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In Fixed Income, Better Questions Lead To Better Strategic Moves

KEYNOTE PRESENTATION: Exploring the strategic and tactical cases for incorporating Securitized Products into insurance portfolios.

Chris Brown, Head of Securitized Products, Portfolio Manager, **T. Rowe Price**

Chris Brown: By way of background, I have been at T. Rowe Price for 19 years. I am currently the Head of securitized products, and I also manage our core plus strategy. T. Rowe Price is a $1.5 trillion AUM global asset manager. Within that $1.5 trillion, a little bit less than $300 billion is in fixed income and within that amount, a little bit more than $30 billion is invested in securitized products. These assets are across all sectors, sub-sectors, and portions of the capital structure. various mandates ranging from low to high risk; fully active to buy and hold; and across investor types, including insurance investors.

When asked at the Clear Path Institutional Investor Live event about the risk versus reward for securitized products was, and whether it had changed since the GFC, it seemed that most impressions of securitized products had either improved or remained unchanged. We would agree with the former view.

As a small anecdote, I was in the APAC region a couple of weeks ago talking about securitized products, and I was struck by the amount of scepticism that was still out there in the region related to securitized. Much of this was a residual of the GFC, but when I thought more about it, it is not too surprising because some of that scepticism remains here in the US, though to a lesser degree.

It does feel that there has been a greater acceptance of securitized products, especially amongst insurance investors over the last 6 to8 years. Now, given the yield environment, there is a lot of interest in fixed income in general and securitized products in particular securitized.

I am here to make the case that the GFC days, and the excesses associated with them, are long over. The market has evolved immensely since then in various ways. Loan underwriting is far stronger, structures are more robust, and the leverage within securitized—and exogeneous leverage as well—is much lower. When you think about the tentacles that existed during the GFC and the various synthetic vehicles like collateralised debt obligations (CDOs) that were at the centre of the crisis— these don't exist anymore. The financial system is also on a far stronger footing with the banking system sturdier as well. We could argue that perhaps it is on too strong of a footing and that regulation may have overstepped, but that is a different topic altogether.

At T. Rowe Price, our fixed income team strongly feels that insurance investors should be allocated to securitized products. We tackle this from two different perspectives. Firstly, and strategically, we feel that insurers should consider owning securitized assets over the longer term. Secondly, from a tactical perspective, consider taking advantage of these opportunities, with Securitized now being one of them.

First, in terms of the structural reason to consider securitized, there is a yield premium to be harvested. It is not a free lunch, of course. They are complex instruments. For instance, when you invest in a corporate bond, essentially the two risks that you are exposed to are duration, or interest rate risk, and credit risk. Depending on what sector you are invested in within securitized, the risk exposures are more expansive and include rate volatility risk, prepayment risk, extension risk, credit risk, liquidity risk, etc. Hence, they are complex instruments with many of these structures backed by hundreds, if not thousands, of loans. Meaning, you need to have the resources to analyse these structures from a fundamental, quantitative, or computational basis.

Fortunately, T. Rowe Price has a very robust research platform through which we can conduct this type of analysis.

Second, there is no denying that liquidity is worse in securitized than it is in corporate bonds. While liquidity is important for everybody, as an insurance investor, you are probably a little bit less concerned with market-to-market risk and with daily or weekly liquidity, as you have that in other parts of the portfolio such as in your core positions. A dedicated securitized allocation can make a lot of sense as it potentially allows you to harvest this illiquidity premium.

To illustrate the embedded complexity and liquidity premium, we can look at the average spread pickup over the past 20 years. In the asset-backed securities (ABS) and commercial mortgage-backed securities (CMBS) markets. Using the respective Bloomberg indices. the average spread pickup relative to comparably rated corporate debt is substantial. If you were to look at the more esoteric parts of the securitized

market that are not included in the indices, this would be even more pronounced. Again, if you have the right resources, you can harvest this extra yield.

In terms of which market offers a better credit quality profile—corporate bonds, or securitized products—when looking at the entire market, you can make a strong case that securitized credits are stronger credits than corporate debt. If you look at the historical experience based on Standard & Poor's analysis of the transition from one rating to the next, either moving up in rating or down in rating over the last ten years, securitized products were upgraded at a higher rate than corporates, and they were also downgraded less often than corporates.

The reason for this is that most securitized products are amortising, so bonds pay down principal through time, causing them to de-lever. Also, the structural enhancements that are embedded in most types of securitized debt are there to protect the investment-grade bond holders.

After the complexity and liquidity premium, an additional reason for the structural case for securitized products is diversification. We mean this in the broad context of asset allocation. For the most part, we are looking at this versus corporate debt, which, of course, many insurance companies are heavily invested in. You can look at diversification in a number of ways. You can look at it in the classic way, which is by looking at empirical returns. If you look at the daily change in spreads in ABS and CMBS relative to corporates, you can see that the correlation is quite low with CMBS having an R-squared of 0.2. For ABS, it is close to zero at 0.09. So, purely from a return perspective, it is a diversifier to your more common corporate allocations.

There is another way to think about diversification, and that is from the perspective of your economic exposures.

Within securitized products, you have the opportunity to express a view on a very targeted portion of the economy. If you want to express a view on the consumer, for example, you can do that in the ABS market with the underlying collateral being credit card or auto loan receivables. You can express a specific view on certain pockets of housing using RMBS areas like non-qualified mortgages (non-QM) and single-family rental bonds. You can also access commercial real estate exposure using CMBS. Here, if you want to be more diversified, you can invest in the conduit market. but, if you want to take a more targeted approach by investing in a specific property, there is the single-asset/single-borrower market.

If you do like having a bit of a corporate flavor, there is the hybrid part of securitized, with CLOs being one obvious example as well as whole-business asset-backed securities.

In terms of what are the best structural reasons to consider incorporating securitized products into an insurance portfolio, the full mosaic of what I have been speaking about are the points that make securitized appealing to many insurance investors.

For the tactical case for securitized products, the complexity, and the liquidity challenges that I mentioned mean that oftentimes when we have market volatility, securitized can sell off more than is justified by the credit fundamentals. We saw this pretty starkly in 2022, with one great example being the non-QM RMBS market, which just got bludgeoned. Yet, if you looked at non-QM delinquencies through that time, they were stable, if not declining. If you plotted spreads versus fundamentals, it didn't make much sense. But if you overlaid this chart with interest rate volatility, spreads were much more correlated to that. This has to do with the fact that there is a lot of optionality embedded in many parts of securitized, resulting in negative convexity securitized Oftentimes, when you have broad market volatility, spreads rise to a level that is not warranted by fundamentals. In such cases, we feel that it makes sense to take advantage of that. As an investor, when there are inefficiencies in the market, these are the times when you want to pick up the bargains.

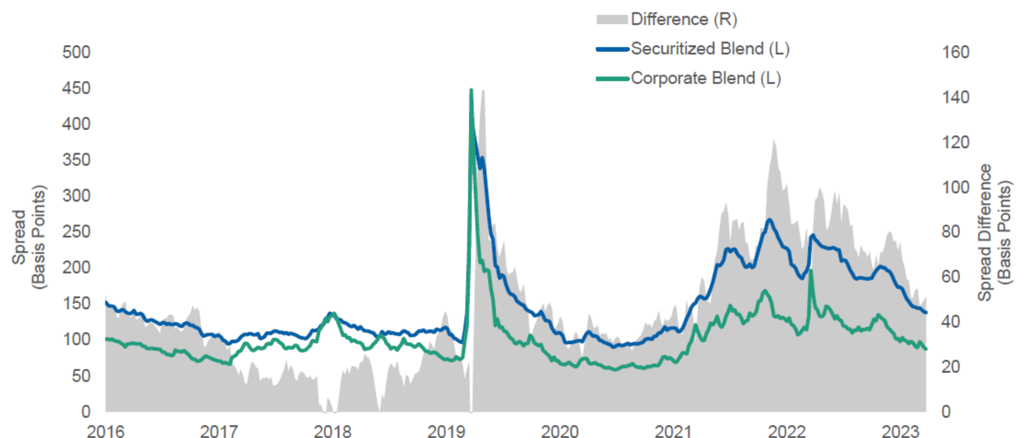
When you need to access liquidity, it helps to have an organization with the level of scale that T. Rowe possesses.

Looking at relative value today, we show a custom benchmark of the securitized credit market relative to corporates. You can see that a lot of the damage that was done in 2022 has been recovered, but not fully. We still haven't gotten back to the types of levels that we saw pre-Covid, so there is still a relative value case to be made for securitized products.

Securitized credit relative value

As of 28 March 2024

Spread to corporates has not fully normalized to pre-pandemic levels



For details on the composition of the securitized and corporate blends referenced above please see below Source: Bloomberg Index Services Ltd, JP Morgan, Bank of America, ICE BofA, Analysis by T. Rowe Price.

Lastly, we show an example of a securitized credit portfolio that we manage for a large US-based insurer. It is a high quality, single-A rated portfolio containing almost every type of securitized credit except for CLOs (but we also manage a dedicated CLO

portfolio for this particular client). In this portfolio, the yield to worst is 7%, which is quite attractive.

Sample securitized credit portfolio

As of 28 March 2024

	Sample Client Portfolio ($516.6 million)			Portfolio YTW		6.90%	Custom Benchmark[1]		Benchmark YTW		5.60%	Portfolio Net Of Benchmark		YTW vs. Bench		1.30%
	Exposure (%)	Book Yield (%)	OAS (bps)[2]	YTW (%)[3]	C2YTW (%)[4]	C2ed (yrs)[5]	Exposure (%)	OAS (bps)[2]	YTW (%)[3]	C2YTW (%)[4]	C2ed (yrs)[5]	Exposure (%)	OAS (bps)[2]	YTW (%)[3]	C2YTW (%)[4]	C2ed (yrs)[5]
Total Portfolio	100.0	4.2	231	6.9	6.9	3.0	100.0	110	5.6	5.6	3.3	-	121	1.3	1.3	(0.4)
CASH	2.0	-	-	-	-	-	-	-	-	-	-	2.0	0	0.0	0.0	0.0
ABS Total	23.3	4.9	186	6.5	1.5	0.7	40.0	54	5.2	2.1	1.0	(16.7)	133	1.3	(0.6)	(0.4)
CMBS Total	46.1	3.8	323	8.0	3.7	1.1	60.0	148	5.9	3.6	2.3	(13.9)	175	2.1	0.1	(1.2)
Agency MBS Total	6.0	6.6	53	5.8	0.3	0.2	-	-	-	-	-	6.0	53	5.8	0.3	0.2
RMBS Total	22.6	4.1	159	6.1	1.4	1.0	-	-	-	-	-	22.6	159	6.1	1.4	1.0

KEY RATE DURATION (YRS)

	6-Mo	2-Year	5-Year	10-Year	20-Year	30-Year	Total Option-Adj. Duration
Sample Client Portfolio	0.13	0.79	1.23	0.60	0.20	0.03	2.98
Custom Benchmark[1]	0.13	0.90	1.47	0.57	0.16	0.06	3.34
Difference	0.00	(0.11)	(0.24)	0.03	0.04	(0.03)	(0.36)

Large global insurer client sought a highly customized securitized credit portfolio that could provide an attractive source of book yield and further diversify their existing core bond, high yield, and bank loan portfolios

Past performance is not a reliable indicator of future performance.

The information presented is for illustrative purposes only and is not intended to be a recommendation to buy or sell any particular security. The sample portfolio is based on an internal model and results shown may differ materially from an actual portfolio managed by T. Rowe Price Associates, Inc.

[1]40% Bloomberg US ABS/60% Bloomberg US Non-Agency CMBS: Agg Eligible.

[2]OAS – Option-Adjusted Spread (bps).

[3]YTW – Yield to Worst (%).

[4]C2YTW – Contribution to Yield To Worst (%).

[5]C2ed – Contribution to Effective Durations (yrs).

At T. Rowe Price, we feel very strongly that the insurance business is a high-touch, white-glove type, and we believe in partnering with our clients. This extends to offering access to our investment staff, providing education to those who may not have a lot of experience in the securitized asset class, and creating customized solutions.

Thank you for your time.

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Additional Information

Securitized Blend	
JPM CMBS 3.0 10-Year Last Cashflow AAA Index	12.5%
Bank of America AAA 2Y Fixed Rate NON-QM Nonagency vs Treasury Index	7.5%
Bank of America AAA 4Y Fixed Rate RPL A1 Nonagency vs Treasury Index	5.0%
JPM CLO 2.0 AAA Index	10.0%
Bank of America AAA 3Y Fixed Rate Subprime Auto vs Treasury Index	2.5%
Bank of America AAA 3Y Fixed Rate Prime Auto vs Treasury Index	2.5%
Bank of America AAA 3Y Fixed Rate Equipment vs Treasury Index	2.5%
Bank of America AAA 3Y Fixed Rate Timeshare ABS vs Treasury Index	2.5%
Bank of America AAA 5Y Fixed Rate Rental Car ABS vs Treasury Index	2.5%
Bank of America AAA 3Y Fixed Rate Refi Student Loan vs Treasury Index	2.5%
JPM CMBS 3.0 10yr Single-A Index	5.0%
JPM CMBS 3.0 10yr AA Index	7.5%
Proprietary series of OAS based on new issuance observations	6.3%
Bank of America OTR A 5Y Floating Rate STACR M1A CRT vs SOFR Index	6.3%
JPM CLO 2.0 AA Index	7.5%
JPM CLO 2.0 A Index	2.5%
JPM Subprime Auto BBB 3Y Index	5.0%
JPM Prime Auto BBB 3Y Index	5.0%
JPM Equipment A 3Y Index	2.5%
Bank of America Class B 7Y Fixed Rate Refi Student Loan vs Treasuries Index	2.5%

Corporate Blend	
JULI IG 3Y Single-A Index	37.5%
JULI IG 10Y Single-A Index	12.5%
JULI IG 3Y BBB Index	37.5%
JULI IG 10Y BBB Index	12.5%

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