For professional clients only

Aon Investment Research and Insights

Securitised credit

March 2018

Aon
Empower Results®

Table of contents

Executive summary 3

What is securitisation? 4

Securitised credit after the global financial crisis. 4

- Credit ratings 4
- Modelling 5
- Other regulatory changes. 5

What are the key purposes of securitisation and why should investors be interested in securitised credit? 5

- Floating rate cashflows 5
- Short maturities. 5

Different types of securitisations that investors should focus on 6

The case for securitised credit 6

How can clients gain exposure to securitised credit? 7

Conclusion 8

About Aon Investment Research and Insights

Aon's robust portfolio of ideas, tools and researched solutions support trustees and sponsors to anticipate their future investment requirements.

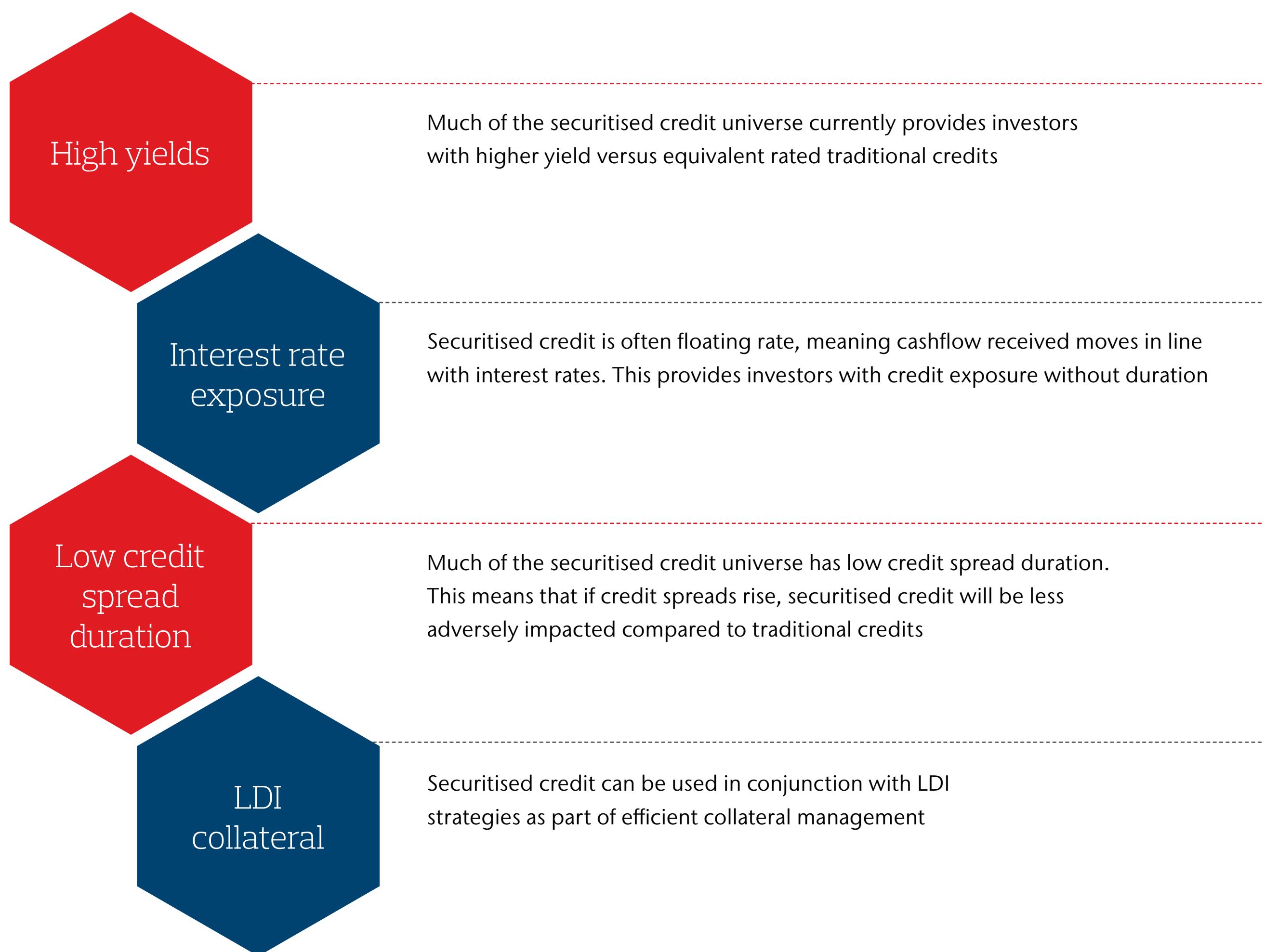
By beginning to identify investment research and communicate ideas before they are needed we can shorten the implementation times for our clients and act in a timely way when opportunities are correctly priced.

To learn more and to access other research and insights from Aon's investment experts, visit **aon.com/investmentuk**

Executive summary

Securitised credit strategies are often overlooked in favour of traditional credit markets; however we believe there are a number of key benefits by investing in securitised credit. This paper provides an overview of the benefits of the securitisation process and why it is an attractive asset class for investors to consider.

Key conclusions are as follows:



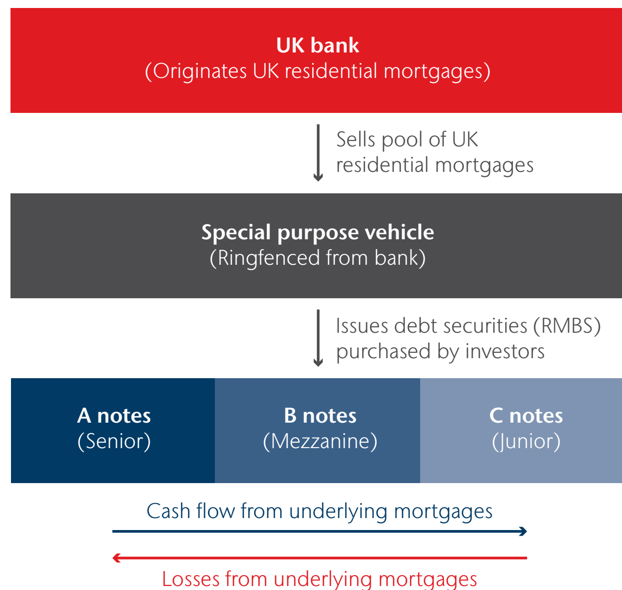
What is securitisation?

Securitisation is the process of grouping a number of assets together and selling the cash flows from these assets to investors.

These assets can be a right to any set of future cash flows such as loans, bonds, mortgages or toll revenues. Securitisations often have different "tranches" of debt. The most senior tranche has the first claim on the pool of underlying assets, with losses being absorbed by other tranches before the senior investors. By providing different tranches with different risks and coupon levels, investors with varying needs can obtain the exposure they desire.

The image to the right shows a simplified example of a securitisation of UK residential mortgages.

Note that the securitised credit asset class is often also referred to as asset backed securities and structured credit, however in this paper we will refer to it as securitised credit.



Securitised credit after the global financial crisis

Securitised credit is often described as being at the heart of the global financial crisis and is perhaps still tainted by its association. In reality, defaults in securitised credit were predominantly in securities related to US sub-prime mortgages. Ultimately, other types of securitised credit assets performed well.

Due to the following regulatory and structural changes, we believe that securitised assets are much safer than before the financial crisis:

Credit ratings

Prior to the crisis, there was a shortage of high quality debt. This, combined with the fact that credit rating agency fees are paid for by the underwriter, created an incentive for credit rating agencies to choose methodologies which could give securitised assets superficially high credit ratings.

Regulatory oversight on the ratings agencies has since increased, and methodologies have been changed in an attempt to ensure ratings are a true representation.

Modelling

Financial modellers made several major errors. In the case of subprime mortgages, they failed to model in a falling house price environment and also failed to recognise that default rates were likely to be highly correlated.

Today, the modelling is more sophisticated and can more accurately simulate these effects.

Other regulatory changes

- There is now a greater quantity of riskier tranches relative to senior tranches meaning the losses on the underlying pool of assets have to be greater before the senior tranches are hit.
- Putting securities which are themselves securitised into another securitisation is now banned.

What are the key purposes of securitisation and why should investors be interested in securitised credit?

The securitisation process offers the following two key benefits:

- Securitisation can convert lots of small loans, which would otherwise not be economically viable to trade, into tradable securities.
- It can turn a pool of assets into a variety of securities with differing levels of risk and potential return.

The securitisation process therefore allows investors to gain exposure to more assets in the real economy and at a level of risk appropriate for their risk tolerance.

Floating rate cashflows

- Securitised credit assets are often floating rate. If rates rise, so does the level of cashflow received from the underlying asset pool.
- These floating rate securitised credit assets can be used in conjunction with leveraged LDI strategies; generating the floating payments required to repay the LDI borrowing costs. In the case of highly rated and liquid securities, these can be used as assets readily realisable should there be a call for capital within a pooled LDI strategy.

Short maturities

Senior tranches of securitised credit often have short maturities which cause the asset’s credit spread duration to be relatively low. This means that if spreads widen, the price is less adversely affected. Conversely, if spreads narrow, securitised credit will miss out on the price appreciation traditional credits will experience.

Different types of securitisations that investors should focus on

The Asset Backed Security (ABS) universe is extremely broad with much of it focused on the needs of short-term investors.

The following are the types of ABS that we think are interesting for longer-term investors:

- **Mortgage Backed Securities (MBS)** – securities backed by mortgages
- **Collateralised Debt Obligations (CDO)** – secured by tradable securities such as leveraged loans, high yield bonds and other structured credit securities
  - **Collateralised Loan Obligations (CLO)** – secured by tradable leveraged loans

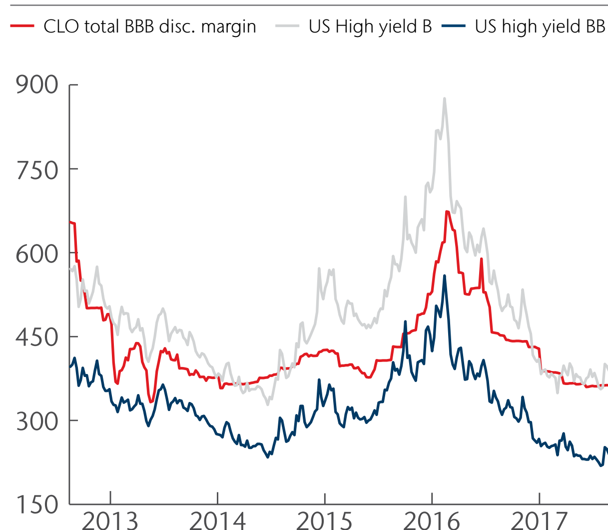
A recent report by the asset allocation team *('AA View – Securitised Credit: A Good Alternative to Corporate Bonds?')* argued that senior tranches of CLOs were a particularly attractive asset class. They are extremely cautious on traditional investment grade credit given that spreads are very tight. They argue that senior tranches of CLOs have minimal credit risk, but still pay an attractive spread. Furthermore because credit spread and rate duration are both low they are less exposed to a widening spread and higher rates environment which they fear will be a feature of 2018.

The case for securitised credit

Why investors should pay attention to securitised assets is perhaps best illustrated by comparing the spreads on BBB rated CLOs versus high yield corporate debt. Assuming we can rely on the credit ratings agency ratings, the below chart shows that investors can achieve high yield spreads by investing in CLOs despite only taking investment grade risk.

The graph shows the credit spread on different securities through the passage of time.

Investment Grade Securitised Credit Spreads versus Corporate High Yield Spreads



Source: JP Morgan, BAML and Thomson Reuters

There are various explanations given as to why securitised assets trade at a higher yield. We believe the best explanation is because the credit market is somewhat inefficient and that only the best securitised credit managers can capitalise on this. This inefficiency in the market could well be linked to the associations with the Global Financial Crisis.

Other common explanations to explain the differing spreads are as follows, but may not be plausible for the following reasons:

- **Credit agency mistrust** — some argue that the reason why securitised assets trade at a higher yield is because investors do not believe the rating agencies. However, this does not explain why some forms of securitised credit trade in line with their ratings whilst others don't.
- **Iliquidity premia** – investors demand extra return in order to compensate for the fact that it will be difficult to sell the asset at the prevailing market price, particularly in a stressed market. However, this does not ring true in the case of CLOs as the assets are currently liquid yet still have wide spreads.

Many commentators also reference a complexity premium. We reject this concept — the idea behind it is that investors demand extra return for the effort involved in researching complex securitised credit assets. However, if it is required in securitised credit then why is it that it is not present in all areas of financial markets? For example, there is no evidence to suggest that investing in companies with complex business structures yields higher returns.

How can clients gain exposure to securitised credit?

There are a number of ways in which clients can access securitised credit

- **A standalone strategy** — a number of investment managers offer specialist strategies investing solely in securitised credit. We have an array of buy rated products which range in liquidity and risk/return profile.
- **A structural component within Multi-Asset Credit (MAC) strategies** — there are a number of buy rated MAC products which use securitised credit as a core holding.
- **An opportunistic allocation in strategies across the fixed income spectrum and Diversified Growth Funds** — where permitted, portfolio managers can benefit from the additional diversification and higher yields provided.

Conclusion

We believe that securitised credit should be considered by investors given the higher yields available compared to equivalent-rated credit.

We believe that securitised credit should not be disregarded due to its associations with the Global Financial Crisis and that securitised credit can be safer than traditional credit.

Securitised credit can be accessed on a wide spectrum in terms of risk/return and liquidity.

Care should be taken when selecting a manager as we believe the market to be complex and somewhat inefficient. We believe this means that only the best securitised credit managers can capitalise on opportunities.

Please contact your usual Aon investment consultant to learn more about securitised credit and how securitised credit can fit in your portfolio.

We're here to empower results

For more information visit
aon.com/investmentuk
or contact your Aon representative.

Contacts

John Belgrove
Senior Partner
john.belgrove@aon.com
+44 (0)20 7086 9021

Kate Charsley
Partner
kate.charsley@aon.com
+44 (0)117 900 4414

Sion Cole
Senior Partner and Head of Client Solutions
sion.cole.2@aon.com
+44 (0)20 7086 9432
Follow me on twitter – @PensionsSion

Tim Giles
Head of UK Investment Consulting
tim.giles@aon.com
+44 (0)20 7086 9115

With thanks to our authors

Derry Pickford
Principal Consultant

Michael McKenna
Investment Analyst

About Aon

Aon plc (NYSE:AON) is a leading global professional services firm providing a broad range of risk, retirement and health solutions. Our 50,000 colleagues in 120 countries empower results for clients by using proprietary data and analytics to deliver insights that reduce volatility and improve performance.

For further information on our capabilities and to learn how we empower results for clients, please visit http://aon.mediaroom.com.

© Aon plc 2018. All rights reserved.

This document and any enclosures or attachments are prepared on the understanding that it is solely for the benefit of the addressee(s). Unless we provide express prior written consent, no part of this document should be reproduced, distributed or communicated to anyone else and, in providing this document, we do not accept or assume any responsibility for any other purpose or to anyone other than the addressee(s) of this document.

Notwithstanding the level of skill and care used in conducting due diligence into any organisation that is the subject of a rating in this document, it is not always possible to detect the negligence, fraud, or other misconduct of the organisation being assessed or any weaknesses in that organisation's systems and controls or operations.

This document and any due diligence conducted is based upon information available to us at the date of this document and takes no account of subsequent developments. In preparing this document we may have relied upon data supplied to us by third parties (including those that are the subject of due diligence) and therefore no warranty or guarantee of accuracy or completeness is provided. We cannot be held accountable for any error, omission or misrepresentation of any data provided to us by third parties (including those that are the subject of due diligence). This document is not intended by us to form a basis of any decision by any third party to do or omit to do anything.

Any opinions or assumptions in this document have been derived by us through a blend of economic theory, historical analysis and/or other sources. Any opinion or assumption may contain elements of subjective judgement and are not intended to imply, nor should be interpreted as conveying, any form of guarantee or assurance by us of any future performance. Views are derived from our research process and it should be noted in particular that we can not research legal, regulatory, administrative or accounting procedures and accordingly make no warranty and accept no responsibility for consequences arising from relying on this document in this regard.

Calculations may be derived from our proprietary models in use at that time. Models may be based on historical analysis of data and other methodologies and we may have incorporated their subjective judgement to complement such data as is available. It should be noted that models may change over time and they should not be relied upon to capture future uncertainty or events.

Aon Hewitt Limited is authorised and regulated by the Financial Conduct Authority. Registered in England & Wales. Registered No: 4396810.

Registered Office:
The Aon Centre
The Leadenhall Building
122 Leadenhall Street
London EC3V 4AN

Copyright © 2018 Aon plc

aon.com

AON
Empower Results®