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Viewpoint

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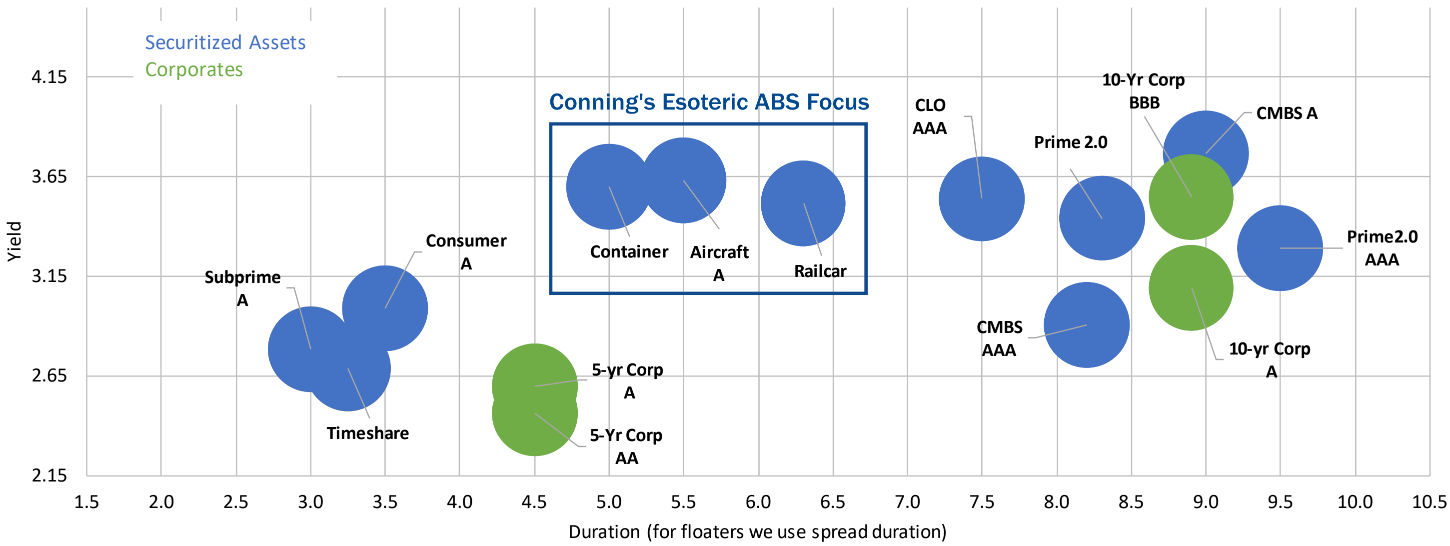
Esoteric ABS: A Clear Opportunity for Uncertain Times

By Paul Norris, Head of Structured Products

The asset-backed securities (ABS) subset known as “esoteric ABS” may have a moniker suggesting that it is hard to understand, but don’t let the name fool you. If you are not familiar with esoteric ABS, you may want to know that the asset class is currently offering yields at a premium to traditional ABS (see Figure 1) as well as other assets of similar quality and duration, features strong liquidity, and may improve portfolio diversification. These are valuable attributes in a time of rising market uncertainty.

Most esoteric ABS are in fact backed by collateral that is relatively easy to understand, such as commercial aircraft, railcars and shipping containers. While not as well-known as more traditional ABS collateral such as credit card receipts, esoteric collateral has a great deal of information available for analysts to study. While gathering and formatting the data may take additional work, the effort can be worth the rewards.

Figure 1 - Esoteric ABS, IG Structured Assets & Corporates: Yield vs Duration*



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Investors may find esoteric ABS help portfolios diversify away from more traditional corporate credit, a staple of many insurance investment strategies. The ongoing market uncertainty suggests that increased defensive positioning may be wise, and ABS also offer a wide range of opportunities across various sectors, durations and risk profiles.

Esoteric ABS structures are generally similar to traditional ABS, an asset class that since the financial crisis has seen many improvements in structural simplicity, underwriting standards, rating agency transparency and credit enhancements. As more investors become aware of the potential opportunities within the ABS sector, a better understanding of esoteric ABS can be helpful in assessing the potential benefits to fixed income insurer portfolios.

Benefits to Insurance Portfolios

Figure 1 illustrates the primary appeal of esoteric ABS, as the esoteric ABS examples demonstrate their current significant yield advantages – as much as 100 basis points versus similarly rated corporate bonds - for their respective durations. ABS performance in general often benefits from amortization (which reduces outstanding principal) and the corresponding ratings upgrades, which are less common in corporate bonds. This yield and credit quality features can benefit insurance portfolios.

ABS also feature strong liquidity, low correlations to investment grade corporate credit and U.S. Treasurys, and have negative correlation to equities. ABS are structured to provide investor protection with excess spread, credit enhancement and collateral, and offer investors strong legal protections.

With many investors concerned about the length of the current credit cycle, esoteric ABS have shown resilient performance during down markets. Many investors mistakenly conflate non-traditional ABS with non-agency RMBS, but during the financial crisis the distinctions were quite clear: the esoteric ABS categories aircraft, auto, consumer, container, equipment, rental and timeshare did not suffer a loss, while CMBS and prime and subprime RMBS did, even in the securities rated AAA, AA and A.

Deep Analysis of Collateral and Issuers

Esoteric ABS collateral can include a wide range of assets, but Conning believes that insurance portfolios may benefit from securities backed by business-critical assets like containers, railcars and aircraft. Some investors assume that higher yields mean novel products, but that is clearly not the case with these forms of collateral.

In addition, most esoteric ABS are from companies with significant histories in the market, and while they may be less programmatic in their issuance, there is nonetheless plenty of information available to fully underwrite the securities.

To best meet the demands of insurance portfolios, we suggest a focus on esoteric ABS from issuers that:

- Are publicly traded entities and can be monitored for their financial health via various data sources (such as stock price, credit ratings and default probability)
- Have significant retained equity in the transaction, providing an incentive to maximize collateral performance
- Have extensive experience in the asset class, particularly through various market cycles, and can lend confidence that the bonds can withstand severe economic stress without suffering a principal loss

Similarly, insurers are likely better served by avoiding securities from issuers that:

- Are private entities for which information is hard to come by
- Have interests that are not aligned with investors
- Practice potential adverse selection, i.e., contributing less than their best assets
- Have prior adverse collateral performance and/or non-investor-friendly activities
- Have limited or no collateral loss history

ABS: A Decade of Progress

The ABS asset class in general has come a long way since the financial crisis.

ABS securities have normally been assigned grades by credit rating agencies but, importantly, 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 structures' investment strategy and more insight, such as providing loan-level data for the collateral. (While rating agency input is valuable to Conning's analysis, we also analyze each ABS tranche and assign our own rating, independent of agency viewpoints.)

Esoteric ABS may provide the enhanced yield, credit quality and diversification that insurers would welcome as markets become more uncertain.

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. Within each tranche, investors are receiving higher levels of credit enhancement, 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.

Conclusion

Insurers' demands for greater portfolio yields show no signs of abating. Meanwhile, the ongoing deterioration of credit quality in corporate bonds is driving insurers to consider new options that can help them maintain or improve portfolio credit quality. Esoteric ABS may be an option for insurers.

Insurers will likely benefit from working with managers who have demonstrated a greater understanding of the wide array of esoteric ABS collateral, the leasing agreements that cover them, and the ABS structures. Additionally, they would benefit from managers who have a deep understanding of the unique needs of insurance portfolios.

With a focus on collateral that is business-critical, like commercial aircraft, railcar boxes and shipping containers, esoteric ABS may provide the enhanced yield, credit quality and diversification that insurers would welcome as markets become more uncertain.

Paul Norris, is Managing Director and Head of Structured Products overseeing the team involved in the research and trading of structured securities. Prior to joining Conning in 2017, he was a hedge fund portfolio manager focused on mortgage derivatives. Previously, Mr. Norris was head of securitized products at Dwight Asset Management, where he led a team of portfolio managers, traders and analysts, and also has served as director of mortgage and non-mortgage investments at Fannie Mae. Mr. Norris earned a BS in finance from Towson University and an MBA from the University of Maryland.

Risk

Investment Risk - The potentially complex structure of the security may produce unexpected investment results not based on default or recovery statistic

Valuation Risk - Valuation of structured credit products are provided by third parties, based on models, indicative quotes, and estimates of value, in addition to historical trades. There is inherent difficulty in valuing these assets, and there can be no assurances the assets can be disposed of or liquidated at the valuations established, or that published returns will be achieved

Underlying Asset Credit Risk - During periods of economic uncertainty and recession, the incidence of modifications and restructurings of investments may increase, resulting in impairments to the underlying asset value

Economic Risk - Changing economic, political, regulatory or market conditions, interest rates, general levels of economic activity, the price of securities and debt instruments and participation by other investors in financial markets may affect the value of the structured security and all other asset classes

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