

FEBRUARY 2024

# SECURED FINANCE

## ACHIEVING LIQUIDITY FROM ILLIQUID ASSETS

ACHIEVING THE CASHFLOWS AND THE CERTAINTY OF THOSE CASHFLOWS REQUIRED BY INVESTORS DOES NOT MEAN AVOIDING ILLIQUID ASSETS. THROUGH CONSIDERED EXPERT INVESTMENT, SECURED FINANCE CAN NATURALLY PROVIDE INVESTORS THE CASHFLOWS THEY NEED, WHEN THEY NEED THEM.

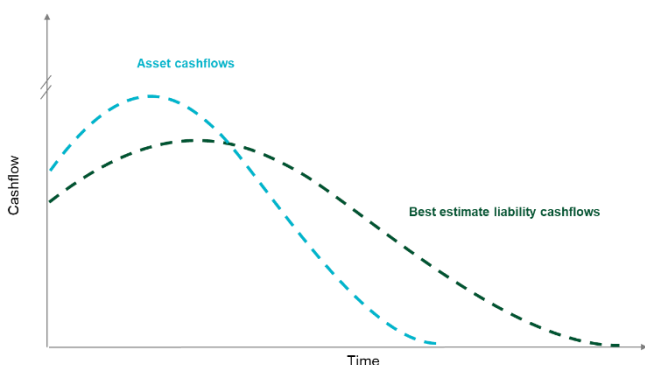
- Secured finance has some key attractive characteristics that any investor can make work to their advantage. Too often secured finance is dismissed as a viable investment, being regarded as illiquid, but illiquidity has different shades.
- Many investors' impression of secured finance is rooted in a past that is distinctly different to the present.
- Expert application of secured finance assets have the potential to deliver investment objectives of most clients, so it may play a valuable role in any broad investment portfolio.

### ILLIQUID ASSETS CAN PROVIDE LIQUIDITY NATURALLY

Citing illiquidity for not holding secured finance may mean missing some critical and attractive features of the asset class, as they may still be completely capable of meeting liquidity requirements. If they pay coupons or mature naturally before the need for cash arises (what we call 'natural liquidity'), concerns about not being readily saleable in the open market may be overstated. Consequently, illiquid assets can play an important part of a maturing asset base – particularly secured finance with a relatively short maturity profile.

For our UK pension scheme clients, we typically use assets with up to approximately three years to maturity. This means they can play a role so long as the total amount held is less than the expected liability cashflow (below the green line in Figure 1).

Figure 1: In early years, excess asset cashflows over liabilities could help to improve resilience



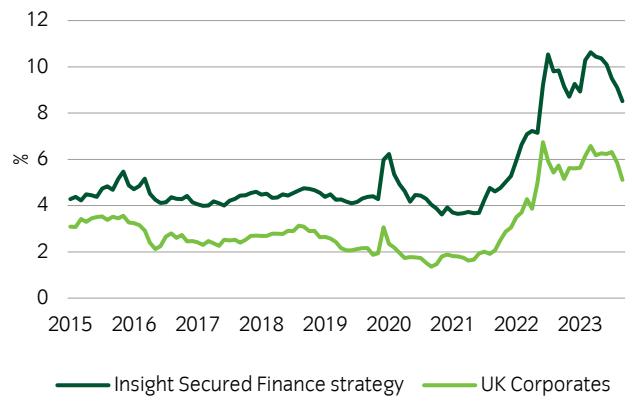
Source: Insight. For illustrative purposes only. Please refer to the risk disclosures at the back of this document.

### YIELD APPEAL

For schemes with suitable time horizons, switching from public assets into private markets as they come closer to maturity may also provide a yield enhancement. The credit spread on public market assets typically tightens for short maturities, so there is potential for a yield pick-up by moving into private assets.

The last time yields on the broad investment grade (IG) UK corporate market exceeded 6% was before the 2008 global financial crisis. Similarly, it has been a long time since IG secured finance had yields available around current levels (see Figure 2).

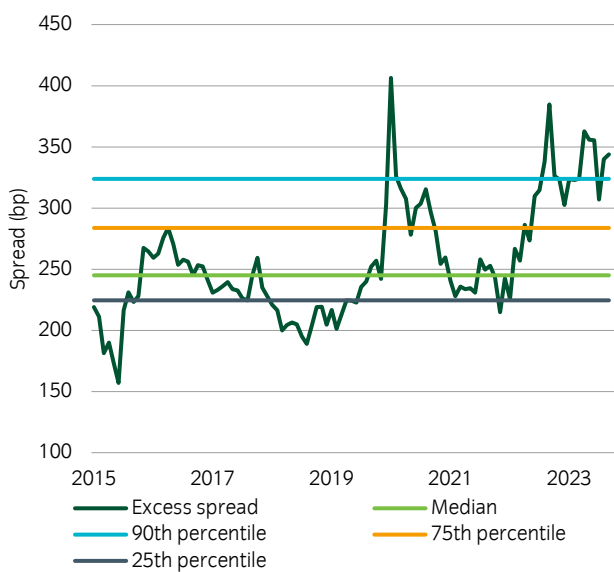
Figure 2: Yields have moved sharply higher along with short-term interest rates



Source: Insight, Bloomberg. As at 31 December 2023. Insight Secured Finance strategy yield is the discount margin on the representative portfolio plus the generic 3-year GBP swap rate. UK Corporates represented by Yield to Worst on ICE BofA UK Corporate Index (UR00).

In addition to the attractive absolute levels of yields, defined benefit (DB) pension schemes may find the amount of additional yield that a secured finance strategy currently offers over comparable corporate bonds appealing. The excess spread level of Insight's Secured Finance strategy over an equivalent sterling corporate market index is currently more than 300 basis points (bp), as illustrated in Figure 3. That is within the top quartile of what has been available since the strategy's representative portfolio began in 2015 (see Figure 3). During that period the average excess spread available has been close to 250bp.

Figure 3: Secured finance – excess spread over sterling corporate bonds



Source: Insight, Bloomberg. As at 31 December 2023. Discount margin on Insight Secured Finance strategy representative portfolio versus ICE BofA Corporate Index (UR00).

### NOT ALL ILLIQUID ASSETS ARE THE SAME

While secured finance may be viewed as illiquid, it has materially different characteristics to perpetual assets such as private equity or long dated infrastructure projects.

The degree of liquidity available is unlikely to be uniform across all illiquid asset classes. That means different categories of assets with limited liquidity are likely to have different characteristics and different appeal in the broader portfolio construction decision process.

Table 1: Illiquid asset characteristics

Type of illiquid asset	Principal and interest paid	Investment grade quality	Typical average maturity
Private secured finance (e.g. asset backed)	Yes	Yes	1-2 years
Private debt (e.g. middle market corporates)	Yes	Not generally	5-7 years
Private equity	No	No	7-10 years

Source: Insight. For illustrative purposes only

### TRANSFORMING SECURED ASSETS INTO NATURAL LIQUIDITY

Secured finance may benefit materially from natural liquidity if designed appropriately, even if they may face difficulty in being sold prior to maturity.

Insight is a market leader in providing risk management solutions. Pension schemes with an excess of maturing assets do not have to be forced sellers to meet liquidity needs.

An added benefit for pension schemes is that, if the portfolio is structured as such, the collateral adequacy of the scheme could steadily be topped up over time, as more than 100% of outflows could be met from maturing assets.

#### Secured finance assets – a refresher

##### What is secured finance?

The secured finance market, which includes asset-backed securities (ABS), is a credit market in which the coupons and principal payments are backed by, and frequently derived from underlying pools of loans that act as the collateral.

The key difference between secured finance and more mainstream corporate bonds is that the latter are typically unsecured (particularly in the investment grade market) and also offer comparatively little in the way of structural protection.

##### How ABS are structured

Banks create ABS structures by taking loans from their books (such as mortgages previously written to customers) into a separate legal structure known as a special purpose vehicle (SPV). The loans are then repackaged into bond structures that investors can buy.

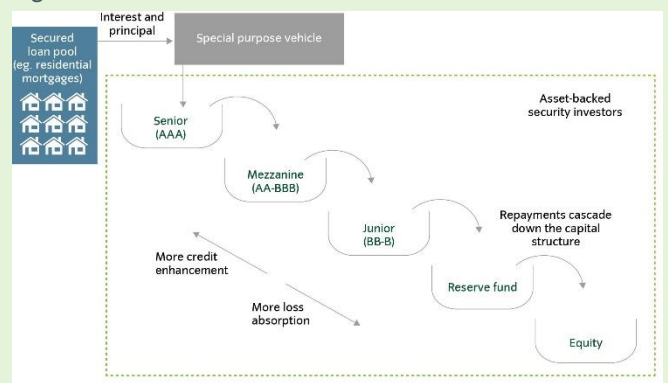
##### How ABS can enhance credit quality

ABS are structured into different classes of bonds with different credit ratings.

As Figure 4 illustrates, the principal and interest payments from the underlying loan pools flow through to the SPV which then distributes the payments to holders of the highest-rated bonds (senior bondholders) first. Only once these bondholders have been paid in full are proceeds distributed to the holders of lower-rated bonds (mezzanine or junior). This cascading pattern continues all the way down the capital structure and is known as a ‘waterfall’ structure.

Effectively, the bonds higher up the capital structure have a higher credit quality than the underlying loan pool in aggregate because they will generally still be repaid even if a portion of the underlying loans default. We call this process ‘credit enhancement’. However, those at the bottom of capital structure would suffer losses immediately should loans in the pool begin to go bad, hence they are called ‘loss absorbing’.

Figure 4: Secured finance “waterfall”



Source: Insight. For illustrative purposes only.

## IMPORTANT INFORMATION

### TEN-YEAR PERFORMANCE RECORD TO 31 DECEMBER 2023

	Calendar year returns									
	2023	2022	2021	2020	2019	2018	2017	2016	2015	2014
Insight secured finance strategy	9.17	0.52	5.83	0.37	5.20	2.59	7.59	6.82	--	--
SONIA	4.77	1.42	0.06	0.29	0.80	0.72	0.35	0.50	--	--

	12-month rolling returns									
	2023	2022	2021	2020	2019	2018	2017	2016	2015	2014
Insight secured finance strategy	9.17	0.52	5.83	0.37	5.20	2.59	7.59	6.82	--	--
SONIA	4.77	1.42	0.06	0.29	0.80	0.72	0.35	0.50	--	--

Please refer to the following risk disclosures. Returns are shown gross of fees. The Insight secured finance strategy (C0937) is in GBP. Inception date: 27 November 2015.

### RISK DISCLOSURES

**Past performance is not indicative of future results. Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.**

The performance results shown, whether net or gross of investment management fees, reflect the reinvestment of dividends and/or income and other earnings. Any gross of fees performance does not include fees, taxes and charges and these can have a material detrimental effect on the performance of an investment. Taxes and costs incurred when purchasing, holding, converting or selling any investment, will impact returns. Costs may increase or decrease as a result of certain currency conversions, such as currency hedging, and exchange rate fluctuations.

Any target performance aims are not a guarantee, may not be achieved and a capital loss may occur. The scenarios presented are an estimate of future performance based on evidence from the past on how the value of this investment varies over time, and/or prevailing market conditions and are not an exact indicator. They are speculative in nature and are only an estimate. What you will get will vary depending on how the market performs and how long you keep the investment/product. Strategies which have a higher performance aim generally take more risk to achieve this and so have a greater potential for the returns to be significantly different than expected.

Any projections or forecasts contained herein are based upon certain assumptions considered reasonable. Projections are speculative in nature and some or all of the assumptions underlying the projections may not materialize or vary significantly from the actual results. Accordingly, the projections are only an estimate.

Portfolio holdings are subject to change, for information only and are not investment recommendations.

### ASSOCIATED INVESTMENT RISKS

#### Secured Finance Fund

- A credit default swap (CDS) provides a measure of protection against defaults of debt issuers but there is no assurance their use will be effective or will have the desired result.
- Derivatives may be used to generate returns as well as to reduce costs and/or the overall risk of the portfolio. Using derivatives can involve a higher level of risk. A small movement in the price of an underlying investment may result in a disproportionately large movement in the price of the derivative investment.
- Investments in bonds are affected by interest rates and inflation trends which may affect the value of the portfolio.
- The investment manager may invest in instruments which can be difficult to sell when markets are stressed.
- Where leverage is used as part of the management of the portfolio through the use of swaps and other derivative instruments, this can increase the overall volatility. While leverage presents opportunities for increasing total returns, it has the effect of potentially increasing losses as well. Any event that adversely affects the value of an investment would be magnified to the extent that leverage is employed by the portfolio. Any losses would therefore be greater than if leverage were not employed.
- The specific collateral used to secure a loan may decline in value or become illiquid, which would adversely affect the loan's value. Also, many loans are not actively traded, which may impair the ability of the portfolio to realise full value in the event of the need to liquidate such assets.
- Property assets are inherently less liquid and more difficult to sell than other assets. The valuation of physical property is a matter of the valuer's judgement rather than fact.



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