Insight INVESTMENT

AUGUST 2024

A SECURED FINANCE PRIMER
CAPTURING VALUE BY UNDERSTANDING AND EXPLOITING COMPLEXITY

We believe secured finance may be a rare example of an asset class that has the potential to regularly provide higher returns for lower risk than other credit assets.

EXECUTIVE SUMMARY

We believe that secured finance is a greatly underappreciated fixed income asset class. This may be due to the complexity of the analysis required to understand the asset class properly, the lower levels of liquidity in private debt assets or even legacy issues relating to the tribulations of the 2008 global financial crisis. From a credit risk perspective, potential investors may not be aware that defaults[1] have been rare in the secured finance markets. Despite such rarity, secured finance frequently offer a higher return than corporate bonds of similar or even higher credit quality, driven by the complex nature of the analysis required to properly analyse and model each asset. This represents an exploitable premium for investors rather than having to take more credit risk to improve returns. Consequently, secured finance could be considered one of the most defensive yet rewarding sources of yield currently available in the fixed income markets.

SECURED FINANCE DE-MYSTIFIED

What is secured finance?

The secured finance market, which includes asset-backed securities (ABS), is a credit market in which the interest (coupons) and principal payments are backed by a ring-fenced pool of underlying loans and are often "secured" against either a set of assets or a defined set of cash flows.

Examples of these loans can include residential or commercial mortgages or corporate loans, many of which are secured against hard assets, like real estate, which can provide investors protection in the event the underlying borrower defaults.

Broadly, three types of collateral are common in the market: residential and consumer, commercial real estate and secured corporate, as illustrated in Figure 1. Instruments backed by these types of collateral can either be in publicly traded instruments (ABS) or private, bilateral loans (such as commercial real estate loans).

Figure 1: Secured finance market breakdown[2]

	Residential and consumer	Commercial	Secured corporates
Public securities	• Prime residential mortgages • Buy-to-let mortgages • Consumer ABS	• Commercial mortgage securities • CRE CLOs • Multi-family	• Collateralised loan obligations (CLOs) • Whole business securitisations
Private debt	• Mortgage pools • Bridging finance • Auto/credit card pools	• Office • Retail • Hotel	• Corporate loan warehouse • Small medium enterprise pools • Trade finance

Investors also could potentially benefit from other protections beyond collateral assets providing security, such as covenant packages, which are essentially terms and conditions that help lenders manage the risk of default and "credit enhancement" where the structure of the deal provides for additional protection in the form of more junior bond holders or a reserve account or equity holding that face losses before investors.

A 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 are secured finance instruments structured?

Banks create a separate legal structure known as a **special purpose vehicle (SPV)**. This SPV issues bonds or loans that essentially fund the purchase of a defined pool of loans (such as residential mortgages) from the originating bank.

This step may sound like a technicality, but it is crucial, as it means that the SPV is '**bankruptcy remote**' from the originating bank. This means if the originating bank goes bust, it will have no direct impact on the secured finance or ABS instruments. The credit risk for investors is to the underlying mortgages being repaid, not the originating bank. This is what differentiates the market from say, covered bonds, which, despite their security,

[1] Defined as securities S&P Global has downgraded to a D rating, or the equivalent by other credit rating agencies.

[2] Source: Insight. For illustrative purposes only. As at 31 July 2024

still ultimately leave investors exposed to the issuing bank's credit risk.

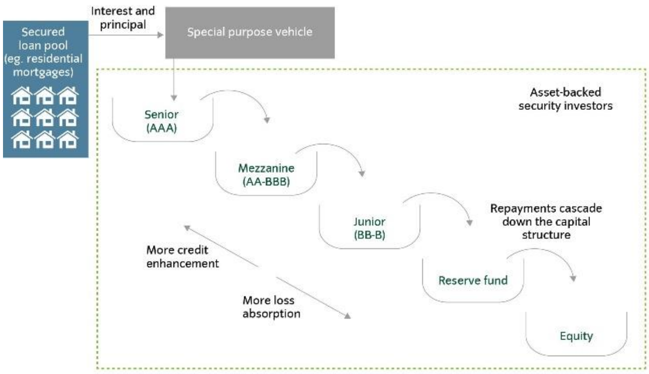
How secured finance or ABS enhance credit quality

Secured finance and ABS instruments are structured into different classes of bonds with different credit ratings.

As Figure 2 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. Typically, 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 2: Secured finance "waterfall"[3]

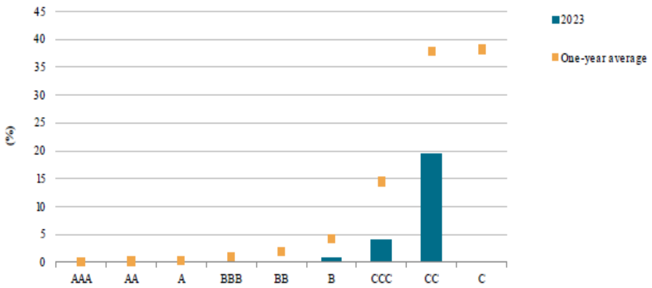


SECURED FINANCE – MORE DEFENSIVE THAN YOU MIGHT THINK

Many investors may not appreciate that much of the global ABS market has suffered little or no defaults at all. In 2008, global ABS markets weathered the crisis outside the problem areas of US subprime mortgage bonds, US collateralized debt obligations (CDOs) and commercial real estate markets. Despite this, for some with little knowledge of the ABS market, the asset class is synonymous with the global financial crisis of 2008, given the fall-out that related to the subprime mortgage bond market and the disastrous consequences it brought.

A report by S&P Global[4], showed the investment grade (IG) sectors (rated AAA to BBB) of the secured finance universe, have suffered very few defaults over the long term (Figure 3). Although there were more defaults in 2023 than there were in 2022, of the 441 defaults, just five were from the four IG rating categories. At 0.02%, the IG default rate was still well below the longer-term of 0.2% per year. The vast majority occurred in the CCC and CC rating bands of the speculative grade (high yield) universe.

Figure 3: Default rates remain largely confined to the speculative grade level[3]



US: low defaults beyond the subprime housing nightmare

Data compiled by S&P, of US ABS sectors including student loans, auto loans and credit card ABS shows that from 1983 – 2023 the one-year average default rate has been just 0.40% including speculative grade exposures[3], although for 2023, there was an uptick to 0.40% after 0.04% in 2022, which was the lowest rate since 2000. Even during the global financial crisis, the trailing 12-month default rate did not rise above 1% and the last time an IG rated default in the US ABS sectors was recorded was in 2010[3].

Europe: remarkable resilience through various crises

Outside the US, secured finance has also shown remarkable levels of resilience. Investment grade tranches of European ABS have exhibited low levels of default, with zero average default rates in prime UK and Dutch RMBS from 1988 - 2022, according to S&P[5]. The average one-year default rate for European leveraged loan CLOs was 0.1% over the same period and 0.2% across IG commercial MBS.

Default rates are even lower in more senior tranches, with the weighted average one-year default rate in IG-rated European RMBS of just 0.04%[4]. Many of these markets benefit from the recourse nature of the loans, in particular RMBS, as well as the tougher regulatory regimes in place in the aftermath of the global financial crisis in 2008.

SECURED FINANCE – A RARE EXAMPLE OF HIGHER RETURNS FOR LOWER RISK?

Traditionally, in our view, investors expect that, to achieve higher returns they must be comfortable with taking more risk. This assumption has been a cornerstone of portfolio theory since the original mean-variance models of the 1950s.

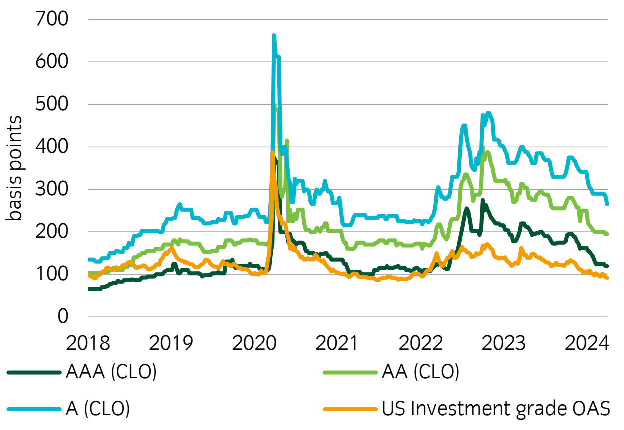
[3] Insight. For illustrative purposes only.

[4] S&P Global Ratings, "2023 Annual Global Structured Finance Default Study and Rating Transitions", March 2024

[5] S&P Global Ratings "2022 Annual European Structured Finance Default and Rating Transition Study", July 2023

However, secured finance may challenge that assumption. We have seen that ABS markets can offer higher credit spreads than comparable corporate bonds with lower credit ratings. An example of this is provided in Figure 4 – where AAA US CLOs offer comparable credit spreads to the US investment grade credit index, which is unsecured and today has more than a 40% weighting to BBB credit. AA and A-rated CLOs have consistently offered materially higher spreads.

Figure 4: Highly rated US CLO spreads are above investment grade corporate credit which is rated lower[6]



The secured finance 'complexity premium'

We strongly believe the main reason secured finance can frequently offer higher credit spreads for higher credit ratings is because of the complexity of the analysis required to understand each security's composition. Managing secured finance strategies can require additional expertise, which can constrain the number of eligible buyers and leads to more attractive credit spreads. When investing in corporate bonds, investors need to analyse the credit metrics of the company they are investing in. However, when investing in a secured finance or ABS instrument, they may need to analyse every single underlying loan backing a deal. This typically requires a great deal of specialist expertise, resource, and process sophistication. An originator might issue several ABS transactions and each one will be different as it is the collateral and credit enhancements that primarily drives credit risk even if the deal is from the same originator.

Furthermore, as most of the loans underlying a secured finance instrument tend to be floating rate and where the principal payments may vary given the borrower repayment profiles (so may pre-pay or extend), investors need to run mathematical stress tests to gain a good understanding of how they might perform under different economic stress scenarios.

This typically requires sophisticated mathematical modelling techniques. The models allow investors to hypothesize various potential outcomes using the effects of historical recessions (such as the recession in the early 2000s or the 2008 global financial crisis) as well severe alternative stress scenarios, to gain a good understanding of the risks.

Some assets, such as collateralised loan obligations (CLO), pose further challenges. CLOs differ from more standard ABS in that the underlying loan pools are not static – instead they are dynamically managed by a dedicated CLO manager.

This adds an additional layer of due diligence to investors' research: evaluating the CLO portfolio managers, their historical performance, manager style, the manager's platform, organization, resources, underwriting capabilities, as well as their portfolio construction and monitoring processes.

This is all in addition to the line-by-line analysis of all the loans the manager is investing in. Finally, when purchasing multiple CLOs, investors would also need to be wary of collateral overlap as different managers may hold the same securities.

Figure 5: Expertise to overcome the analytical complexity can potentially provide higher spreads for equivalent credit risk[7]

SUCCESSFULLY UNDERSTANDING ASSET COMPLEXITY MAY HELP CAPTURE ATTRACTIVE YIELD AND ADDITIONAL VALUE

It can be challenging for investors to achieve attractive income without migrating up the risk spectrum. We believe secured finance stands out as a compelling option, with higher yields being generally available for a given level of credit risk in what, on close investigation may be considered an asset class that is fundamentally defensive. For investors that have a requirement to generate income, the asset class can be particularly attractive, as they can benefit from sacrificing liquidity that they don't need to enhance the level of income they are looking to generate.

At Insight, we have been managing global secured finance portfolios since before the 2008 financial crisis and through several challenging market environments. We also invest in yet more complex related private secured finance markets across that universe, typically on behalf of our large institutional clients, as those assets may have the potential to achieve further additional yield and returns over time.

We believe that, if investors have access to skilled, experienced, and well-resourced asset managers, then investing in secured

[6] Source:Insight, JP Morgan, ICE BofA US Corporate Index (C0A0) As at 28 June 2024.

[7] For illustrative purposes only.

finance could represent a strong opportunity to which they may be underexposed.

RESPONSIBLE INVESTING IN SECURED FINANCE

We consider ESG factors as part of the fundamental analysis undertaken on both the originators and, where applicable and possible, the underlying collateral. This analysis may form an integral part of our decision-making process and typically includes detailed due diligence on the originators.

More specifically, ESG risks are an integral part of a broader assessment of risk factors such as corporate governance, data quality or regulatory standards. Where applicable, in undertaking our fundamental assessment, we examine the list of individual holdings and potential exposure to sectors, countries or issuers that may indicate ESG risks. As part of this, if a sponsor scores poorly, it would be unlikely to be recommended for investment.

IMPORTANT INFORMATION

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 certain charges, such as currency conversion charges may depend on the individual situation of each investor and are subject to change in future.

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.

ASSOCIATED INVESTMENT RISKS

ESG

- **Investment type:** The application and overall influence of ESG approaches may differ, potentially materially, across asset classes, geographies, sectors, specific investments or portfolios due to the nature of the specific securities and instruments available, the wide range of ESG factors which may be applied and ESG industry practices applicable in a particular investable universe.
- **Integration**: The integration of ESG factors refers to the inclusion of ESG risk factors alongside financial risk factors in investment analysis and research to judge the fair value of a particular investment and may also include the monitoring and reporting of such risks within a portfolio. Integrating ESG factors in this way will not typically restrict the potential investable universe, but rather aims to ensure that relevant and material ESG risks are taken into account by analysts and/or portfolio managers in their decision-making, alongside other relevant and material financial risks.
- **Ratings**: The use and influence of our ESG ratings in specific investment strategies will vary, potentially significantly, depending on a number of factors including the nature of the asset class and the structure of the investment mandate involved. For an investment portfolio with a financial objective, and without specific ESG or sustainability objectives, a high or low ESG rating may not automatically lead to a buy or sell decision: the rating will be one factor among others that may help a portfolio manager in evaluating potential investments consistently.
- **Engagement activity**: The applicability of Insight firm level ESG engagement activity and the outcomes of this activity relating to buy, hold and sell decisions made within specific investment strategies will vary, potentially significantly, depending on the nature of the asset class and the structure of the investment mandate involved.
- **Reporting**: The ESG approach shown is indicative and there is no guarantee that the specific approach will be applied across the whole portfolio.
- **Performance/quality**: The influence of ESG criteria on the overall risk and return characteristics of a portfolio is likely to vary over time depending on the investment universe, investment strategy and objective and the influence of ESG factors directly applicable on valuations which will vary over time.
- **Costs**: The costs described will have an impact on the amount of the investment and expected returns.
- **Forward looking commitments and related targets**: Where we are required to provide details of forward-looking targets in line with commitments to external organisations, e.g. Net Zero Asset Managers Initiative, these goals are aspirational and defined to the extent that we are able to define them and in accordance with the third party guidance provided. As such we do not guarantee that we will meet them in whole or in part or that the guidance will not evolve over time. Assumptions will vary but include whether the investable universe evolves to make suitable investments available to us over time and the approval of our clients to allow us to align their assets with goals in the context of the implications for their investments and issues such as their fiduciary duty to beneficiaries.

Insight applies a wide range of customised ESG criteria to mandates which are tailored to reflect individual client requirements. Individual investor experience will vary depending on the investment strategy, investment objectives and the specific ESG criteria applicable to a Fund or portfolio. Please refer to the investment management agreement or offering documents such as the prospectus, Key Investor Information Document (KIID) or the latest Report and Accounts which can be found at www.insightinvestment.com and where applicable information in the following link for mandates in scope of certain EU sustainability regulations https://www.insightinvestment.com/regulatory-home/sustainability-regulations/; alternatively, speak to your main point of contact in order to obtain details of specific ESG parameters applicable to your investment.

Fixed income

- Where the portfolio holds over 35% of its net asset value in securities of one governmental issuer, the value of the portfolio may be profoundly affected if one or more of these issuers fails to meet its obligations or suffers a ratings downgrade.
- 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.
- The issuer of a debt security may not pay income or repay capital to the bondholder when due.
- 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 emerging markets can be less liquid and riskier than more developed markets and difficulties in accounting, dealing, settlement and custody may arise.
- Investments in bonds are affected by interest rates and inflation trends which may affect the value of the portfolio.
- Where high yield instruments are held, their low credit rating indicates a greater risk of default, which would affect the value of the portfolio.
- The investment manager may invest in instruments which can be difficult to sell when markets are stressed.
- Exposure to international markets means exposure to changes in currency rates which could affect the value of the portfolio.
- 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.

FIND OUT MORE

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