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Investment Perspectives

Investment Brief: Asset Backed Securities (ABS)

An overview of the asset class and its investment characteristics.

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Asset-backed securities (ABS) are investment vehicles collateralized by a broad spectrum of consumer receivables such as credit card receivables, auto loans, and student loans. Exposure to these securities can provide an attractive alternative to investing in conventional corporate debt.

ABS can provide several benefits, both on their own as an asset class and when considered in the context of a portfolio. These potential benefits include:

- A large universe of investible products with a broad range of credit quality and liquidity.
- An attractive and investor-friendly structure.
- An attractive risk/return profile.
- Effective diversification.

With the ABS market representing over $750 billion[1] of outstanding loans, and around $1.6 billion of these securities traded every week, the market offers ample liquidity to manage portfolio risk effectively. Furthermore, there is a significant opportunity for investors across different credit qualities and sectors. This market encompasses many sectors and subsectors, including auto loans, equipment leases, credit card debt, timeshare loans, and more. This diversity provides ample opportunities for investors to gain exposure to different areas of the economy. A well-managed ABS portfolio can align with an investor's outlook on the direction of the economy and regulatory policy, while prioritizing high-quality credit investments.

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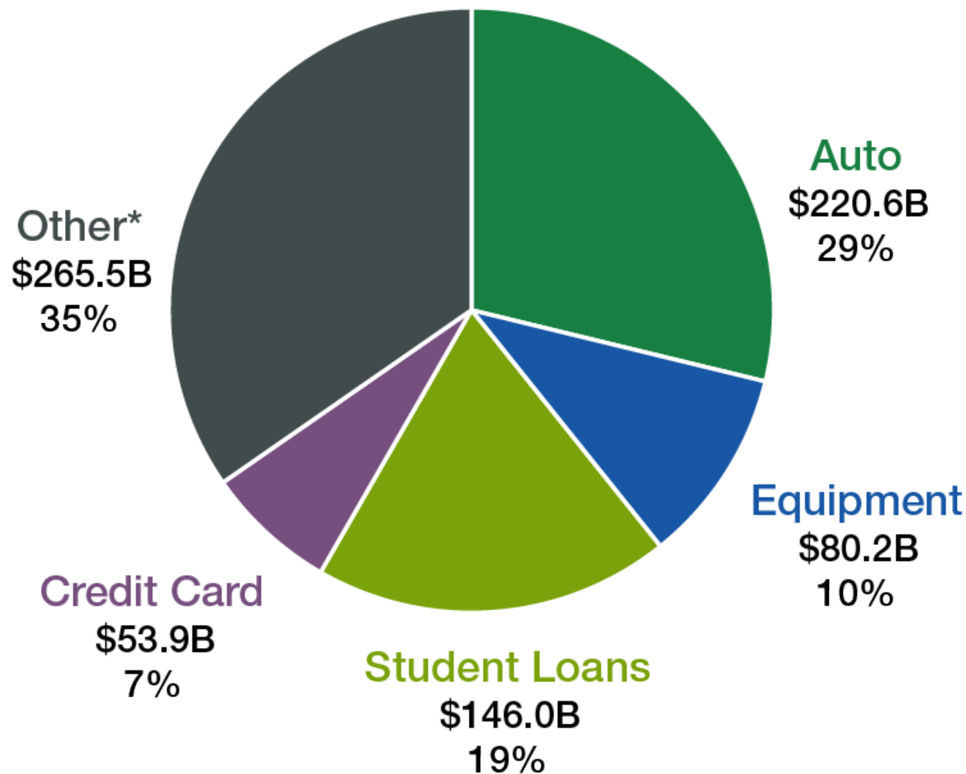
Figure 1. The ABS Market Provides Broad Diversification across Sectors and Subsectors

Composition of outstanding asset-backed securities by type (in billion US$), as of December 31, 2022



*Aggregates numerous subsectors not listed, such as timeshare, cell phone contracts, floorplan, motorcycle, etc.
Source: SIFMA. Latest available data. For illustrative purposes only.

Two Levels of Potential Protection for Investors

ABS provide two forms of increased protection for investors beyond any loss expectations of the initial loans. First, ABS are typically set up as bankruptcy-remote special purpose vehicles (SPVs), meaning that investors are not exposed to any financial difficulties of the sponsor. For example, if an auto lender faces bankruptcy, ABS investors are not affected—they will only be exposed to the performance of the consumer loans, which will still be collateralized by cars. Creditors of the lender do not have access to these assets.

Second, ABS structures provide varying levels of additional credit enhancement for investors. This credit enhancement provides an additional cushion for investors in case the loans perform worse than initial assumptions at the time of underwriting. This credit enhancement is a key part of structuring ABS transactions and is a primary factor in considering credit viability. Investors in AAA-rated ABS, for example, with substantial credit enhancement, have never experienced credit losses, even during times of significant consumer stress and rising loan defaults, as we discuss on the next page.

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There are two primary types of credit enhancements: internal and external.

1. Internal Credit Enhancements: These are structural features built into the securitization transaction itself. They include:

- **Subordination (Senior/Junior Structure):** Here, the ABS is divided into multiple tranches, or levels, of risk. The senior tranche has the lowest risk because it is first in line to receive payments from the underlying assets, and last in line for absorbing losses. The junior tranches, or subordinated tranches, are last in line for receiving payments and first in line for absorbing losses.
- **Overcollateralization:** This refers to the situation when the total value of the underlying assets exceeds the value of the securities issued. It provides a cushion to absorb potential losses from the underlying asset pool.
- **Excess Spread:** This refers to the difference between the interest received from the underlying assets and the interest paid to the security holders. This difference can be used to cover losses on the asset pool.

2. External Credit Enhancements: These are third-party guarantees offered to cover the risk of the ABS. They include:

- **Surety Bonds:** This is a contract under which one party (the surety) guarantees the performance or obligations of another party.
- **Letter of Credit:** This is a letter from a bank guaranteeing that a buyer's payment to a seller will be received on time and for the correct amount.
- **Insurance:** An insurance company might guarantee the performance of the assets or some portion of the ABS.

All of these credit enhancements can increase the attractiveness of an ABS to investors by reducing the risk associated with the investment. They can also help the securities achieve a higher rating from credit rating agencies, which can also make them more attractive to investors.

Consider, for example, the Class C tranche of a subprime auto deal (see Figure 2). While the initial credit enhancement at the time of underwriting is 25.75%, meaning that investors are completely protected in the event of deal losses from defaults of up to 25.75%, the amount of credit enhancement can actually increase (referred to as "deal thickening"). This happens when excess cashflow coming into the deal accrues to various layers of the deal. Note that the allocation of this excess cashflow can be highly deal-specific, depending on the underwriting terms. In this case, after one year of excess cash from strong collateral performance, the credit enhancement increases to be roughly equivalent to that of a tranche with a higher credit rating at the time of underwriting (typically resulting in an upgrade). Investors with a deep understanding of deal structure can take advantage of such opportunities to find the tranches most sensitive to loan outperformance, making for excellent opportunities for active management.

Figure 2. How Credit Enhancement for an ABS Deal Can Evolve Over Time

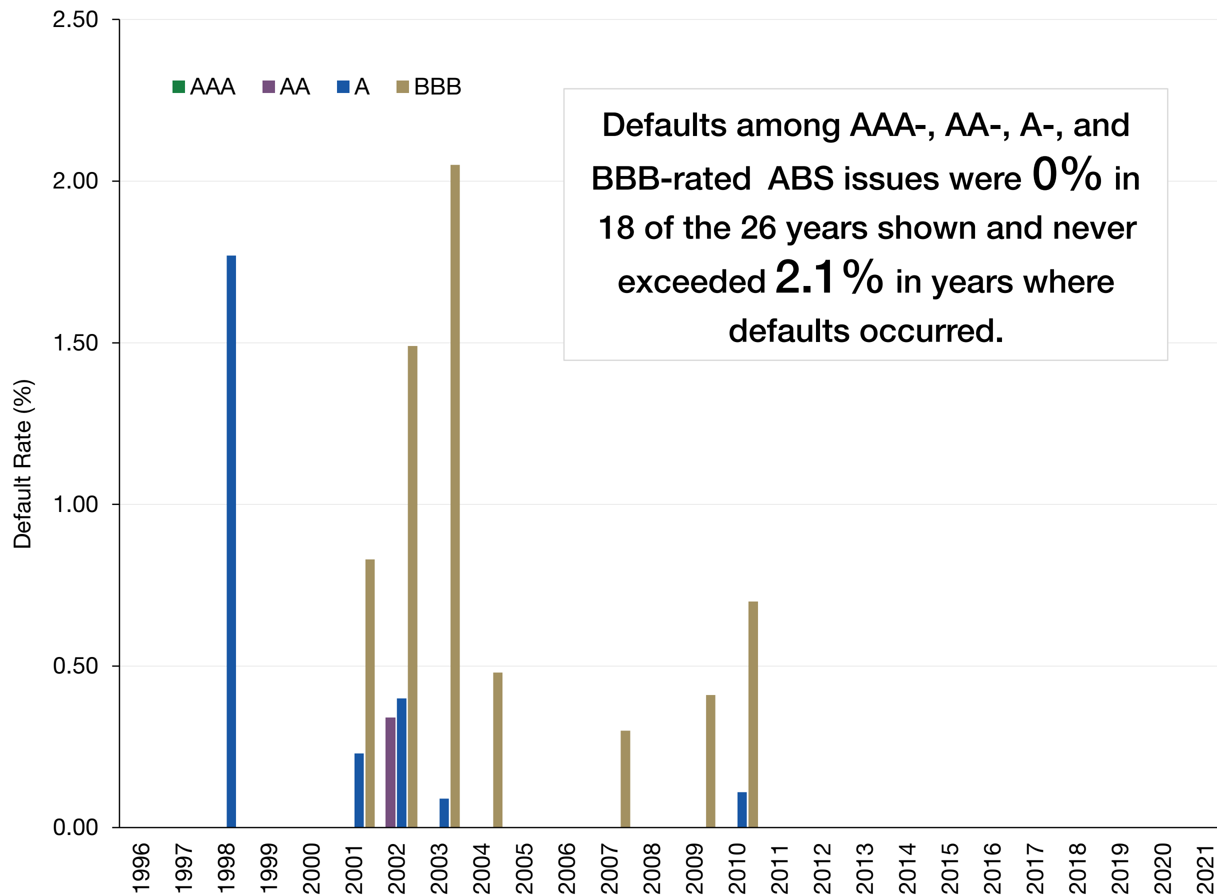
Credit enhancement levels for a hypothetical Class C tranche of a subprime auto-loan ABS

Source: Lord Abbett. An asset-backed security consists of different tranche classes. The senior tranche, A, is almost always the largest tranche and is structured to have an investment-grade rating to make it attractive to investors. The other tranches (B, C, and D) are of correspondingly lower credit quality. The chart shows how the level of credit enhancements in a hypothetical Class C tranche of a subprime auto-loan ABS can change over a 12-month period, based on the structure of the deal. This is a hypothetical example and is not intended to represent the performance of any specific portfolio managed by Lord Abbett or any particular investment.

Credit ratings and actual losses for ABS issues compare favorably with credit ratings in corporate credit. While investors understandably worry about the potential for losses during economic downturns, at the AAA level, default rates have been zero (see Figure 3), even during the Global Financial Crisis of 2008–09, because of consistent underwriting standards and the protections discussed above.

Figure 3. Historically, ABS Have Seen Very Low Default Rates

One-year default rates by ratings category, 1996–2021



Source: S&P Global Ratings. Most recent data available. Subject to change based on changes in the market. For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment.

While there remain headwinds to certain segments of the ABS market, others are experiencing tailwinds, presenting a significant opportunity for those that can discern between them and price risk appropriately. Below are three examples of some of our largest positions to highlight the opportunity in the market.

ABS: Three Recent Opportunities

Example 1: AA-rated prime lease from a major OEM

High prime portfolio (780 weighted average FICO) and ~91% lease to value. The AA-rated tranche was issued with 14.8% hard credit enhancement, which presents a cushion considering no redeemed deals from this issuer have had any accumulated losses at the collateral level.

YTM	OAS (bps)	WAL (yrs)	Hard Credit Enhancement
5.2%	170	2.50	14.8%

Example 2: AAA-rated consumer loan ABS

Another example of structural protection far exceeding the prospective loss potential of the collateral. The transaction offered an initial hard credit enhancement of 21.50% and annual excess cashflow of ~14%, which compared favorably to the worst performing transactions from the issuer having ~7% cumulative net losses. The structure also offered delinquency and default triggers that would pay down this senior tranche early if breached. These loans tended to be short term, with a weighted average original term of 11 months for the 675 WA FICO portfolio.

YTM	OAS (bps)	WAL (yrs)	Hard Credit Enhancement
7.3%	291	1.71	21.5%

Example 3: AAA-rated bank card

Revolving master trust structure with 22% hard credit enhancement and ~10% annual excess cashflow. The portfolio is prime with 71% of the collateral having greater than 700 FICO and 44% > 750 FICO. The trust also sports a very seasoned portfolio with the typical account 16 years old.

YTM	OAS (bps)	WAL (yrs)	Hard Credit Enhancement
5.2%	130	2.98	22.0%

Source: Lord Abbett. YTM=Yield to maturity. OAS=Option-adjusted spread. WAL=Weighted average life. Hard Credit Enhancement=Excess of the asset portfolio balance over the liability balance. BPS=basis points; one basis point equal one one-hundredth of a percentage point. FICO=Credit score used to judge prospective borrowers' creditworthiness for various types of consumer loans. Securities are referenced to illustrate investment strategies and are not intended to constitute investment recommendations.

Putting ABS into Context in a Portfolio

As attractive as ABS can be, we believe the asset class is best owned in the context of a multi-sector portfolio with varied avenues for liquidity. ABS tranches can be considerably less liquid than typical corporate bonds, though having a network of relationships as a large buyer in the space certainly helps. We use this asset class, along with other fixed-income vehicles such as commercial mortgage-backed securities (CMBS), which typically are backed by commercial real estate, and corporate and government bonds, to diversify the risks of each end market and diversify the liquidity risk of the portfolio, leaving us in a flexible position to capture attractive relative value opportunities as they arise.

[1]ABS market data from SIFMA; excludes collateralized debt obligations (CDOs).

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Unless otherwise noted, all discussions are based on U.S. markets and U.S. monetary and fiscal policies.

References to fund yields are for informational purposes only and are not meant to represent any specific Lord Abbett bond fund or portfolio.

Asset allocation or diversification does not guarantee a profit or protect against loss in declining markets.

No investing strategy can overcome all market volatility or guarantee future results.

The value of investments and any income from them is not guaranteed and may fall as well as rise, and an investor may not get back the amount originally invested. Investment decisions should always be made based on an investor's specific financial needs, objectives, goals, time horizon, and risk tolerance.

Market forecasts and projections are based on current market conditions and are subject to change without notice.

Projections should not be considered a guarantee.

Dividends are not guaranteed and may be increased, decreased, or suspended altogether at the discretion of the issuing company.

Dividend policy: A stock is classified as a dividend payer if it paid a cash dividend any time during the previous 12 months; a dividend grower if it initiated or raised its cash dividend at any time during the previous 12 months; and a non-dividend payer if it did not pay a cash dividend at any time during the previous 12 months.

Equity Investing Risks

The value of investments in equity securities will fluctuate in response to general economic conditions and to changes in the prospects of particular companies and/or sectors in the economy. While growth stocks are subject to the daily ups and downs of the stock market, their long-term potential as well as their volatility can be substantial. Value investing involves the risk that the market may not recognize that securities are undervalued, and they may not appreciate as anticipated. Smaller companies tend to be more volatile and less liquid than larger companies. Small cap companies may also have more limited product lines, markets, or financial resources and typically experience a higher risk of failure than large cap companies.

Fixed-Income Investing Risks

The value of investments in fixed-income securities will change as interest rates fluctuate and in response to market movements. Generally, when interest rates rise, the prices of debt securities fall, and when interest rates fall, prices generally rise. High yield securities, sometimes called junk bonds, carry increased risks of price volatility, illiquidity, and the possibility of default in the timely payment of interest and principal. Bonds may also be subject to other types of risk, such as call, credit, liquidity, and general market risks. Longer-term debt securities are usually more sensitive to interest-rate changes; the longer the maturity of a security, the greater the effect a change in interest rates is likely to have on its price.

The credit quality of fixed-income securities in a portfolio is assigned by a nationally recognized statistical rating organization (NRSRO), such as Standard & Poor's, Moody's, or Fitch, as an indication of an issuer's creditworthiness. Ratings range from 'AAA' (highest) to 'D' (lowest). Bonds rated 'BBB' or above are considered investment grade. Credit ratings 'BB' and below are lower-rated securities (junk bonds). High-yielding, non-investment-grade bonds (junk bonds) involve higher risks than investment-grade bonds. Adverse conditions may affect the issuer's ability to pay interest and principal on these securities.

Glossary & Index Definitions

Asset-backed security (ABS) is a financial security backed by a loan, lease or receivables against assets other than real estate and mortgage-backed securities. For investors, asset-backed securities are an alternative to investing in corporate debt.

Spread is the percentage difference in current yields of various classes of fixed-income securities versus Treasury bonds or another benchmark bond measure. A bond spread is often expressed as a difference in percentage points or basis points (which equal one-one hundredth of a percentage point). The option-adjusted spread (OAS) is the measurement of the spread of a fixed-income security rate and the risk-free rate of return, which is adjusted to take into account an embedded option. Typically, an analyst uses the Treasury securities yield for the risk-free rate.

Tranches are a collection of securities that are separated and grouped based on various characteristics and sold to investors. Tranches can have different maturities, credit ratings, and yields–or interest rates.

Weighted average life refers to the length of time that each unit of unpaid principal in a debt obligation is expected to remain outstanding.

Yield to maturity (YTM) represents the expected return (expressed as an annualized rate) from the bond's future cash flows, including coupon payments over the life of the bond and the bond's principal value received at maturity.

Yield to worst (YTW) is the lowest yield that can be paid on a bond, assuming the issuer does not default. The calculation takes into consideration worst-case scenarios in which the bond would be paid prior to maturity. It is assumed the bond will be prepaid if current interest rates are lower than the current coupon rate.

The **Bloomberg U.S. CMBS Investment Grade Index** measures the market of U.S. Agency and U.S. Non-Agency conduit and fusion CMBS deals with a minimum current deal size of $300 million. The Bloomberg U.S. CMBS 1-3.5 Year Index is a maturity-specific subset of the Bloomberg U.S. CMBS Investment Grade Index.

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