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Viewpoint

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Esoteric ABS: Spreads Suggest Opportunity but Manager Experience, Focus May be Valuable

By Paul Norris, Head of Structured Products

It only took a few weeks in early 2020 for a segment of asset-backed securities (ABS) to go from relatively popular to nearly untouchable.

And while the ABS market has mostly recovered from the wider spreads of mid-March thanks to actions by the U.S. Federal Reserve (the Fed) and some reopening of the economy, the esoteric ABS segment has been an outlier. The gap reflects that investors are not fully comfortable and/or familiar with esoteric ABS collateral, which includes less understood assets such as leases for airlines, railcars and shipping containers.

While wider spreads proffer esoteric ABS as an opportunity, they also suggest ongoing investor concerns about economic growth as well as the evolving market dynamics affecting the collateral. The way forward in the asset class is a work in progress; to glean additional insight, Conning is also studying the business recovery patterns of previous natural disasters as the pandemic has caused a broad, immediate cessation of economic activity, much like a hurricane or earthquake.

There are attractive opportunities within esoteric ABS, but the heightened levels of idiosyncratic risk imply an even greater emphasis on security selection. Investors are advised to be ever more diligent in their analysis, and experience in the asset class, including structural nuances, may prove valuable.

Esoteric ABS Spreads Remain Wider as Market Rebounds

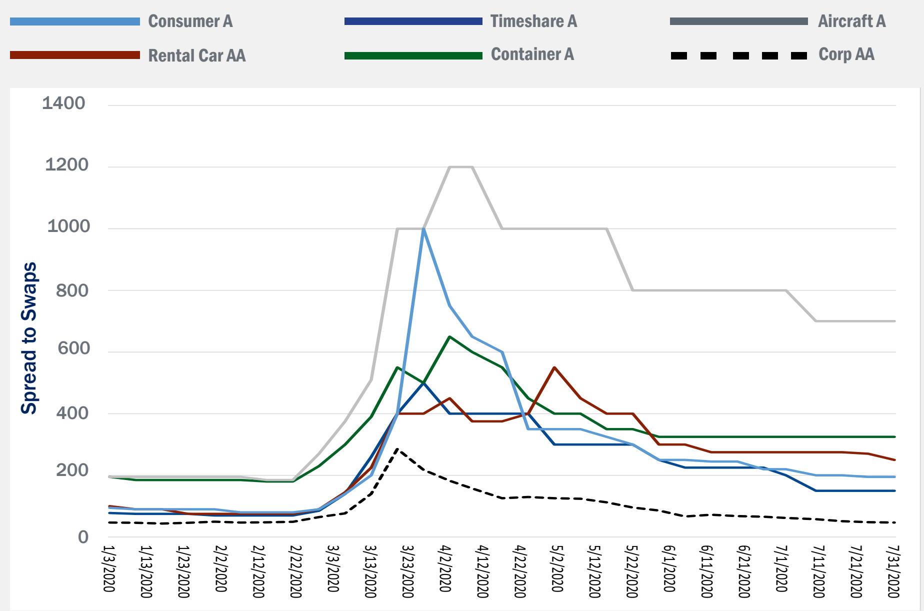
The path of esoteric ABS spreads in the first quarter offers an example of "risk on" and "risk off" investor sentiment.

Since late 2019, investors seeking yield had become so comfortable with the securities that their tighter spreads were hampering the value proposition versus corporates and non-agency mortgages.

Once the pandemic began in the U.S. in early March, spreads of all types of debt securities quickly widened to levels not seen since the financial crisis (see Figure 1). As esoteric ABS securities are less mainstream, their spreads were wider still; senior airline ABS reached 14%.[1] These conditions

Figure 1

Esoteric ABS Spreads Remain Wider After March Market Dislocation



*Data from January 1, 2020 through July 31, 2020
Prepared by Conning, Inc. Source: Bloomberg Index Services Limited. Used with permission.[1]

presented compelling investment opportunities but were fraught with uncertainty as Conning believed that at least some of these securities would be written down.

Yet within two weeks, conditions reversed. On March 23, 2020, the Fed announced its programs to support broad swaths of debt, including a restart of the Term Asset-Backed Loan Facility (TALF), a well-regarded instrument from the financial crisis. Within 48 hours, many corporate and traditional ABS security yields were tighter by as much as several hundred basis points.

While the Fed programs offered support for corporate and high yield bonds and much of ABS, they didn't include esoteric ABS and non-agency mortgage-backed securities (MBS).

As a result, many AAA ABS securities, such as prime auto, subprime, credit cards and equipment leases, now have tighter spreads than a more traditionally stable asset class such as agency MBS, a surprising result given the ongoing market uncertainty.

Conning believes scale matters and will continue to target the best and biggest issuers while staying away from newer entrants, focusing on deals with more credit enhancement and better structures.

However, the general re-tightening of spreads has esoteric ABS yields back to more palatable levels (as of 7/31/2020).[1] At around 4-4.5% on average (airliners remain an outlier at 7.5%, but down from the sky-high 14%), they present opportunities for investors seeking yield opportunities over similarly rated corporate bonds.[1]

A Changing Landscape for Collateral

Beyond the attractive yields, esoteric ABS investors must also understand the evolving market dynamics for the underlying assets, as what was true prior to the pandemic may not be true today.

One example is the used car market, which is largely financed by nonprime auto loans. Used-car prices plummeted in early March but that all changed once the pandemic hit and consumers sought to buy vehicles to move further from cities and avoid subway systems and ride-hail services. The demand drove used-car prices to all-time highs in July. Hertz, which uses fleet-sale proceeds to pay bondholders, experienced this spike first-hand: it sold 40,000 cars in June at 10% above book value, good for Hertz as well as for subprime loan investors.[1]

However, uncertainty still dominates investor thinking and will likely drive yields in the months ahead for esoteric sectors.

Conning expects airline lease yields to remain wide until business travel resumes at stronger levels, which may be years away. Railcar yields are also subject to U.S. economic growth, as many goods are shipped by rail, while shipping containers are reliant on global GDP conditions. Consumer spending remains under pressure as well as unemployment is high, and conditions are cloudy for further government stimulus, the development of a vaccine, and the patience for social distancing.

Natural Disaster Recovery Patterns as Study Guide

Building a strategy for the way ahead is a challenge in such a unique environment. One method Conning is employing in the process is studying post-trauma recovery patterns from recent natural disasters.

Hurricane Maria offers an example. After the storm ravaged Puerto Rico in September 2017, mortgage delinquencies surged for agency and non-agency MBS. However, the majority of the borrowers became current by the end of the lengthy recovery. We think MBS markets could follow a similar pattern through the COVID-19 pandemic, suggesting a period of significant downward pressure but ultimately securities performing as expected.

In the near term, Conning expects to see growing government debt levels and a continuation of lower interest rates, supporting our view that ABS may help investors find greater yields. We expect other investors to follow this path as well. Strong investment discipline and experience in evaluating structures and collateral will likely be of even greater value.

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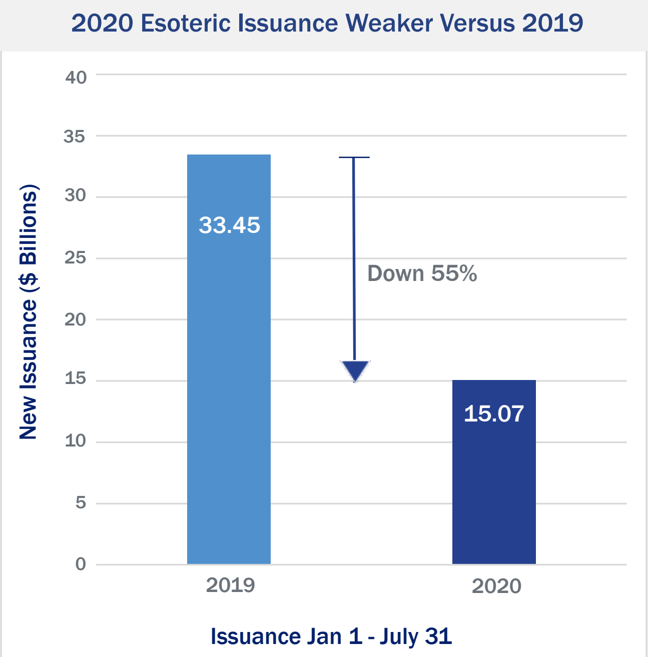
Understanding "Esoteric"

Conning's view is that the market for esoteric ABS offers compelling opportunities for investors seeking greater yields against more traditional fixed income securities of similar quality and duration. The asset class can also offer additional diversification, liquidity, and a low history of defaults. Issuance in the first half of 2020 fell by half compared to the same period in 2019 (see Figure 2) but we expect a rebound in the fourth quarter. Spreads remain wider now than pre-pandemic, but we believe there are investments that are worth the risk – although we encourage investors to work with asset managers well experienced in the asset class.

The term "esoteric" to some investors suggests an asset class that is difficult to understand. Our client experience suggests that is not the case – it's more that the class is backed by collateral that many investors may be less familiar with. Just because the securities offer higher yields than similarly rated debt does not necessarily mean they are less safe. They do present different risks but working with an experienced asset manager should help investors understand what those risks are and weigh the opportunities.

Figure 2



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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.

Esoteric ABS Risk Factors

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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Footnotes

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