

Demystifying **portfolio construction** for secured finance assets



Speed Read

- The market for secured finance assets enables investors to exploit alternative return sources and diversify into less accessible and less liquid instruments that would otherwise only exist on bank balance sheets
- The diverse and segmented nature of the secured asset market creates a need for the portfolio construction process to be dynamic to achieve the dual objective of stable cash flows and growth
- The pooling of secured assets is critical to risk management. It incentivises avoiding as much as it incentivises investing at the right time; encourages thorough relative value analysis and provides the agility required to take advantage of time limited opportunities that arise.

Introduction

It is only in the last few years that institutional investors have started to comprehensively consider the more niche alternative asset classes available to them. While risk appetite has been growing for a decade since the financial crisis, it first manifested itself within asset classes/styles/structures that were familiar to investors (for example higher allocations to smart beta, concentrated equity, core property or high yield credit). The focus in more recent years has shifted towards the niche alternatives such as alternative risk premia strategies, secured assets, infrastructure, commodities, and private debt.

The shift in the stance towards niche alternatives, either by way of investing or as a first step understanding, is more pronounced for pension funds and insurance companies, in particular those with stable income generating needs as it translates into having to add cashflow management to the existing balance sheet management

challenges, at a time when there is an opportunity to expand the tools available to get there (i.e. the niche alternatives).

The potential for meaningful shifts to strategic asset allocations combined with the need to understand the characteristics of the more niche asset classes has prompted some practitioners to re-evaluate the portfolio construction *around and within* these more niche alternatives¹. While the scope of this paper is not going to be able to cover all the newer options available to institutional investors, secured assets (as defined in Table 1) are one such asset class that are niche and less familiar but present a growing opportunity for institutional investors. The ideas that follow in later sections will describe portfolio construction *within secured assets combined with the objective of generating stable cashflows*. The paper also briefly covers the benefits of diversifying a traditional credit portfolio with these assets (please see call out box).

¹ For the purpose of this paper we consider core direct property investments as traditional and hedge funds, infrastructure, commodities, private equity, risk premia and secured asset strategies as alternatives.

Traditional portfolio construction is a guide, not a jailor

Portfolio construction in the context of secured assets does not (and importantly should not) look identical to traditional asset class portfolio construction processes. This is because while publicly available risk, return and correlations are well documented time tested starting points for traditional asset class portfolio construction, using a model to optimise allocations for non-normally distributed asset classes can easily start resulting in (the model suggesting) allocations that cannot be achieved. Traditional inputs are not necessarily a good enough starting point in the case of secured assets. We provide three reasons below.

- a) **Data:** lack of extensive risk, return and correlation data especially when it comes to multiple market cycles
- b) **Market context:** Asset allocations can differ widely for portfolios with the same objective owing to market context, top-down views, supply, regulatory regime and in large part owing to liquidity needs and the time horizon required for investing
- c) **Dynamic risk analysis:** Whereas top-down and bottom-up portfolio construction can be separate functions for traditional asset classes there is a need to blend these process for the more niche asset classes. Blending the process
 - incentivises avoiding as much as it incentivises investing at the right time
 - caters better towards the dual objective of delivering stable cashflows and growth
 - provides the agility required to take advantage of time limited opportunities that arise and
 - encourages thorough relative value analysis.

Therefore, portfolio construction for secured assets is best considered a guide or checklist that informs systematic thinking rather than a closed form framework that delivers the final strategic asset allocation. This means that whilst there is an element of historical data input, there is a larger qualitative assessment piece.

This paper outlines some principles and guidelines to help inform portfolio construction *within* the secured asset universe. The diverse and segmented nature of the secured asset market² makes it less efficient. This inefficiency is partly responsible for the potential premium³ that exists in the market. Those same characteristics also mean there is a need for the portfolio construction process to be dynamic enough to cater towards the dual objective of delivering stable cashflows and growth.

Secured finance assets defined

The secured asset universe encompasses debt instruments beyond traditional credit (public bonds) secured by different types of collateral across consumer lending, corporate lending and real asset debt. The universe can be accessed through public and private debt investment strategies and helps investors gain exposure as shown in the table below:

Table 1: Secured finance asset universe

Gain exposure to...	Liquid	Private
... corporates	CLO	Loans, Warehouse Financing, Corporate Asset Financing
... consumers	ABS, RMBS	Consumer Asset Financing
... real assets	CMBS	CRE Debt, Infrastructure Debt

Note: Liquidity is relative to private bucket

Diversifying a traditional credit portfolio with secured assets:

Investing in secured assets enables investors to **diversify into** granular, less accessible and less liquid instruments that would otherwise only exist on **bank (or originator) balance sheets**.

Secondly, in contrast to conventional credit, where returns are usually extracted from spread tightening and default avoidance, secured assets can exploit alternative return sources to achieve better risk-adjusted yields.

** Where cashflow generation alongside the option of capital appreciation is the objective, special and distressed situations are limited to going down to BB credit quality ratings and not any further.*

Acronyms used through the document: CLO (Collateralised Loan Obligations), ABS (Asset Backed Securities), RMBS (Residential Mortgage Backed Securities), CRE (Commercial Real Estate), NPL (Non-Performing Loans)

This potential **yield pickup can be derived from** performance drivers such as **complexity** (via strategies that require a dedicated operational setup), **illiquidity** (captured through access to private market opportunities), **structuring** (tailoring transactions - subordination and features of the waterfall) and **access (in a market with high entry barriers)**, where by identifying assets that are distressed for short-term fundamental or technical reasons, pockets of value that are otherwise inaccessible might be identified*.

Finally, while the secured asset opportunity set is diverse, by using the various levers available through the structuring process (for example the terms of a special purpose vehicle, tranching and credit support mechanisms) investors could take advantage of investing in a wider credit rating band or otherwise difficult market conditions – building more robust portfolios in the process. For example:

- **In a rising credit spread environment**, a CLO manager would have the opportunity to replace maturing loans by higher yielding ones and/or purchase loans at discount (as spread rises knock down loan prices). This could increase the level of excess cashflow and improve the valuation of equity CLO tranches. This is only possible due to the CLO structure
- **In a recovering housing market in continental Europe**, investors in RMBS could go down the capital structure (lower credit rating) to have exposure to the housing recovery - capturing more of the potential upside of the recovery.

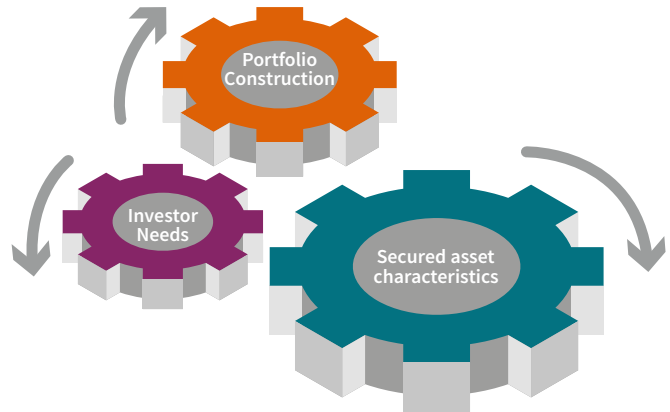
² A general lack of benchmark indices (apart from U.S. MBS) is part validation for the complexity of this market as well.

³ Through illiquidity and complexity premium rather than leverage and duration

From niche to global opportunities

The growth of investor interest in the secured asset universe has coincided with growth within the asset class itself. The secured asset market is becoming more global, with the recent growth in the Chinese market complementing the more established markets in the US, Europe and in Australia⁴. This has generally meant standalone allocations in favour of niche opportunistic trades which have been the norm so far (investors dipping their toes in the water) might be too narrow a trade going forward (the secured asset universe is estimated at close to \$19tr).

As the asset class continues its evolution into investor portfolios (improving depth, liquidity, asset types and understanding at investor level) a blended solution-driven approach (instead of stacking strategies in layers) could be a more sustainable way to ensure a stable strategic asset allocation through the various market cycles.



Cashflow matching, with optionality for capital appreciation

Investment strategy for any investor (e.g. institutional investors like pension funds) is very rightly heavily influenced by objectives. For institutional investors this has largely meant:

- a) turning to a part of the portfolio for the most effective way to generate high levels of returns
- b) using another part to manage liabilities and downside risk relative to liabilities, and now more recently
- c) an element that addresses income and cashflow needs, either directly (matching outflows) or indirectly (generating income).

While secured assets can be used individually to generate growth, they can also be pooled (at strategy level) in a manner that converts underlying discrete loan payments into secured diversified income streams in a total return approach, across strategies, with a tailored income profile. **Pooling is especially beneficial in the late stage of a credit cycle where balancing the need for growth with risks that lie ahead is difficult and where being agile enough to take advantage of opportunities that arise is critical to risk management.** Secured assets therefore, if blended, could provide investors with income and cashflow matching characteristics as well as credibly catering for growth.

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⁴ The Framework for Seeking Alpha in the Global Securitization Market, The Journal of Structured Finance, Summer 2019, <https://jsf.ijournals.com>

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The liquidity premium will always exist but that does not make investing in illiquid assets a better relative value trade all the time.”

A multi-asset format to unlock maximum potential

As the asset class evolves from a niche to global opportunity and enables the possibility of addressing growth and cashflow matching needs, the maximum potential of secured assets, in this scenario is unlocked by managing secured assets in a multi-asset format that enables:

- a) **Mitigating a cash drag:** The ability to invest across a range of asset classes and sectors in the liquid and private space means there is a very high probability of being able to ramp up a portfolio without compromising on quality and yet avoiding a cash drag
- b) **Choice of entry point/Opportunistic capital deployment:** Agility in strategic and tactical asset allocation as liquidity at a total portfolio level can be deployed across public and private markets as appropriate to take advantage of market conditions
- c) **Being highly selective:** An illiquidity premium will always exist, but this does not mean it is always a better risk-adjusted trade to invest in illiquid assets. A portfolio with a global mandate spanning consumer, corporate and real assets sectors can be highly selective in capital deployment
- d) **Taking advantage of market drawdowns:** In a multi-asset format, senior and short dated positions may be exited in favour of more attractive opportunities where the relative valuation is attractive
- e) **Effective ramp up:** The option of being able to competently cherry pick between seven strategies (corporate, consumer and real assets – illiquid and liquid as well as insurance-linked securities) means never being forced to overweight a strategy. This implies being able to ramp up satisfactorily to a reference portfolio whilst ensuring risk is taken care of in a well-diversified manner as opposed to targeting a pre-conceived strategic asset allocation, which may or may not materialise given market opportunities.

Portfolio construction

To ensure that the portfolio within which secured assets are managed has enough flexibility to cater to the most effective ramp up, it is imperative that the structure within which it operates is:

- a) not held hostage to market conditions and forced to invest at the wrong time only to reduce dry powder for reporting reasons
- b) able to assess opportunities with a wide range of liquidity profiles (with the knowledge that there is a lock in period that will allow the investment opportunity to run its course)
- c) focused on risk diversification, not only from a quantitative perspective (low correlations are not a good measure by themselves in this market) but is also fundamentally diversified by underlying risk exposures and by market cycle. For example,
 - while corporates today are said to be in the late stage in terms of increasing debt levels, declining earnings and loosening covenants, consumers are at their low levels of indebtedness with very low non-performing loans and arrears improving
 - in terms of real assets, lease terms are increasing in length, making selling of these assets easier as longer leases have higher present values
- d) letting top-down and bottom-up analysis interact and influence each other – so that avoiding asset classes is incentivised as much as investing at the right time.

Top-down analysis: how do market cycles influence portfolio construction?

Top-down portfolio construction for a diverse and segmented set of secured opportunities is about identifying an area of the opportunity set to focus on (**market cycle analysis**) while ensuring broader parameters remain well diversified (**overall allocations**).

While macro level inflation, growth forecasts, central bank actions, economic cycles and geopolitical changes do not directly impact all secured assets in the same way, underlying risks require reassessment depending on the overall environment. Top-down analysis sets the strategic direction for new investments (and reviews the parameters for the existing ones). Examples of the sort of direction top-down analysis can provide are listed below:

- whether or not to be more aggressive or defensive (usually using the liquid portion of the portfolio to navigate market cycles)
- increase or decrease credit duration
- where to position upcoming investments in the capital structure (senior/ mezzanine/ subordinated)
- assess how attractive the illiquidity premium is and if any allocations should be made as a result
- determine what the most attractive jurisdictions are
- identify the most attractive sectors and
- carry out portfolio level cash-flow analysis to ensure maturity schedules are in line with reinvestment timescales, interest coverage ratios are stable, asset coverage of debt moves according to the market cycle and position in the capital structure is analysed regularly (alongside covenants if required).

While it is almost impossible to provide a closed form solution or framework that captures the intuitive understanding that comes with the experience of managing secured assets, with Table 2 below we have tried to give a sense of how some underlying situations affect decision making in the secured asset universe from a top-down perspective.

Table 2: Portfolio construction for secured finance assets

	Negotiating power	Liquidity Tradable (ABS/ MBS) secured asset spreads	Defaults	Volatility in tradable secured assets	Pipeline of opportunities	Implications for portfolio construction
Expansion	Borrowers have a stronger negotiating position.	High liquidity & low credit risk mean low bid/ offer spreads.	Defaults are low and decreasing .	Very few divergent market views therefore low volatility and one-way tightening.	Usually a robust pipeline with a lot of choice but also a lot of competition from other investors.	<ul style="list-style-type: none"> • Where risk management is the main objective, alpha should be restricted to market beta • Capital Structure: lean towards higher beta names
Slowdown	The negotiating powers are balanced between borrowers and lenders.	Decreasing liquidity & increasing credit risk means bid/offer spreads start to widen and defaults start arriving.	Defaults low but start to pick up/ increase .	Volatility starts to increase as divergent market views start to come in and the market is unsure of whether the momentum of the expansion is slowing down OR an end to expansion is expected.	The pipeline of opportunities starts to reduce just as negotiation powers start to move to lenders.	<ul style="list-style-type: none"> • Drawdown management is key • Move up the capital structure (from mezzanine level) and select high recovery assets
Recession	The lenders have higher negotiating powers but a lower incentive to lend.	Very Low liquidity & high credit risk mean bid/ offer wide (and widening). This means difficulty in trading.	Defaults are high and with no sign of decreasing .	Low volatility given all participants have the same negative view. That usually means a one way widening.	The pipeline of opportunities is low .	<ul style="list-style-type: none"> • Capturing the widest spread possible without going down in credit quality • Keeping dry powder
Recovery	The lenders have higher negotiating powers and a high incentive to lend .	Improving liquidity & improving credit risk mean bid/ offer spreads start to close & and are decreasing.	Defaults continue to be high but decreasing .	More volatile spreads than in recession as once again parts of the market believe the recession is over while other parts don't.	The pipeline of opportunities is scarce but on the rise towards the end of the cycle.	<ul style="list-style-type: none"> • Deploy dry powder • Move down the capital structure and buy discounted assets

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How top-down analysis acts as an input into the bottom-up process

There are aspects of the top-down analysis that determine the focus of the bottom-up process. For example:

- a) As the US economy is often ahead of Europe, a situation in which the US would hint towards a recession and Europe is still undergoing a late recovery would lead to a bottom-up focus in favour of a strategic geographic tilt towards the European region while diversifying across strategies as opposed to a large diversification outside Europe into the US on a narrower range of strategies
- b) Once the headline risks of the UK leaving the European Union started to spread in the market, it became imperative to focus the bottom-up effort on private non-marked-to-market transactions in sectors that could potentially benefit from the impact of this outcome rather than be penalised. This meant avoiding low quality UK RMBS, notably in the buy-to-let and non-conforming sectors and considering liquid European ABS instead. Also taking the view that tourism would benefit from the decrease in value of the GBP prompted a decision to avoid UK office sectors in favour of UK hotels for CRE loans.

Bottom-up security analysis

Given the wide variability of valuations metrics used for bottom-up portfolio construction (for various secured assets) we discuss these through examples. The examples below show how not only are the metrics used differently in all cases, but how they are also very different for seemingly similar underlying exposures.

a) CMBS and CLOs: both are loans to corporates but assessed differently

- Commercial mortgage backed securities (CMBS) are portfolios of loans for properties. Their evaluation on a transaction-by-transaction basis requires, amongst other things, an assessment of loan-to-value (acceptable levels vary by asset class for example hotels at 50/60% or offices at 60/70%), seniority in capital structure (senior/mezzanine) vacancy rates (acceptable levels vary by location for example, 5/7% in France, 3/5% in central London are equivalent to 8%-10% in Netherlands), lease profiles (example length of unexpired lease terms), interest coverage ratios (using rents), diversity of tenants and the likelihood of refinancing the loan at maturity etc. While the tenants occupying the properties can change, the underlying assets are static in nature
- On the other hand, CLOs, which are also secured loans to corporates, are usually assessed by evaluating average ratings of underlying loans, average spreads, sector diversification, borrowers' concentration, percentage of CCC exposure and covenants on a more aggregate but name by name basis. In addition, unlike CMBS securities, the underlying loans in CLOs are not static especially in the reinvestment period.

b) RMBS and ABS: both are loans to consumers but assessed differently

- Residential mortgage backed securities (generally more sensitive to prepayment and call risk) need to be evaluated through metrics such as average loan-to-value, debt-to-income, underlying properties' regional distribution, borrower's profile (employed, self-employed etc), originators' underwriting criteria and debt service process, borrowers' historical delinquencies and losses
- Asset backed securities (generally have a shorter weighted average life, and more sensitive to default/losses) on the other hand are evaluated with more aggregate statistical analysis of the tail risk.

Relative value analysis

As mentioned previously, benefits of a multi-asset approach to investing in secured assets include investing based on relative value analysis. Some examples of relative value are provided here, naturally these are examples based on our experience.

- a) **CMBS vs. CRE Debt:** Relationships with the sponsor and syndicating bank allowed us to have access to a refinancing opportunity of a portfolio of luxury hotels in the UK. While we had exposure to similar underlying assets through a commercial mortgage loan (CMBS backed by a portfolio of UK hotels) a decision was made to recreate that exposure through a private format (CRE Debt). **Switching from the public to private market meant an 80bps pick up** (illiquidity premium) with strong risk control and sourcing components to support the decision, these included, moving up in quality for similar risks (23% lower LTV), prime assets (good balance of hotels between London and the rest of UK with global brands), a well-capitalised and experience sponsor and privately negotiated terms. All this was made possible due to the ability to underwrite specialist investments and deploy leverage at speed
- b) **Capital relief allocation (BBB) vs. CLO (BBB):** A preference was made, to invest in a private BBB (internal rating) regulatory capital opportunity (from a European bank) compared to investing in a BBB CLO tranche. **The regulatory capital relief transaction was less liquid but offered the same level of spread as the CLO tranche, with more diversity and lower risk** in terms of collateral. The underlying loans could be ‘cherry picked’ and were at lower leverage levels with limited overlap in the underlying exposure compared to the CLO collateral
- c) **CRE Debt vs. non-performing loans (NPL):** While superficially this may not seem to be a like-for-like transaction, this is an interesting example as it shows how **relative value analysis may not only be conducted between like-for-like asset classes**. A CRE debt deal was considered to better remunerate the risk of getting exposure to the Spanish jurisdiction, as compared to a portfolio of Spanish NPLs. This was done by analysing if there was a spread differential in the opportunities beyond the fact that two slightly different asset classes were being used to access a region (Spain). While it is true that investor appetite and thus pricing is difficult to gauge without a benchmark (often the case in private transactions), we felt more confident about our valuation for the CRE Debt opportunity compared to the NPL opportunity. This is because a comparable Irish NPL opportunity was used as a benchmark for the price and quality of lending available in Spain. This decision was made in the context of a higher possibility of rating downgrades and a more likely weighted average life (WAL) extension in the case of the Spanish NPLs as well.

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Conclusion

The ideas outlined in this paper should help inform portfolio construction within the secured asset universe, but it is important to recognise that portfolio construction is best considered a guide rather than an end. This is especially true in the case of the diverse and segmented nature of the market which creates a need for the portfolio construction process to be dynamic to achieve the dual objective of stable cash flows and growth. Secured assets, blended together (rather than stacked together), could provide investors with income/cash flow matching characteristics alongside credibly catering for growth.

Importantly, the pooling of secured assets incentivises avoiding as much as it incentivises investing at the right time; encourages thorough relative value analysis and can be especially beneficial in the late stage of a credit cycle where balancing the need for growth with risks that lie ahead is difficult and where being agile enough to take advantage of opportunities that arise is critical to risk management.

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