BARINGS

PUBLIC FIXED INCOME

Why Securitized & Why Now: $12.5 Trillion Market Goes on Sale

INSIGHTS

Today's securitized market presents a rare opportunity to add diversification via an asset class with the potential to provide defensive opportunities with outsized returns.

Doug Trevallion, CFA
Head of Securitized Markets

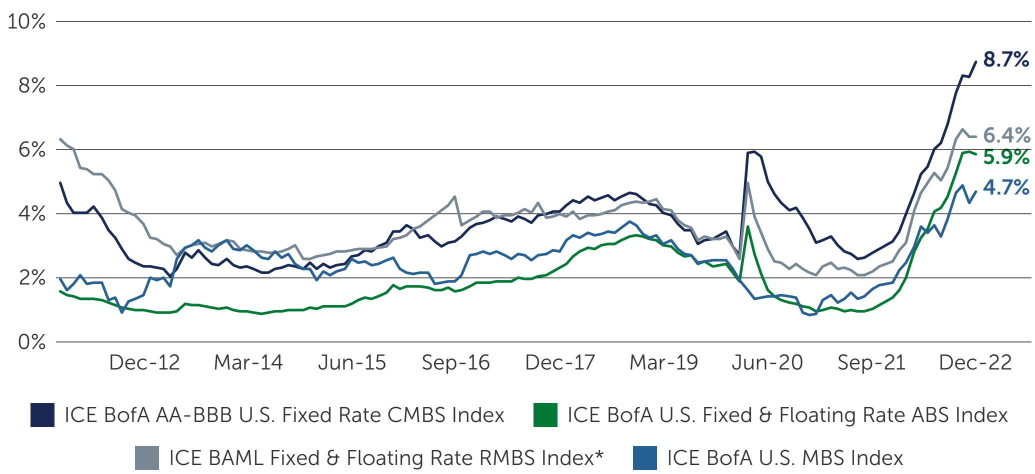
Yulia Alekseeva, CFA
Head of Securitized Research

Public fixed income markets broadly underperformed in 2022, with the U.S. Aggregate Index down by more than 13% at year-end, and the Global Aggregate Index down more than 16%.[1] The massive $12.5 trillion securitized market has not escaped the carnage of higher rates and wider spreads, with MBS, CMBS and ABS components of the Aggregate indexes down 11.8%, 10.9% and 4.3%, respectively.[2] More dramatic are the broader securitized investment grade credit indexes, excluding AAAs, which underperformed materially, with CMBS down -12.6%, ABS -6.3% and RMBS -15.7% through the end of December.[3]

Securitized Yields: Most Compelling Levels in a Decade

At the same time, with the move higher in interest rates, securitized yields are significantly higher across the board. IG CMBS, excluding AAA securities, are currently yielding roughly 8.7%, well above the 3.7% average of the last 10 years. ABS yields have nearly doubled, increasing from an average of 3.0% to 5.9% in the same period, while RMBS yields have jumped from an average of 3.7% to 6.4%. Meanwhile, Agency MBS yields have increased from an average of 2.5% to 4.7% **(Figure 1)**.

Figure 1: Securitized Yields are Higher Across the Board



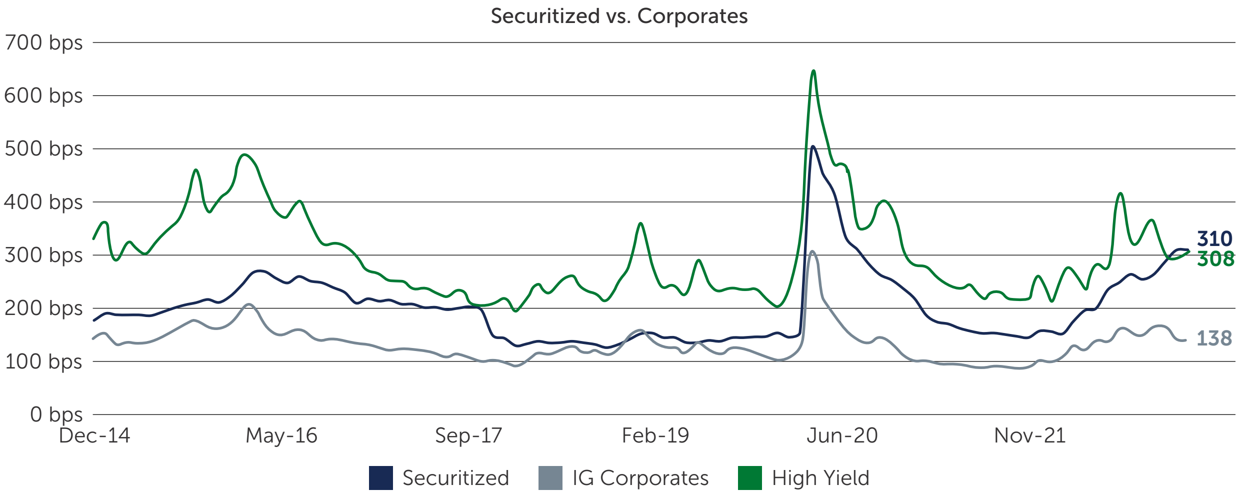
As of December 31, 2022.
*Housing related sectors of Manufactured Housing collateral and Home Equity Loans below AAA.

This cycle presents a unique opportunity to exploit relative value resulting from the simultaneous increase in both interest rates and credit spreads, an outcome of the U.S. Federal Reserve's current tightening cycle. Distinct from previous credit-led downturns, today's market is presenting attractive asset valuations during a period of strong underlying U.S. fundamentals across both commercial and consumer sectors. Given the likelihood of elevated rates for longer, we believe this technically driven dislocation provides a compelling relative value opportunity for the securitized asset classes, which are well positioned to withstand a potential recessionary economic slowdown.

1. Source: Bloomberg. As of December 31, 2022.
2. Source: Bank of America. As of December 31, 2022.
3. Source: Bank of America. As of December 31, 2022.

Of note, the relative spread differential between broad securitized assets and investment grade corporates has not been this wide in over a decade, apart from the global pandemic. In fact, this is one of the few times in the last 10 years that BBB securitized spreads have converged with high yield BB spreads **(Figure 2)**.

Figure 2: A Wide Spread Differential Between Securitized Assets and HY and IG Corporates



Sources: ICE BAML indexes: 50% ICE BofA AA-BBB US Fixed & Floating Rate Asset Backed + 30% ICE BofA AA-BBB U.S. Fixed Rate CMBS + 20% ICE BofA U.S. Fixed Rate Home Equity Loan Asset Backed Securities indexes; ICE BofA U.S. Corporate Index; ICE BofA BB U.S. High Yield Index. As of December 31, 2022.

Further adding to the attractiveness of the asset class, the relative value between public and private markets has converged meaningfully. Historically, private markets added roughly 75 bps, on average, of additional yield over public bonds, but that differential compressed as public assets underperformed on a relative basis throughout 2022. In some cases, the relative spread advantage has inverted, turning the public/private basis negative. For example, longer dated (6–9 year maturity) liquid, public BBB bonds may at times trade wide of private BBB assets.

Why Securitized?

HIGHER RESILIENCY IN STRESSED ENVIRONMENTS

The potentially attractive opportunity on offer today is within the context of securitized assets providing several embedded structural protections, such as:

EXCESS SPREAD

OVERCOLLATERALIZATION

SUBORDINATION

RESERVE ACCOUNTS

PERFORMANCE TRIGGERS

These protections effectively work in concert to provide higher resiliency in stressed environments and a healthy ballast to weather potential recessionary environments.

Additionally, post-GFC risk retention regulation ensures **originators of these assets maintain skin-in-the-game** through vested economic interest, which helps align incentives. At the same time, amortizing structures provide **natural deleveraging** and often lead to increased credit enhancement and positive ratings migration over time, increasing stability and potential total return. In addition, many investments are designed with protections that result in shortened amortization periods in times of stress.

Seniority of claims over cash flows within legally bankruptcy-remote vehicles and perfected security packages are further benefits, and provide enhanced legal rights and direct access to trust assets. The **bankruptcy remote nature** of the investments often leads to materially improved workout recoveries vs. unsecured product offerings, which is particularly meaningful in distressed and late-cycle environments such as we are in today.

Further, bankruptcy-remote trusts are often serviced by third party providers and require backup servicers. This decoupling from the originating corporate entity can **insulate trusts from negative rating actions**. There have been multiple cases where corporate entities have filed for bankruptcy while the securitized trusts remained intact, avoiding downgrades and capital impairment.

Given the abovementioned protections inherent in securitized structures, historical investment grade losses over the past 10 years have been de-minimis. In fact, ABS and RMBS impairments have been zero, while losses within CMBS have been limited to the BBB U.S. CMBS bonds of GFC-impacted vintages **(Figure 3)**.

Figure 3: Multiyear Cumulative Impairment Rates by Original Rating (2009–2021) (Horizon Year)

Asset Class/Quality	Initial Size	1	2	3	4	5	6	7	8	9	10
U.S. ABS	**6,747**	**0.00%**	**0.00%**	**0.00%**	**0.00%**	**0.00%**	**0.00%**	**0.00%**	**0.00%**	**0.00%**	**0.00%**
AAA	3,973	–	–	–	–	–	–	–	–	–	–
AA	1,216	–	–	–	–	–	–	–	–	–	–
A	886	–	–	–	–	–	–	–	–	–	–
BBB	672	–	–	–	–	–	–	–	–	–	–
U.S. RMBS	**2,928**	**0.00%**	**0.00%**	**0.00%**	**0.00%**	**0.00%**	**0.00%**	**0.00%**	**0.00%**	**0.00%**	**0.00%**
AAA	1,205	–	–	–	–	–	–	–	–	–	–
AA	655	–	–	–	–	–	–	–	–	–	–
A	530	–	–	–	–	–	–	–	–	–	–
BBB	538	–	–	–	–	–	–	–	–	–	–
U.S. CMBS	**4,196**	**0.00%**	**0.00%**	**0.00%**	**0.00%**	**0.00%**	**0.18%**	**0.18%**	**0.24%**	**0.45%**	**0.84%**
AAA	2,778	–	–	–	–	–	–	–	–	–	–
AA	631	–	–	–	–	–	–	–	–	–	–
A	416	–	–	–	–	–	–	–	–	–	–
BBB	371	–	–	–	–	–	1.84%	1.84%	2.37%	3.62%	6.32%
EMEA ABS, CMBS, & RMBS	**4,347**	**0.00%**	**0.00%**	**0.00%**	**0.00%**	**0.00%**	**0.00%**	**0.00%**	**0.00%**	**0.00%**	**0.00%**
AAA	2,060	–	–	–	–	–	–	–	–	–	–
AA	896	–	–	–	–	–	–	–	–	–	–
A	781	–	–	–	–	–	–	–	–	–	–
BBB	610	–	–	–	–	–	–	–	–	–	–

Source: Moody's. As of June 30, 2022. "Impairment and loss rates of structured finance securities: 2009–21". Impairment is defined by Moody's as "A security is impaired when investors receive—or expect to receive with near certainty—less value than would be expected if the obligor were not experiencing financial distress or otherwise prevented from making payments by a third party, even if the indenture or contractual agreement does not provide the investor with a natural remedy for such events, such as the right to press for bankruptcy". U.S. Securitized statistics shown are ex Home equity loans.

"An allocation to securitized products may improve performance metrics such as Sharpe and Information ratios for multi-product strategies and provide diversification benefits."

LOW CORRELATIONS/IMPROVED PERFORMANCE METRICS

There is also a strong case to be made that an allocation to securitized products may improve performance metrics such as Sharpe and Information ratios for multi-product strategies and provide diversification benefits. Performance can be less correlated with and reactive to broader markets as it tends to be idiosyncratic and specific to individual transactions. Looking as far back as 2005 indicates that:

- Securitized products have demonstrated significantly lower asset class correlation vs. broader fixed income markets
- Lower correlations exist within individual subsectors (between ABS/CMBS/RMBS within securitized vs. financials/industrials/utilities for corporates)

Figure 4: Securitized Performance Has Historically Been Less Correlated With and Reactive to Broader Markets

		Correlation of Total Returns Since 2005				
		Financial	Industrials	Utility	CMBS	ABS
Corporate	Financial	1.0	–	–	–	–
	Industrials	0.83	1.0	–	–	–
	Utility	0.78	0.96	1.0	–	–
Securitized	CMBS	0.56	0.59	0.50	1.0	–
	ABS	0.51	0.60	0.54	0.51	1.0
	RMBS	0.36	0.29	0.25	0.46	0.36

Financial: ICE BofA U.S. Financial Index; **Industrial:** ICE BofA U.S. Industrial Index; **Utility:** ICE BofA U.S. Utility Index; **CMBS:** ICE BofA U.S. Fixed Rate CMBS Index; **Consumer ABS:** R010 (ICE BAML Fixed & Floating Rate Asset Backed Securities Index) subset excluding Manufactured Housing and Home Equity Loans; **RMBS:** (ICE BAML Fixed & Floating Rate Asset Backed Securities Index) subset including Manufactured Housing collateral and Home Equity Loans below AAA.
As of December 31, 2022.

FROM DIVERSIFICATION & UNIQUE EXPOSURES TO FAVORABLE CAPITAL TREATMENT

Additional benefits to investing in securitized products include:

- The ability to invest up and down the entire capital structure (from AAA down to residuals), allowing investors to move up and down the capital structure based on risk appetite, relative value shifts and changes in market conditions
- The flexibility to move between fixed/floating-rate coupon investments and long/short maturities based on the interest rate environment
- One of the few available ways to get direct exposure to the U.S. consumer via the statistical universe of auto, residential, government guaranteed student loans and other forms of consumer debt

For insurance companies in particular, there may be a favorable capital treatment benefit. Select CMBS and RMBS bonds are often structurally so well enhanced or protected that they are afforded a higher NAIC rating than their letter grade rating. In several examples this "ratings arbitrage" affords BBB and BB bonds the highest (1A) capital treatment allowed by the NAIC.

Navigating Choppy Waters

In our view, investors focused on capital preservation and mitigating downside risk in the face of a potential recession currently have one of the most attractively valued asset classes on sale at historically discounted prices. Yet, to navigate today's volatility and take advantage of both the attractive income opportunity and total return potential, a strong focus on fundamental credit underwriting and issue selection are key—particularly when it comes to avoiding potential losses.

Given most investors remain largely under-allocated to securitized products, today's market presents a rare opportunity to add diversification via an asset class that may provide defensive opportunities with outsized returns, allowing experienced managers to exploit a unique period in fixed income market history.

Barings is a $347+ billion global investment manager sourcing differentiated opportunities and building long-term portfolios across public and private fixed income, real estate and specialist equity markets. With investment professionals based in North America, Europe and Asia Pacific, the firm, a subsidiary of MassMutual, aims to serve its clients, communities and employees, and is committed to sustainable practices and responsible investment.*

IMPORTANT INFORMATION

Any forecasts in this document are based upon Barings opinion of the market at the date of preparation and are subject to change without notice, dependent upon many factors. Any prediction, projection or forecast is not necessarily indicative of the future or likely performance. Investment involves risk. The value of any investments and any income generated may go down as well as up and is not guaranteed by Barings or any other person. PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS. Any investment results, portfolio compositions and or examples set forth in this document are provided for illustrative purposes only and are not indicative of any future investment results, future portfolio composition or investments. The composition, size of, and risks associated with an investment may differ substantially from any examples set forth in this document. No representation is made that an investment will be profitable or will not incur losses. Where appropriate, changes in the currency exchange rates may affect the value of investments. Prospective investors should read the offering documents, if applicable, for the details and specific risk factors of any Fund/Strategy discussed in this document.

Barings is the brand name for the worldwide asset management and associated businesses of Barings LLC and its global affiliates. Barings Securities LLC, Barings (U.K.) Limited, Barings Global Advisers Limited, Barings Australia Pty Ltd, Barings Japan Limited, Baring Asset Management Limited, Baring International Investment Limited, Baring Fund Managers Limited, Baring International Fund Managers (Ireland) Limited, Baring Asset Management (Asia) Limited, Baring SICE (Taiwan) Limited, Baring Asset Management Switzerland Sarl, Baring Asset Management Korea Limited, and Barings Singapore Pte. Ltd. each are affiliated financial service companies owned by Barings LLC (each, individually, an "Affiliate"). Some Affiliates may act as an introducer or distributor of the products and services of some others and may be paid a fee for doing so.

NO OFFER: The document is for informational purposes only and is not an offer or solicitation for the purchase or sale of any financial instrument or service in any jurisdiction. The material herein was prepared without any consideration of the investment objectives, financial situation or particular needs of anyone who may receive it. This document is not, and must not be treated as, investment advice, an investment recommendation, investment research, or a recommendation about the suitability or appropriateness of any security, commodity, investment, or particular investment strategy, and must not be construed as a projection or prediction.

Unless otherwise mentioned, the views contained in this document are those of Barings. These views are made in good faith in relation to the facts known at the time of preparation and are subject to change without notice. Individual portfolio management teams may hold different views than the views expressed herein and may make different investment decisions for different clients. Parts of this document may be based on information received from sources we believe to be reliable. Although every effort is taken to ensure that the information contained in this document is accurate, Barings makes no representation or warranty, express or implied, regarding the accuracy, completeness or adequacy of the information.

Any service, security, investment or product outlined in this document may not be suitable for a prospective investor or available in their jurisdiction.

LEARN MORE AT BARINGS.COM

**As of December 31, 2022*

23-2712477