Securitized Credit: Where opportunities lie

The continuation of macro uncertainty has led to persistent volatility in financial markets. We examine why this backdrop can offer an attractive entry point in securitized credit.

Securitized credit bonds can provide attractive yields, are typically floating rate and have significant protection from defaults. In certain parts of the market, we have seen significant widening of spreads due to high and persistent inflation, central bank hiking, weaker growth outlooks and the Russia/Ukraine conflict. These moves have been exacerbated by negative technicals for the asset class.

Lucy Best and **Tom Mowl** highlight why this dislocation can provide investors with an attractive entry point in securitized credit.

Lucy Best: I'm Lucy Best, Institutional Portfolio Manager within BlueBay's Securitized Credit and CLO management team. Today I'm joined by Tom Mowl, Portfolio Manager within the team to highlight some of the attractive characteristics in the securitized credit market. Bonds in securitized credit are typically higher yielding floating rate and have significant protection from defaults. In today's market environment, we think these benefits are even more attractive than sometimes they may seem to be. Given the macro volatility that we've seen this year, there are some areas of the securitized credit market that offer very attractive entry points for investors. We will highlight some of the attractive characteristics of securitized credit and why we think today is an attractive opportunity for investors to come into the market.

What is the current opportunity in securitized credit?

Lucy Best: Spreads in some parts of the securitized credit market have dislocated from fundamentals and today are trading at or close to COVID-era wides in some areas. In fact, in some parts of the markets, spreads are at the widest level excluding COVID in nearly 10 years. This means today some sectors of the securitized credit market offer very attractive IRRs for investors. In investment grade, bonds in securitized credit offer somewhere in the region of 10% to 20% and, in sub-investment grade, the IRRs on offer are in the region of 20% to 40%.

The spread widening has been driven by the macro backdrop that we all know well. Persistent and high inflation, central bank rate hiking, weaker global growth outlooks, and the Russia-Ukraine conflict. It's fair to say that this weak macro backdrop has led to a global risk-off environment but, in certain areas of securitized credit, the weak technical backdrop has led to further spread widening in some parts of the market. Securitized credit is offering strong absolute and relative value opportunities for investors. At the same time, bonds are typically floating rate, and, very important in today's market environment, bonds have significant protection from defaults. This means bonds that are deep in the capital structure, and those that are more senior have a lot of protection from a pickup in defaults. Something that is very much at the forefront of investors' minds in today's market environment.

When we actually look at previous cycles, bonds, even right at the bottom of the capital structure, are not impaired by previous default cycles and we'll come on to this more later. The current state of play is truly a once-in-a-decade opportunity to access bonds that offer high potential IRRs and have significant protection from defaults and preservation of capital.

The securitized credit market is large and diverse – where are you currently seeing the opportunity?

Tom Mowl: In a market environment like we have today, dislocations can happen at any time and the key for investors is to try to target dislocations that are more technical rather than fundamental in nature. There are areas that are more dislocated and less dislocated than others. Within the securitized credit market, in today's environment, CLOs are typically more dislocated and therefore offer a better opportunity for investors.

Today, bonds that are single-A rated are trading below 90 cents on the dollar in cash price. BBBs are in the low to mid-80s and BBs are in the 70s. It's important to remember that these bonds were generally trading at or very close to par at the start of the year and, because they're floating rates, the price declines are due to spread widening, rather than interest rate moves. This means that the bonds offer anywhere between 20% and 30% IRRs over the next one or two years.

Whilst also offering attractive return profiles, these bonds also have a significant amount of credit protection embedded in their structures, which means sustained high levels of defaults are needed to impair them. From a fundamental perspective, they're very high quality. So CLOs are currently at the epicenter for dislocation, but we are seeing very attractive opportunities across the securitized credit spectrum. That ranges from mortgage-backed securities both in the residential and commercial space, as well as other ABS asset classes.

Relative value versus other assets – exactly how much value is there?

Tom Mowl: In order to monitor the relative value between securitized credit and other fixed income asset classes, we can compare the spread on offer for similarly rated tranches of ABS securities to their corporate counterparts. For example, let's compare the spreads on offer in BB-rated CLOs to their European high-yield counterpart. Looking at the basis and spreads over the last five years, the average difference between the CLO spread and the corporate spread has been around 400 basis points. Whereas, today, that basis has increased to around 750 basis points, so, much wider than historical levels. In fact, in line with what we've seen in the COVID era. Now this phenomenon isn't only true of the BB-rated tranches, but it's also true across the capital structure. Whether you're talking about high-grade tranches, so AAAs and AAs, but also the more medium investment grade tranches, BBBs and single-As.

Apart from relative value – why does securitized credit make sense for investors today?

Lucy Best: Aside from the attractive absolute and relative value on offer in securitized credit, there are a number of other factors of the asset class that make it very attractive today. One of these is the fact that most of the asset class is floating rate. A dynamic that we've seen over the last couple of years is that longer duration assets that are interest rate sensitive have underperformed those assets that are floating rate. For example, with investment grade, long dated fixed rate investment grade corporate bonds have underperformed the floating rate investment grade ABS securities. While much of the move in rates has already happened or has at least been priced in by markets, there's still a lot of uncertainty and volatility that could affect interest-rate-sensitive bonds. As such, the floating rate nature of the asset class is just one of the factors that is a real benefit for investors today.

Tom Mowl: The second factor, and probably the most important in today's market environment is protection against defaults. All securitized credit are backed by collateral and, on top of that, you get extra protection from the structure, which means that, in total, you get a large protection against an increase in defaults. Now, if we continue with our CLO example, we can see how much protection you actually get.

If we look at how many cumulative defaults that BB and BBB-rated CLOs can withstand before the bonds themselves are impaired, BB-rated CLOs can withstand around 40% cumulative defaults and BBBs around 60%. Now, if we compare this to historical credit cycles, the level of protection afforded by these tranches is much in excess of what we have witnessed historically. If we look back at the last three cycles, being the early '90s, the late '90s, early 2000 cycle and the global financial crisis, the cumulative defaults in all three of these cycles peaked at around 20% to 25% - so you get a large protection from CLO bonds. So, in summary, securitized credit offers a high protection against defaults, at the same time, offering very attractive yields for investors to generate outsized returns.

What are the downside risks from here?

Tom Mowl: So, what are the downside risks from here? There are certainly chances that asset valuations can go lower from where they are today. We are in an extremely uncertain macroeconomic environment. However, we believe that the valuations on offer today in securitized credit are extremely compelling and offer an excellent entry point.

How is the BlueBay Fixed Income Team best placed to take advantage of the opportunity?

Lucy Best: We are experienced. We currently manage around 5 billion in AUM across a range of securitized credit products that offer investors varying risk-return profiles. Our growth has been driven by our strong track record, alongside our ability to create unique products for investors to capitalise on market opportunities. We are active across asset types, regions, and up and down the capital structure and our global presence is one of the reasons that we are able to assess relative value opportunities and enhance our sourcing capabilities.

Our global securitized credit team are true veterans of the asset class with on average 16 years of investment experience. We have specialist experts across a range of asset types and across regions who have been in the market through multiple cycles. Our team is well-supported by the broader BlueBay investment platform, and experts in areas such as leveraged finance and emerging markets plays into our investment process. We're also ready to take advantage of this opportunity set. We felt that the market dislocation was coming due to the building macro factors at the start of the year, so we are ready to take advantage of the entry point today.

We're reaching out to our investor base to highlight the attractive opportunities in securitized credit. We feel that the time is now for securitized credit and we are ready to take advantage of it.

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