Connecting The Dots

Episode 2: **Misconceptions and opportunities in ABS**

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Opening soundbite, Matt Wardle: *We think that really you're met with an opportunity here where you get the opportunity in ABS to invest in an asset class that has proven and has earned, we think, a very defensive reputation and yet, nonetheless, it's an asset class that offers you a return pick-up despite those qualities versus other instruments in the fixed income universe.*

Romil Patel: Hello and welcome to Connecting the Dots, the investment podcast series brought to you by M&G Investments where each month, experts from across our global network of investors will join us to bring you their insights across private markets, fixed income and equities. My name is Romil Patel, Global Managing Editor and I'm delighted to be joined here today by Matt Wardle, Head of Investment Grade Structured Credit, and Harry Bullamore, Investment Director here at M&G Investments. Welcome to you both.

Matt Wardle: Hi there.

Harry Bullamore: Hello.

Romil: Today's topic of conversation is opportunities in asset-backed securities or ABS for short. But before we get into the weeds, Matt, could you give us some background on ABS, what it's about and who it's meant for?

Matt: Asset-backed securities are financial instruments which are backed by granular, predictable pools of collateral, such as residential mortgages, corporate, consumer or auto loans. They are pulled together and fixed income instruments are issued against them of various ratings categories – AAA all the way through to the non-investment grade parts of the capital structure as well. That really allows investors to focus their purchases on the parts of the capital structure which make most sense to them from a risk-return point of view, from a time horizon perspective and also to suit their own liquidity needs.

Romil: Matt, to what extent do you feel there's still investor misconceptions around ABS?

Matt: We think it's pretty significant to be honest. Our view is still that if you asked many investors in the market to give their views on asset-backed securities, they would start off with the experience of the US subprime market during the GFC, where there was some relatively poor performance from that part of the market. But actually, if you focus on the European asset-backed securities universe, you can observe a very long and stable performance and that's really driven by a variety of factors, including the very, very conservative underwriting of the collateral and the very strict enforcement regime, which you have particularly surrounding residential mortgages and other consumer borrowings in the European market.

So actually, we think that if investors are prepared to put in the time to educate themselves about the asset class, particularly from a European perspective, there's a lot of opportunity and value to be derived from, as you say, the misperception that all of ABS is largely the experience that the US subprime market went through during the GFC.

Romil: So what do you identify as some of the key attractive aspects of ABS from an investor's perspective?

Matt: We think there are many reasons to like ABS from an investor's point of view. Firstly, I would suggest credit resiliency. We believe that if we think about particularly residential mortgages, the loan to values that mortgages are underwritten at in recent years is far, far lower than was the case during the GFC.

So we think fundamentally these are safer investments today compared to 2006/2007. At the same time, we think over the last 15 years or so, the structures of ABS transactions have proven themselves to be very resilient, even to periods of harsh and prolonged economic stress. So we really feel that when we look forward, investors should have a lot of confidence in the view that ABS is a very, very defensive asset class and obviously that can be appealing from a portfolio construction perspective. One of the other interesting things about the ABS market, in our opinion, is the relative value that it offers versus corporate and government bonds.

Now, we believe that relative value and that yield pick-up that you get in ABS is structural in nature. Therefore, we think it's going to persist for many years to come. It's driven by structural factors in the market, such as the relatively onerous level of regulation that governs ABS relative to other asset classes, particularly for banks and insurance companies.

It also reflects what we think are the high structural barriers to entry from an investor perspective in allocating to the ABS market. And that's largely a reflection of the very sophisticated resources and large teams that you need to analyse this market efficiently. We think that you're met with an opportunity here where you get the opportunity in ABS to invest in an asset class that has proven and has earned, we think, a very defensive reputation, and yet nonetheless, it's an asset class that offers you a return pick-up despite those qualities versus other instruments in the fixed income universe.

Harry: I think that the fact that it's a growing market is also key. So far this year we have seen almost 100 billion euros of ABS issuance within Europe specifically and we expect that higher issuance volumes will continue from here on out. I really think that that dynamic is more of a medium term trend as banks are accessing the ABS market in a more consistent and programmatic manner especially following the ending of quite attractive, cheap funding from the likes of central banks during that QE period.

Matt: I think coming out of the GFC, we were concerned at one point that the ABS market would continue to shrink in size with more bonds maturing each year than would being newly created. So at one time, there was a concern that the asset class would be intellectually interesting, but not necessarily particularly scalable from an investor's point of view.

We certainly feel that over the last three to five years, that tide has very much turned and actually now you're seeing, as Harry says, very decent issuance year-on-year and a clear expectation that that increases going forwards such that we now think it's really sort of gained critical mass from an investment universe perspective. We think that's going to attract more capital into the asset class, looking forwards

Romil: And just going back a bit, Matt, you identified some of the defensive characteristics. How do you think, Harry, this could entice more investors to get involved in this opportunity set? And what are some of the other core defensive characteristics of ABS?

Harry: It's a great question. Firstly, take mezzanine notes kind of secured on static portfolios of mortgages and auto loans. They tend to be more loss remote over time as the underlying loans repay and the senior notes within the structure amortise. This leads those notes to exhibit quite a positive rating momentum over time and that feature is quite unique for the ABS asset class as a whole, especially when compared to, say, the corporate bond market where you might have a particular corporate issuer. They would tend to typically target a specific credit rating when they're issuing their debt rather than see those ratings dramatically improve over, say, a three or five year period, as you see in the ABS market.

Matt: It's a really interesting point. It's not unusual in ABS to see a bond which started out its life rated BBB ending up as a AAA rated instrument by the time it matures. To Harry's point, you almost never see that sort of ratings migration in the corporate bond world. So again, it's an aspect of ABS that we think is kind of underappreciated, but there's a very observable track record of this asset class getting better, more credit resilient the longer you own ABS, so again, another reason that we think investors should be attracted to it.

Harry: On top of that if we think about the collateral for ABS, it tends to be predominantly consumer focused, which is really a nice diversifier versus, say, corporate bond exposures, which investors may typically have.

What we have observed over the long-term is really this low correlation of the investment grade ABS asset class relative to other asset classes like government bonds and equities. That's really attractive as a feature in terms of the diversification benefits that it offers investor portfolios.

Matt: ABS has a track record of delivering high predictable income, again which we really think feeds into the low volatility nature of the asset class as well, which is very important. Again, when we think about our investors constructing their fixed income portfolios having a floating rate product, which as Harry says is lowly correlated to other instruments that they might have in their portfolio and also operates with low volatility over a variety of different market conditions. Again, we think is a really kind of appealing profile for ABS from an investor's perspective.

Harry: I'd say that floating rate nature has been a real benefit to the asset class specifically over the last couple of years where we've had this rate hiking cycle. Although, we've observed within the ABS asset class, our prospective returns increasing as those cash rates increase. Now, one question we are obviously getting more recently is given we're maybe coming to the end of that rate cycle and the market is expecting more rate cuts than rate hikes from here on out, how does a floating rate asset class benefit them in their portfolios?

Matt: It really comes down to a couple of things. First and foremost, my personal view is that rates are not going to come down very quickly from here in the UK and Europe. We have large structural themes which we think are going to keep unemployment low, the labour market pretty tight and obviously have some demographic changes in terms of ageing populations and things.

In my personal view, [this] means that inflation is likely to be stubbornly higher than maybe central banks hope, which we think is likely to keep interest rates certainly very far away from what we've experienced during the zero rate environment that we've seen over a large part of the last decade. But even if rates come down more aggressively – it's my own personal forecast over the course of the next year or two – we think that the yield premium for ABS compared to corporate bonds is so significant that even if we do see rates coming down very, very significantly, the all in relative value and yields on offer on ABS will still look pretty compelling versus other fixed income alternatives.

Romil: Well, sadly, we're running out of time. But before we go, Matt, who are asset-backed securities really aimed for and where does it sit when it comes to overall portfolio construction, in your view?

Matt: It's a great question. From a portfolio construction perspective, again, one of the reasons we really like ABS as an asset class is you have bonds rated AAA all the way down through the investment grade and non-investment grade capital structure, down through to single B and even unrated junior equity tranches. We really think this allows asset-backed securities to be a market for everyone, for every type of investor, whether they're looking for low, predictable returns in the senior and investment grade parts of the capital structure or more equity-like returns further down in our market. We really think it allows the flexibility for investors to pick and choose the parts of the of the universe they want to invest in and the parts of the capital structure they want to focus on. Again, we really feel that that allows them to meet their risk return targets, but also do so in a way which suits them from a liquidity perspective as well.

Harry: We're not suggesting that investors consider replacing their corporate bond exposure purely with ABS, but rather ABS is a complementary allocation alongside the corporate bond exposure offering you that diversification and lower volatility of the asset class as well.

Matt: Absolutely. And I think we've definitely seen that over the last 12 to 18 months. There's been a much greater willingness of a larger number of investors from different jurisdictions to want to understand the asset class and once they've gone through that process to actually allocate to it. So again, if we come back to our expectation of the market growing in the future, both in terms of the amount of supply of ABS, but also the demand for it from a growing number of different parts of the investor community, we think the outlook for the asset classes is very positive.

Romil: Well sadly that's all we have time for today. Matt, Harry, it's been a real pleasure connecting the dots with you. Thanks indeed for joining us, and we look forward to hopefully welcoming you to another episode in future.

Harry: Thanks for having us.

Matt: Thank you.

Romil: And thanks to you. Our audience, as ever, for tuning in. Don't forget, you can subscribe to this podcast and we look forward to seeing you next time. But it's goodbye for now.

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