Asset-Backed Securities: Attractive Opportunities for Fixed-Income Portfolios

Investor-friendly features and meaningful diversification suggest that most fixed-income portfolios might benefit from the inclusion of asset-backed securities (ABS).

by Adam Castle, Lord Abbett Portfolio Manager, Taxable Fixed Income and

Andrew Fox, Lord Abbett Investment Strategist, Fixed Income

IN BRIEF

- Asset-backed securities (ABS) may provide an attractive alternative to investors who seek to allocate to high levels of credit quality while maintaining a level of diversification difficult to achieve in the corporate credit market alone.
- Historically, ABS have delivered attractive risk-adjusted returns through several market cycles.
- We believe the sector presents a compelling and scalable investment opportunity, with an aggregate market size comparable to the highest-rated parts of the corporate bond market.
- As measured by correlation, ABS have exhibited a relatively low-strength directional relationship with other fixed-income assets, of both high and low credit quality, creating an opportunity for diversification as well as an increased opportunity set for potential excess returns.
- ABS are typically set up as bankruptcy-remote special purpose vehicles (SPVs) that protect the underlying assets from the claims of creditors other than those of ABS bondholders themselves. The bonds also often feature structures that are friendly to debt investors.

While most sophisticated fixed income investors have some familiarity with the $11 trillion securitized product market, we find that relative value in certain sub-markets has been persistently underappreciated by investors. Here we attempt to highlight the value of asset-backed securities within high-quality fixed income portfolio construction and will seek to demonstrate that ABS backed by consumer and commercial loans and leases may offer scalable and repeatable compelling alpha opportunities for fixed income investors.

This component of the securitized product market totals approximately $870 billion as of December 31, 2018, according to the Securities Industry and Financial Markets Association (SIFMA), and is populated with consumer and commercial lenders, finance companies, and banks, all of whom originate loans or leases to consumers or businesses. These issuers in aggregate rely on the ABS market in a material way to fund loan creation.

The $870 billion of ABS outstanding represents about 22% of the $3.95 trillion of all outstanding U.S. consumer credit. As the U.S. economy has recovered from the 2008–09 financial crisis, ABS have played a key role in the expansion of consumer credit, with issuance averaging approximately $235 billion per year since 2014, up from about $120 billion of issuance in 2010, according to SIFMA.

Used by established and emerging lenders alike, the consumer ABS market represents a persistent part of the capital markets, one that has been a reliable source of funding through various regulatory regimes and economic environments. Despite a shifting political and regulatory landscape since the Great Recession that has seen the adoption of changed accounting rules, SEC requirements, and financial legislation, we believe the case for using asset-backed securities remains as robust as ever. And importantly to investors, it is a part of the fixed-income market that historically has delivered attractive risk-adjusted returns through cycles, and that continues to present compelling and scalable opportunities.

ABS can provide:

- a broad opportunity set with a range of credit quality and liquidity,
- investor friendly features,
- an attractive return profile, and
- meaningful diversification.

Finding high-quality credit investment opportunities can be challenging if restricted to the corporate credit markets. In the 1980s, around 60 corporate issuers laid claim to a 'AAA'-credit rating. By 2008, that number had fallen to six, and today it stands at two, representing a tiny fraction of issuers. If we include all issuers above A+ the list increases to 48—just shy of the number of 'AAA'-credit ratings decades back (and representing about 3.2% of the Bloomberg Barclays U.S. Aggregate Bond Index, or about $600 billion). By expanding the opportunity set to ABS, investors would find a comparably deep market of high quality opportunities, with about $550 billion of the $870 billion market rated A or higher, according to SIFMA, spread across a greater number of issuers.

Asset-backed securities provide a potentially attractive source of total return for investors who seek to allocate to high levels of credit quality while maintaining a level of diversification difficult to achieve in the corporate credit markets alone. The ABS market consists of half a dozen major sectors and several dozen subsectors that include aircraft leasing, credit card debt, cell tower leases, and even timeshare loans, among others. Because of the breadth and depth of economic activity that ABS supports, opportunities to gain exposure to specific areas of the economy abound within the asset class. A tactically managed ABS portfolio can reflect an investor's wide range of expectations regarding the economic and regulatory environment, while also exhibiting a bias for high quality credit exposure. Over $3 billion in ABS trade weekly at average ticket sizes of $1.5 to $2.0 million, providing for robust liquidity conditions with which to manage ABS portfolio risk on an ongoing basis.

TABLE 1. ABS HAVE TRADED AT ATTRACTIVE SPREADS RELATIVE TO OTHER FIXED-INCOME ASSET CLASSES

*Average daily volume (in billions), as of December 31, 2016**

SECURITY	BID-ASK SPREADS	GROWTH** 2012 - 2016
MBS	$0.25	-37%
TBA	$0.04	-20%
CMBS	$0.16	-49%
Agency CMO	$0.63	-24%
Non-Agency CMO	$0.58	-23%
ABS Auto	$0.04	1%
ABS Card	$0.04	10%
ABS Student	$0.15	-40%
ABS Misc	$0.13	-60%
Corp. Bond Active	$0.34	-14%
Corp. Bond Less	$0.35	-28%

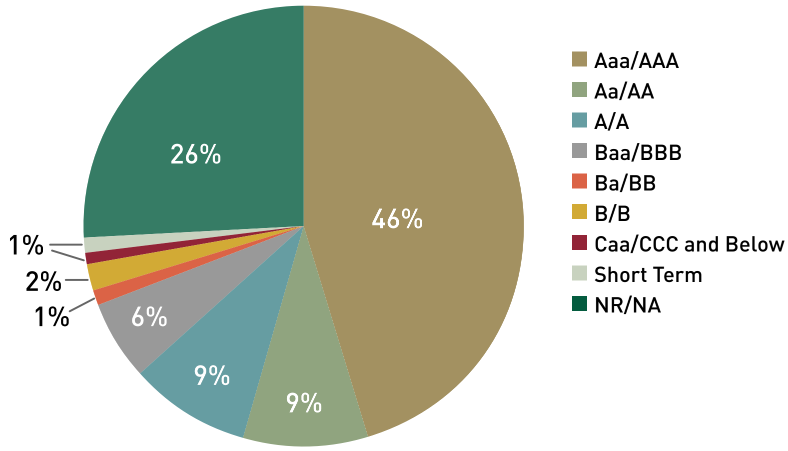
Source: *The data in this table is based on a 2017 FINRA study. Although FINRA has not updated the data, we believe it continues to represent the market. Financial Industry Regulatory Authority, Inc. (FINRA), "Analysis of Securitized Asset Liquidity," published in June 2017, using data as of December 30, 2016.

The information shown is for illustrative purposes only. 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.

**Represents the rate of growth of the average daily dollar trading volume (in billions) across the securitized markets.

CHART 1. ABS MAY PROVIDE AN ATTRACTIVE ALTERNATIVE FOR INVESTORS SEEKING HIGH CREDIT QUALITY

$870 billion outstanding ABS market, as of December 31, 2018



Source: Securities Industry and Financial Markets Association (SIFMA).

INVESTOR-FRIENDLY FEATURES

ABS are typically set up as bankruptcy-remote special purpose vehicles (SPVs). This provides investors with protection from sponsors who are facing financial difficulty, blocking direct expropriation of SPV-sheltered assets by creditors in the event of a sponsor bankruptcy.

ABS structures are also typically debt friendly in that they restrict cash flow to equity, while forcing the transaction structure to de-lever over time or, at the very least, maintain levels of leverage. While excess cash flows received from the underlying loans (beyond that which satisfies both the principal and interest obligations and the restrictive trust documents) may flow to the equity holder, the trust may not typically issue subsequent debt that would serve to subordinate ABS holders' interests or adversely impact the trust's credit profile. This is an important contrast to corporate bonds, where holders can see their claims to cash flows diluted by subsequent debt offerings as companies lever or re-lever, pay dividends, seek merger and acquisition opportunities or engage in other corporate actions for the benefit of equity investors.

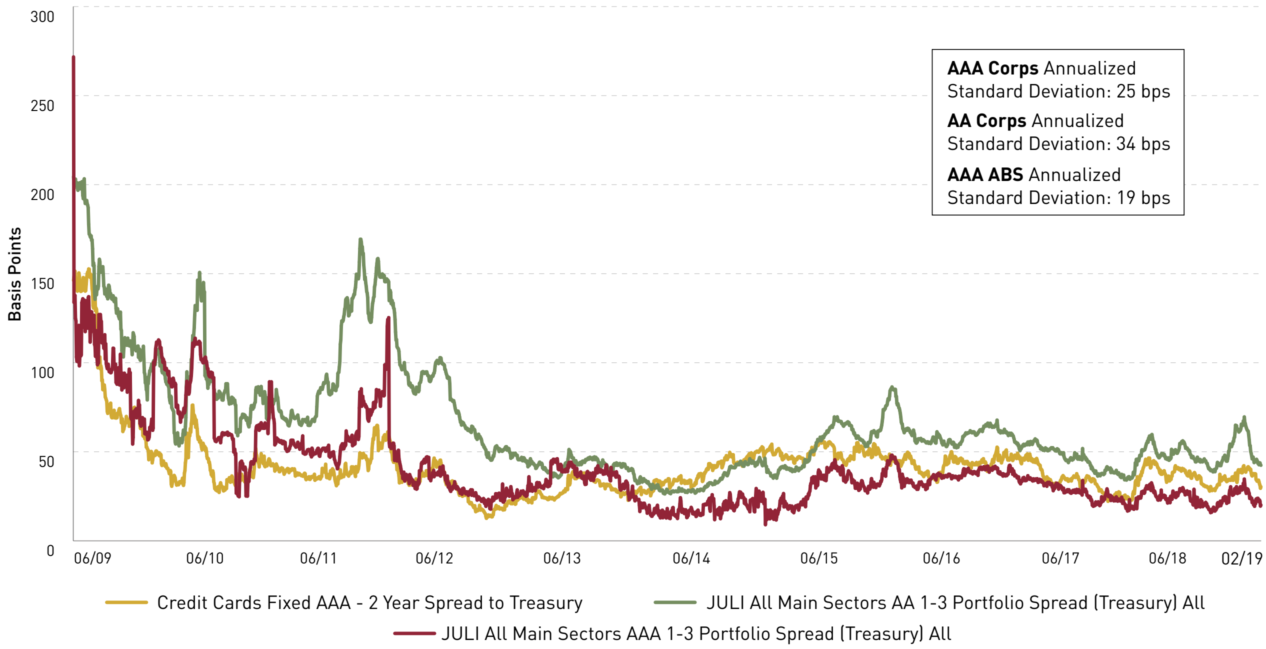
There are numerous components to the overall structure of an asset-backed security. The structural protections that may be embedded with an ABS for the benefit of investors are collectively considered credit enhancements. Total credit enhancement is a key factor in assessing the creditworthiness of an ABS in the context of the risk profile of the trust's underlying assets. ABS backed by riskier assets would be expected to possess more credit enhancement relative to an equivalent rated security backed by higher-quality assets. Credit enhancement can come in the form of overcollateralization, subordination of lower-rated debt, excess spread, as well as via external enhancements such as surety bonds, letters of credit or parental guarantees. Trust documents also tend to include various covenants and performance triggers to ensure credit enhancements are maintained throughout the lifecycle of a transaction and to provide for early amortization of debt to the extent any covenants or triggers are breached.

ATTRACTIVE RETURN PROFILE

Given the material size and diversity of the 'AAA'-rated consumer ABS market relative to the 'AAA'-rated corporate bond market (which consists of just two issuers), we believe it makes sense to expand an analysis to 'AA'-rated corporates (totaling 45 issuers as of February 22, 2019) as well as 'AAA' when assessing the relative return characteristics of high quality ABS and corporates. What we observe is that historically, 'AAA'-rated ABS have exhibited lower spread volatility and have offered spreads over equivalent average-life U.S. Treasury securities that have been comparable in most environments and superior in some environments to the highest quality corporates. Note we've chosen for the analysis that follows in Chart 2 the most liquid and high quality of ABS for this comparison: 'AAA'-rated ABS securitized by receivables from major money-center bank credit-card issuers.

CHART 2. 'AAA'-RATED ABS VOLATILITY AND SPREADS HAVE COMPARED FAVORABLY TO THOSE OF U.S. CORPORATES

June 4, 2009 – February 22, 2019

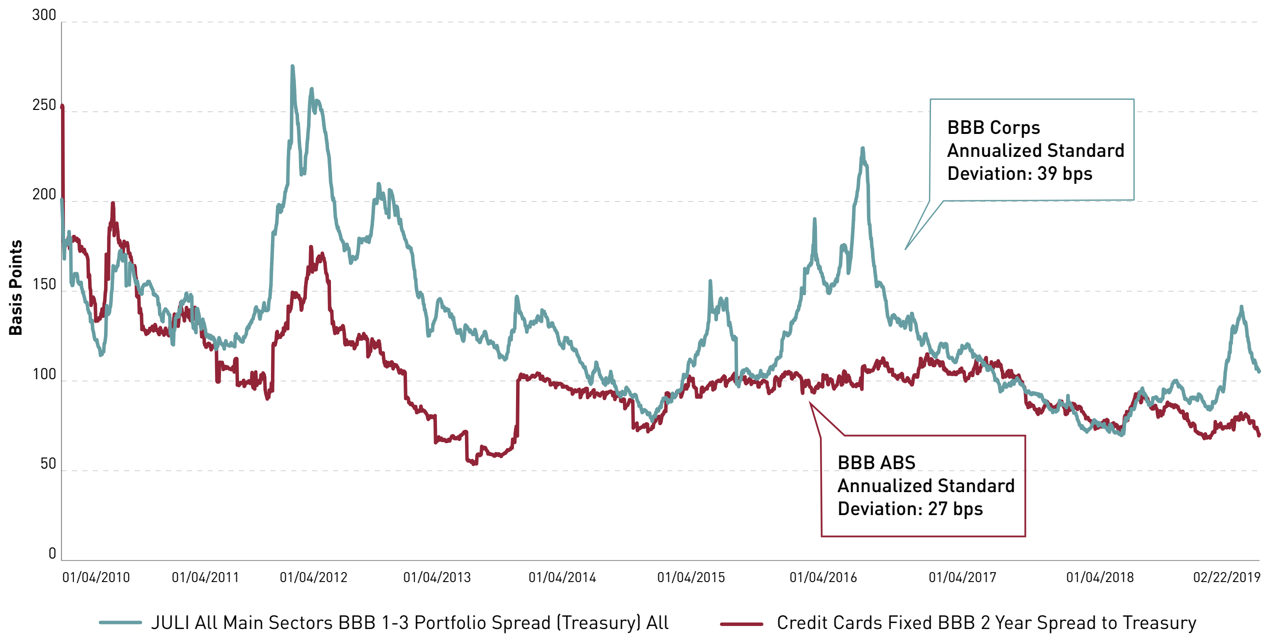


Source: Securities Industry and Financial Markets Association (SIFMA). JULI = J.P. Morgan U.S. Liquid Index. For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment. Statements concerning financial market trends are based on current market conditions, which will fluctuate. There is no guarantee that markets will perform in a similar manner under similar conditions in the future.

These attractive characteristics persist as we move down in credit quality. Chart 3 also tracks corporate versus credit-card ABS, but this time at the 'BBB'-rated level:

CHART 3. THESE ATTRACTIVE CHARACTERISTICS HAVE PERSISTED IN LOWER-QUALITY CREDITS

January 4, 2010 – February 22, 2019

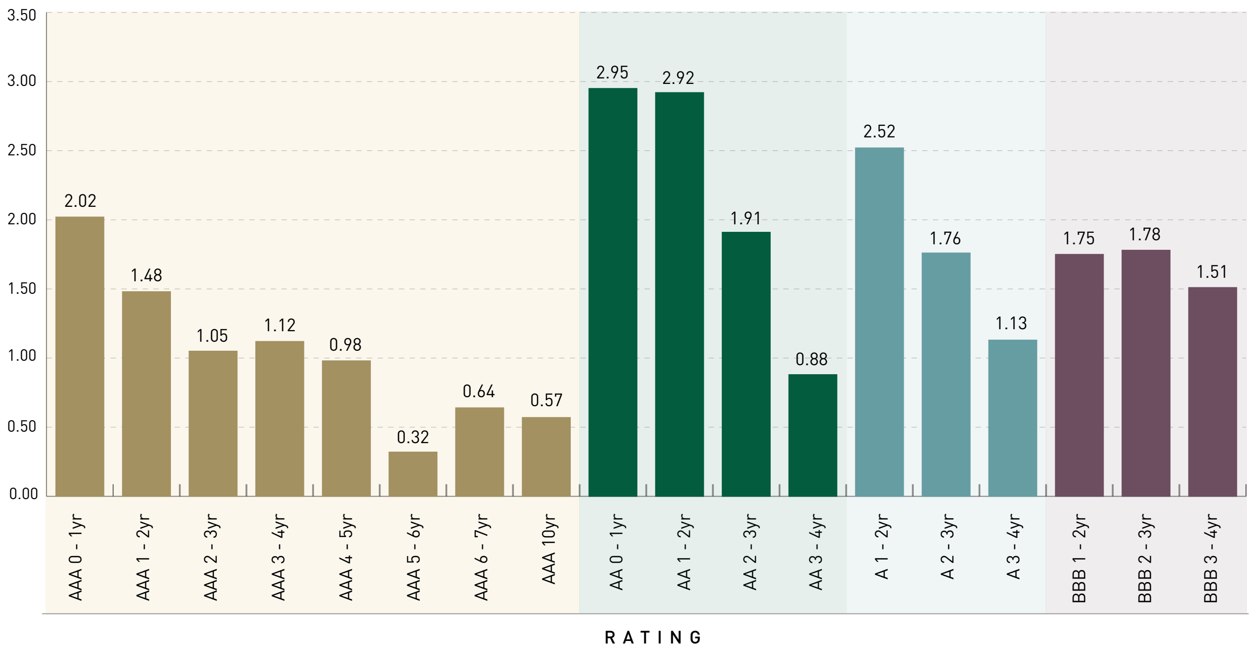


Source: Securities Industry and Financial Markets Association (SIFMA). JULI = J.P. Morgan U.S. Liquid Index. For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment. Statements concerning financial market trends are based on current market conditions, which will fluctuate. There is no guarantee that markets will perform in a similar manner under similar conditions in the future.

ABS have also provided attractive Sharpe ratios across the spectrum of quality and maturity, but especially at the shorter end of the maturity spectrum. As we've noted in "Short Term Bonds: A History of Opportunity," the difficulty in managing short credit product gives rise to excess returns for managers with expertise and the ability to scale in this area. Given the high degree of investment in human and technological capital needed to manage structured product, it should come as very little surprise that the "anomaly" we note on the corporate side also exists to an even greater degree in ABS, as evinced in Chart 4. The challenges of investing in corporates are taken a step further due to the complexity inherent in the analysis of structured products. This "complexity premium" may explain, to some degree, the attractive risk-adjusted returns offered by high-quality short-term ABS.

CHART 4. ABS HAVE ALSO PROVIDED ATTRACTIVE SHARPE RATIOS, ESPECIALLY AT THE SHORT END

Sharpe ratio, Bloomberg Barclays ABS Index, (as of December 30, 2013- December 30, 2018)



Source: Securities Industry and Financial Markets Association (SIFMA). The information shown is for illustrative purposes only. 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.

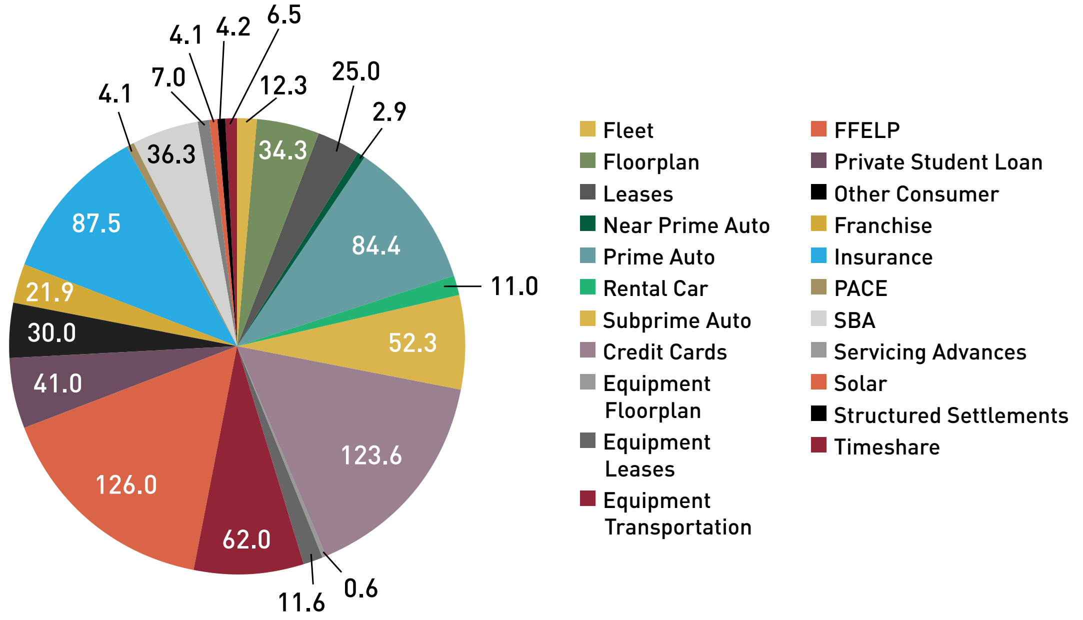
DIVERSIFICATION

ABS provide diversification within the asset class and when used in conjunction with some other assets. By virtue of the securitization process, idiosyncratic risk contributions from individual borrowers are diversified away. The second level of diversification provided stems from the wide range of economic activity ABS support. Individual subsectors retain sensitivities specific to the economic activity they finance, and therefore are subject to factors affecting that market, encompassing all of those that would be familiar to corporate credit buyers and more.

ABS may also provide diversification when used in a portfolio of broader fixed-income assets. As measured by correlation, ABS exhibit a relatively low strength directional relationship with other fixed-income assets, of both high and low credit quality. So a strategic allocation to ABS can help diversify portfolios containing a variety of fixed-income assets. The low correlation also means the relative value of ABS to the asset classes fluctuates, providing opportunity for tactical positioning by an active manager.

CHART 5. THE ABS MARKET PROVIDES BROAD DIVERSIFICATION ACROSS SECTORS AND SUBSECTORS

ABS market outstanding $870 billion, as of December 31, 2018



Source: Securities Industry and Financial Markets Association (SIFMA).

THE BOTTOM LINE

ABS offer investors access to a broad, deep and expanding opportunity set that in aggregate has provided an attractive risk-reward profile. Investor-friendly features and meaningful diversification at the security, sector, and portfolio level also suggest that many fixed-income portfolios might benefit from their inclusion. While their relatively sophisticated structures necessitate equally sophisticated analysis, we find most structural complexity has been to the benefit of debt investors, and we believe investors willing and capable of putting forth the requisite effort may be well served for doing so.

IMPORTANT INFORMATION

The information provided here is for general informational purposes only. It does not constitute a recommendation nor investment advice, and should not be used as the basis for any investment decision. This is not a representation of any securities Lord Abbett purchased or would have purchased or that an investment in any securities of such issuers would be profitable.

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. Bonds may also be subject to other types of risk, such as call, credit, liquidity, interest-rate, and general market risks. 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. Moreover, the specific collateral used to secure a loan may decline in value or become illiquid, which would adversely affect the loan's value. 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.

Diversification does not guarantee a profit or protect against loss in declining markets.

Glossary

A **basis point** is equivalent to 0.01% (1/100th of a percent) or 0.0001 in decimal form.

A **bid-ask spread** is the difference between the highest price that a buyer is willing to pay for an asset and the lowest price that a seller is willing to accept.

A **special purpose vehicle (SPV)** is an entity with an asset/liability structure and legal status that makes its obligations secure, even in the event of a bankruptcy.

Sharpe ratio is a way to examine the performance of an investment by adjusting for its risk. It is the average return earned in excess of the risk-free rate per unit of volatility or total risk.

The **Bloomberg Barclays U.S. Aggregate Bond Index** represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities.

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 **J.P. Morgan U.S. Liquid Index (JULI)** is a broad measure of the performance of the most liquid securities in the U.S. investment grade corporate bond market.

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 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. High yielding, non-investment-grade bonds involve higher risks than investment-grade bonds. Adverse conditions may affect the issuer's ability to pay interest and principal on these securities.