SECURED CREDIT INSIGHT

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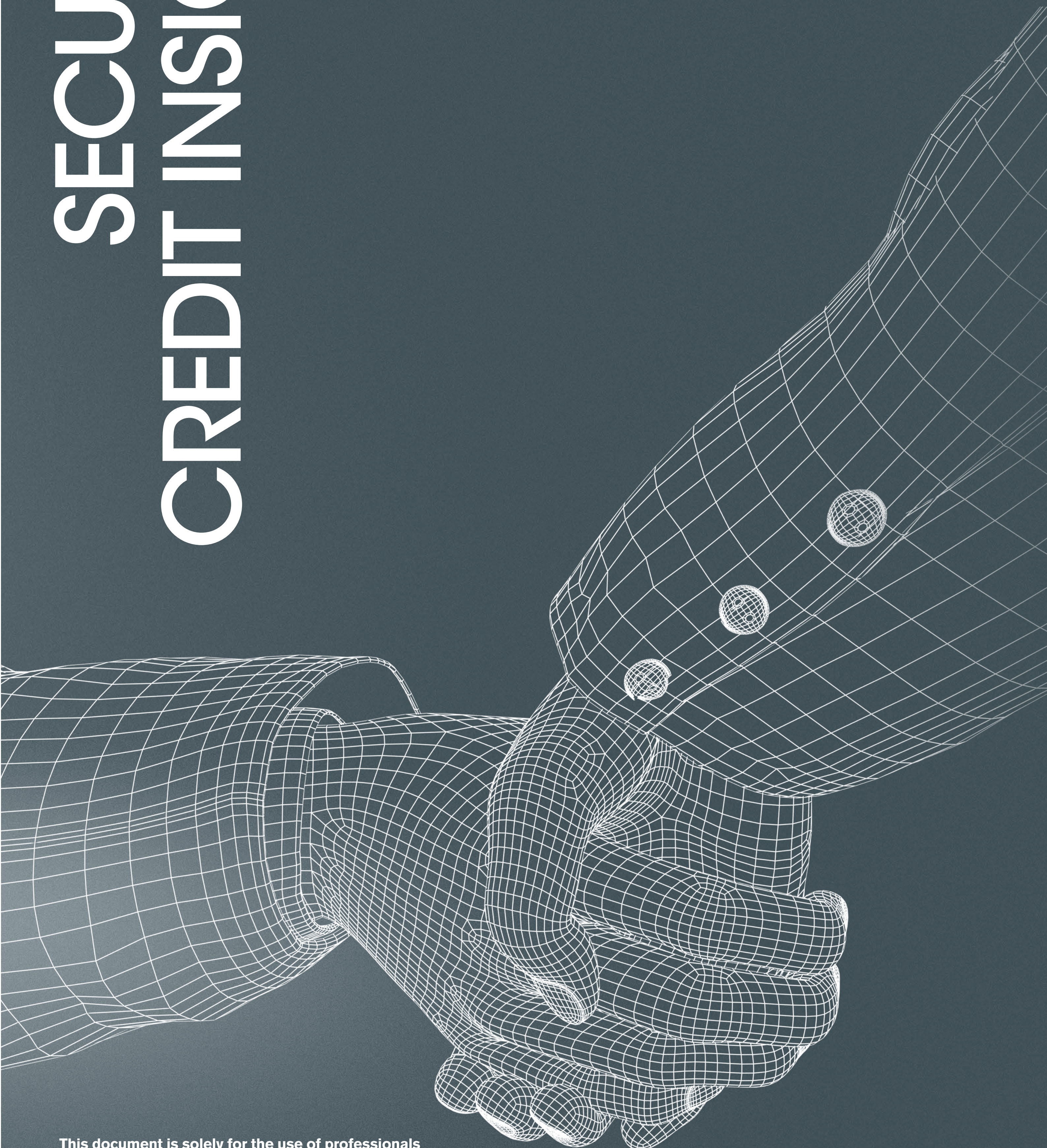

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Seniority and security at no extra cost

December 2016

In this edition of Secured Credit Insight, we analyse two of our core markets in some detail — secured loans and asset-backed securities (ABS).

We find that the benefits of seniority and security look to be undervalued by sub-investment grade bond investors.

We also believe that the attractive relative valuation of investment grade ABS versus corporate bond equivalents endures.

Additionally, we assess the increased attention that the US sub-prime auto loan sector is receiving; finding no cause to panic about the state of the US ABS market.

Favouring European secured loans

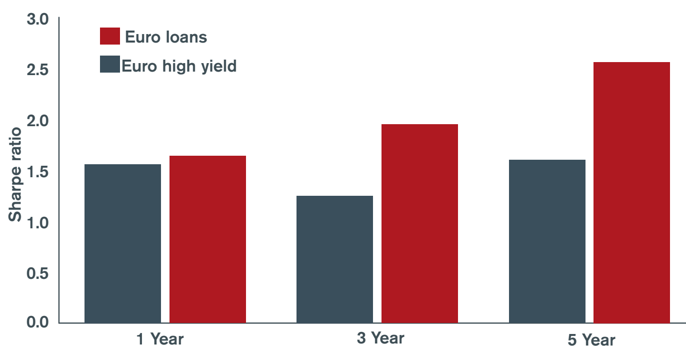
We have long been advocates of an allocation to European secured loans, both on a stand alone basis or as part of a mutli-sector fixed income portfolio. Here, we outline some of the reasons why this is still the case.

Central banks continue to provide extreme levels of monetary stimulus into the global economy. This is particularly relevant in Europe with negative interest rates and asset purchase programmes driving fixed income yields to records lows in many markets. Sub-investment grade default rates have remained low in light of these policy measures. With low default rates expected to persist and the insatiable appetite for higher yielding assets, we expect demand for secured loans to remain high.

Favouring loans over bonds

Historically, European loans have provided superior risk-adjusted returns for investors, as shown in the first chart. We expect this to continue and believe the benefits of seniority and security should deliver a less volatile stream of returns for loans investors versus high yield. As the second chart shows, the credit spread available in European secured loans is higher than that available from equivalently rated fixed rate high yield bonds. Effectively, this gives you the benefit of this seniority and security at a discount.

Chart 1: Sharpe ratio of European loans versus European high yield bonds

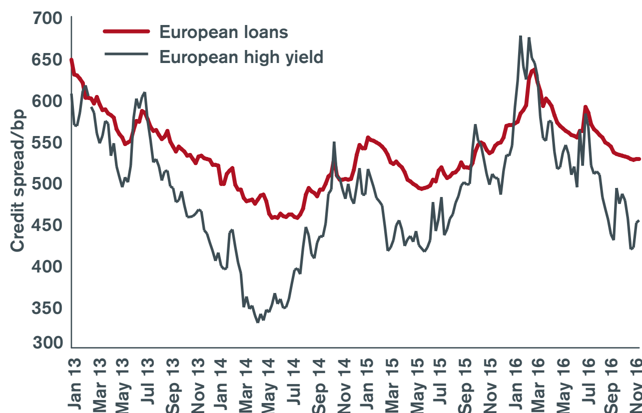


Source: Credit Suisse, BofA Merrill Lynch, as at 30 September 2016

Note: Indices are the Credit Suisse Western European Leveraged Loan Index (CS WELLI) and the BofA Merrill Lynch European Currency Non-Financial High Yield 2% Constrained Index (HPIC).

Note: The Sharpe ratio is the average return earned in excess of the risk free rate (1-month Libor in this instance) per unit of volatility.

Chart 2: credit spreads undervalue seniority and security

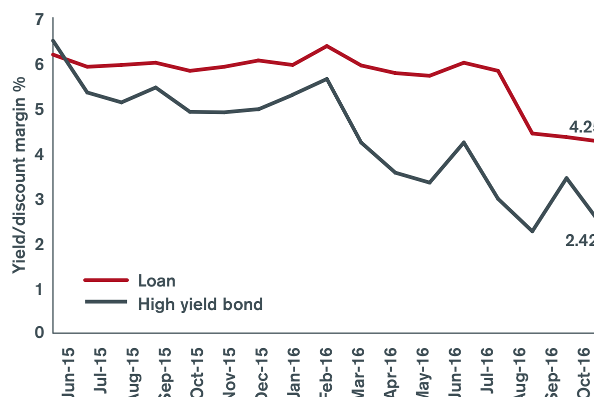


Source: Credit Suisse, BofA Merrill Lynch, as at 10 November 2016

Note: Indices are the Credit Suisse loans index (CS WELLI) assuming a 3-year average life and BofA Merrill Lynch single B high yield (HE20) index

Chart 3 shows the yield available from the senior secured loan and senior secured high yield bond of the same issuer (ranking pari passu). As can be seen, the secured loan offers a higher yield for taking on the same credit risk, despite a recent repricing of the loan to pay a lower coupon. When assessing the relative value of the two instruments, we continue to favour secured loans.

Chart 3: a clear yield advantage



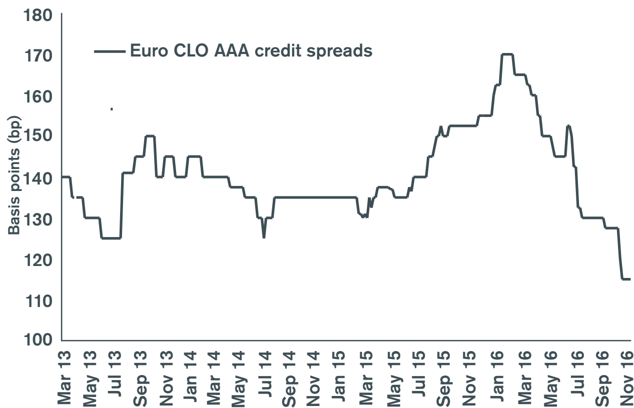
Source: Henderson Global Investors, Bloomberg and Credit Suisse, as at 31 October 2016. Note: The above example is based on the debt of Douglas Holding (yield-to-worst on senior secured high yield bond, 3-year discount margin on loan). It is intended for illustrative purposes only and is not indicative of the historical, future performance or the chances of success of any particular strategy.

Technical support

We believe the European loans market is set for continued demand from three key areas:

- Yield-hungry European investors — European institutions are being forced into non-traditional areas of fixed income markets (like secured loans) in the search for yield. Many have sold investment products with guaranteed returns that can no longer be met solely through government bond and investment grade corporate bond markets.
- Collateralised loans obligations (CLOs) — the most senior, AAA tranche, often makes up over 60-70% of the liability structure of a CLO. Chart 4 shows that the cost of issuing CLOs has been falling this year. As a result, we expect increased issuance from CLO managers providing important demand for secured loans. We have recently seen the senior most tranche of a new CLO deal price with a credit spread of less than 1% for the first time since the financial crisis.

Chart 4: cost of issuing CLOs falls to post crisis lows



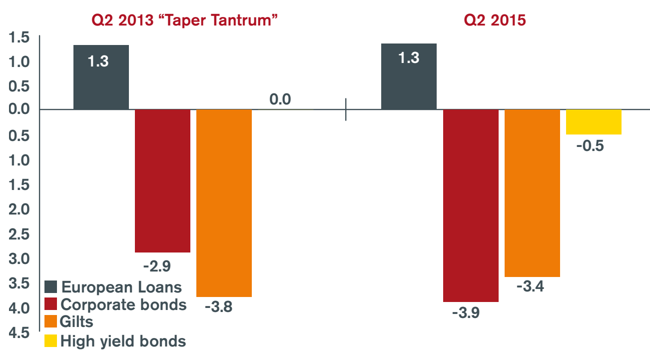
Source: Citi, 9 November 2016

- US investors looking to Europe – investors who operate in US dollar terms can earn a significant pick-up in yields when buying euro-denominated assets and hedging this exposure back to dollars. We expect more US investors to exploit this situation while it persists, increasing demand for European loans.

Loan resilience in rates market volatility

Donald Trump's surprise election victory, recent headlines about the possibility of the ECB slowing down its quantitative easing programme and increased rhetoric around fiscal stimulus have led to bouts of higher volatility in government bond markets. As a result, the possibility of a prolonged period of rising yields has crept back onto investors' agendas. Chart 5 shows the resilience that European loans demonstrated during two recent government bond sell-offs.

Chart 5: secured loans offer resilience during government bond sell-offs



Source: Henderson Global Investors, Bloomberg, as at December 2016

Note: Based on total return of the following indices — Credit Suisse Western European Leveraged Loan Index (CS WELLI). iBoxx £ non-gilts (IXBW), FTSE Actuaries UK Gilts All Stocks (FTFIBGT) and the BofA Merrill Lynch European Currency Non Financial High Yield 2% Constrained Index (HPIC). All returns are hedged to GBP.

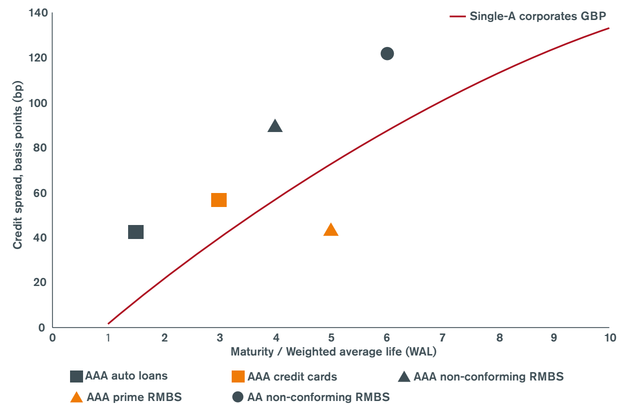
Asset-backed securities

Better credit spreads for less credit risk

We have spoken before about the relative value offered by asset-backed securities when compared with traditional corporate bonds. For investors looking for cash flow generative assets, the higher spreads available and the amortising nature of some ABS instruments make them a compelling investment.

Chart 6 plots the interpolated credit spread curve of single A rated sterling-denominated corporate bonds alongside typical credit spreads available from a number of different ABS asset classes. The ABS assets chosen are generally more highly rated than the corporate bonds used in this comparison. The chart shows the relative attractiveness of the ABS market is quite pronounced at shorter maturities. We have specifically shown more highly rated ABS to emphasise that better credit spreads can generally be obtained from better quality assets.

Chart 6: ABS offers attractive credit spreads compared to bonds



Source: Henderson Global Investors, JP Morgan, BofA Merrill Lynch and Bloomberg, as at 16 November 2016

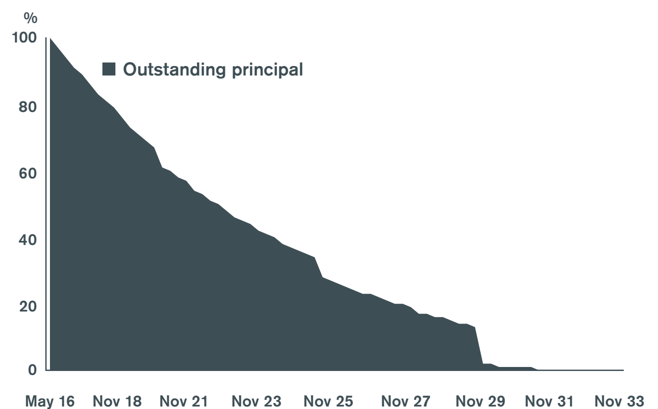
Note: Index UR00 for £ corporate bonds. Henderson estimated generic credit spread levels for ABS.

WAL=weighted average life. The average length of time the initial investment remains outstanding; ie, the time by which you expect to have received half of your money back.

Useful cash flow generation

In chart 6 we have marked in black those ABS assets with an amortising cash flow profile. These assets differ from a traditional bond investment that distributes regular coupon payments, with principal repaid, in full, at maturity. An amortising ABS is structured in such a way that investors receive periodic repayment of principal during the life of the investment. Chart 7 shows an example of what this might look like in practice for a bond of similar profile, ie, a non-conforming UK residential mortgage-backed security (RMBS) with a weighted average life (WAL) of around six years (black circle in Chart 6).

Chart 7: amortising ABS generates useful cash flows



Source: Henderson Global Investors, as at 30 November 2016

Note: RMAC 2004-NS3X ASA. Amortising, floating rate security.

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Thus, the asset is cash generative for investors from early in its life. We believe that ABS can be a useful cash flow generating asset providing diversification from other investments and attractive credit spreads when compared with corporate bond equivalents.

ABS comes with higher default risk… right?

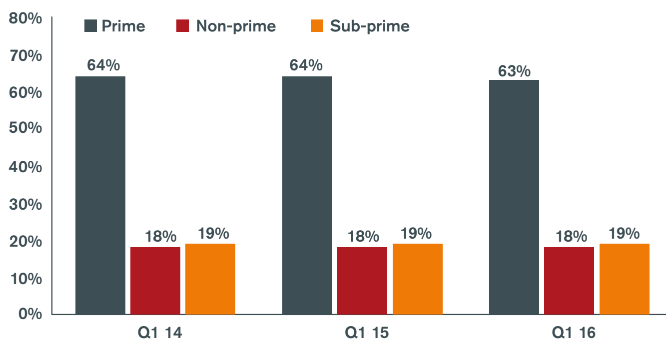
ABS assets were held up, rightly so in some cases, as the ugly poster child of the financial crisis with very high default rates in some areas of the US markets, when loose underwriting standards and complex structures led to large losses in certain sectors for investors. In Europe, the story was much different; with a benign default environment in residential mortgage-backed securities and other consumer ABS. The former suffered a cumulative default rate of 0.2% and the latter a cumulative default rate of 0.4% from mid 2007 to 31 December 2015[1].

To put these numbers in context, cumulative defaults in global investment grade corporate bonds were approximately 2.6% over this period[2].

US sub prime auto loans… not quite the next 'big short'

There has been a big increase in the attention and coverage of the US auto loan securitisation market. New lenders have entered a hot market, driven by record auto sales and a large increase in cars purchased on finance. With this expansion in credit provision, we have seen evidence of looser lending standards, higher default rates on underlying loans and more repossession. We do not believe some of the market hysteria that the sector represents the next 'big short'. Lending standards may have deteriorated within the sub-prime portion of the market but the proportion of the overall represented by this sector has actually remained relatively stable over the last couple of years (see chart 8).

Chart 8: sub prime auto loans not a rapidly growing part of the US market



Source: Expedia, Henderson Global Investors, March 2016
Note: Auto loans market in the US.

Performance of the underlying loans has deteriorated. The proportion of 60+ delinquencies[3] in both prime and sub-prime auto loans has increased by around 20% (from 0.40% to 0.48% in prime and 3.6% to 4.2% in sub-prime). The decline in fundamentals can largely be attributed to the newer lenders in the market deliberately moving down the credit spectrum where they can continue to originate profitable loans.

However, we think comparisons to the sub-prime mortgage crisis of 2007-08 are overdone. The auto loan market is substantially smaller than the mortgage-backed market whose collapse sparked such widespread panic in credit markets, the broader financial system and the global economy. In the US, the sub-prime segment of the auto loans ABS market has barely grown since 2007, and it represents only around 5% ($43bn) of the total ABS market. To put this in context, there was almost $3trn of RMBS assets at the peak in 2007.

In addition, the level of credit enhancement enjoyed by investors at the top of these capital structures (where most institutional investors can be found) is very robust and we do not see a contagion risk to the broader market.

Conclusion

Opportunities are still presenting themselves for both long-term and short-term investors in secured credit markets. The benefits of seniority and security seem to be undervalued in sub-investment grade bond markets. We do not believe that increased stress in the US auto loan market is a harbinger of darker times ahead for the market and the economy, ABS assets offer attractive prospective returns when compared with corporate bond equivalents. Amortising structures can be a useful cash flow generating investment for investors looking to earn additional returns from cash set aside to meet shorter-term obligations.

[1] S&P

[2] Moody's issuer weighted default rate for the 2007 cohort through the end of 2015

[3] A 60+ delinquency is a loan that is in arrears by more than 60 days

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