Market evolution: Investing in Asset-Backed Securities.

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Author: Chris Whitcombe

Challenger Investment Management

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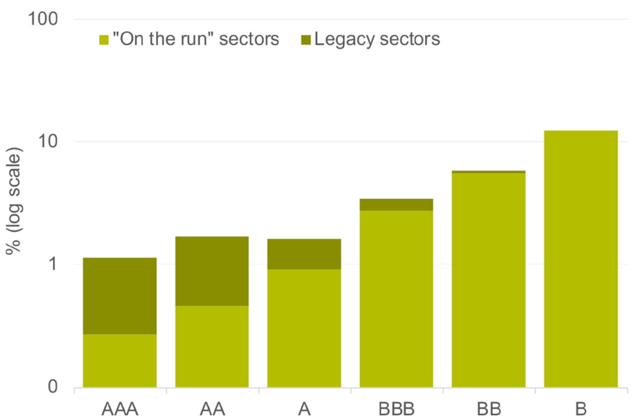
Since its inception in the 1970's, the global asset backed securities market has evolved beyond mortgage-backed assets to include loans secured by autos, equipment, credit card/personal loan receivables as well as high yield corporate loans. As the range of investment opportunities has grown, there is an opportunity for enhanced yield compared to similarly rated corporate credit.

Market standards are higher following lessons learned across markets through GFC.

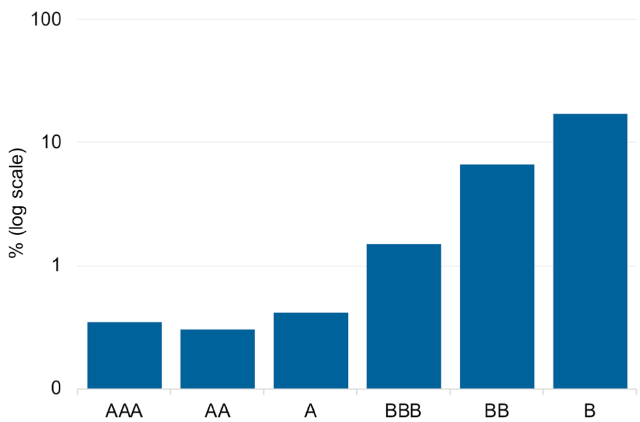
Pre-Global Financial Crisis (GFC), risks in the subprime mortgage and CDO markets were generally underappreciated by the market. More than a decade on, lessons learnt in these markets have been incorporated more widely across ABS sectors and deal structures which have improved markedly, resulting in significantly lower credit risk. In fact, long term default rates are similar to corporate credit when adjusting for legacy sectors, as shown in the chart below. Yet, this asset class often remains overlooked. What is sometimes less understood is the lessons that have been learned and implemented.

Five-year cumulative default rates, European securitizations



Based on 1983-2022 period. Legacy sectors are structured credit outside CLOs. Source: S&P Global Ratings.

Five-year cumulative default rates, Global corporates



Based on 1981-2022 period. Source: S&P Global Ratings.

- Underwriting standards for the underlying loan pool have improved significantly and structural enhancements have taken place. For example, assets are tested to withstand severe stress scenarios with higher rated tranches subject to more stringent requirements.
- Increased oversight has led to better transparency and standardisation.
- Loan data and performance data is more widely available.

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Following the GFC, global regulatory bodies established a framework of rules intended to prevent excessive risk taking within the banking, insurance and pension fund ecosystems, a byproduct of which increased the cost and decreased the availability of assed backed capital within these ecosystems. This has allowed alternative financiers to step in to fill the gap.

Time to consider ABS?

The global asset backed securities market provides investors with high quality, yield enhancing and diversifying investment opportunities.

1. **Low duration:** Most ABS securities issued in European and Australian markets are floating rate which means not only higher returns in a rising rate environment but also lower duration relative to traditional fixed income.
2. **Shorter repayment:** Typically, repayments are within 1 to 5 years, much faster than traditional corporate credit exposures. This reduces the underlying volatility and correlation of asset backed finance with traditional growth assets as well as traditional fixed income products due to the insulation from interest rate and credit spread duration risk.
3. **Diversification and niche market opportunities**: With a broad range of asset classes, capital structures, underlying collateral types and jurisdictions, relative value opportunities continually present themselves as the performance outlook and investor appetite across sectors change. The breadth of securitisation markets also gives rise to attractive niche markets, such as the Australian non-bank mortgage market. Despite being relatively niche, the opportunities in these markets can be significant and provide attractive relative value for investors who have access to them.

The UK LDI crisis in Sept 2023 was a prime example of when this combination of floating rate, short duration and a robust performance outlook presented a compelling opportunity for asset managers. Many were able to carry out large sales of highly rated securitised bonds at relatively low discounts to par. This experience stood in stark contrast with more traditional long duration fixed income instruments which experienced large capital losses and consequently extreme illiquidity during this period. We estimate that over a 3-week period roughly $15 billion in securitised bonds traded, a telling demonstration of demand for the asset class and also, the liquidity available.

The complexity of the asset class does necessitate specialised investment management. Deep experience and expertise is a pre-requisite. Underwriting a corporate borrower is a very different skillset to underwriting a highly granular and diversified pool of collateral. In addition to making an assessment on the credit risk of the investment, it is essential to understand how the cashflows from the collateral will pass along a bespoke cashflow waterfall structure. The reticence and underweight allocation to securitised assets from some investors creates a bigger opportunity for those that understand the asset class and its evolution.

Challenger IM Global ABS Fund

The Challenger IM Global ABS Fund is available to institutional investors to extend CIM's existing range of products which aim to exploit inefficiencies in the pricing of credit risk across public and private markets. To date, all funds have invested across corporate, securitised and real estate backed credit targeting returns of between 3% and 8% per annum over cash. The CIM Global ABS Fund is CIM's first offering which provides dedicated access to securitised credit. With over A$8 billion invested in securitisation markets, investment experience dating back to 2005 and 14 investment professionals dedicated to ABS investing, the team has developed a strong edge in this relatively niche part of the credit landscape.

The Fund will target a 3-4% per annum through the cycle return before fees over the Euro Short Term Rate by investing predominantly in publicly rated investment grade opportunities across global developed securitised markets, with a particular focus on Europe, UK, Australia and opportunistically in the US. By selectively blending attractive private market opportunities with public market transactions, the Fund will offer incremental yield in addition to diversification away from more traditional strategies. It will focus on floating rate assets with exposure to interest rate and currency hedged.

About Challenger Investment Management

Challenger Investment Management 'CIM' was established in 2005 and has a strong pedigree in the less liquid parts of the global developed credit markets. The Fixed Income team is focused on accessing investment opportunities across a broad spectrum of fixed income credit markets and believes that high income, diversifying and defensive portfolios can be constructed by taking a multi-strategy approach to credit investing across both public and private markets. By having a broad mandate and incorporating both public and private sector credit, the team seeks to identify and exploit pricing inefficiencies across credit, liquidity, and complexity risks. The team looks to dampen volatility by seeking to avoid interest rate and currency risks and aims to keep spread duration relatively short, particularly for less liquid strategies.

Glossary

CDO	Collateralised Debt Obligation	CDO's are a complex structured finance product that is backed by a pool of loans and other assets and sold to institutional investors.
LDI	Liability-Driven Investment	LDI is an approach that focuses the investment policy and asset allocation decisions on matching the current and future liabilities of the pension plan. LDI can effectively manage portfolio risk and help minimise the impact of the pension plan on the sponsor's financial health.
ABS	Asset-Backed Securities	A type of financial investment that is collateralised by underlying pool of assets – usually ones that generate a cash flow from debt, such as loans, leases, credit card balances, or receivables.

Contact Us

E: FidanteEuropeSales@fidante.com
W: challengerim.com.au

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