lend against portfolios of loans originated by innovative, non-bank corporate lenders (eg, FinTech, early-stage, specialist lenders) in i) jurisdictions with lower penetration from large banks; or ii) in products which are operationally complex and/or where non-bank lenders have an edge	Private securitisations and asset-based lending
4. CLOs	Leveraged loans	Market dislocation, mispricing and inefficiency in deal structures Key themes include (but not limited to): • Short-dated junior debt • Warehouse financing and creative refinancing solutions on the roll • Unloved CLO equity in secondary	Public securitisations (debt, equity, warehouse)
5. Consumer ABS	• Residential mortgages (prime, buy-to-let (BTL), non-conforming) • Auto finance (loans, leases) • Unsecured personal loans • Credit card balances	Market dislocation, mispricing and inefficiency • Attractively-valued junior tranches in European consumer ABS/RMBS	Public securitisations (RMBS, Consumer ABS)

The above table is for illustrative purposes only, subject to change, and there can be no assurance that any such investment or portfolio will be able to achieve its objectives.

A structured fit for portfolios

We believe the combination of strongly performing collateral, attractive valuations and the potential for significant income generation should continue to support an expansion of the investor base for structured credit asset classes, particularly as investors pursue opportunities to seek to optimise their asset allocations for attractive risk-adjusted returns and diversification potential.

While robust credit underwriting and disciplined stock selection will remain key, we believe opportunities in the asset class will continue to look compelling relative to fixed income and credit alternatives. Investing in the asset class requires a differentiated skillset and understanding of how to analyse and value the underlying assets together with the structuring expertise and levers to generate alpha through asset sourcing, less competition (higher barriers to market entry) and exploiting market and structural inefficiencies as well as harvesting complexity/illiquidity premiums.

Manager selection: the success factors

Having discussed why we believe the structured credit asset class offers compelling long-term opportunities for investors, perhaps the final question is which key criteria define an effective and successful manager of structured credit assets? There are certain characteristics we believe are pre-requisites and demonstrated indicators of a manager's ability to seek to successfully manage structured credit investments:

- Pedigree and in-house origination capability – does the manager have a long-standing and established presence in the structured credit market? This is important as reputation and recognised experience facilitates access to unique and differentiated deal flow. By utilising an extensive network of relationships within this investment space, long-established managers can seek to leverage their size and market presence to help secure a robust pipeline of deals in primary, secondary and direct co-investments.

  Extensive experience within the universe allows identification and the potential capture of attractive risk/reward premium in key growth areas, market inefficiencies and potentially mispriced opportunities. Structured credit is a data-rich asset class and having built large proprietary databases and monitoring tools to extract the value from granular data we receive from issuers/borrowers helps enable a strong focus on asset resilience, an ever-desirable attribute in these times of uncertainty.

  M&G has been active in the European private and alternative debt markets for over 40-years, both as an originator and investor. One of Europe's largest active fixed income investors with over €300bn in AUM[3], we are also one of the largest private debt investors with c. €80bn[3] invested. M&G has been making consumer asset-backed and CLO investments since the late 1990's, while our first SRT investment was in 2008 with over 75 SRT investments executed to date, and our first specialty finance investment in 2012, with 65 investments completed.

- Speed and flexibility – having the speed and flexibility to source, evaluate and transact on potential opportunities ahead of the competition is fundamental if participants are to gain a differentiator in European high yield structured credit. In our opinion, this requires deep sector knowledge and established analytical capabilities that can only grow with an on-the-ground presence. Within the wider private markets team, M&G can seek to leverage the experience of over 550 investment professionals.

- Scale – the structured credit market is a rapidly evolving area of investment. Successful managers have both the investment expertise and resources to respond, adapt and innovate within the space. Those managers who have managed to grow their market position within European structured credit over time are often pioneers within the asset class. They have an ability to deploy their scale across these higher-returning asset classes either via a single strategy or utilising building blocks to tailor portfolios to different needs and risk profiles.

[3] Source: M&G, as at 31 December 2023.

- **Dedicated team** – investing in structured credit is a highly specialised discipline. Sustainable success depends on building dedicated private-side investment teams. This is required to develop analytical expertise and the deep sector knowledge which is required.

  M&G has market-leading sector experience and significant investment and sourcing capability. The Structured Credit Team at M&G comprises 40 professionals, including portfolio management and deal origination team, managing €7.5bn[3] in AUM of dedicated structured credit pooled funds and separately-managed accounts, supported by a strong structured credit and private markets research function.

Key risks associated with these asset areas/strategies:

Credit risk: The assets may be exposed to the possibility that a debtor will not meet their repayment obligations.

Liquidity risk: The investments may be illiquid, as a result it may be difficult for the strategy to realise, sell or dispose of an investment at an attractive price or at the appropriate time or in response to changing market conditions.

Concentration risk: Due to a limited number of investments, the strategy may be affected adversely by the unfavourable performance of a single issuer.

Equity risk: As equity is subordinate to all other claims into an underlying investment, the strategy may be exposed to the possibility of a low or zero recovery on some of its investments.

Prepayment risk: Loans may be prepaid by issuers at short notice, as a result it may be difficult for the strategies to locate and reinvest capital at an attractive price or at all, which may affect the strategies adversely.

Derivative risk: The use of derivatives for non-hedging purposes may expose the strategies to a higher degree of risk and may cause larger than average price fluctuations.

Currency risk: The strategies may be exposed to currency rate movements.

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[3] Source: M&G, as at 31 December 2023.

The authors

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Head of Structured Credit

James joined M&G Investments in 2003 as a fund manager within the Alternative Credit group and is responsible for the ongoing development of M&G's Structured Credit business. Prior to M&G, James worked for Citigroup, initially in the corporate bank and, latterly, in the alternative investments group as portfolio manager and credit analyst focusing on asset-backed securities and industrials.

James graduated from Durham University with a degree in Business Economics.

Vincent Charles-Gervais
Director and Senior Portfolio Manager, Structured Credit

Vincent Charles-Gervais started working in structured and alternative credit in 2003. He started his career first as a structurer for AXA IM and then as VP for Lehman Brothers in London.

In 2008, he moved to the portfolio management side as senior analyst co-heading Zais Group corporate platform research and in 2014 as an asset backed portfolio manager for ICG Alternative Credit. Since 2018, Vincent is a senior portfolio manager for M&G non-investment grade structured credit funds.

Vincent holds a Masters' degree from French 'Grandes écoles' ENS de Cachan and ENSAE, and a postgraduate degree from Paris VI University in Probability applied to Finance.

Jo Tomkins
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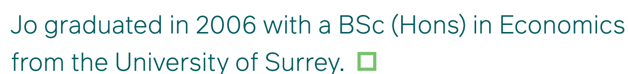
Jo joined M&G Investments in 2016 and moved to M&G's Private Markets division in June 2022 to work in the Structured Credit business, where she serves as investment director and specialist. In this role, Jo's focus includes articulation of Structured Credit investment strategies to external and internal audiences and acting as an investment team point of contact for clients.

Prior to joining M&G, Jo spent over six years working at an independent macroeconomic and financial markets research firm, serving in Fixed Income strategist and economist roles.

Jo graduated in 2006 with a BSc (Hons) in Economics from the University of Surrey.



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