SECURED CREDIT INSIGHT

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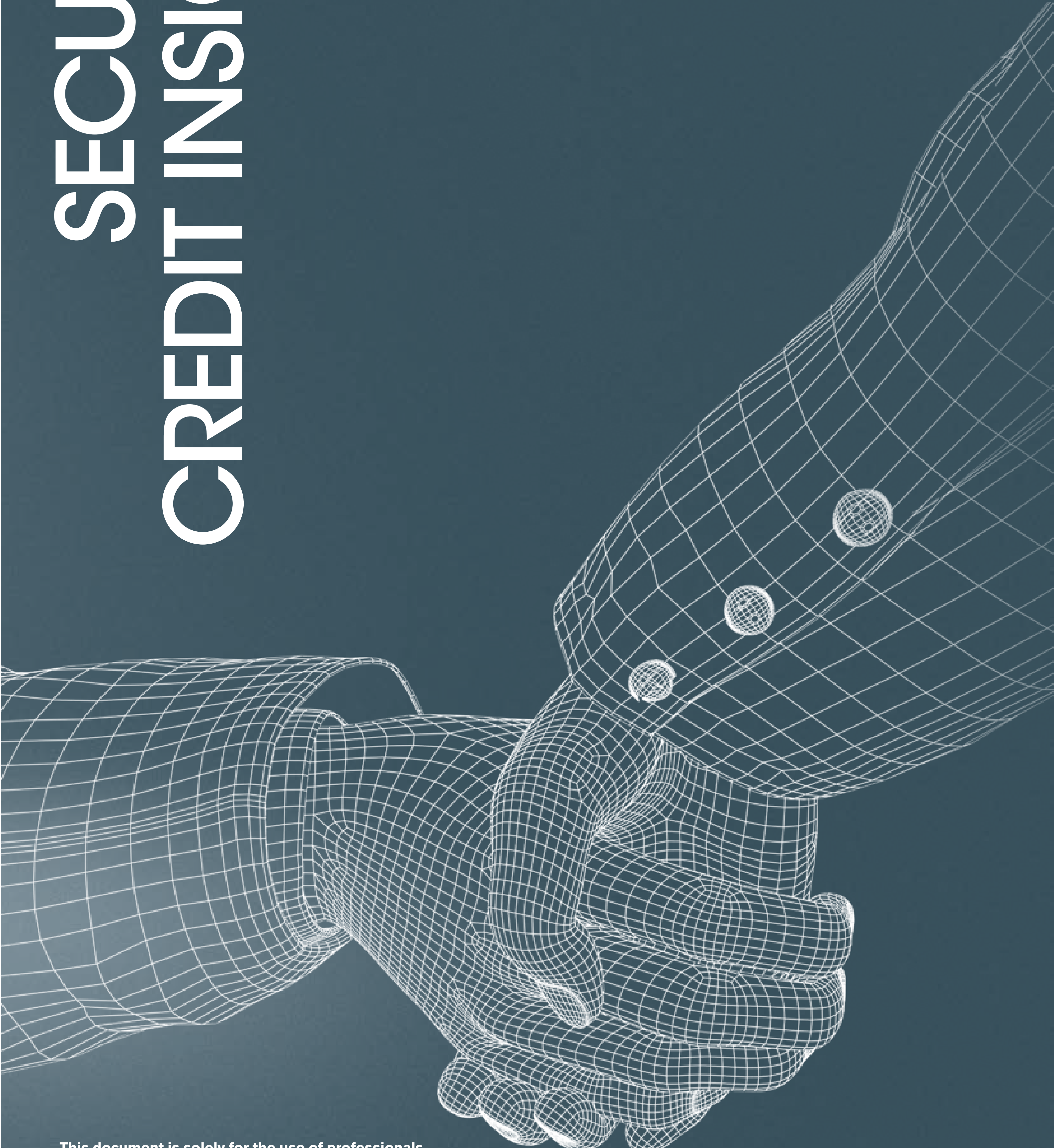

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Developing trends in secured credit

September 2015

This edition explores the ongoing attraction of secured credit on a risk-adjusted basis. We look at reasons for the outperformance of Europe over the US and some fundamental trends shaping the secured loans and asset-backed securities (ABS) market. Institutional investor demand and stable leverage levels are supporting the European secured loans market, while we also highlight the current opportunities within residential mortgage-backed securities (RMBS) and collateralised loan obligations (CLOs).

European secured loans – the standout performer so far in 2015

So far in 2015, financial markets have had to absorb the impact of events in Greece and China and constant uncertainty over the timing, quantum and impact of the US rate hiking cycle. As a result, it has been a mixed year for fixed income performance, with bouts of volatility in government bond markets dominating for large periods.

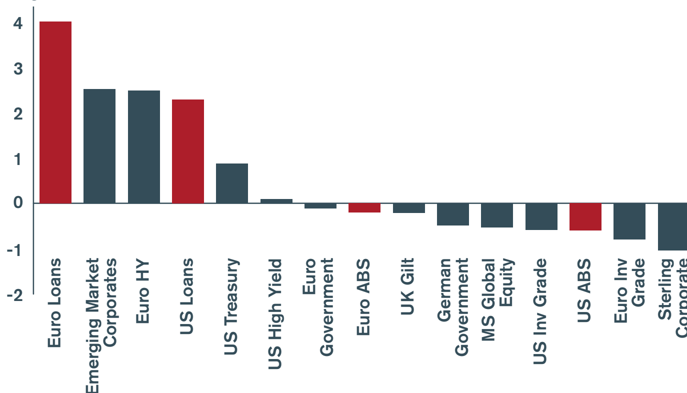
Figure 1 shows year to date returns of a number of fixed income asset classes, highlighting the core secured credit assets — ABS and secured loans. The outperformers so far this year have been assets offering attractive yields combined with low interest rate sensitivity (duration), as investors rely more on coupon income than price appreciation.

The standout asset class in this regard has been European secured loans, paying floating rate coupons and offering attractive credit spreads. This performance has also been achieved with remarkably low volatility (1.0%[1]). Market dynamics in Europe have also been favourable for investors, leading to outperformance when compared with US secured loans.

For our multi-asset credit portfolios, we also invest in high yield bonds (with a focus on senior and secured issuance) alongside secured loans. Here, European investments have also outperformed their US counterparts, due to continued accommodative monetary policy from the European Central Bank (ECB) and limited exposure to the troubled energy sector. The US market in particular has struggled, with the falling oil price weighing heavily on energy-related bonds.

Returns have generally been lacklustre in the higher rated parts of the ABS markets, with very low coupon income when compared to secured loans and high yield bonds. Price levels in ABS have also been negatively impacted by short-term supply and demand factors. For example, the slower than anticipated ABS purchase programme (ABSPP) from the ECB and significant new issuance in the sterling RMBS market, which have put pressure on secondary markets. However, we often use highly rated ABS as a substitute for investment grade corporate bonds in our portfolios and this has proved beneficial so far this year.

Figure 1: Performance of fixed income asset classes – year to date



Source: B of A Merrill Lynch, Credit Suisse, Bloomberg, Morgan Stanley (MS), Henderson Global Investors, 31 August 2015.

[1] Source: Henderson Global Investors, year to date, based on weekly Credit Suisse data to 31 August 2015.

Review of risk-adjusted returns

In the following table, we consider the Sharpe ratio[2] of a number of asset classes over the past five years to see how effectively risk has been turned into returns in these markets. The table shows that secured loans and ABS come out favourably when looking at this measure of risk-adjusted returns. While it could be argued that these numbers are elevated due to the overall more benign fixed income environment that continued central bank intervention created, we believe it is still striking to see how well secured credit has performed under this assessment.

	5y Sharpe ratio[2]
€ loans	1.75
€ ABS	1.65
$ loans	1.64
$ ABS	1.45
$ equities	1.31
€ corporate bonds	1.21
€ high yield	1.21
$ high yield	1.21
€ government bonds	0.96
£ corporate bonds	0.95
€ equities	0.92
£ government bonds	0.73

Source: B of A Merrill Lynch, Credit Suisse, Bloomberg, Morgan Stanley (MS), Henderson Global Investors, 31 August 2015.
[2] The Sharpe ratio is the average return earned in excess of the risk free rate (as represented by one month cash rates in this case) per unit of volatility. For example, an asset class with very high returns and very low volatility will look attractive (have a higher Sharpe ratio) by this measure.

Secured loans – drowning out the noise

Secured loans, particularly in Europe, have produced stable returns throughout this year's often volatile fixed income markets. These floating rate assets, with coupons based on underlying Libor rates, generally offer a healthy credit spread of 4 to 5%.

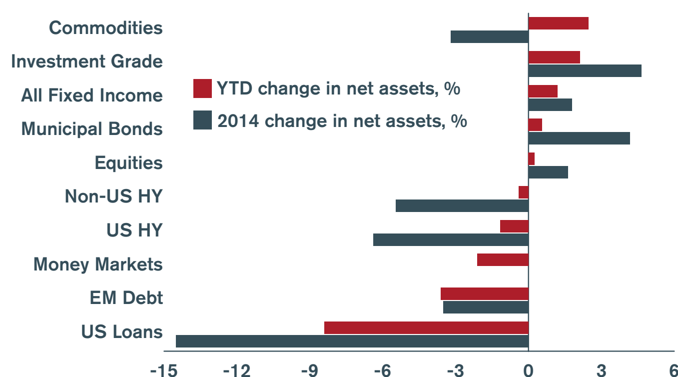
The European market has largely outperformed its US counterpart, helped by key factors impacting the supply and demand dynamic in the European market which we discuss below. These lead us to prefer lending in euros, rather than US dollars.

European stability

The prevalence of CLO issuance in both the US and European market has provided strong support for loan prices. CLOs remain an important marginal buyer for secured loans, adding a significant level of overall demand in both markets.

However, there are other factors leading to extra stability in Europe. Due to regulatory restrictions (UCITS), the European secured loans market is predominantly an institutional market place and sources of 'faster' money (such as mutual and exchange-traded funds targeted at retail investors) are not as prevalent in this market. Figure 2 shows the significant level of outflows that the US loans market has witnessed in 2014 and so far this year. As a result, periods of significant inflows and outflows, which can distort the fundamental value in the market, are seen less frequently in Europe.

Figure 2: Large outflows from US loans funds

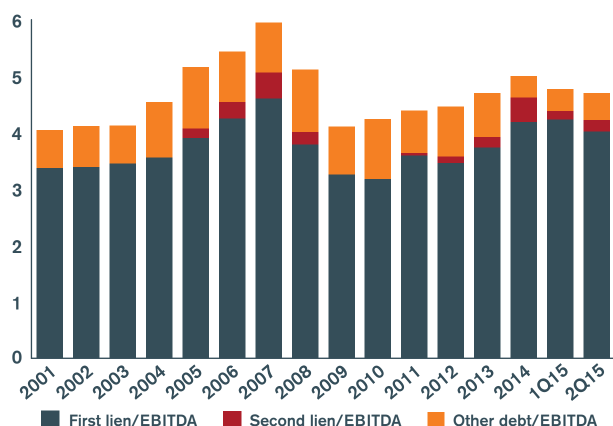


Source: Bank of America Merrill Lynch, fund flows, US dollar million, as at 9 September 2015.

Quality of issuance

In recent years, there has been a general trend of increasing average leverage in new secured loans deals brought to the market. Pleasingly, 2015 has seen this trend come to a halt (see figure 3). We believe this shows that the much spoken about "hunt for yield" has not led to lenders accepting unfavourable terms from borrowers, and that the market remains disciplined.

Figure 3: Increasing leverage comes to a halt in 2015



Source: S&P CIQ LCD, 30 June 2015

Further to this, 2015 has seen a relatively stable proportion of new issuance being used for refinancing existing debt — which is generally seen as a lower risk activity than mergers and acquisitions or buyouts.

Activity	2011 – 2015	H1 2015
Acquisition	10%	12%
LBO / MBO	24%	25%
Dividend	4%	3%
Refinancing	62%	60%

Source: Credit Suisse, based on Western European Leveraged Loan Index (WELLI), as at 30 June 2015.
Note: LBO = leveraged buyout, MBO = management buyout

Exposure to Energy Sector

The US high yield bond market has struggled due to its large exposure to the troubled energy sector (over 13%[3]), which has weighed on investor sentiment this year as oil prices touched multi-year lows. Credit spreads have widened and performance has been negative from this sector. This weakness appears to have spilled into the US secured loans market, which has seen outflows coinciding with those seen more widely in US high yield bonds. As a result, performance of US secured loans has lagged the European market, even with a relatively modest exposure to the energy sector (4%[3]).

By contrast, the wider European high yield bond market has a more limited exposure to energy (over 5%[3]) and has generally remained resilient in the face of oil price weakness. European secured loans have even less exposure to the sector (3%[3]), and have largely ignored the fall in the oil price.

[3] Source: B of A Merrill Lynch, Credit Suisse, 31 August 2015.

Asset-backed securities – lacklustre but stable performance, attractive opportunities

As noted, lower coupon income has hindered highly rated ABS, and returns have generally been lacklustre so far this year.

Price levels have been negatively impacted by the relatively slow pace of the ECB's asset purchase programme (ABSPP), while the sterling sector has been buffeted by significant new issuance volumes and the expectation of further issuance — both of which led to wider credit spreads in some areas of the ABS market. However, we believe the continuation of historically low interest rates and gradually improving macroeconomic conditions will support highly rated securitised assets.

We believe there are two areas of the ABS market with particular potential to outperform over the medium term.

1. Residential mortgage loans

One area of interest is the UK non-conforming residential mortgage-backed securities (UK NC RMBS) market, which has seen credit spreads widen disproportionately during 2015 (generically from 1.0% in January 2015 to 1.5% in August 2015[4]) due to weak supply and demand dynamics, primarily related to expected excess supply in the market.

For example, the Co-op Bank has embarked on an asset sale programme for non-core assets, which relies significantly on the securitisation of its non-conforming mortgage loan portfolio. The UK government has also recently announced it is examining the sale of the assets of Northern Rock Asset Management (NRAM), wholly-owned by UK Asset Resolution (a governmental agency). These assets include the £13 billion Granite prime RMBS programme, which is expected to be repaid and re-issued as a result of any sale of NRAM.

With the expected large amounts of potential new issuance, pricing of existing bonds in the UK NC RMBS space has suffered. However, if we look through this short-term weakness, we can see a generally improving trend in the performance of the underlying assets backing these securitisations, with the amount of loans that are in arrears/ delinquent falling steadily since the financial crisis (see figure 4).

[4] JP Morgan, 31 August 2015 (for senior most bonds)

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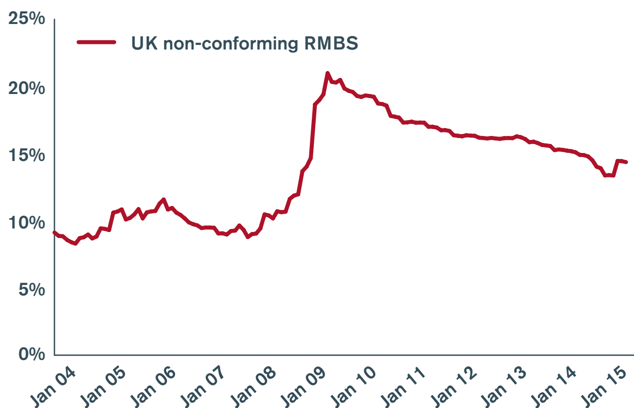
Figure 4: UK NC RMBS delinquency rates



Source: JP Morgan 30 June 2015
Note: based on % of underlying assets over 90 days in arrears

Given the wider spreads in the market, combined with the expected strong credit fundamentals of the sector, we see an attractive investment opportunity in UK NC RMBS. We expect prepayment rates on the underlying mortgage loans to increase. This is due to improving housing markets and the increasing availability of financing as the UK economy continues to strengthen. However, we expect that a rising interest rate environment might place some borrowers in difficulty and that the default rate on some of the loans underlying the RMBS will rise. By focusing on the senior most tranche of these transactions, our holdings should be robust in the face of uncertainty caused by higher interest rates and in fact benefit as defaulted mortgage recoveries are used to pay down senior bonds.

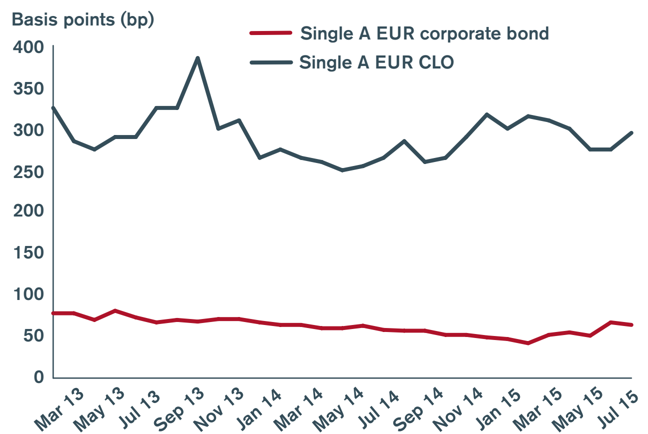
2. Collateralised Loan Obligations

As noted, CLOs are one of the reasons why the secured loans market has been resilient so far this year. This is an area of the ABS market that we like, with attractive credit spreads and risk-adjusted returns on offer.

For example, single A CLOs offer considerable value compared to single A corporate bonds (see figure 5). While there is a degree of additional leverage in a CLO structure, we estimate they can still withstand some 80% of cumulative defaults on the underlying loan portfolios prior to any losses being experienced on the single A tranche of the CLO. To put this in context, this compares with cumulative defaults on European secured loans of 29% from 2008 to 2014 (3.7% annual average)[5].

[5] Credit Suisse, 30 June 2015

Figure 5: CLOs offer attractive credit spreads



Source: JP Morgan, BofA Merrill Lynch (ER30 index), 30 June 2015
Note: Based on CLO 2.0 issuance

In addition to attractive new issue credit spreads, individual stock selection of pre-crisis CLOs has also been an opportunity to further enhance returns. These discount price bonds have paid off more quickly than market expectations when purchased, leading to a healthy 'pull-to-par'.

Summary

Secured credit markets and high yield bonds have generally remained resilient in the face of increased volatility in fixed income markets and continue to deliver compelling risk-adjusted returns in our view.

The secured loans market has been a strong performer this year, particularly in Europe and we believe that the supply and demand dynamics look set to support the market into the end of 2015, and beyond.

ABS returns have not performed to the same degree as higher yielding assets this year, due largely to technical factors such as a slower than expected purchasing programme from the ECB. However, prices have generally remained stable, outperforming investment grade corporate bonds, and we believe underlying trends in the market are positive for the future.

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