RBC Global Asset Management

US Securitized Credit

Securitized credit solutions Q&A

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Securitized Team
BlueBay Fixed Income Team

> "Given the appetite for attractive returns without taking on undue risk, we believe an allocation to securitized credit is prudent for investors today."

Interest in fixed income has increased due to the higher yields available across the spectrum. Private credit has also appealed to investors because of its floating rate nature, seniority in capital structure, stable cash flows, and incremental yield vs. more traditional fixed income.

Securitized credit provides a compelling alternative, capturing all of these characteristics: bonds in this asset class offer a combination of floating rate coupons, high seniority and protection from defaults, stable cash flows, and very attractive yields. The asset class also complements more traditional fixed income and private credit in a portfolio due to lower correlations and sensitivity to credit-specific events, as the underlying collateral consists of pools of diversified assets and not single-name obligors that could be exposed to idiosyncratic events.

We have seen increased interest for securitized credit solutions, with various inflows into our existing funds as well as the launch of new products tailored to specific client needs.

Given the appetite for attractive returns without taking on undue risk, we believe an allocation to securitized credit is prudent for investors today. In the Q&A, we tackle some of the key reasons.

1. What is the current opportunity set in securitized credit?

Securitized credit is a USD4 trillion asset class, with a range of opportunities across different types of securitizations including mortgages (residential & commercial), corporate loans, auto leases, and other types of financing. Varying returns can be achieved depending on risk/return appetite, with opportunities from AAA through BB or equity available.

High Grade	Investment Grade	High Income / Opportunistic
Avg. Yield (USD): 6-7%	Avg. Yield (USD): 7-8%	Avg. Yield (USD): 10-15%
Avg. Rating: AAA	Avg. Rating: AA/A	Avg. Rating: BBB/BB
Avg. Spread: 1-2 yrs Duration	Avg. Spread: 2-3 yrs Duration	Avg. Spread: 3-4 yrs Duration
Liquidity: Daily	Liquidity: Daily	Liquidity: Monthly/ Quarterly

Source: Illustrative only. RBC Global Asset Management.
The figures provided are typical average levels for the various profiles within the Securitized Credit platform. The data is provided for the limited purpose of demonstrating the depth of information and detail available to the investment team in assessing potential investments. It is not and should not be viewed as a recommendation to buy or sell any specific security.

The market opportunity in securitized credit is compelling across the risk spectrum due to the high level of protection from defaults that securitized bonds offer in a macro environment where idiosyncratic defaults are rising. At the same time, these bonds offer significantly higher yields versus more traditional areas of corporate credit due to a combination of wider credit spreads, driven predominantly by high supply, and higher front-end rates. Finally, bonds in this space offer stability and security as they are backed by observable collateral and make periodic floating rate coupon payments, which can provide comfort to investors in a time of macroeconomic uncertainty.

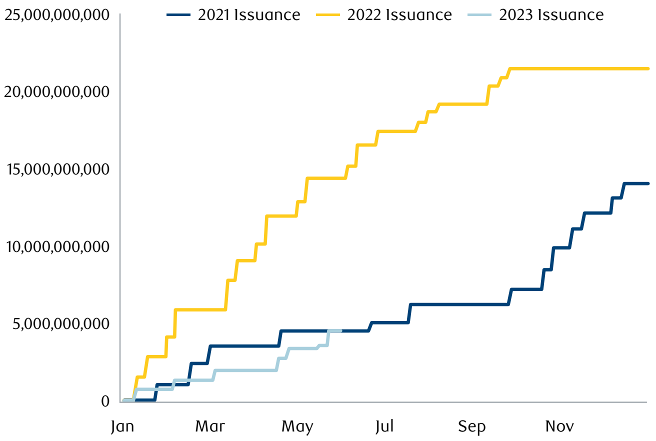
2. Where do you see the most attractive value in securitized markets?

There are opportunities across the rating spectrum in securitized credit depending on investor risk and return appetite. Below we highlight three opportunities that we believe are very compelling across the risk spectrum.

a) High yields for high-quality bonds: primary AAA CLOs at 5.5%-6% yield

Traditional 'anchor' collateralised loan obligation (CLO) AAA buyers have stepped away due to various regulatory or market pressures. This has left a large hole in the buyer base at a time when CLO issuance has not materially slowed down, putting pressure on spreads and creating a large amount of tiering with spreads now at 175-225 basis points (bps) depending on the CLO manager. With yields at 5.5%-6% for senior, liquid bonds that have significant default protection (no AAA or AA CLO has ever taken an impairment) we see excellent risk-adjusted value in this part of the market for the more defensive investor. This profile also carries additional upside, as the historically high coupons being created in the primary market today will likely be refinanced in 18-24 months, and the inverted shape of the yield curve puts the return to a call scenario at 6%+.

Cumulative CRT issuance



Source: Bank of America, as at 31 May 2023.

b) Attractive value in more seasoned US residential real estate: 7-8% yield for A-BBB rated risk

Another story of oversupply over the course of 2022 has pushed spreads wider as the large number of mortgages originated in 2021 and 2022 hit the securitisation market as seen in the graph below. At the same time, targeting a more seasoned borrower reduces credit risk as borrowers have more equity in their homes when indexed for house price moves.

c) 'Sweet spot' with 8%-12% yields and high default protection: BBB/BB CLOs

We think that the sweet spot where one can generate a high return but still receive high protection from defaults is BBB and BB CLOs. Today these bonds are trading 150-200bps wider than historical levels due to a combination of heavy supply and macro uncertainty. BBB-rated CLOs appear particularly dislocated to us. These tranches typically trade 100bps tighter than single B corporates but currently trade 50bps wider, implying a 150bps pick-up to the historical basis. One can take advantage of this dynamic and effectively earn higher returns but take on less credit risk by investing in more senior BBB & BB CLOs versus lower-rated corporate bonds. Based on current market conditions, potential IRRs over a 1-3 year investment horizon are shown below for these bonds:

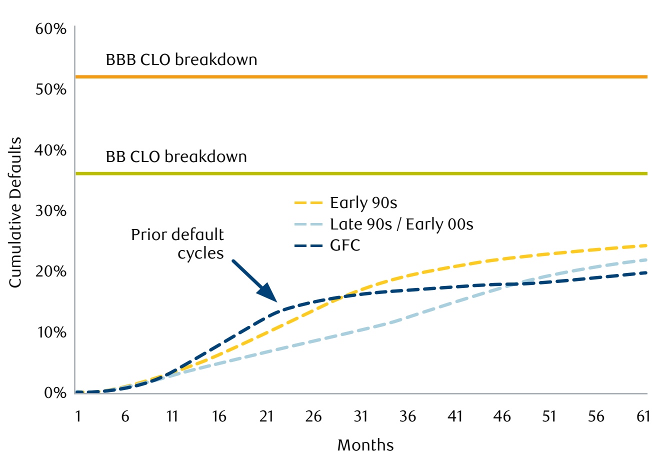
Rating	Indicative entry price	Indicative entry spread	Indicative exit spread	1 yr exit modelled IRR	2 yr exit modelled IRR	3 yr exit modelled IRR
BBB	High 80s	540	300	18%	13%	11%
BB	M80s	905	600	30%	20%	16%

Source: RBC BlueBay Asset Management, as at 31 May 2023.

3. How will Securitized Credit protect me in a world of rising uncertainty?

2023 has illustrated the unpredictable and idiosyncratic nature of markets, with rising rates already causing pockets of stress and the outlook going forward just as uncertain.

Cumulative Default Breakeven Analysis



Source: Intex, RBC BlueBay Asset Management, as at 31 May 2023.

Securitized Credit offers significant protection from defaults due to structural protections – the main two being bonds subordinate in the capital structure and the ability to divert cash away from junior bonds in times of stress.

> **"Historical performance combined with our expectations that overall defaults will be lower in this cycle we believe that there is a significant margin of safety here."**

These structural features offer meaningful protections to investors. For instance, BBB and BB rated CLO bonds can absorb **cumulative defaults of 50% and 35%, respectively, before the bonds are impaired.** Prior default cycles have resulted in cumulative defaults of 20-25%. Historical performance combined with our expectations that overall defaults will be lower in this cycle we believe that there is a significant margin of safety here.

4. Which areas of Securitized Markets are 'ones to watch'?

Within securitized markets, US commercial real estate (CRE) is certainly one to watch. It is a huge USD11 trillion market with over USD4 trillion of debt outstanding. CRE has been in the headlines recently due to three key issues creating stress for the sector:

1. Regional banks are a significant provider of capital to the asset class, representing approximately 25% of lending.
2. There is a short-term maturity wall that needs to be refinanced into much higher rates: approximately one-third of the debt outstanding comes due by the end of 2025.
3. Hybrid work has created huge distortions and excess supply in the office market.

The impact of the above concerns is evidenced in the spread widening across parts of the CMBS (commercial mortgage-backed securities) market. However, we think there is more stress to come as the market works through some of the underlying issues and therefore in the future believe there will be a significant high return potential in this space. We are now positioning appropriately to be prepared for that opportunity set when the time comes.

5. How does securitized credit compare to private credit?

In our experience, many investors have favoured investments in private credit as a way to add incremental yield to a portfolio while accessing floating rate senior parts of the capital structure that provide stable cash flows during uncertain economic conditions. Our view is that securitized credit offers many of the same positive characteristics with the addition of other benefits outlined in this piece that make the asset class an interesting complement or even an alternative to private credit. Below we compare some of the key features of both areas:

Private credit	Securitized credit
Predominantly floating rate	Predominantly floating rate
10-15%+ returns	10-15%+ returns (opportunistic strategies - BBB/BB focused)
Illiquid: typically, 5+ year lock up	Monthly/quarterly or fixed-term liquidity
Single name risk	Diversified collateral with significant structural protection from defaults

6. Why RBC BlueBay for securitized credit?

We are an experienced, global manager with a combined 140 years of portfolio manager experience on the team and a strong track record across our securitized credit platform. We are experienced in launching and managing separately managed accounts across the risk spectrum and can tailor solutions to suit investor needs. Finally, we are a CLO manager with multiple deals in the US and Europe; this enhances our capability as a securitized credit investor due to our deep knowledge and experience of underlying credit markets and CLO trends.

Portfolio Manager Perspectives

Our experts offer their perspectives on the latest developments in global credit and the state of the markets.

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