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Multi-Asset Credit: The Asset-Backed Finance Allocation

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KEY TAKEAWAYS

- While many people may not realize it, the Asset-Backed Finance (ABF) market is part of our daily life and is a critical source of financing for small and medium sized companies.
- As banks have retrenched from the ABF market over the past decade, specialty lenders and private capital have filled the gap with innovative financing solutions.
- Today, the ABF market spans a broad range of sectors and industries that represent a diversified opportunity set in credit and one that is bigger than the US corporate fixed income market.
- An allocation to ABF may provide attractive benefits including portfolio diversification and yield enhancement as well as a possible hedge against inflation.

The Asset-Backed Finance market is known by many names: securitized debt, securitized products, or structured credit. Asset-backed securities are created through the pooling together of similar debt obligations, often backed by hard assets, and selling the resulting cash flows backed by those loans to investors through a wide variety of securitized structures **(Exhibit 1)**. Historically focused on the residential mortgage market, asset-backed finance in recent years has extended its reach into wide swaths of the real economy and everyday life, with securitizations not just of mortgages but of car loans, credit card loans, and even music royalties.

Outsized investment opportunity growing ever more favorable

The securitized market dates back to the 1970s in the U.S., when home mortgages were packaged together and sold off by US-backed government agencies. Today, the total securitized debt outstanding in the US exceeds that of the corporate debt market **(Exhibit 2)**.

Exhibit 1: Asset-Backed acronyms

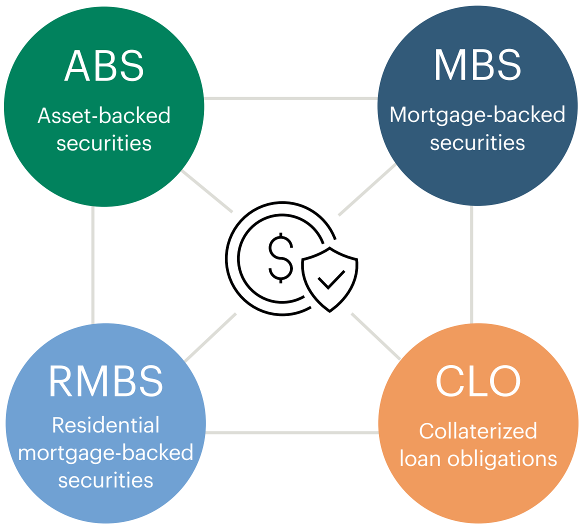
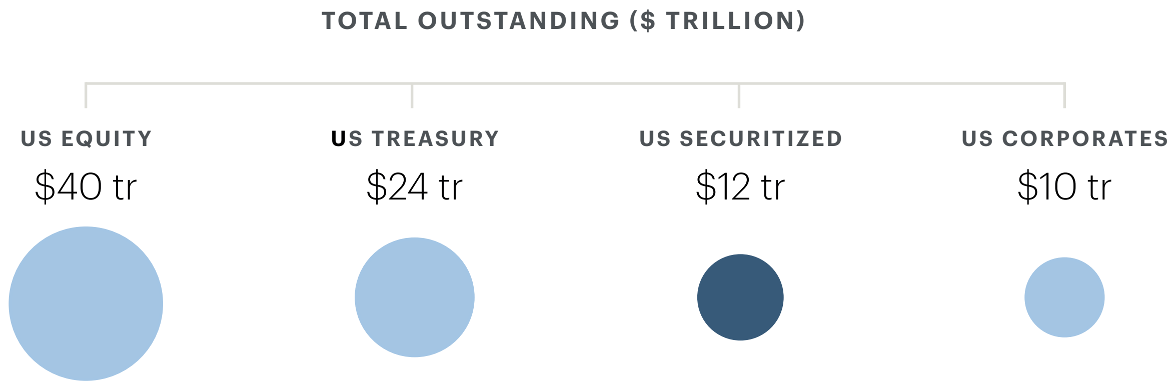


Exhibit 2: The asset-backed finance market is bigger than you think



Sources: Barclays Research, Morgan Stanley Research, SIFMA Research. Data as of December 31, 2022.

Beginning in the 1980's and leading up to the Global Financial Crisis (the GFC), we witnessed a "boom" in securitization in the US that was driven by the growth of the banking system and the housing market. Following the GFC, regulators responded by imposing rules that constrained banks ability to originate new securitizations. As the banks retreated from the business, specialty lenders and other pools of private capital stepped in to fill the gap. The diversity of new market entrants has led to a broadening of the market over the last decade into new sectors and industries, creating a wide array of new investment opportunities across the ABF spectrum **(Exhibit 3)**.

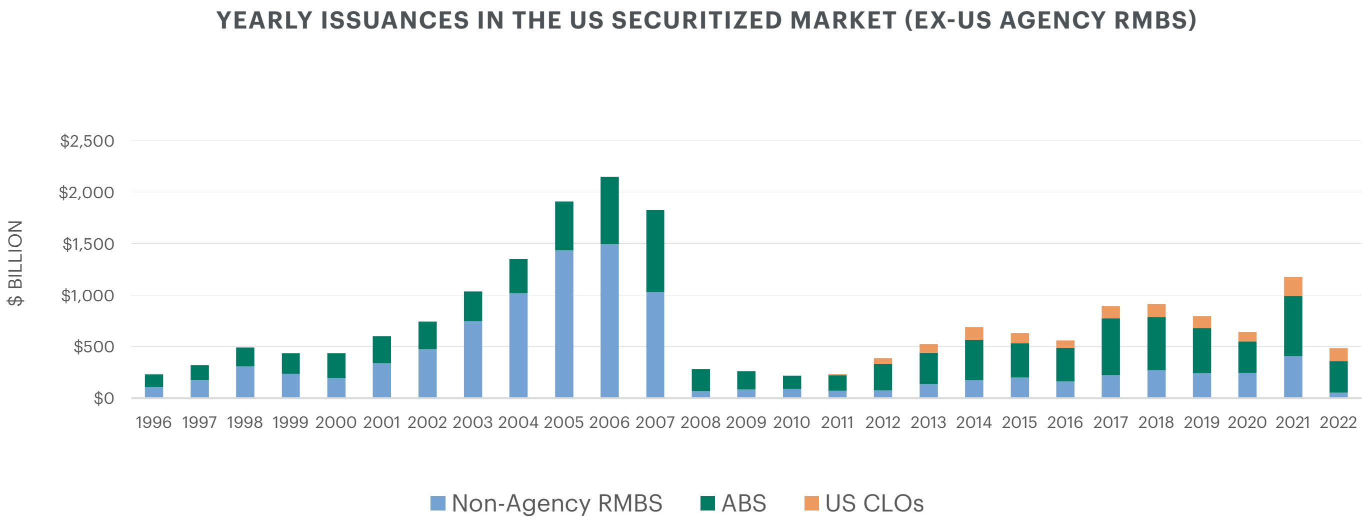
The rise of private ABF

Historically, the easiest way for investors to access ABF was by buying securitizations from banks. But as lending conditions have tightened and banks have retreated, the private ABF market, through its ability to originate ABF securities directly, is growing in importance. For example, during the recent bout of market volatility in March, US regional banks turned to the ABF private market for liquidity as traditional routes to securitize assets were not available.

We believe Multi-Credit portfolios can benefit from exposure to both public and private ABF markets and expect that the latter will evolve in much the same way that private credit has over the last ten years. Private ABF markets seek to offer enhanced yields and downside protection for investors' portfolios versus traditional public fixed income markets, given the ability to customize ABF solutions which suit borrower's needs (customized solutions normally cost borrowers more in terms of yield) and given the structural protections securitizations can provide. This private market provides financing in the form of whole loans, securitizations, or platform equity to a variety of sectors including:

- Consumer Finance (Auto Loans, Auto Leases, Credit Card, Student Loans, Other Unsecured Consumer)
- Residential Mortgage Loans
- Commercial Real Estate
- Hard Assets (Transportation, Power, Communications, Infrastructure, Solar, Agricultural Lending, Corporate Fleet Leasing & Management, Rental Car)
- Financial Assets (Music Royalties, Sports Media & Player Transfer, Inventory Finance, Trade Finance, Equipment Finance, Corporate Loans, Select Platform Equity)

Exhibit 3: After a retrenchment following the Global Financial Crisis, the securitization market remains a robust source of financing today



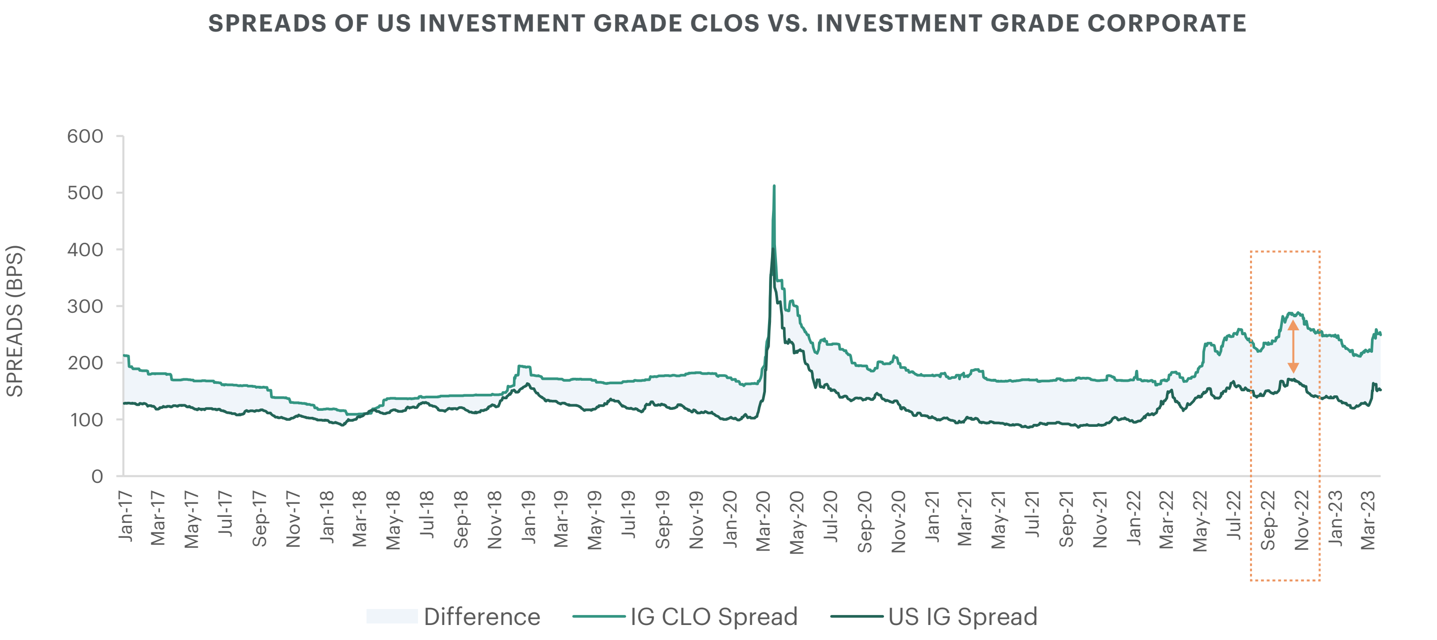
Sources: SIFMA Research, LCD Research, and Apollo Analysts. Data as of April 2023.

The case for an ABF allocation in Multi-Asset Credit portfolios

Like corporate bonds, ABF provides a recurring income stream. But ABF also offers several other important potential benefits including:

- **Enhanced Diversification and Downside Protection:** ABF is secured against a diversified pool of assets that share similar characteristics. Through structuring, it may also offer credit enhancement and other protections in a downside scenario (for example a capital cushion or overcollateralization). The benefit of this diversification and structuring can be seen by observing the recent performance of investment grade-rated tranches of US CLOs, which have not experienced a default since the GFC.
- **Inflation Protection:** ABF securities are typically floating rate instruments, with coupons that reset periodically based on short-term interest rates, which makes them a compelling allocation in a time of rising rates or high inflation.
- **Yield Enhancement:** ABF can offer higher yields compared with traditional corporate or fixed income instruments due to their complexity, illiquidity premium and smaller buyer base.
- **Tailored Returns:** ABF could enable the creation of different tranches, each of which have different levels of associated risk and expected returns. Investment returns (principal and interest repayments) and losses are allocated among the various tranches according to seniority. This allows the option to choose tranches that best align with the particular risk and return objectives.
- **Total Return Enhancement:** The complexity and thinner secondary trading volumes in ABF, as compared to more liquid credit markets, may make the securitized market more prone to dislocations during periods of market stress. This dynamic can help promote flexible mandates such as a semi-liquid multi-asset credit portfolio, that are able to tactically invest in the asset class during periods of market volatility. In September 2022, we saw a prime example of how a period of stress in the market can materialize quickly, resulting in high single-digit yields for A-rated CLOs **(Exhibit 4)**.

Exhibit 4: Investors able to tactically invest in ABF can take advantage of periodic dislocations in the market



Sources: JP Morgan Research and ICE. Data as of January 31, 2023.

Conclusion

We believe ABF represents a compelling allocation proposition for Multi-Asset Credit portfolios, particularly during times of elevated uncertainty and volatility in the markets. An allocation to ABF, and in particular, private ABF may provide portfolios with diversification, yield enhancement and inflation protection in a downside-protected manner.

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