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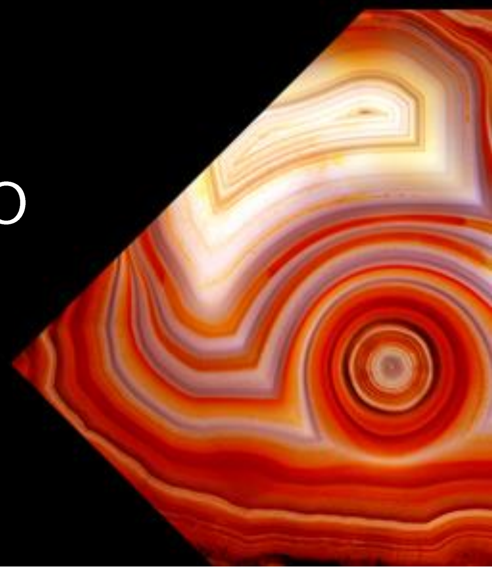

Securitised Credit: What to expect going forward

For Professional Clients only.

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> Investors are allocating to Securitised Credit across our institutional, wholesale and retail segments for differing reasons, such as income generation and portfolio diversification, due to the low correlations Securitised Credit has with traditional fixed income.

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How are US and global trade restrictions impacting markets?

The current market backdrop is generating three things:

- The first is inflation. Markets are likely to be inflationary, and that is going to lead to make it more difficult for central banks, particularly the Fed, to cut interest rates. This should result in a higher for longer interest rate environment which is good news for Securitised Credit investors, given the predominantly floating rate nature of the segment of this asset class that we invest in.

- The second is an economic shock to the system, that will be broader based across the global economy. In anticipation of this, spreads in Securitised Credit have also widened in sympathy with broader fixed income markets. However, this asset class benefits from credit enhancement. This is the ability to withstand an economic shock. So, the asset class is well placed to manage through a mild recession, particularly for the senior and mezzanine tranches of a securitisation. This allows us to add risk selectively, and carefully in this environment, given the higher returns on offer.

- The third one is a lot of uncertainty in the market. We always trade with care, but particularly now, we are trading more cautiously and investing prudently on behalf of our end investors.

How is Securitised Credit different to traditional fixed income?

The asset class is largely floating rate. That means it is short duration and effectively pays base rates plus a credit spread. As we expect base rates to remain higher for longer, we can also expect a good income coming from this asset class.

This also means Securitised Credit is a good diversifier within a fixed income portfolio. Many of our investors are allocating 20 to 30% of their fixed income portfolios into this asset class. Essentially, Securitised Credit provides higher returns with a lower volatility, thus adding high risk-adjusted returns to an existing fixed income portfolio.

Because of the way a securitisation is constructed, we can choose the risk point that we want to invest in. And we similarly have several products that can be very defensive, or high yielding. And that is all wrapped up with the ability to benefit from that credit enhancement if there is a shock to the economic system.

Why do investors allocate to Securitised Credit?

Essentially, it is all down to the yield premium. Securitised Credit has wider credit spreads compared to corporate bonds. That is still being maintained, largely because of the complexity of the product and the credit risk embedded in it.

The other aspect relates to the liquidity premium. This product is somewhat less liquid than equivalent corporate bonds. For the senior tranches, AAA, AA, A, liquidity is pretty good, but we acknowledge that there is a premium being paid for being slightly less liquid than traditional fixed income. So essentially, investors choose this asset class because it pays more.

Should investors be concerned about market liquidity?

The short answer is no, it is a very large market. The global market as a whole is about $4 trillion. Whilst we acknowledge Securitised Credit is a little less liquid, it is still quite liquid.

What we have seen in the current environment, post the immediate shock of trade restrictions, is that liquidity was well maintained. This was also the case through previous shocks such as the Covid crisis and the Russian Ukraine war. So, even in periods of crisis, the asset class recovers quite well.

We are seeing reasonable secondary activity now and even the primary market recovered within a couple of weeks of initial announcements. We manage liquidity with caution and acknowledge the slightly less liquid nature of Securitised Credit but have no liquidity concerns.

How do you identify opportunities?

We have two main processes, the key part of which is our bottom-up approach as we are set up to address the two points of value in the chain.

Firstly, our portfolio managers are specialists in their respective areas of responsibility. They are there, in part, to unlock liquidity premium, but the core of the team is based around credit risk analysis. Every transaction goes through a very thorough credit analysis, where we assess the credit risk management and the complexity risk very carefully.

We align that bottom-up approach with a careful top-down approach. We have a formal meeting every month, where we look at the risks and opportunities that are emerging in the market. We then move our portfolio to where those opportunities are best, and where the relative value is providing us with the greatest opportunity to provide income and aim to steer clear of the risks.

How strong is the investment case for Securitised Credit?

I think its strong. Essentially because it is likely there will be an economic shock to the system. Now that shock is not looking like a complete crisis, and generally speaking, Securitised Credit performs very well in a mild recessionary environment.

We may not even get to that environment, so we have that credit protection which I think is key. We are also set for an environment where we will continue to generate quite strong current income.

In summary, the careful management of liquidity, the potential for strong income, and the protection in the event of recession, add up to quite a powerful investment proposition, especially in a deteriorating macro-economic situation.

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