Taking Another Look at Securitized Credit

Fundamental research can reveal opportunities in the asset class.

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KEY INSIGHTS

- Securitized credit can be a useful fixed income allocation for institutional investors who focus on book yield or those trying to match future pension liabilities.
- The asset class typically provides a meaningful credit spread advantage over corporate bonds with similar credit quality, as well as diversification benefits.
- Building a customized securitized credit portfolio is an iterative process in which we work closely with the client to refine investment guidelines.

Securitized credit can be a useful fixed income allocation for institutional investors who focus on book yield or those trying to match the cash flows of future pension liabilities. The asset class, which broadly consists of asset-backed securities (ABS), non-agency mortgage-backed securities (RMBS), commercial mortgage-backed securities (CMBS), and collateralized loan obligations (CLOs), typically provides a meaningful credit spread advantage over corporate bonds with similar credit quality. Although bonds in the asset class are often complex, this complexity can work to an investor's advantage as thorough fundamental research can often uncover attractive opportunities in securitized credit.

While liquidity can be limited in some segments of securitized credit, particularly versus high-grade corporate and government bonds, it is meaningfully better than in some alternative pension fund allocations, such as private credit. Also, book yield-focused investors are generally reluctant to realize gains or losses on their holdings because of unfavorable tax treatment, so they can largely be considered buy and hold investors. This makes them less sensitive to mark-to-market price fluctuations and less focused on returns relative to a benchmark. Because of their longer-term horizon, they may also be more comfortable holding less-liquid assets.

Typical Spread Premium to Similar-Quality Corporates

We have found that many investors focusing on book yield have historically had relatively concentrated exposure to corporate credit, both investment grade and high yield. Because of its relative complexity and more limited liquidity, securitized credit generally offers a spread premium to comparable corporate credit, a factor that has historically helped generate relatively attractive risk-adjusted returns (i.e.,

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Sharpe ratios). The securitized credit asset class also offers diversification benefits for portfolios with large corporate credit exposure because securitized performance is driven by different risk factors, such as consumer and real estate fundamentals, and can diverge from corporate performance at different points of the credit cycle.

Another advantage of securitized credit for some institutional investors is that there are also meaningfully more AAA rated bonds available in securitized credit than in other fixed income asset classes such as corporate bonds, where top-rated issuers are increasingly rare. Regulations require some investors to hold less reserves against these high-quality securities than against lower-quality bonds, freeing up assets and reducing their cost of capital.

Focus on Identifying Attractive Book Yield and Robust Fundamentals

T. Rowe Price's focus on deep fundamental research, which seeks to identify credit deterioration ahead of the rating agencies, allows us to concentrate on identifying attractive book yields from securities that have robust fundamental underpinnings. As long as we have a high degree of confidence that a security will mature at par, permitting the investor to capture the full book yield over the life of the investment, we—and more importantly, the end investor—can be somewhat indifferent to day-to-day price fluctuations related to market risk sentiment or liquidity conditions.

We pride ourselves on partnering closely with our book yield-focused investors, tailoring their portfolios to maximize book yield given each client's unique credit quality constraints, risk tolerance, and return targets. The heterogeneous nature of the securitized credit sectors and subsectors, combined with our deep research capabilities, allows us to find yield from a variety of sources, including both traditional and more esoteric areas of the securitized markets.

Iterative Process to Build Customized Portfolio

Building a customized portfolio for a book yield-focused investor is typically an iterative process in which we work closely with the client to fine-tune the investment guidelines over time. This is particularly true for investors that may have had limited exposure to securitized credit in the past. In these instances, we focus on educating the client through conversations with our portfolio managers and credit analysts.

Once the portfolio is established, we communicate regularly with the client to maximize book yield and manage portfolio credit quality by integrating cash inflows resulting from the client's business growth. We also reinvest interest income and security paydowns to minimize cash drag. Because the asset class lacks a comprehensive benchmark, we can collaborate with the client to create a custom benchmark to measure the portfolio's relative performance over time.

Updates on Evolving Securitized Credit Markets

We provide regular updates on account performance and the factors that drove returns, and our investment and client relationship teams keep clients informed of our market outlook and new developments as securitized markets evolve. We also analyze the potential costs or benefits of realizing a gain or loss on a security where our analysts have concerns around its credit quality trajectory or see better opportunities in other areas of the market.

Book yield-focused investing also requires unique recordkeeping capabilities given the tax-sensitive nature of these types of portfolios. To assist in that regard, we have partnered with Clearwater Analytics to provide our clients with seamless, real-time access to all the requisite portfolio accounting data. As of December 31, 2022, clients had entrusted more than USD 17 billion in securitized credit assets to our management, demonstrating our expertise in the asset class.

General Fixed Income Risks

Capital risk—the value of your investment will vary and is not guaranteed. It will be affected by changes in the exchange rate between the base currency of the portfolio and the currency in which you subscribed, if different.
ESG and Sustainability risk—May result in a material negative impact on the value of an investment and performance of the portfolio.
Counterparty risk—an entity with which the portfolio transacts may not meet its obligations to the portfolio.
Geographic concentration risk—to the extent that a portfolio invests a large portion of its assets in a particular geographic area, its performance will be more strongly affected by events within that area.
Hedging risk—a portfolio's attempts to reduce or eliminate certain risks through hedging may not work as intended.
Investment portfolio risk—investing in portfolios involves certain risks an investor would not face if investing in markets directly.
Management risk—the investment manager or its designees may at times find their obligations to a portfolio to be in conflict with their obligations to other investment portfolios they manage (although in such cases, all portfolios will be dealt with equitably).
Operational risk—operational failures could lead to disruptions of portfolio operations or financial losses.

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