IR+M

INCOME RESEARCH + MANAGEMENT

IR+M UPDATE

# The Best Defense is a Good Defense

July 24, 2017

**While the fixed income market seemingly has competing views on almost everything, one pervasive concern has been interest rates and the direction thereof. With corporate bond yields near post-crisis lows, we believe that investment grade securitized bonds represent an opportunity for short and intermediate duration strategies. Despite the overhang from the Global Financial Crisis (GFC), we believe that the securitized sector is a versatile asset that offers insulation from rising rates, additional income, and diversification.**

## Benefits of Shorter Duration[1]

- We believe that the best defense is a good defense. Fixed income securities differ in how they react to interest rate changes due to variations in duration, credit, and structure.
- The duration of the securitized sector is typically shorter than that of corporate bonds. In the Bloomberg Barclays US Aggregate Index as of June 30, the duration of corporate bonds was 7.5 years; the Agency mortgage-backed securities (MBS) sector was 4.7 years; and asset-backed securities (ABS) was only 2.3 years. As a result, the price decline of securitized bonds may not be as severe in a rising rate scenario.[2]
- In general, the duration of securitized bonds is short to intermediate in nature. The reason is twofold – the self-liquidating feature of the financial assets, such as mortgages and leases, generates cash flows that may be reinvested at potentially higher rates, and the shorter terms of the underlying loans or contracts.

## The Power of Diversification

- We believe that the securitized sector can be a good source of diversification, which may result in higher risk-adjusted returns.
- Since 2008, the securitized sector has exhibited a low correlation to investment grade corporates, high yield bonds, and equities. Within the asset class, securitized subsectors have also had low correlations to other subsectors.[3]
- The low correlation has been driven in part by disparate borrower types. With securitized bonds, investors are reliant on cash flows that may be derived from mortgages or auto loans that are paid by individual debtors. With corporate bonds, investors are dependent on the financial strength of corporate borrowers.

**Correlations to Other Asset Classes Are Low[3]**

| 10 Year | MBS | ABS | CMBS | IG Corp | HY Corp | S&P 500 |
|---|---|---|---|---|---|---|
| MBS | 1.00 | | | | | |
| ABS | 0.46 | 1.00 | | | | |
| CMBS | 0.47 | 0.49 | 1.00 | | | |
| IG Corp | 0.45 | 0.76 | 0.58 | 1.00 | | |
| HY Corp | 0.60 | 0.69 | 0.81 | 0.83 | 1.00 | |
| S&P 500 | 0.48 | 0.32 | 0.47 | 0.54 | 0.68 | 1.00 |

## This Is Not 2008

- Due to the aftereffects of the GFC, some investors may be reluctant to invest in today's securitized market; however, this is not 2008.
- Leading up to the downturn, the securitized market was characterized by a proliferation of risky subprime loans, which were made to borrowers with weak credit profiles that were often levered.
- While the overuse of financial leverage contributed to the GFC selloff, the securitized market is far less levered today.
- Since then, the securitized market has evolved in numerous credit positive ways, including stricter underwriting standards, increased regulation and transparency, decreased financial system leverage, and risk retention.
- Additionally, there have been several constructive developments, such as a renewed focus on collateral fundamentals and increased sponsorship of Agency MBS by the Federal Reserve.
- New issuance of MBS reflects the evolution of the securitized market over the past 10 years. In 2006, over half of all MBS issuance was non-agency, and almost 20% was subprime. In 2016, less than 10% of MBS issuance was non-agency, and less than 1% was subprime. Investors have kept their focus on high quality collateral.[4]

| Percent of Total MBS Issuance[4] | 2006 | 2016 |
|---|---|---|
| Non-Agency | 54.6% | 8.6% |
| Subprime | 17.0% | 0.1% |

[1]List includes a select number of benefits and does not include risks that could be associated with shorter duration, please contact us for more information about shorter duration. [2]Bloomberg Barclays as of 6/30/17. [3]Barclays POINT as of 6/30/17; data points shown are correlations of Bloomberg Barclays indices' excess returns, except for the S&P 500 Index, which is the total return of the index; excess returns are the curve-adjusted excess return of a given index relative to a term structure-matched position in Treasuries; darker green indicates lower correlation. [4]SIFMA. This report is for informational purposes only and is not intended to provide specific advice, recommendations for, or projected returns of any particular IR+M product. 

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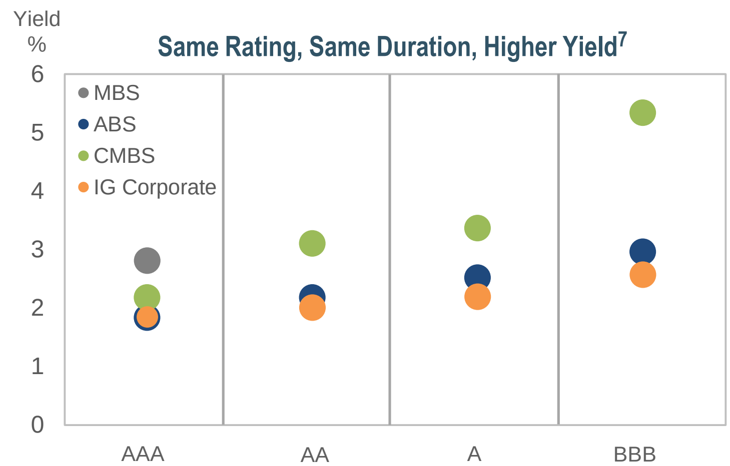
## Liquidity Continues to Improve Post-Crisis

- The liquidity profile of investment grade securitized bonds has improved since the GFC, and is not necessarily less than that of corporate bonds.
- Compared to Treasuries, riskier securitized and corporate bonds may experience more variability in liquidity during periods of market volatility.
- There are securitized subsectors that are more liquid than corporates. In 2016, the narrowest bid-ask spreads (4bps) were in ABS Autos and Credit Cards and To Be Announced (TBA) mortgage deals. Non-agency collateralized mortgage obligation (CMO) spreads were widest (58bps).[5]
- From 2012 to 2016, the bid-ask spread declined across nearly every securitized subsector. The exception was ABS Autos and Credit Cards, which was unchanged due to increased delinquencies on auto loans and credit card balances.[6]

| Security | 2012 Bid-Ask Spreads[5] (bps) | 2016 Bid-Ask Spreads[5] (bps) |
|---|---|---|
| MBS | 40 | 25 |
| TBA | 5 | 4 |
| Non-Agency CMO | 75 | 58 |
| ABS Auto/Credit Cards | 4 | 4 |
| Corporate | 40 | 34 |

## Yield Advantage of Today

- Although the market has largely recovered from the GFC, securitized bonds may still provide a yield advantage over corporate bonds that have comparable ratings and duration.
- For AA-rated securities in the one to five-year duration bucket, CMBS and ABS may offer added yield versus a similarly rated corporate bond.[3]
- Currently, the yield premium on securitized bonds is more pronounced in the AA, A, and BBB-rating categories. Investors can enjoy not only interest rate protection and diversification, but also attractive carry.[3]




## Sizeable and Diverse Universe

- At IR+M, in our short, intermediate, and core products, we believe in buying the most senior tranches of securitized deals that are backed by high-quality collateral.
- We have been focused primarily on the $10 trillion investment grade securitized market, which we believe is a strong and diversified opportunity set. Its size eclipses that of the investment grade corporate market, which amounts to nearly $5 trillion.[4]
- Just over half of securitized assets are fairly uniform Agency TBA mortgage deals; the remainder is heterogeneous. As such, we believe that we can identify value through our experience as bottom-up security selectors.[4]
- For example, the ABS sector, which accounts for nearly $1.3 trillion of the securitized market, is secured by a myriad of collateral types, such as credit cards, autos, shipping containers, aircraft, and franchise royalties.[2]
- Additionally, there can be diversity within deal structures. Securitized assets are segmented into tranches, which may provide different seniority, duration, and yield characteristics.

**At IR+M, we believe in taking what the market gives us, and exploiting opportunities as they arise. We feel that securitized bonds may be an appealing complement to corporate credit in the short/intermediate parts of the yield curve. Securitized bonds can provide not only greater loss protection during periods of rising rates, but also diversification and attractive carry. We maintain a steadfast commitment to bottom-up security selection and sector rotation, which we believe will help us deliver excess returns.**

[5]FINRA. [6]Wall Street Journal. [7]Sources: Bloomberg Barclays and IR+M analytics as of 6/30/17; sectors listed refer to Bloomberg Barclays Aggregate Index sectors and have been partitioned to include only the 1-5 year duration bucket of each respective sector. The views contained in this report are those of IR+M and are based on information obtained by IR+M from sources that are believed to be reliable. This report is for informational purposes only and is not intended to provide specific advice, recommendations for, or projected returns of any particular IR+M product. 