INVESTMENT INSIGHTS

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How Securitized Credit Can Help Enhance a Fixed-Income Portfolio

An evolving macro environment coupled with positive market fundamentals make securitized credit investments an attractive option for pension funds looking to diversify their fixed-income portfolios.

"I think in this macro environment, there are definitely some implications for the credit side of a fixed-income portfolio," said Dave Goodson, who is head of securitized credit at Voya Investment Management, which managed $17.2 billion in securitized credit as of March 31, 2019. "And I think a big takeaway is that securitized credit offers a very nice diversifying alternative to the risks that support a corporate credit allocation."

According to Goodson, securitized credit, which includes asset-backed, commercial and residential mortgage-backed securities, and collateralized loan obligations, makes a lot of sense to help promote diversification of risks in a fixed-income portfolio, especially against the current backdrop in which more risks could be brewing.

"A low-rate regime is definitively back in place, at least in our minds, and is supported by what you see in the shape of the yield curve," Goodson said. "And if you were to look at forward curves of what the market's pricing in for changes in the federal funds rate, it would suggest we're in for a relatively long period of suppressed rates."

Such an environment can benefit securitized credit investments because it increases the ability to refinance a larger portion of loans that collateralize the strategy's transactions, according to Goodson. And while that can also increase prepayments, which can hurt portfolio returns, "for a large portion of this universe, those prepayments actually represent good guys — cash flows that will deleverage your structure, which the market, over time, perceives as increased creditworthiness."

DIVERSIFICATION THROUGH THE CYCLE

With the likely ensuing upgrades in bond holdings, Goodson said that "we see some micro-level benefits from the lower-rate environment starting to manifest, and we're at the very front end of that today.

"I think the market's yet to price that in, so there's some opportunity that comes with this low-rate environment," he continued.

Irrespective of these tactical opportunities, Goodson said he believes that pension funds considering securitized credit should think of it as "a through-the-cycle allocation, one that can stand alongside investment-grade corporate credit, high yield and emerging markets."

The strategy's drivers of return — generally U.S.-centric securities — are "a pretty diverse mix of risks that you can attach yourself to," allowing for "lots of options as, inevitably, the market cycles through time, and different risks become more attractive than others," Goodson said.

"So being able to have a way to play the markets in a wide range of scenarios using the complete securitized credit footprint, uniquely provides that potential edge to win, and do it consistently," he continued.

Securitized credit also accommodates a relatively wide range of tolerances for risk or volatility with the structure around the securities' underlying collateral pools a key lever, Goodson said.

"We can structure, for example, an investment-grade-only level of risk in a mandate for a client that would carry inherently less volatility," he explained. "Or for somebody who is still very income-hungry, we can be more unconstrained in the approach, and be more risk-seeking and more tolerant of volatility on behalf of the underlying client. In either case, a mandate can be constructed to best match to the client's particular outcome and vision when making an allocation."

Risks particularly inherent in the strategy are credit, prepayment and, as in the case with other forms of fixed income, liquidity. Goodson said investors should be aware of those specific risks to the portfolio, although he does not expect securitized credit to be "the next source of the bubble that pushes us further along in the cycle."

"I don't see bubbles in the risks that we take in the securitized credit context," he said.

Goodson said Voya spends a lot of time getting clients comfortable with the asset class, especially in terms of benchmarking, credit rating and duration, all of which are different and present some challenging nuances.

"We invest a lot of time with the client up front, letting them know the options for how to measure our performance and the limitations from a benchmarking perspective that exist in securitized credit markets," he said. "Those are real; we don't shy away from them or try to minimize the relevance. There are meaningful limitations there. But we do attempt to present the best alternatives that are available for clients to consider," such as absolute return benchmarks, he said.

BENCHMARK ALTERNATIVES

For clients who require a benchmark approach to performance measurement, Goodson said, "we do have some alternatives in the traditional benchmarking space that we would propose as best case. We'd also, at the same time, have to highlight the limitations, whether it's a significant mismatch in the opportunity set that we would seek to invest in or what the benchmark actually measures."

Other common topics of discussion with clients include a securitized credit portfolio's composition, which includes securities that are investment grade and below investment grade, how that corresponds with the portfolio's volatility, and the complexity of measuring portfolio duration given its components, he said.

In the future, new asset classes are likely to be securitized, Goodson said, particularly in residential real estate, driven by two factors: changes in Fannie Mae and Freddie Mac through government-sponsored enterprise reform efforts in Congress, and changes in how mortgage credit will be delivered into the private markets in the future.

"We think it's a matter of time before the [government-sponsored enterprises] extend mortgage credit changes in a potentially very, very meaningful way," he said. "There will be wealth created and wealth destroyed by how that ultimately occurs. And it will take place over a long period of time." •