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Viewpoint

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ABS Offer Potential Portfolio Diversification, Quality and Defense

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Many market observers believe we are late in the credit cycle, and spreads are at historically tight levels. Interest rates may also move higher. For insurers and other institutions seeking to be more defensive and diversified in their portfolios, an allocation to asset-backed securities (ABS) may be worth consideration.

ABS currently offer compelling yields versus fixed-income assets of similar quality and duration, including typical mainstays such as U.S. Treasurys and corporate bonds (see Figure 1). ABS offer portfolios additional diversification, as they are backed by a variety of assets not found in traditional fixed-income strategies. ABS offer a high degree of liquidity, and in an environment of potentially rising interest rates, their amortizing feature can provide investors with additional capital to reinvest and take advantage of higher rates.

The ABS market has also seen several structural improvements since the financial crisis. Rating agencies are operating with greater transparency, and securities are offering improved underwriting as well as greater credit enhancements for stronger investor protection. New structures are smaller and simpler and issuers must now retain a portion of all new deals, helping to better align their interests with those of investors.

With the structural enhancements, currently compelling performance and a favorable capital-charge profile for insurers, ABS is a fixed-income asset class that investors may wish to learn more about.

Leveraging Cash Flows

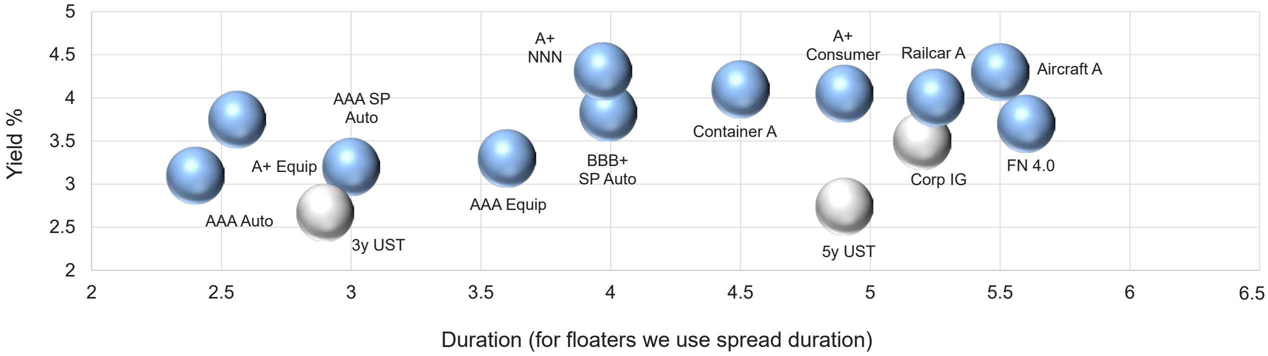
The assets backing ABS securities typically fall into two general categories: commercial (e.g., leases for commercial aircraft, shipping containers and rail cars) and consumer (e.g., credit card or cell phone receivables, auto loans and student loans).

ABS are structured securities and operate similar to other asset-backed investments. A deal sponsor provides a diversified array of loans/leases (which are generating principal and interest payments) to an investment bank. The Investment bank structures the cash flows of these loans/leases into securities of varying levels of risk and offers them to investors. The cash flows backing the securities are expected to fulfill the ABS's obligations (as are the hard collateral behind the loans/leases if needed) and drive the rating agencies' grades for the securities.

Competitive Performance and Amortization

ABS's compelling yields versus corporate bonds and Treasurys of similar quality and duration may be of spe-

Figure 1 Yield vs Duration - IG ABS, IG Corporate Bonds, U.S. Treasurys



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cial interest to property and casualty (P&C) insurers. Tax reform has reduced the relative value of tax-exempt municipal bonds, a P&C portfolio staple, and ABS may provide an alternative offering competitive yields and opportunities to maintain portfolio credit quality.

ABS assets' low correlation to investment-grade and high-yield bonds and equity (see Figure 2) may help diversify portfolios. And the asset is highly liquid: the $1.3 trillion ABS market has averaged annual trading volume of between $200 billion and $300 billion from 2011 to 2017, per FINRA's Trade Reporting and Compliance Engine (TRACE). Current trading features generally tight bid-offer spreads, helping to ensure same-day liquidity in most cases.

Figure 2 ABS Correlation to Major Asset Classes (2008-2018)

Investment Grade	0.34
High Yield	0.05
Equity	-0.17

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Compares correlations of Bloomberg Barclays US Agg ABS Index to Bloomberg Barclays US Bond Index, Bloomberg Barclays VLI: High Yield Index, and S&P 500 Total Return Index, June 29, 2008 to June 29, 2018.

ABS securities also are one of the few fixed-income assets featuring amortization. Not only does amortization offer investors principal payments to reinvest and take advantage of possibly rising interest rates, it also deleverages the ABS structure which can lead to credit upgrades for the securities. This may appeal to insurers concerned with portfolio credit quality.

Reforms Build Investor Protections

All ABS securities are assigned grades by credit rating agencies, but the agency process has grown far more transparent in the past decade.

Agency staff offer more explanations regarding their rating decisions, which help investors better understand the thinking behind the grade. Additional competition in industry ratings agencies has also driven better service levels. Issuers themselves have also improved transparency, as management teams are offering more details on their structure's investment strategy and more insight, such as providing loan-level data for the collateral.

Underwriting has improved, as deals feature higher FICO scores, lower loan-to-value ratios and better documentation. The deals are also for smaller amounts than pre-crisis with fewer tranches, making them easier to analyze. A common pre-crisis deal might be in excess of $3 billion with more than 15 tranches; deals in mid-2018 have as few as two tranches and are closer to $800 million. Within each tranche, investors are receiving higher credit enhancements, but especially within the AAA through A levels. These ensure greater protections against potential investment losses, which is another valuable feature at this late stage in the credit cycle.

On top of the additional protections for investors, their interests and those of issuers are now more closely aligned because of the five-percent retention rule for issuers on new deals. Issuers are now among the more significant equity investors in their own deals.

Value of Market and Insurance Expertise

Much has changed in the ABS market in the past decade that Conning thinks investors should understand to help them fully appreciate the opportunities in the asset class today. While the assets backing these deals may not be ones many typically invest in, the ABS securities themselves have historically offered high quality credits, portfolio diversification and competitive yield. In the current market environment, with the additional amortization feature that may help investors take advantage of possibly rising interest rates, we think ABS deserve careful consideration.

As with any asset class, investors are often best served with strong market expertise. A deep set of skills and a seasoned team familiar with not only ABS but the broader structured market can be of great value. Insurers would also be wise to seek out managers with the additional expert knowledge of insurance asset management and the constraints on insurance portfolios.

Investment risks: Investments are subject to issuer's ability (or perceived ability) to make scheduled payments and may lose value if interest rates rise. Investments are also subject to payment ability of underlying borrowers. Securities may lose value in general market downturns regardless of market impact on issuer or underlying borrowers. Liquidity risk can occur when market conditions do not allow transactions to be made in a quick and orderly fashion in relation to indicative market prices. Many fixed-income securities allow the issuer to repay all or a portion of the security prior to maturity and holders of callable securities may not benefit fully from an increase in value when rates decline.

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