

Frequently Asked Questions: Securitized Credit



Trust must be earned

How liquid are securitized assets?

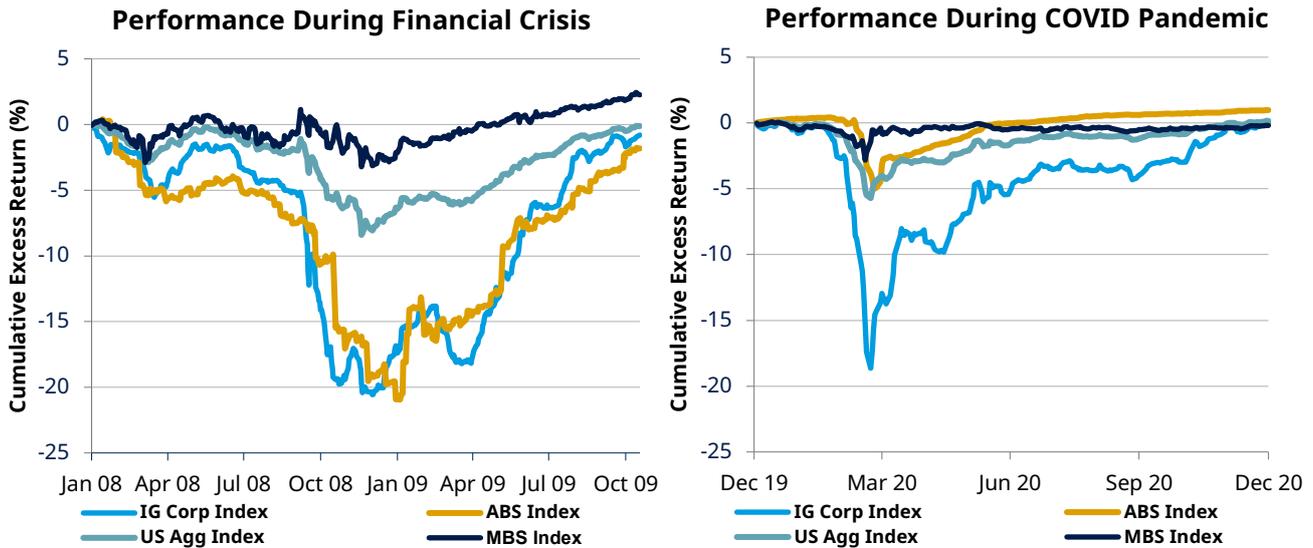
Securitized credit liquidity varies by sector size and market stress. Agency mortgage-backed securities (MBS), backed by the U.S. government, are normally considered the second most liquid asset in the world behind U.S. Treasuries. Securitized credit assets (not government-guaranteed), as a general statement, have similar transaction costs (bid-ask) to comparably rated corporate bonds in a normal market environment. However, securitized credit assets are smaller in comparison to corporate credit in terms of annual issuance, amounts outstanding, and trading volume. Therefore, while the transaction costs may be similar to corporate credit, corporate credit may be able to transact in larger sizes.

Additionally, securitized credit sectors are diverse and numerous in nature, leading to a broad spectrum of credit ratings, market sizes, and liquidity. Financial regulations affect sectors differently in terms of broker-dealers' willingness to provide balance sheet, and the Federal Reserve Bank has implemented liquidity support programs specifically to subsectors within the space. In terms of government and regulatory liquidity support, we believe agency MBS are generally supported most, followed by corporate bonds, with non-agency securitized credit typically receiving the least outside liquidity support.

What if there is another global financial crisis / COVID?

Broadly speaking, credit strategies should be expected to experience substantial mark-to-market volatility during a crisis scenario. However, we believe the epicenter of the next financial crisis is unlikely to be found within the securitized sectors in which we are currently focused. Therefore, though an economic downturn or crisis would likely affect investment performance, we believe the backward-looking biases against the asset class have resulted in the market assigning overly cautious scenarios to securitized valuations. In our view, investors with a forward-looking perspective have been rewarded with excessive risk premiums.

During both the financial crisis and COVID pandemic shock, agency MBS protected well to the downside, while many securitized credit sectors saw large drawdowns followed by steady recoveries. Should another economic downturn take place, the resilience of fundamentals should ultimately prevail over short-term technical dynamics.



What is the capacity of securitized assets?

The agency MBS market is close to \$10 trillion in size, similar to that of the U.S. corporate market. While capacity is not an issue in the agency MBS market, securitized credit sectors such as non-agency MBS, commercial MBS, and consumer asset-backed securities (ABS) combined total around \$3 trillion, leaving certain sectors large and liquid and others more size-constrained and unique. We believe our investment process allows us to stay nimble and retain access to some of these size-constrained sectors where we look for value where other market participants may not participate.

Is it late in the credit cycle?

We think the credit cycle within many securitized sectors is dislocated from the credit cycle playing out in other asset classes. Given the large subset of investible securitized sectors such as residential housing, consumer credit cards, automobile loans, hotels, and commercial properties, active managers are bound to find pockets of the market where they find value and where they don't find value at any given point in the credit cycle. Investors seeking to reduce their credit exposure but maintain their income potential may consider reallocating to securitized credit away from corporate credit.

Are U.S. mortgage prepayments important to mortgage-backed securities?

While prepayments (homeowners paying back their mortgage early and forgoing making long-term interest payments) are a central consideration when investing within Agency MBS, they are of ancillary importance in many securitized credit sectors. Some credit sectors have typically included features that protect investor's interest income from borrower's prepayments, and many residential credit securities actually benefit from prepayments to the extent that prepayments help de-lever the security's capital structure. Prepayment expectation modeling is a centralized part of our investment process and is a large part of our strategy to produce excess returns.

How should I view securitized assets in broader portfolio construction?

We believe investors should consider a long-term strategic allocation to securitized strategies either within a multi-sector mandate or through a dedicated strategy. Because of the post-2008-crisis inefficiencies that persist within securitized sectors, as well as post-COVID shock demand dynamics, we believe investors should consider a tactical overweight to this exposure. While the overall risk and return profile depends on whether your exposure is heavily weighted to U.S. government-guaranteed assets (typically considered AAA rated) like agency MBS vs. investment grade or below investment grade securitized credit sectors, the relatively low historic correlation to corporate credit and equity markets suggests that securitized assets can serve as a valuable complement to other traditional exposures.

What should I expect from securitized assets within a multi-sector portfolio?

The role in most scenarios of securitized assets is to provide diversification and income enhancements to the broader portfolio context. For example, in most scenarios, the cash flows from a pool of auto loans in the southeastern United States would have a low correlation with global monetary policy, unemployment rates in Europe, or GDP levels in China. However, we have seen these kind of macro risk factors drive equity and corporate bond returns. At the same time, these are assets that have generally offered high income potential. So securitized credit can either complement core portfolio positioning, or enhanced income, or fall somewhere in between.

Agency MBS on the other hand may be a source of additional yield over Treasuries while still providing risk-off protection in times of market stress. There has never been a default on an agency MBS security, not even during the Global Financial Crisis in 2008. We believe any multi-sector portfolio that allocates to government bonds, should also allow allocations to agency MBS or else they are missing a potential return enhancer.

How do you determine an allocation to securitized assets in multi-sector portfolio?

The Pioneer Investment team believes in modern portfolio theory, which dictates that evaluating a larger opportunity set of securities should provide a better chance at producing excess returns. The team monitors current yield levels, spreads, historical relative value levels, and inter-sector valuation relationships to determine which bond sectors, in our view, have the most promising forward-looking risk adjusted returns. We then factor in correlation levels between sectors in order to produce a diversified portfolio, with multiple sources of returns that is overweighted to high expected risk adjusted return sectors. Sometimes our analysis will suggest an overweight to securitized assets, and sometimes valuation levels will suggest an underweight, the point is that we want to have securitized assets in our investible universe so we can take advantage of the potential opportunities that present themselves.

How do securitized credits react to rate cut environment?

In an interest-rate cutting cycle, securitized credits, when paying fixed rates, will experience a valuation support similar to traditional corporate bonds (i.e. there is an inverse relationship between yield and security price). On the other hand, securitized credits, when paying floating rate (for instance CLOs), will not experience such support, as the coupons will reflect lower yield as the central lower rates.

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