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INCOME RESEARCH + MANAGEMENT

IR+M UPDATE

Securitized 2.0: Revisiting the Securitized Market Post-Crisis

February 26, 2019

After falling out of favor post Financial Crisis, the securitized market is again in vogue. The latest iteration is decidedly different, with increased transparency, new issuers, and varied collateral types. The sector spans a wide spectrum, from government-backed bonds to structured credit, with seemingly something for everyone. At IR+M, we believe that our experience as bottom-up security selectors helps us uncover opportunities in this highly nuanced sector. Non-traditional securities may provide investors with attractive return and diversification potential.

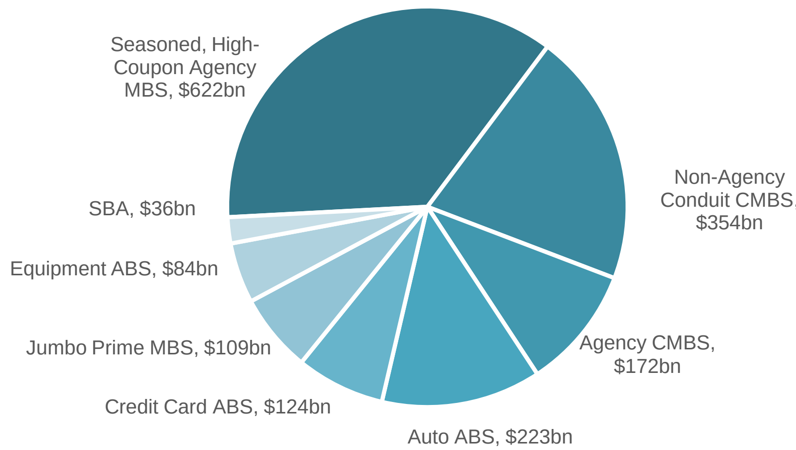
Variety is the Spice of Life

The $11 trillion securitized market offers an array of yield profiles, collateral options, and structural protections. Agency mortgages comprise the majority of bonds outstanding; the remainder is distributed across a variety of assets.

Government-backed bonds can provide differentiation. While these securities do not have credit risk, they do have risk related to the timing of cash flows.

We believe that the diversity inherent in the securitized sector is an opportunity. We rely on our extensive experience as bottom-up security selectors to dissect complex structures and reveal value.

A Slice of the Securitized Market



More Yield, Less Credit Risk

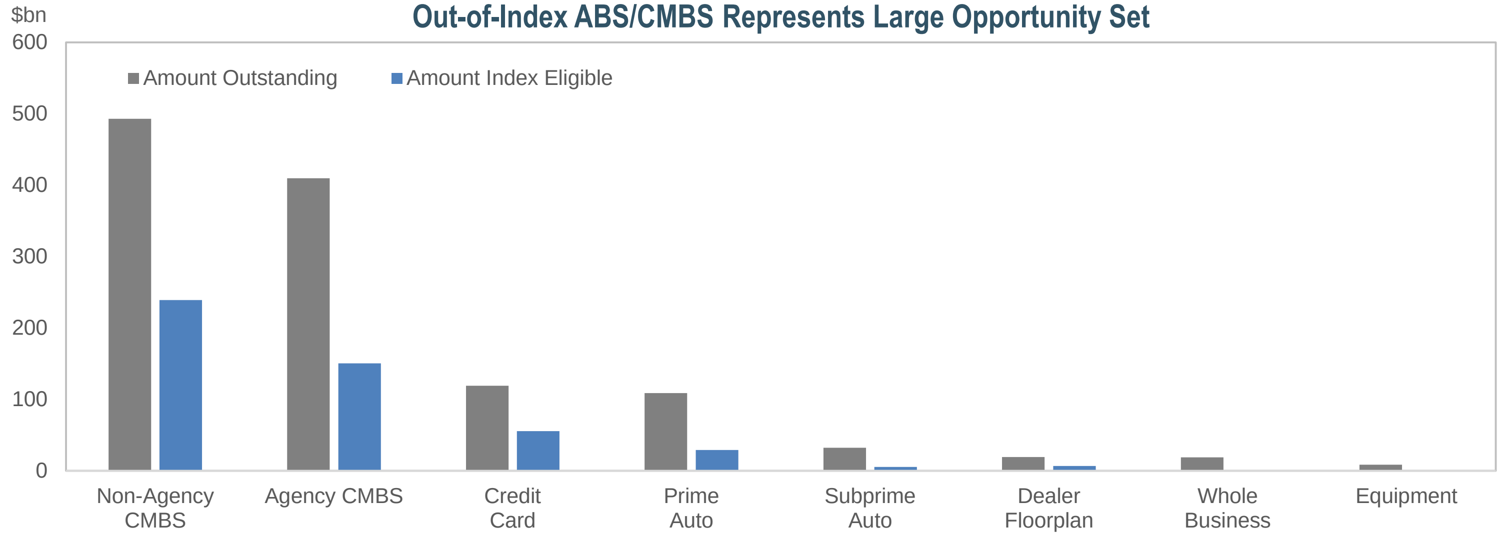
We see opportunity in government programs that may be new, limited in size, or less-followed. Small Business Administration (SBA) bonds fit this description. The SBA issues bonds that are guaranteed by the US government and typically have a 50 to 100 basis point yield advantage over Treasuries.

We use specified pools to gain exposure to Agency mortgages. With specified pools, we analyze both the loan-level and borrower characteristics of the underlying mortgages. We select pools that have more predictable future cash flows, which mitigate duration volatility during large interest rate swings.

	Seasoned, High-Coupon Specified Pools within Agency MBS	Freddie Mac Small Balance Multifamily Loan Program (FRESB)	Seasoned Credit Risk Transfer (SCRT)	Small Business Administration Bonds (SBAs)
Collateral	Seasoned, high-coupon (>4%) mortgage loans	Small balance, multifamily loans ($750k-$7mm)	Seasoned, modified, re-performing mortgage loans	Loans to small businesses
Credit Risk	None, Agency-backed	None, Agency-backed	None, senior tranches are Agency-backed	Carries full faith and credit of US Government
Issuance	Over $550 billion outstanding	~$500 million/month	$1 billion or more/quarter	~$300 million/month
Prepayment Penalty	No	Yes	No	Yes
Loan Features	Borrower seasoning decreases rate sensitivity; high quality and very liquid	Some tranches backed by Hybrid ARM loans, protecting against rising interest rates	Modified loans and once-delinquent borrowers offer two layers of prepayment stability	Underlying loans have embedded prepayment penalties to limit loan turnover
Spread	+40 to 60bps over Treasuries	+40 to 85bps	+90 to 100bps	+60 to 80bps

Sources: Bloomberg Barclays, JPMorgan, and SIFMA as of 12/31/18. Seasoned, high-coupon Agency MBS refers to segment of BloomBarc MBS Index with issue date of 2012 or earlier and coupon of 4% or higher.

Out-of-Index ABS/CMBS Represents Large Opportunity Set



Differentiated Credit Risk

We believe that securitized credit bonds can play many roles – either complementing or replacing corporate credit. The credit risk depends on the underlying collateral. For example, non-agency mortgages' credit risk is related to the housing market. We seek to mitigate that risk by focusing on bonds with high-quality borrowers and solid credit enhancement.

For asset-backed securities, the underlying collateral may consist of vehicles, credit cards, or equipment. In these deals, we maintain a senior position, and are further protected by investor-friendly performance and leverage triggers, which may help moderate losses and improve liquidity.

	Out-of-Index ABS (Asset-backed securities)	Non-Agency MBS 2.0
Collateral	Backed by tangible, high-quality collateral, such as equipment or franchise royalties	Pools of mortgage loans that do not meet criteria for inclusion in Agency pass-throughs
Credit Risk	Yes, but senior position in capital structure mitigates risk	Yes, but focus on borrowers with pristine credit and loans backed by full documentation, and asset verification
Issuance	Over $90 billion expected in 2019	$40 billion expected in 2019
Spread	+50 to 160bps over Treasuries	+85 to 125bps
Structural Features	Triggers that reroute cash flows to pay senior bonds in times of stress; credit enhancement covers estimated losses by 2-3x	Front cash flow tranche mitigates extension risk; credit enhancement covers estimated losses by 2-3x

As bottom-up investors, we believe that there is an abundance of opportunities to add value in the Securitized 2.0 marketplace. Depending on the strategy and client preferences, we invest across the securitized spectrum – from high-quality, government-backed bonds to higher yielding asset-backed securities (ABS) and non-agency mortgage-backed securities (MBS). We seek to unearth securities that add yield and improve the convexity profile and diversification of portfolios across our product solutions set. In broadly diversified portfolios, our corporate credit and securitized sector allocations vary based on cross-market, risk-adjusted relative value determinations. For clients who believe that the credit cycle may be nearing its end, or want to "disaggregate the Agg," a high-quality, best ideas securitized-only portfolio may be an attractive option.

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