— Investing for a world of change

Credit spotlight: Structured credit

Understanding the Multi-Asset Credit investment universe

May 2024

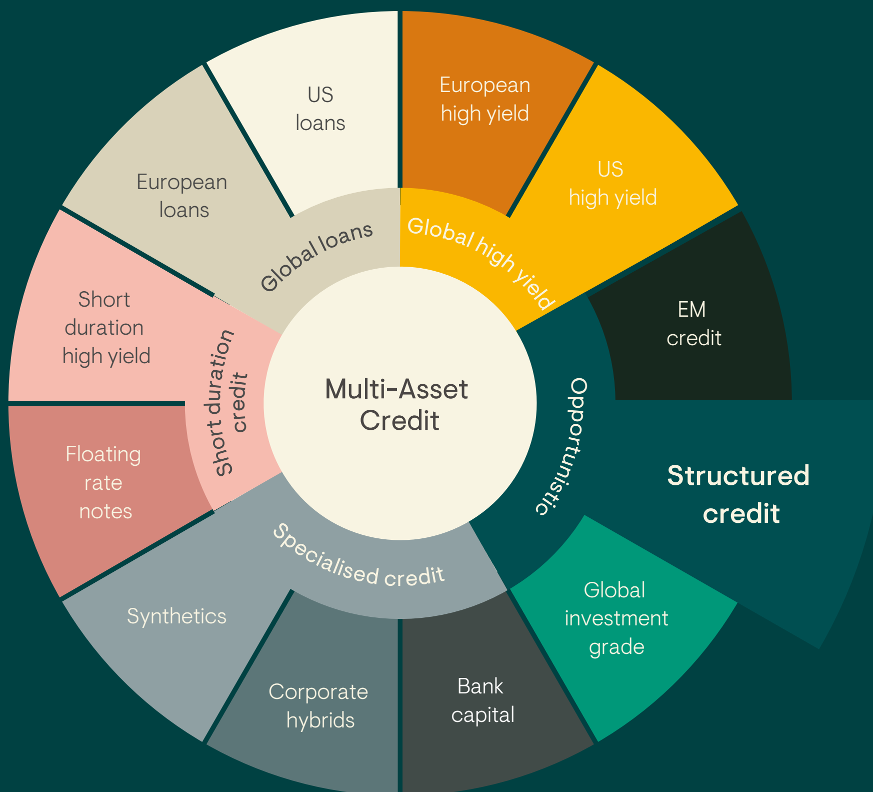
For professional investors and financial advisors only. Not for distribution to the public or within a country where distribution would be contrary to applicable law or regulations.

Our Multi-Asset Credit strategy aims to generate attractive long-term total returns by investing dynamically across global credit markets.

To target a smoother investment journey and competitive risk-adjusted performance, the investment team actively allocates across a broad credit opportunity set.

This paper focuses on the structured credit market.

Ninety One's Multi-Asset Credit strategy investment universe



A key feature of our approach is our willingness to use the broad global credit market opportunity set and seek to dynamically allocate the portfolio to the more attractive elements of the market at the right time.

For further information on investment teams and investment process, please see Important information section. For professional investors and financial advisors only. Not for distribution to the public or within a country where distribution would be contrary to applicable law or regulations.

The fast view

Rondeep Barua
Analyst

Jared Cook
Portfolio Specialist

- The term 'structured credit' encompasses a wide variety of securitisation markets (markets that pool underlying assets into tradable securities).
- This paper focuses on collateralised loan obligations (CLOs) as this part of the structured credit market is most relevant for our Multi-Asset Credit strategy.
- Compared with traditional corporate credit investments, CLOs offer various benefits, including historically lower loss rates for comparable credit ratings than corporate bonds across most rating categories.
- CLOs also represent a potential source of additional yield for investors with a deep understanding of the asset class, thanks to their 'liquidity premium' and 'complexity premium'.
- We believe the distinct and dynamic behaviour of CLOs present significant relative-value opportunities to active and experienced credit investors.

What is structured credit?

The term 'structured credit' encompasses a wide variety of securitised products, which offer fixed income investors opportunities across countries, underlying asset types and risk profiles.

Securitisation is the technique of converting a stream of anticipated future cash flows into one or more tradable securities, or bonds. The bulk of the market consists of bonds backed by pools of residential and commercial mortgages, consumer loans and corporate loans.

The securitisation process, discussed in more detail below, involves creating various 'tranches', which are bonds with ratings ranging from AAA (the safest tranche) through to unrated equity/residual cash-flow tranches (the riskiest tranches).

CLOs: a key part of a credit investor's toolkit

The underlying assets in a CLO are corporate loans — typically a diverse pool of senior secured and sub-investment grade rated loans, spanning a wide range of industries. The assets are actively managed by a CLO manager. Although these are the same corporate loans our credit team analyses individually and daily, when these are packaged together into a CLO they offer quite distinct potential benefits to portfolios.

Multiple tranches of varying seniority are issued from each CLO, creating a range of risk and return profiles for a portfolio manager to choose from.

A flexible tool

The 'tranching' of the CLO liabilities creates a waterfall of risk levels for investors to choose from. The most senior tranche (AAA rated) offers the lowest level of risk as it has a priority claim on the cash flow of the structure; this tranche would have a significant cushion in the event of the underlying pool of assets experiencing any stress (or defaults)[1]. Conversely, lower-rated mezzanine (BB and B rated) and unrated equity tranches are exposed to higher credit risk; investors owning these tranches are paid higher coupons to compensate, making them relatively high-yielding assets.

Thus, depending on the tranche selected, portfolio managers can use CLOs either as a defensive anchor (seeking to protect against downside risk) or for yield enhancement; their overall view of market conditions will determine their choice.

Depending on the tranche selected, investors can use CLOs either for downside protection or for yield enhancement

—

1. Each CLO tranche is not tied to any specific loans; instead, the cash from the loan portfolio as a whole is allocated to the tranches, such that the senior tranches have first priority claims over cash received from all of the underlying loans in the CLO and are the last to suffer any potential losses.

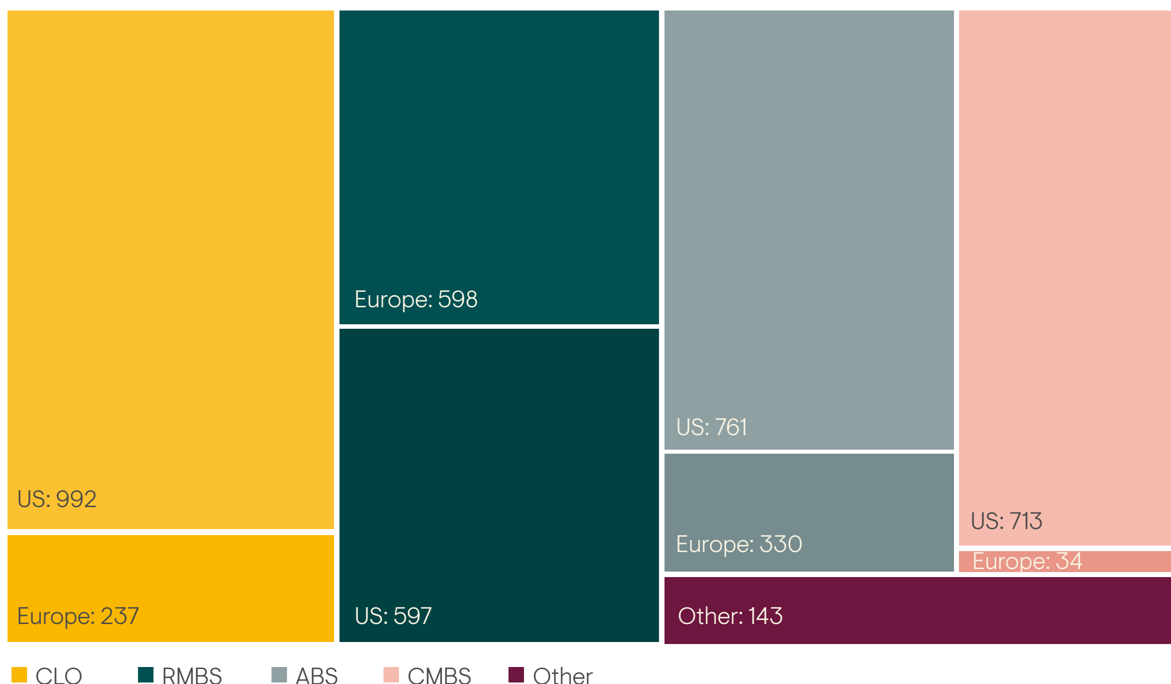
Sizing up the market

Securitised products are an important component of fixed income markets. In the US alone they account for over US$13 trillion of the entire US$55 trillion[2] fixed income market (24%). This compares to almost US$24 trillion of outstanding treasury bonds and around US$10 trillion of outstanding US corporate bonds.

Outstanding European securitised products currently total US$1.2 trillion[3], and other active markets exist in regions including Asia, Latin America and Australia.

Figure 1 shows the split of the US$4.4 trillion US and European securitised products outstanding, excluding US agency mortgage backed securities[4].

Figure 1: Market components (US$ billions)

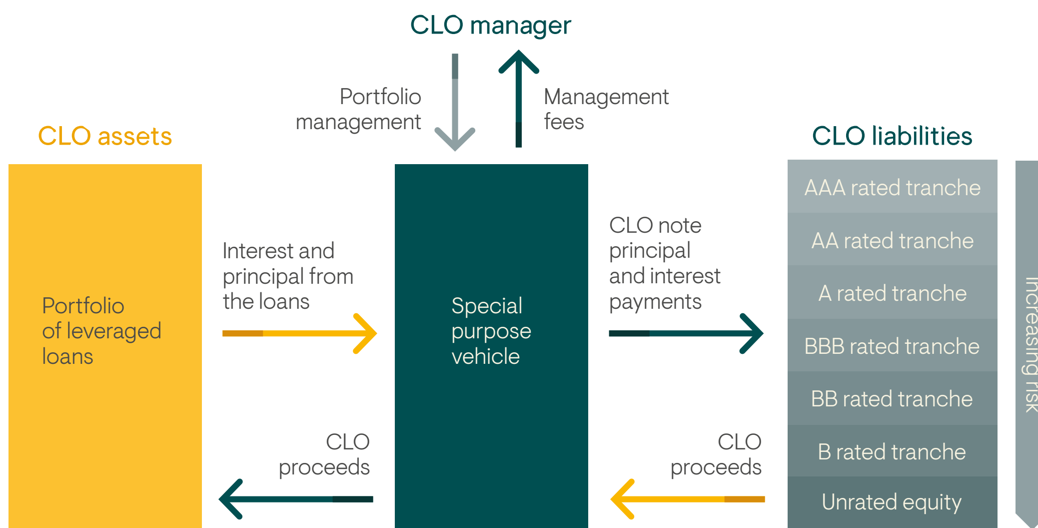


Source: US estimates from BofA Global Research as at Q3 2023, excluding US$10.8 trillion of US agency mortgage-related securities. European estimates from AFME as at Q3 2023, converted to USD using quarter-end exchange rates.

—

2. Source: SIFMA, as at end 2022.
3. Source: AFME, as at Q3 2023.
4. Mortgage-backed securities issued by US government-sponsored organisations such as Freddie Mac or Fannie Mae.

How a CLO works



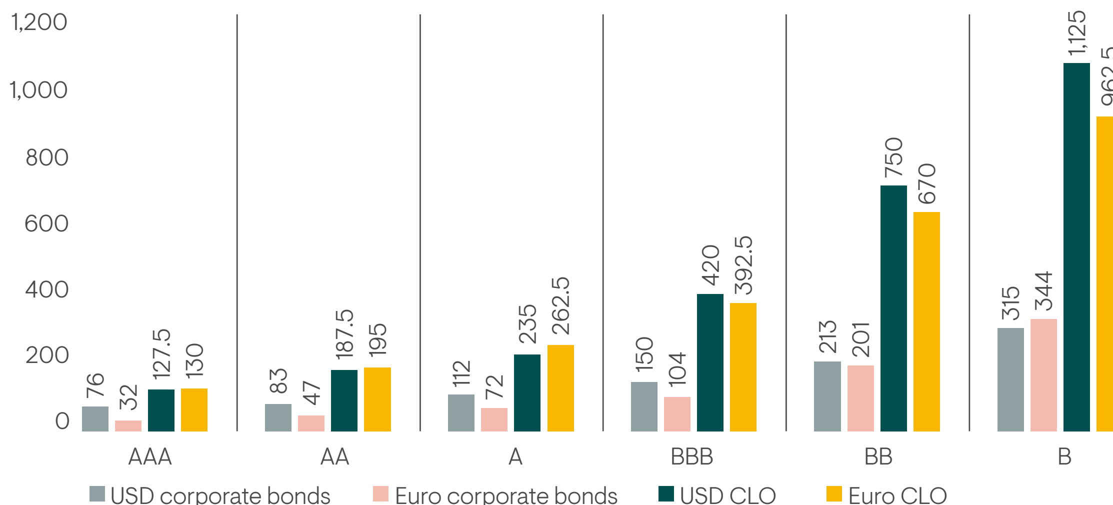
Source: Ninety One. For illustrative purposes only.

Offering relatively high spreads

Part of the attraction of investing in CLOs is that individual CLO bonds tend to trade at higher spread levels than corporate bonds with an equivalent rating, as shown in Figure 2. This differential, or premium, is largely explained by two factors: a liquidity premium and a complexity premium.

While these securities are tradeable and traded daily, they are arguably not quite as liquid as traditional corporate bonds, hence the liquidity premium. The need for a specialist skill set to analyse and price the securitisation structure – more complex than traditional corporate bonds – results in a complexity premium.

Figure 2: USD and Euro CLO and corporate bond spreads, basis points



Source: CLO spreads are from Citi Velocity as at 29 February 2024. Corporate bond spreads are asset swap spreads from rating based sub-indices of ER00, HE00, C0A0 and H0A0 from ICE Bond Indices as at 29 February 2024.

Requiring deep expertise

Understanding the structural nuances of each deal is key to valuing individual CLO tranches. Importantly, each deal includes a set of performance triggers, which if breached, can cause interest payments on junior tranches to be diverted to repaying the principal on more senior tranches. Junior tranche interest deferral was a common occurrence in the Global Financial Crisis (GFC), helping protect senior tranche investors through a period of loan market stress. In most cases, the cumulative deferred interest on the non-senior tranches was repaid following the later recovery in loan market performance.

> A specialist skill set is required to analyse and price the securitisation structure

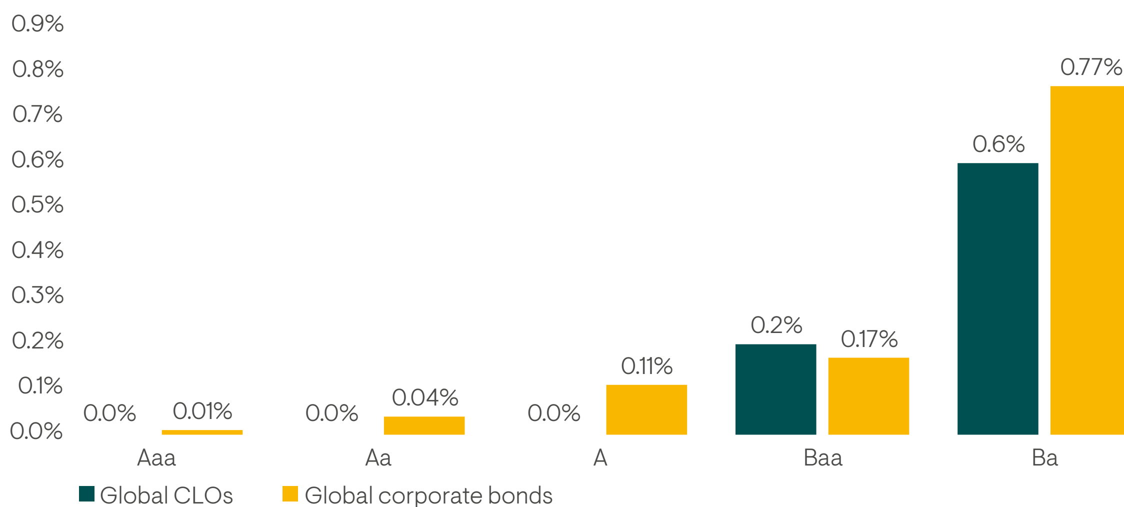
Detailed due diligence on the CLO manager and the deal-specific constraints within which they operate is another key part of the investment process for a CLO investor. Successful CLO managers can add value for investors by actively managing the underlying loan portfolio and minimising credit losses. Each CLO contains a list of portfolio concentration and quality limits, according to which managers must construct and trade the underlying portfolios.

Specialist experience and understanding of these structural features are critical in harnessing the complexity premium available in CLOs investing. Investment managers must be able to distinguish between different CLO structures, as well as a wide range of CLO manager styles and track records to ensure that they are being compensated adequately for the underlying risks.

What about the risks?

While specialist experience is critical in evaluating any CLO investment, historically, CLOs backed by leveraged loans have performed very well from a loss perspective. They have suffered comparable or lower loss rates than equivalently rated senior unsecured corporate bonds, even including the GFC of 2008, as shown in Figure 3.

Figure 3: 10-year loss rates (annualised) for CLO tranches vs. senior unsecured corporate bonds by rating (1993 – 2019)



Source: ICE BofA Merrill Lynch, Moody's as at 31 December 2023. Using 10yr cumulative loss rates for global CLOs (1993 – 2021 and annualising). For corporates, we annualise 10yr default rates (1983-2019) and apply the long-term average (1987-2019) recovery rate for senior unsecured bonds of 47%.

The distinct behaviour of CLOs creates opportunities

While CLO price movements have historically been closely correlated with price movements of other corporate credit-related instruments, factors specific to each market can cause them to diverge periodically. These factors can include elements such as differences in investor base and investment horizons, or even supply/demand imbalances within specific markets. As a result, the extent of the premium to be earned by investing in CLOs compared to similarly rated corporate bonds can vary meaningfully over time.

> Structured credit is a useful and flexible addition to a credit investor's toolkit

The distinct characteristics of the CLO market can mean that CLO tranches exhibit very different behaviour in a variety of market conditions. This can present compelling opportunities to an unconstrained credit investor with a deep understanding of these instruments. The ability to invest across the CLO capital structure (i.e., to choose from all the available tranches of a CLO) allows a portfolio manager to seek to take advantage of any relative-value opportunities that arise.

In summary, we believe structured credit – and the CLO market in particular – is a useful and flexible addition to a credit investor's toolkit, offering the potential for an attractive yield pick-up while also displaying attractive behavioural characteristics. However, in our view, investment in this area requires dedicated and specialist expertise.

General risks. The value of investments, and any income generated from them, can fall as well as rise. Where charges are taken from capital, this may constrain future growth. Past performance is not a reliable indicator of future results. If any currency differs from the investor's home currency, returns may increase or decrease as a result of currency fluctuations. Investment objectives and performance targets are subject to change and may not necessarily be achieved, losses may be made.

Specific risks. **Default:** There is a risk that the issuers of fixed income investments (e.g. bonds) may not be able to meet interest payments nor repay the money they have borrowed. The worse the credit quality of the issuer, the greater the risk of default and therefore investment loss. **Derivatives:** The use of derivatives may increase overall risk by magnifying the effect of both gains and losses leading to large changes in value and potentially large financial loss. A counterparty to a derivative transaction may fail to meet its obligations which may also lead to a financial loss. **Interest rate:** The value of fixed income investments (e.g. bonds) tends to decrease when interest rates rise. **Liquidity:** There may be insufficient buyers or sellers of particular investments giving rise to delays in trading and being able to make settlements, and/or large fluctuations in value. This may lead to larger financial losses than might be anticipated. **Loans:** The specific collateral used to secure a loan may decline in value or become illiquid, which would adversely affect the loan's value. Many loans are not actively traded, which may impair the ability of the Portfolio to realise full value in the event of the need to liquidate such assets.

Australia
Level 28 Suite 3, Chifley Tower
2 Chifley Square
Sydney, NSW 2000
Telephone: +61 2 9160 8400
australia@ninetyone.com

Botswana
Plot 64289, First floor
Tlokweng Road, Fairgrounds
Gaborone
PO Box 49
Botswana
Telephone: +267 318 0112
botswanaclientservice@ninetyone.com

Channel Islands
PO Box 250, St Peter Port
Guernsey, GY1 3QH
Telephone: +44 (0)1481 710 404
enquiries@ninetyone.com

Germany
Bockenheimer Landstraße 23
60325 Frankfurt am Main
Telephone: +49 (0)69 7158 5900
deutschland@ninetyone.com

Hong Kong
Suites 1201-1206, 12/F
One Pacific Place
88 Queensway, Admiralty
Telephone: +852 2861 6888
hongkong@ninetyone.com

Luxembourg
2-4, Avenue Marie-Thérèse
L-2132 Luxembourg
Telephone: +352 28 12 77 20
enquiries@ninetyone.com

Namibia
Am Weinberg Estate
Winterhoek Building
1st Floor, West Office
13 Jan Jonker Avenue
Windhoek
Telephone: +264 (61) 389 500
namibia@ninetyone.com

Netherlands
Johan de Wittlaan 7
2517 JR Den Haag
Netherlands
Telephone: +31 70 701 3652
enquiries@ninetyone.com

Singapore
138 Market Street
CapitaGreen #27-02
Singapore 048946
Telephone: +65 6653 5550
singapore@ninetyone.com

South Africa
36 Hans Strijdom Avenue
Foreshore, Cape Town 8001
Telephone: +27 (0)21 901 1000
enquiries@ninetyone.com

Sweden
Västra Trädgårdsgatan 15,
111 53 Stockholm
Telephone: +46 8 502 438 20
enquiries@ninetyone.com

Switzerland
Dufourstrasse 49
8008 Zurich
Telephone: +41 44 262 00 44
enquiries@ninetyone.com

United Kingdom
55 Gresham Street
London, EC2V 7EL
Telephone: +44 (0)20 3938 1900
enquiries@ninetyone.com

United States
Park Avenue Tower, 65 East 55th Street
New York, 10022
US Toll Free: +1 800 434 5623
usa@ninetyone.com

—

www.ninetyone.com
Telephone calls may be recorded for training, monitoring and regulatory purposes and to confirm investors' instructions.
For more details please visit www.ninetyone.com/contactus

Important information

This communication is for professional investors and financial advisors only. It is not to be distributed to the public or within a country where such distribution would be contrary to applicable law or regulations.

The information may discuss general market activity or industry trends and is not intended to be relied upon as a forecast, research or investment advice. The economic and market views presented herein reflect Ninety One's judgment as at the date shown and are subject to change without notice. There is no guarantee that views and opinions expressed will be correct and may not reflect those of Ninety One as a whole, different views may be expressed based on different investment objectives. Although we believe any information obtained from external sources to be reliable, we have not independently verified it, and we cannot guarantee its accuracy or completeness (ESG-related data is still at an early stage with considerable variation in estimates and disclosure across companies. Double counting is inherent in all aggregate carbon data). Ninety One's internal data may not be audited. Ninety One does not provide legal or tax advice. Prospective investors should consult their tax advisors before making tax-related investment decisions. Nothing herein should be construed as an offer to enter into any contract, investment advice, a recommendation of any kind, a solicitation of clients, or an offer to invest in any particular fund, product, investment vehicle or derivative. Investment involves risks. Past performance is not indicative of future performance. Any decision to invest in strategies described herein should be made after reviewing the offering document and conducting such investigation as an investor deems necessary and consulting its own legal, accounting and tax advisors in order to make an independent determination of suitability and consequences of such an investment. This material does not purport to be a complete summary of all the risks associated with this Strategy. A description of risks associated with this Strategy can be found in the offering or other disclosure documents. Copies of such documents are available free of charge upon request.

In the US, this communication should only be read by Institutional Investors (Accredited Investors and Qualified Purchasers), Financial Advisors (FINRA-registered Broker Dealers) and, at their exclusive discretion, their eligible clients. It must not be distributed to US Persons apart from the aforementioned recipients. THIS INVESTMENT IS NOT FOR SALE TO US PERSONS EXCEPT ACCREDITED INVESTORS AND QUALIFIED PURCHASERS. Note that returns will be reduced by management fees and that investment advisory fees can be found in Form ADV Part 2A. In Australia, this document is provided for general information only to wholesale clients (as defined in the Corporations Act 2001).
This material is being sent to you in your capacity as professional investors, institutional investors, other qualified investors as defined by relevant local laws and regulations and strictly for your internal use only; and should not be reproduced or distributed to any other persons without prior written consent from Ninety One. If you are not an intended recipient you must ignore this material and take no action based on the information in it. In Hong Kong, it is for professional investors only, issued by Ninety One Hong Kong Limited and has not been reviewed by the Securities and Futures Commission (SFC). In Singapore, it is for institutional investors only, issued by Ninety One Singapore Pte Limited (company registration number: 201220398M) and has not been reviewed by the Monetary Authority of Singapore. In the People's Republic of China (the "PRC"), it can be directed only at certain eligible PRC investors as prescribed by applicable PRC laws. In Taiwan, it is for professional institutional investors only. In Indonesia, Thailand, the Philippines and Brunei, it is for institutional investors and other qualified investors only. For Korean and Malaysian clients this material has been issued to you upon your request, without any marketing or solicitation activities conducted by Ninety One. All information contained in this material is factual information and does not reflect any opinion or judgment of Ninety One. The information contained in this material should not be construed as an offer, marketing, solicitation or investment advice with respect to any investment products or services. The website mentioned in this communication has not been reviewed or approved by any regulatory authority in any Asia jurisdictions, and may contain information with respect to investments products that may not be registered in some jurisdictions. Ninety One Botswana Proprietary Limited, Plot 64289, First floor, Tlokweng Road, Fairgrounds, Gaborone, PO Box 49, Botswana, is regulated by the Non-Bank Financial Institutions Regulatory Authority. In Namibia, Ninety One Asset Management Namibia (Pty) Ltd is regulated by the Namibia Financial Institutions Supervisory Authority. In South Africa, Ninety One is an authorised financial services provider.

Except as otherwise authorised, this information may not be shown, copied, transmitted, or otherwise given to any third party without Ninety One's prior written consent. © 2024 Ninety One. All rights reserved. Issued by Ninety One, issued May 2024.

Additional information on our investment strategies can be provided on request.

Investment team

There is no assurance that the persons referenced herein will continue to be involved with investing for this Strategy, or that other persons not identified herein will become involved with investing assets for the Manager or assets of the Strategy at any time without notice. References to specific and periodic team meetings are not guaranteed to be held or fully attended due to reasonable priority driven circumstances and holidays.

Investment process

Any description or information regarding investment process or strategies is provided for illustrative purposes only, may not be fully indicative of any present or future investments and may be changed at the discretion of the manager without notice. References to specific investments, strategies or investment vehicles are for illustrative purposes only and should not be relied upon as a recommendation to purchase or sell such investments or to engage in any particular Strategy. Portfolio data is expected to change and there is no assurance that the actual portfolio will remain as described herein. There is no assurance that the investments presented will be available in the future at the levels presented, with the same characteristics or be available at all. Past performance is no guarantee of future results and has no bearing upon the ability of Manager to construct the illustrative portfolio and implement its investment strategy or investment objective.

Indices

Indices are shown for illustrative purposes only, are unmanaged and do not take into account market conditions or the costs associated with investing. Further, the manager's strategy may deploy investment techniques and instruments not used to generate Index performance. For this reason, the performance of the manager and the Indices are not directly comparable.

If applicable MSCI data is sourced from MSCI Inc. MSCI makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indices or any securities or financial products. This report is not approved, endorsed, reviewed or produced by MSCI. None of the MSCI data is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such.

If applicable FTSE data is sourced from FTSE International Limited ('FTSE') © FTSE 2024. Please note a disclaimer applies to FTSE data and can be found at www.ftse.com/products/downloads/FTSE_Wholly_Owned_Non-Partner.pdf

CS_577 03/2024 MACS17354