

# Portfolio Update: Securitized Credit

March 20, 2020

## Executive Summary

- An unprecedented flight to quality in response to worldwide concerns over the coronavirus, compounded by the energy price war between Saudi Arabia and Russia have triggered some of the largest spread widening across securitized credit sectors since the 2008 crisis.
- Spreads across all markets are clearly pricing in a recession, and from a security selection standpoint, this is a cash buyer's paradise. Fundamentals have been generally supportive across the consumer, housing and commercial real estate, so access to these same general risks at meaningfully wider spreads is a fantastic starting point for asset allocators.
- In the securitized space, where every cusip has a story, the ability to pick around residual idiosyncratic risks that become more established (certain cities, hotels, restaurants, airlines) is a real advantage—the magnitude of opportunities in the securitized universe is as vast as we have observed since the depths of the 2008 credit crisis.

## Portfolio Performance: Year-to-Date as of March 19, 2020

Uncertainty surrounding the Coronavirus has caused significant selling pressure across virtually all risk-related asset markets. Plummeting oil prices have exacerbated volatility, after talks between OPEC and non-OPEC members failed to reach an agreement on production cuts.

U.S. Treasuries, as the world's preferred risk-free asset, was the only sector posting positive returns at +5.13% YTD through March 19, 2020. The degree of underperformance across sectors has gone hand in hand with credit quality and the degree of exposure between U.S. and global factors. While Voya's Securitized Credit strategy has held up relatively well compared to spread sectors like high yield and senior loans, year-to-date, the strategy has lagged the Bloomberg Barclays U.S. Securitized MBS/ABS/CMBS index due to the index's large weighting to agency MBS, which declined only modestly (the Securitized Credit strategy is structurally underweight agency MBS).

| YTD Performance<br>As of March 19, 2020 | Total Return | Excess Returns<br>(vs Treasuries) |
|---|--------------|-----------------------------------|
| US Treasuries                           | +5.13%       | —                                 |
| Agency MBS                              | -0.05%       | -2.87%                            |
| CMBS                                    | -1.06%       | -5.44%                            |
| IG Corp                                 | -10.03%      | -15.86%                           |
| HY Corp                                 | -17.61%      | -20.47%                           |
| Emerging Mkt \$ Sovereign               | -18.92%      | -24.71%                           |

\* Treasuries as represented by Bloomberg/Barclays U.S. Treasury Index, Agency MBS as represented by Bloomberg/Barclays Securitized – U.S. MBS Index, CMBS as represented by Bloomberg/Barclays Securitized – Non-Agency CMBS Index, IG Corp as represented by Bloomberg/Barclays Corporate Bond Index, HY Corp as represented by Bloomberg/Barclays U.S. Corporate High Yield: 2% Issuer Cap Index, Bank Loans as represented by the S&P/LSTA Leveraged Loan Index and Emerging Mkt \$ Sovereign as represented by JP Morgan EMBI Global Diversified Index. **An index is unmanaged and does not reflect fees, brokerage commissions, taxes or other expenses of investing. Investors cannot directly invest in an index.**

## Portfolio Positioning: How We Are Managing this Volatile Environment

### Assessing the Coronavirus

Our central case is that meaningful and forceful monetary and fiscal stimulus will help the U.S. and the world recover from the economic fallout related to efforts to contain the spread of the coronavirus. To date, the U.S. Federal Reserve has been extremely active, taking significant steps to ensure liquidity in the U.S. Treasury market. Proposed fiscal measures seem to be forthcoming and appear to be appropriately aggressive. It is up to lawmakers to decide how fast that process can unfold. We expect a W-shaped rebound, supported by global monetary and fiscal measures, and dotted with an occasional episode of concerns that will keep volatility elevated.

## Portfolio Strategy—Attractive Opportunities across the Complex

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The pandemic is certain to have continued impact on the economy, and we acknowledge commercial ABS, which includes aircraft will struggle, as will CMBS deals with elevated exposure to hotels. However, in this space, where every cusip has a story, the ability to pick around residual idiosyncratic risks that become more established (certain cities, hotels, restaurants, airlines) is a real advantage in the current market turmoil and allows us to navigate around these concentrated pockets of identified, unattractive risk.

Across Securitizations, from a security selection standpoint, opportunities are available across the complex. Fundamentals have been generally supportive across the consumer, housing and commercial real estate, so access to these same general risks at meaningfully wider spreads is presenting attractive entry points. Below is a summary of the opportunities across the different securitized sectors.

### Non-agency RMBS

With the credit spread widening observed in non-agency RMBS, scalable opportunities in discount priced bonds have emerged. As low rates manifest and the refi mechanism re-solidifies post Fed moves, elevated prepayments will make today's spreads look all the more attractive over time, fostering sponsorship for the space and, as structures de-leverage, a virtuous cycle of ratings upgrades. As liquidity considerations have seemingly crushed risk adjusted value assessments, spreads have pushed into the 10+% area for high quality, money good parts of the CRT universe. This represents all time wides for a space fundamentally buttressed by low rates and a housing market with runway in its cycle.

### Agency RMBS

While not a natural securitized credit allocation, agency RMBS looks attractively priced on a risk adjusted basis, and concerns around REIT de-leveraging have accentuated the opportunity. Negative convexity remains well priced and the lack of a credit risk component has real value as markets gyrate and more credit risk gets priced into the system. The Fed's targeting reintroduces an inefficient buyer to the market, which will support the space technically. Amid this backdrop, we are now evaluating ways to efficiently incorporate this segment into our securitized credit strategy and advocate featuring exposure in this traditionally liquid sector in fixed income portfolios.

### ABS

High quality consumer ABS have been caught in an illiquidity buzz saw. As front end markets have remained stubbornly locked-up, clients seeking access to cash have tapped ABS holdings for selling, driving a vicious cycle of spread widening. High quality AAA positions across student loans, prime auto loans, credit card loans, solar leases and consumer loans offer spreads 250-500bps, with strong structural protections and well underwritten U.S. consumers. A profound opportunity not sniffed since the credit crisis, when government sponsored stimulative programs (recall TALF) stepped in to support these crucial financing mechanisms to support US consumers.

### CLOs

CLOs are close to ground zero for the supposed bubble in corporate credit. As such, the space has seen illiquidity conspire with real credit risk aversion to indiscriminately punish the entire universe. Previous drivers of value like spread duration, market value O/C and manager quality have been run over as risk takers have evaporated from the space. Dollar prices are at meaningful discounts up and down the capital structure. At certain points, triggers will act to end re-investment periods and accelerate repayment of the senior and middle mezz tranches. In short, when staying up in the capital structure, this trade should perform across an extremely wide range of scenarios, and benefit from pockets of positive convexity as markets inevitably normalize.

### CMBS

CMBS, while particularly sensitive to economic fallout from the pandemic in the hotel sub-segment, have seen illiquidity account for the brunt of a vicious sell off across transaction types (conduit, SASB, CRE CLO). This has left profound opportunities to security select pandemic insulated CRE (think multifamily, office, industrial as insulated property types) up and down the capital structure, tailored for a client's particular objective and risk tolerance. AAAs have widened well into the 200s and money good BBBs offer extreme value approaching spreads of 1000.

**Past performance is no guarantee of future results.**

The principal risks are generally those attributable to bond investing. Holdings are subject to market, issuer, credit, prepayment, extension and other risks, and their values may fluctuate. Market risk is the risk that securities may decline in value due to factors affecting the securities markets or particular industries. Issuer risk is the risk that the value of a security may decline for reasons specific to the issuer, such as changes in its financial condition. The strategy may invest in mortgage-related securities, which can be paid off early if the borrowers on the underlying mortgages pay off their mortgages sooner than scheduled. If interest rates are falling, the strategy will be forced to reinvest this money at lower yields. Conversely, if interest rates are rising, the expected principal payments will slow, thereby locking in the coupon rate at below market levels and extending the security's life and duration while reducing its market value. High yield bonds carry particular market risks and may experience greater volatility in market value than investment grade bonds. Foreign investments could be riskier than U.S. investments because of exchange rate, political, economic, liquidity and regulatory risks.

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