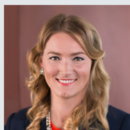
FIXED INCOME

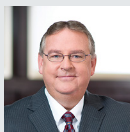
From Diversification to ESG: The Evolving Opportunity in ABS

BARINGS INSIGHTS

Asset-backed securities can offer a number of benefits as part of a broader fixed income mandate—particularly given the strong structural protections, diversification benefits and advancements in ESG.



Yulia Alekseeva, CFA
Portfolio Manager & Head of Securitized Credit Research



Douglas Trevallion II, CFA
Head of Securitized Products

Asset-backed securities (ABS) have attracted increasing interest in recent years as the market has continued to evolve and expand, and as yields across most fixed income markets have trended lower. More recently, through the pandemic-induced volatility and economic slowdown, ABS has proven to be resilient—but in some cases has lagged in its recovery relative to corporate credit, suggesting that now may be a good time for investors to dig in on ABS to understand where the true opportunities lie. In this piece, we provide a brief overview of the securitized universe and discuss why adding or increasing exposure to ABS can be beneficial as part of a broader fixed income allocation.

Why Securitized?

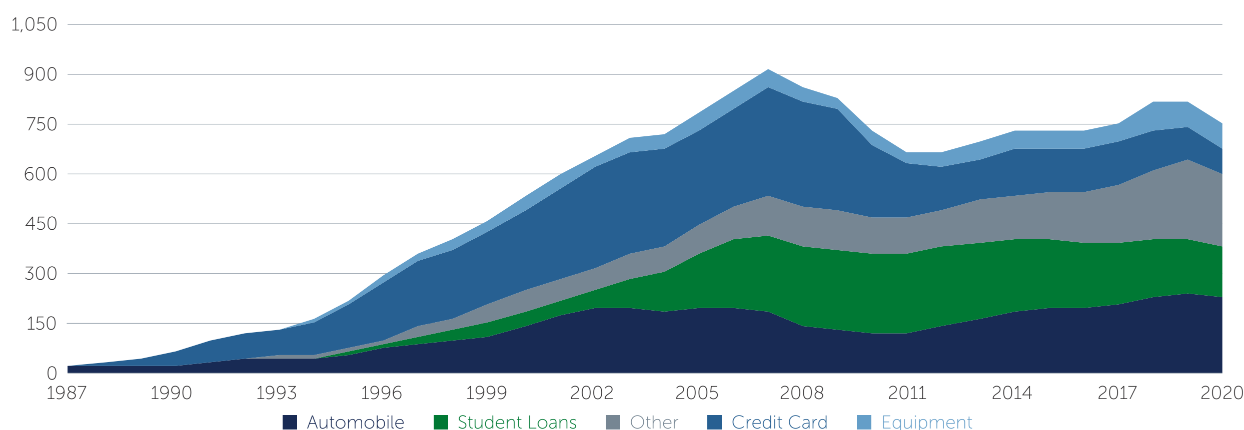
A LARGE & EVOLVING MARKET

The securitized market has experienced tremendous growth over the last decade, with over $9 trillion in outstanding securitizations across:

- ABS
- Mortgage backed securities (MBS)
- Commercial mortgage backed securities (CMBS)
- Residential mortgage-backed securities (RMBS)
- Collateralized loan obligations (CLOs)

At roughly $750 billion, ABS is sizeable in and of itself **(FIGURE 1)**. Like the broader securitized universe, ABS has evolved significantly as a number of new issuers—many of which are already active in the corporate bond markets—have come to the market seeking financing. Dealer participation has also increased in both the primary and secondary markets, and as follows, more investors have entered the space as well.

FIGURE 1: A Large and Diverse Market ($B)



SOURCE: SIFMA. As of December 31, 2020.

Liquidity, by extension, has also improved. While the securitized market is generally perceived to be less liquid than investment grade corporates, liquidity can vary based on factors like sector and position in the capital structure. For instance, higher-rated AAA and AA securities—particularly those in on-the-run ABS sectors like credit cards and autos—tend to be fairly liquid, in many cases on par with corporate credit. Lower-rated BBB and BB securities tend to be less liquid, as do certain asset classes like CMBS, where issuance and trading can be limited given the longer-dated nature of the securities and large institutional (buy-and-hold) buyer base.

DIVERSIFICATION & UNIQUE EXPOSURES

Coming off of a year marked by extreme volatility, one of the most compelling reasons for considering securitized assets is their potential for diversification. Unlike corporate bonds, ABS are collateralized, or backed, by pools of underlying assets such as student loans or aircraft leases. They are issued by special entities that own the underlying assets, and that are separate from the sponsoring companies or originators of those assets. In this capacity, securitized assets represent one of the most effective ways for investors to diversify away from idiosyncratic corporate risk and gain direct exposure to unique parts of the economy, such as the consumer and housing sectors.

Consumer & Housing

The consumer ABS market, while still dominated by credit cards and auto loans, has expanded to encompass many other sectors—from student loans to solar loans. Over the last year, although the effects of the pandemic and subsequent lockdowns were widespread, the U.S. consumer has been an area of strength. As a result of restrictions on activities like travel and dining out, savings rates have increased, and many consumers have been able to pay down debt. Defaults, delinquencies and losses have therefore remained quite low relative to history **(FIGURE 2)**. And with the announcement of the $1.9 trillion stimulus package in the U.S., we expect the consumer to remain well-supported, which may bode well for performance going forward.

FIGURE 2: Consumer Defaults and Losses Remain Low Relative to History

SOURCE: BofA Merrill Lynch. As of March 2021.

Commercial

Securitized assets also offer unique exposure to commercial sectors, which have traditionally included areas ranging from aircraft, shipping container and rail leases to franchise receivables, where issuers include household names like Domino's Pizza and Dunkin' Donuts. In recent years, there has been an influx of new entrants into the commercial ABS market, most notably in areas like logistics and last-mile distribution, as well as data.

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In some ways, the pandemic has accelerated this evolution. While issuance in sectors like last-mile distribution, for instance, was more sporadic prior to COVID, it has become more frequent over the last year, particularly with the entrance of big issuers like Amazon. Data centers too, received a strong tailwind as more people worked from home and reliance on servers skyrocketed. Though not an emergent sector, container ABS is another area that has benefited from pandemic-induced trends. As the aviation industry essentially shut down for a number of months, demand for shipping surged. At the same time, the low interest rate environment prompted a wave of refinancing—helping 2020 issuance for the sector reach record levels.

Of course, many sectors and businesses were impacted negatively and now face steep challenges going forward. Just as in the corporate credit markets, sectors like aviation and hospitality—including restaurants, retail, travel and entertainment—felt the impact most acutely. Within these broader sectors, however, there was also divergence. Looking at restaurant franchises, for instance, drive-through and quick-service businesses performed very well, while sit-down establishments saw revenues decline to near zero almost overnight and stay low through the prolonged lockdown period.

A Buffer Against Rising Rates

With projections for a strong rebound in economic growth and looming concerns over inflation, rising rates are top of mind for many. Due to their self-amortizing structures and duration characteristics, asset-backed securities can help mitigate interest rate risk—another reason for considering the asset class as part of a broader investment grade or high yield allocation. ABS tends to be shorter duration in nature than corporate credit, although the asset class offers the flexibility to move between shorter and longer-duration products, as well as fixed or floating rate products, based on risk appetite and changing market conditions. As we look across the market today, we see particular value in shorter-dated consumer ABS, which we believe have significant runway to continue building credit enhancement and delveraging given the unprecedented levels of recent fiscal stimulus support.

STRUCTURED TO WITHSTAND VOLATILITY

Securitized assets have demonstrated resilience in response to market volatility over time, largely a result of built-in credit enhancements and structural protections. Similar to other securitizations, ABS typically offers seniority of claim over cash flows within "bankruptcy-remote" vehicles, meaning they are somewhat insulated from financial stress on the part of an issuer or sponsoring company. As added protection, many asset-backed securities are overcollateralized, meaning the collateral value of the assets—such as the fleet of aircraft underlying an aviation lease—exceeds the debt liabilities, thus providing a buffer against initial losses. The structure of ABS also has the potential to provide natural deleveraging by virtue of self-amortizing (liquidating) assets (e.g. auto loan amortization).

These enhancements and protections were certainly tested over the last year. At the onset of the pandemic, securitized prices experienced widespread volatility, much like their corporate credit counterparts, as concerns around liquidity peaked. Across the board, the broad-based selling pressure caused securitized prices to dislocate, or to decline to levels significantly below what the underlying fundamentals warranted. However, due to their inherent protections, securitized assets fared relatively well—such as in the case of car rental company Hertz.

Structural Protections in Action: Hertz

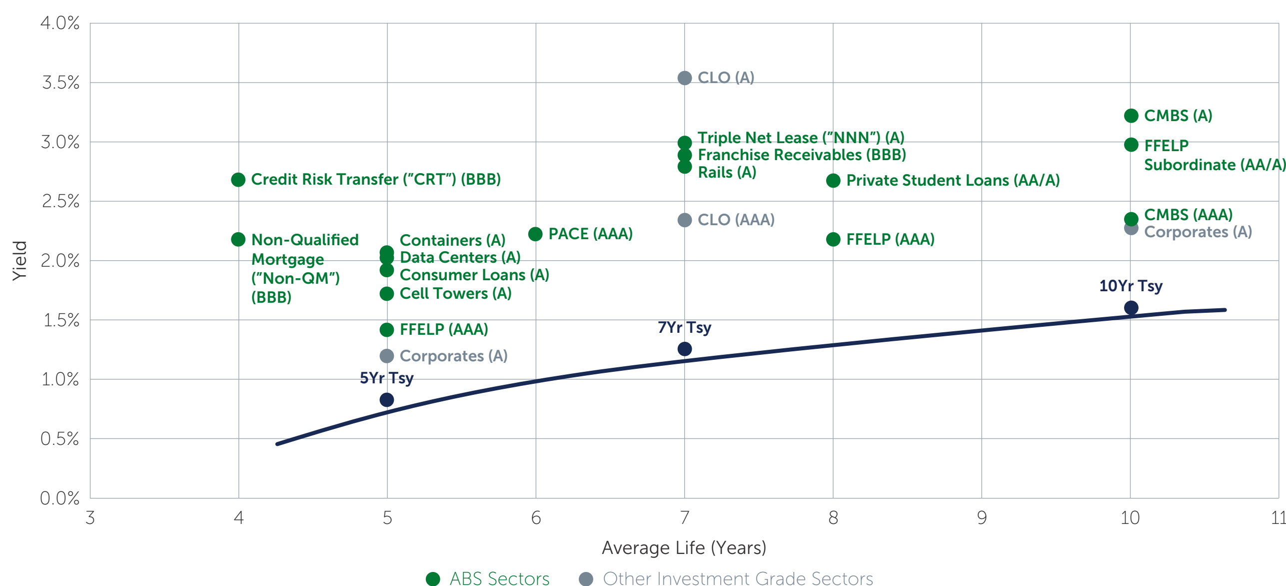
Hertz was negatively impacted early in the pandemic as air travel virtually shut down, materially impacting their airport-centric business model and leading the company to file for bankruptcy shortly afterward. While that resulted in losses for unsecured bondholders, securitized bondholders were insulated given the assets' bankruptcy remote structure. As vehicle prices recovered and auto auction houses re-opened, Hertz continued to downsize its fleet of cars—ultimately resulting in no losses and no principal impairment to securitized bondholders.

Why Now?

RELATIVE VALUE POTENTIAL

Looking across the markets today, we believe securitized products offer an attractive risk-return profile relative to other fixed income asset classes, as well as a premium over the risk-free rate. For instance, a number of investment grade-rated securitized assets are currently yielding higher than single-A corporates—including AAA FFELP student loans, which are government guaranteed **(FIGURE 3)**. This is particularly compelling, in our view, given the securities' strong structural protections versus unsecured corporate bonds.

FIGURE 3: Securitized Market Relative Value



SOURCE: Barings. As of March 11, 2021.

The asset class has also performed well historically on a risk-adjusted basis. While securitized products did not benefit as directly from 2020's unprecedented stimulus measures, the asset class has, over time, offered attractive risk-adjusted returns—as measured by excess return per unit of excess volatility—versus broader fixed income markets **(FIGURE 4)**. In this capacity, securitized assets can also help improve resilience and reduce overall volatility as part of a broader multi-asset mandate.

FIGURE 4: Securitized Credit 9-Year Excess Return vs. Volatility

Sector	Excess Annual Return	Excess Annual Vol	Ratio
Residential Credit	4.09%	3.78%	1.08
ABS ex Prime Auto & Cards	1.32%	2.40%	0.55
U.S. HY Index	4.17%	7.66%	0.55
ABS	0.96%	1.78%	0.54
CMBS	1.49%	2.99%	0.50
U.S. IG Corporate Index	1.85%	5.04%	0.37

SOURCE: Bank of America Merrill Lynch; Barings. As of March 31, 2021.

ESG

Longer-term, another area of potential opportunity exists around the growing prevalence of ESG. Because securitized products invest directly in collateral, ESG analysis is focused not only on the issuing company or originator of those assets, but also—and importantly—on the collateral or loan pool itself, as well as the structure of the transaction.

Given the complexity of evaluating ESG across the securitized space, the availability of third-party data is relatively limited. Further, while there may be data available for a sponsoring company—particularly if it's a large investment grade corporate—it is not necessarily representative of the collateral or structure of a specific transaction. In fact, ESG considerations for a company can look very different than those for the collateral. For instance, a large car company may receive poor environmental marks, whereas a securitization backed by a fleet of that company's electric vehicles may score fairly well.

In our view, this presents a significant opportunity for value creation. At Barings, we have developed a proprietary framework that examines and scores ESG factors across three pillars: **the issuing company or originator** of the assets, **the collateral or loan pool**, and **the structure**.

We also evaluate the outlook, seeking to identify not only risks that could negatively impact an investment down the road, but also positive factors that could help reduce long-term risks and improve a security's relative value. A fleet of Tesla's electric vehicles, for instance, may experience a positive tailwind going forward given the development in, and attention on, that space. Property assessed clean energy (PACE) loans also looked well-positioned from an environmental perspective given that they provide financing for residential solar projects, energy efficiency and safety, areas that will likely experience continued momentum going forward. Reverse mortgages and payday lending, on the other hand, do not look favorable from a social angle—in fact, we typically do not participate in these sectors due to our concerns around lending practices and the essence of the related financial products.

ESG Engagement in Action

We had significant exposure to a security of a fintech company that offers personal finance products, from student loan to mortgage refinancing. As part of our underwriting and due diligence, we uncovered some deficiencies in the sponsoring company's consumer lending program—namely, there were certain underlying credit risks that the company wasn't being fully transparent about. As a result, we met with the company's risk and credit managers and suggested a number of improvements. Ultimately, the company took our feedback and adjusted the product in question. As a result, we have been meaningful investors in the securitization for quite some time.

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Our process for integrating ESG, in addition to helping us evaluate and score companies, allows us to track engagement. Despite the fact that securitized trusts are generally seen as passive vehicles, managers typically have strong relationships, and direct lines of communication, with sponsoring companies, meaning there is a very real ability to influence or encourage better ESG practices and disclosure. As active managers engage with sponsoring issuers or companies to gain a better understanding of ESG practices, there are often opportunities to effect positive change, and potentially pave the way for stronger performance over time.

Key Takeaway

Asset-backed securities constitute a large, diverse market that offers a wide range of opportunities for investors seeking diversification, strong risk-adjusted returns and the potential for downside protection as a result of built-in credit enhancements and structural protections. Against the current backdrop of rising rates and lower yields across most fixed income market, we believe there are particular benefits to considering ABS as part of a broad multi-credit allocation—which can help facilitate the timely capture of evolving relative value opportunities and help position investors to capture upside as the market recovers.

That said, while we believe there is room for optimism as we look ahead to the coming months, the recovery across sectors and assets is likely to be uneven. As follows, a rigorous, bottom-up approach to security selection remains paramount, not only to capturing upside, but also to avoiding riskier securities that may face greater difficulties down the road.

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