For Professional Investors Only

Global Asset Management

Securitized Credit

Should medium-term investors be buying here?

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Potential multi-billion dollar 15-25% IRR opportunity

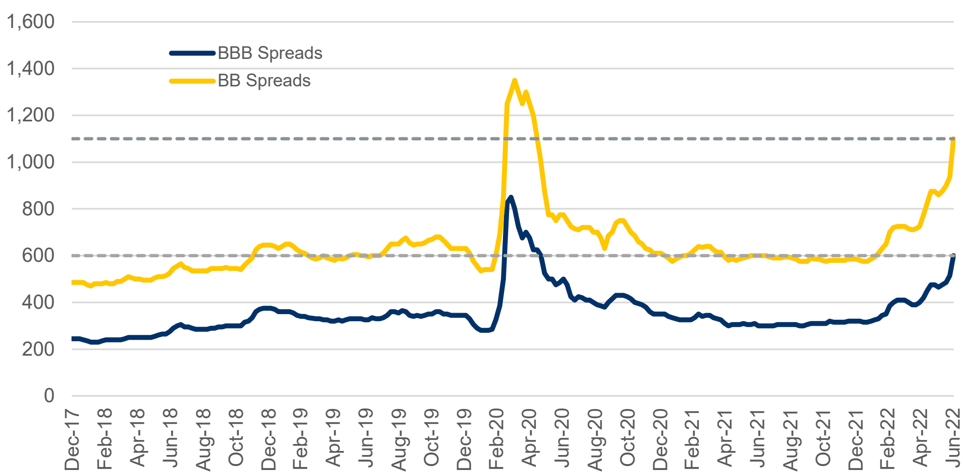
Valuations in securitized credit are fast-approaching levels of dislocation where we believe investors who are able to take a medium-term view can find attractive value.

Recession, inflation and geopolitical concerns have beaten up financial markets in the first half of 2022 – US equities had their worst H1 in 60 years and the US Treasury market its worst six months since 1788. We have written previously about the need to build portfolios to withstand these stagflationary risks – however, we now believe that valuations in certain areas of the securitized credit markets are approaching levels where they are attractive on a medium-term outlook. What's more, this is a sizeable opportunity. In CLOs alone, the mid and lower mezzanine bonds in our investment universe have an outstanding notional of over EUR65bn and there are billions of euros that trade on a monthly basis.

While we think the short-term risks remain elevated and that fundamentals will deteriorate from here, the capital structures in securitized credit are robust and capable of absorbing significant levels of defaults. In fact, CLO bonds have a significant cushion to mitigate a material rise in defaults – for example, a BBB rated CLO bond can withstand in excess of 35% defaults, assuming a 50% recovery on loans, and a BB rated CLO bond can withstand 25–30% defaults under the same assumptions. At the same time, valuations and spreads have dislocated in both the investment grade and sub-investment grade portions of the market. Chart 1 shows that spreads are encroaching levels hit at the worst periods of Covid in 2020 and BBB spreads are now wider than historical BB spreads.

All this means that potential returns in the event of a continued dislocation are now in the 15-25% IRR range in the medium term (see Table 1 overleaf). On a risk-adjusted basis, we think this is worthy of consideration.

Chart 1: CLO spreads



Source: Wells Fargo, BlueBay Asset Management as at June 2022

Table 1: Potential returns in CLOs

Rating	Approx. size of market*	Current price	Target price	Target spread	Exit spread	1-yr exit modelled IRR	2-yr exit modelled IRR	3-yr exit modelled IRR
AAA	EUR225bn	Mid 90s	Low 90s	285	110	11%	7%	5%
AA	EUR39bn	Low 90s	High 80s	370	170	15%	9%	7%
A	EUR27bn	High 80s	Mid 80s	420	210	17%	10%	8%
BBB	EUR22bn	Low/mid 80s	High 70s/80	650	300	29%	16%	12%
BB	EUR18bn	High 70s	Low/mid 70s	1100	600	40%	23%	18%

Source: BlueBasy Asset Management, Intex as at July 2022 . * Include European CLOs and eligible US CLOs.

We have used the example of CLOs in both the chart and table, but we believe opportunities of this nature are popping up across securitized credit markets. One other asset class we are following particularly closely is US agency mortgage credit risk transfers (CRT). Significant oversupply and uncertainty caused by the speed at which mortgage rates have risen has added to macro pressures, forcing significant reductions in valuations. BB-rated tranches, which used to trade inside their corporate bond counterparts by around 25bps at the end of 2021, now trade at a spread of +700bps – almost 200bps wide of corporate high yield. Similarly in BBB-rated tranches, we've seen moves from +165bps in 2021 to +465bps today.

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