Expert Views on Asset-Backed Securities (ABS) in Volatile Markets

Lord Abbett investment leaders discuss the current environment for ABS—and how aspects of these securities designed to protect investors might work during an economic downturn.

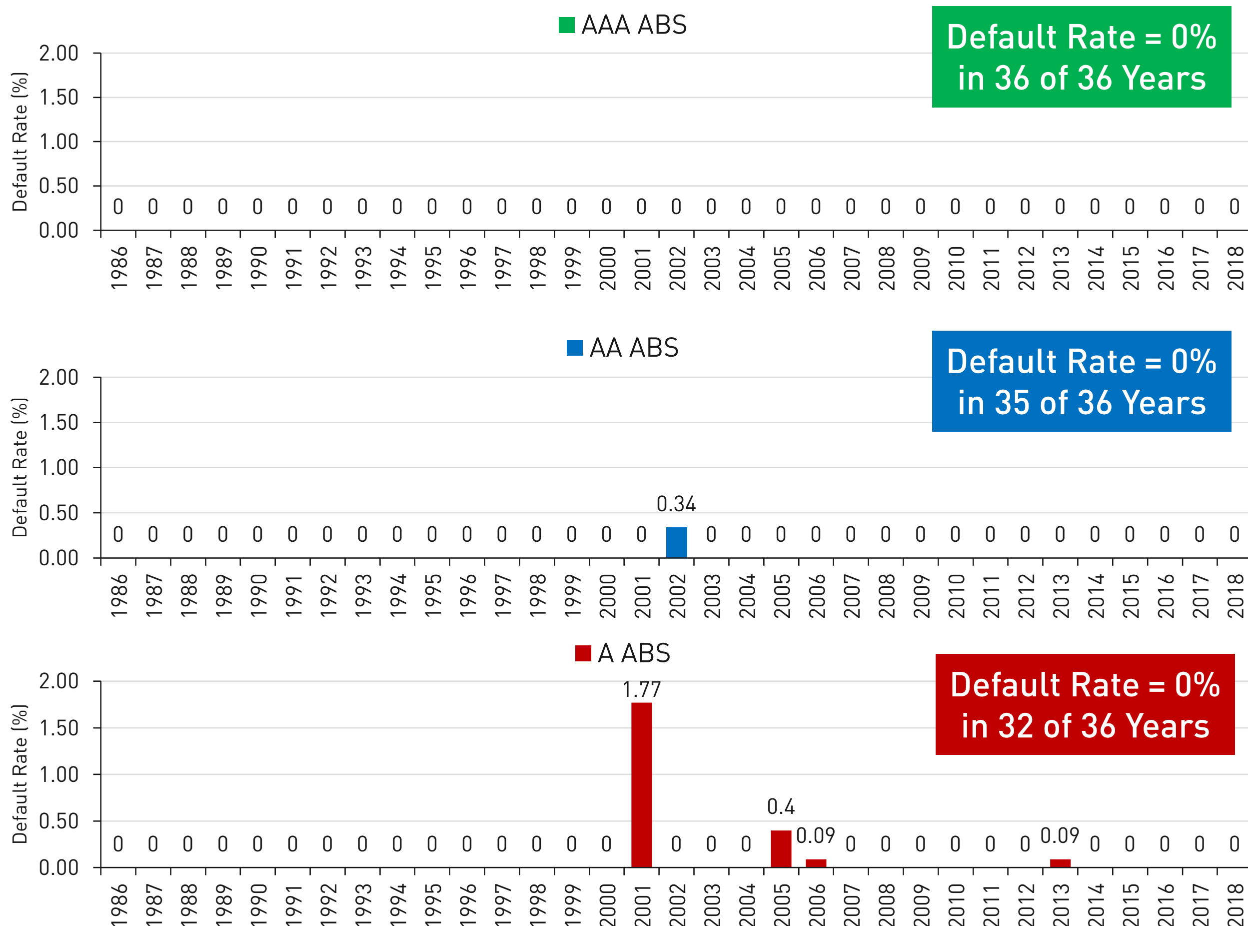
Adam Castle, CFA
Managing Director, Portfolio Manager

Andrew Fox
Investment Strategist

Stephen Hillebrecht
Director, Product Strategy

Chart 1. Historically, ABS Defaults Have Been Extremely Rare

Default rates of asset- backed securities by credit-rating tier, 1986-2018



Source: S&P Global Ratings. Data based on a historical study of defaults by S&P Global; 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.

Asset-Backed

In Brief

- Investors may have questions about asset-backed securities during this period of market volatility.
- Lord Abbett investment professionals discuss the potential investor protections that are part of the designof some of these consumer-focused securities, along with how ABS have fared in light of the economic disruption caused by Covid-19.
- Historically speaking, defaults on ABS have been rare in the past few decades, even during the 2008-09 financial crisis.
- Further, measures introduced by the U.S. Federal Reserve (Fed) and Congress designed to provide aid to the U.S. consumer during an economic downturn may lend support to the ABS market.

In the first of a two-part series looking at structured financial products amid the current market volatility, last week's *Market View* focused on commercial mortgage-backed securities. This week, we will turn to CMBS' more consumer-focused cousin, asset-backed securities (ABS), with insights derived from a recent webinar featuring Lord Abbett Managing Director & Portfolio Manager Adam Castle, Investment Strategist Andrew Fox, and Director of Product Strategy Stephen Hillebrecht. (Register to view a replay of the webinar.)

What Are ABS?

Consumer-linked ABS are financial securities collateralized by a broad spectrum of consumer receivables such as credit card receivables, auto loans, and student loans. The ABS market consists of a half-dozen major sectors and several dozen subsectors that include aircraft leasing, credit card debt, cell tower leases, and even timeshare loans, among others.

As Castle noted in a previous commentary, ABS structures are typically debt holder-friendly in that they restrict cash flow to equity, while forcing the transaction structure to de-leverage over time or, at the very least, maintain levels of leverage. There are numerous components to the overall structure of an asset-backed security. The structural protections that may be embedded with an ABS for the benefit of investors are collectively considered "credit enhancements." Total credit enhancement is a key factor in assessing the creditworthiness of an ABS in the context of the risk profile of the trust's underlying assets.

"The original lender would have to sustain a loss before investors in an ABS deal would sustain a loss," Castle notes. He offers an example: "Typically for an ABS backed by prime auto loans, there would need to be around a 5%-10% default rate that would have to take place in order for the AAA-rated tranche to sustain a principal loss. He notes that as of early March 2020, before the full impact of the Covid-19 crisis, default rates on prime auto ABS were "very low," based on data from S&P Global. In the 2008-09 financial crisis, defaults went from roughly 0.5% to 2%. "Around 15 to 20 times that default level would be needed before a 'AAA'-rated asset-backed auto deal in one of Lord Abbett's portfolios could potentially be negatively affected," Castle says.

Securities (ABS)

Castle says Lord Abbett's investment team has emphasized "more seasoned, mature ABS deals that were originated one to three years ago." In looking at coverage multiples on the 'AAA'-rated segments of the ABS deals that Lord Abbett owns, "they can potentially withstand typically 30 to 50 times more losses than are currently being experienced."

Addressing concerns about the current economy and the prospect of sharply reduced consumer spending, Hillebrecht notes that "the consumer has gone through other periods of difficulty in the past." He cited the historical default record for ABS (see Figure 1 on the front page). "If you look at the default rate on 'AAA'-rated asset-backed securities going back to 1986, the rate has been zero, and on 'AA'-rated ABS, it's been zero in every year except one blip in 2002."

ABS Is a Consumer-Focused Asset Class

"When you think about ABS, traditionally, you think about exposure to the U S consumer and households … consumer balance sheets are a significant proportion of the U S economy," says Castle. Before the Covid-19 impact, those balance sheets had been strengthening, with lower levels of leverage and a higher savings rate.

"Historically, exposure to consumer ABS has provided a very valuable diversification component to a short duration strategy," he added. Typical consumer loan products, like auto loans, are short duration in nature, according to Castle. Balances on credit cards, a form of revolving debt, are paid off monthly by a significant number of consumers, he says. "So not only are they short duration, but they give us access to a very significant component of the U. S. economy, in line with our desire to position ourselves for more domestic strength relative to the global economy, and for lower leverage relative to U.S.-based multinational corporations."

Of course, Castle notes, the Covid-19 pandemic affects all facets of the global economy, including the U.S. consumer's ability to make money to service household debt. But as Fox pointed out in a commentary published on April 1, recent actions by the U.S. Federal Reserve (Fed) and U.S. Congress are aimed at providing significant relief to the U.S. consumer—and could potentially support the ABS market as a consequence.

Current Environment

Since the worst of the volatility in the third week of March, ABS spreads have narrowed somewhat, "but we are certainly not back to where we were," says Fox. "Certainly the things that the Fed has done--in a sense, pulling out some of these old tools that they created for the 2008-09 financial crisis—have been very helpful this time around."

Based on data from Bloomberg, "the recovery in spreads from today [April 7] relative to March 23 has been about 50%," Castle added. "That's a significant recovery--though spreads are still pretty wide--and what that really reflects are the attempts to address the liquidity problems facing the market." After the Fed's efforts to bolster liquidity, "what we're really left with is an elevated risk premium that exists across asset classes considering the degree of volatility and the fundamental uncertainty that pervades all markets."

We see that the market isn't being efficient right now, and that there are plenty of opportunities for us to generate alpha in this environment. He believes the potential exists for active managers to realize a stronger rebound than the benchmark short credit indexes experienced following the volatility in 2008-09 (see Figure 2 on the following page).

Figure 2. ABS Sector Was Part of a Strong Recovery in Structured Products Following the Global Financial Crisis

Total return for the indicated periods

	Short-Term Corporates (1-3 year)	CMBS	Short-Term CMBS (1-3.5 year)	ABS
Q4 2008	+1.5%	-15.0%	-6.1%	-6.8%
2008	-1.4%	-22.7%	-5.1%	-12.7%
2009	**+14.5%**	**+28.1%**	**+22.9%**	**+24.7%**

Source: Bloomberg Barclays Index Data. Short-term corporates=Bloomberg Barclays 1-3 Year U.S. Corporate Bond Index. CMBS (commercial mortgage-backed securities)=Bloomberg Barclays Non-Agency CMBS Index. Short-term CMBS=Bloomberg Barclays 1-3.5 Year Non-Agency CMBS Index. ABS (asset-backed securities)=Bloomberg Barclays ABS Index.

Past performance is not a reliable indicator or guarantee of future results. For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.

In today's market, says Castle, "we believe short credit still makes a lot of sense."

ABS as Part of a Flexible, Multi-Sector Approach

Hillebrecht noted that given Lord Abbett's flexible multi-sector approach to short credit, "ABS is just one asset class that we can invest in." He believes that such a strategic focus can potentially enable asset managers to "find pockets of liquidity to take advantage of opportunities during market dislocations." Fox concurred. "That's one of the nice things about being multi-sector--and a lot of our strategies are structured that way."

Fox summarized Lord Abbett's approach: "It's not just about going out there and finding the absolute cheapest thing you can possibly find… it's about the ability to rotate among sectors, careful credit analysis, and a rigorous approach to security valuation."

"The idea here," he concluded, "is that our investment teams have a lot of levers to pull."

A Note about Risk: 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, interest-rate, 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. Lower-rated bonds may be subject to greater risk than higher-rated bonds.

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

Statements concerning financial market trends are based on current market conditions, which will fluctuate. There is no guarantee that markets will perform in a similar manner under similar conditions in the future.

Forecasts and projections are based on current market conditions and are subject to change without notice. Projections should not be considered a guarantee.

This *Market View* may contain assumptions that are "forward-looking statements," which are based on certain assumptions of future events. Actual events are difficult to predict and may differ from those assumed. There can be no assurance that forward-looking statements will materialize or that actual returns or results will not be materially different from those described here.

A **basis point** is one one-hundredth of a percentage point.

Credit enhancement: Structured financial products such as asset-backed securities and commercial mortgage-backed securities derive their value from underlying assets such as mortgages or credit card receivables. Some of those assets are riskier than others. For such investment products, credit enhancement serves as a cushion that absorbs potential losses from defaults on the underlying loans. Structured products are issued in classes, or tranches, of securities, each with its own credit rating. The tranches are categorized from the most senior to the most subordinated, or junior. Credit enhancements are attached to the highest-rated tranches, giving their buyers priority in any claims for repayment against the underlying assets.

Asset-backed securities (ABS) are collateralized by a pool of assets such as loans, leases, credit card debt, royalties or receivables. An ABS is similar to a mortgage-backed security, except that the underlying securities are not mortgage-based.

Commercial mortgage-backed securities (CMBS) are secured by mortgages on commercial properties rather than residential real estate. The underlying loans that are securitized into CMBS include those for properties such as apartment buildings and complexes, factories, hotels, office buildings, office parks, and shopping malls.

Risk premium refers to the return in excess of the risk-free rate of return an investment is expected to yield; an asset's risk premium is a form of compensation for investors who tolerate the extra risk, compared to that of a risk-free asset, in a given investment.

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.

A **structured product**, also known as a market-linked investment, is a prepackaged structured finance investment strategy based on a single security, a basket of securities, options, indices, commodities, debt issuance or foreign currencies, and to a lesser extent, derivatives.

The **Bloomberg Barclays Asset-Backed Securities (ABS) Index** is the ABS component of the Bloomberg Barclays U.S. Aggregate Bond Index. The ABS Index has three subsectors: credit and charge cards, autos and utility.

The **Bloomberg Barclays U.S. CMBS Investment Grade Index** measures the market of conduit and fusion commercial mortgage-backed securities (CMBS) deals with a minimum current deal size of $300 million. The index is divided into two subcomponents: the U.S. Aggregate-eligible component, which contains bonds that are ERISA eligible under the underwriter's exemption, and the non-U.S. Aggregate-eligible component, which consists of bonds that are not ERISA eligible. The U.S. CMBS Investment Grade Index was launched on January 1, 1997. The **Bloomberg Barclays Non-Agency CMBS Index** and **Bloomberg Barclays 1-3.5 Year Non-Agency CMBS Index** are subsets of the broader index.

The **Bloomberg Barclays U.S. Corporate Bond Index** includes all publicly held issued, fixed-rate, nonconvertible investment-grade corporate debt. The index is composed of both U.S. and Brady bonds. The Bloomberg Barclays 1-3 Year U.S. Corporate Bond Index is a maturity-specific subset of the broader index.

Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.

The credit quality of the securities are 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 principle on these securities.

The information provided is not directed at any investor or category of investors and is provided solely as general information about Lord Abbett's products and services and to otherwise provide general investment education. None of the information provided should be regarded as a suggestion to engage in or refrain from any investment-related course of action as neither Lord Abbett nor its affiliates are undertaking to provide impartial investment advice, act as an impartial adviser, or give advice in a fiduciary capacity. If you are an individual retirement investor, contact your financial advisor or other fiduciary about whether any given investment idea, strategy, product or service may be appropriate for your circumstances.

The opinions in this *Market View* are as of the date of publication, are subject to change based on subsequent developments, and may not reflect the views of the firm as a whole. The material is not intended to be relied upon as a forecast, research, or investment advice, is not a recommendation or offer to buy or sell any securities or to adopt any investment strategy, and is not intended to predict or depict the performance of any investment. Readers should not assume that investments in companies, securities, sectors, and/or markets described were or will be profitable. Investing involves risk, including possible loss of principal. This document is prepared based on the information Lord Abbett deems reliable; however, Lord Abbett does not warrant the accuracy and completeness of the information. Investors should consult with a financial advisor prior to making an investment decision.

Investors should carefully consider the investment objectives, risks, charges, and expenses of the Lord Abbett funds. This and other important information is contained in each fund's summary prospectus and/or prospectus. To obtain a prospectus or summary prospectus on any Lord Abbett mutual fund, contact your investment professional or Lord Abbett Distributor LLC at 888-522-2388, or visit us at lordabbett.com. Read the prospectus carefully before you invest.

Copyright © 2020 by Lord, Abbett & Co. LLC / Lord Abbett Distributor LLC. All rights reserved. | T 1.888.522.2388 | lordabbett.com