SECURED FINANCE: CAN EXTRA YIELD BE ATTAINED WITHOUT SACRIFICING CREDIT QUALITY?

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Investors may not have to look towards the lower end of the credit ratings spectrum in order to earn higher yields than those currently available in investment grade corporate bonds.

In a world in which trillions of dollars of government bonds trade at negative yields, the regular cash flows available from investment grade corporate bonds can be too low to help investors meet regular cash flow requirements. Therefore many institutions have been forced down the risk spectrum. However, this could be a strategy that inflicts pain in an environment of economic uncertainty and heightened political risks.

A solution such as secured finance – which potentially offers higher yields without imposing higher credit risks – could be worth considering instead.

What is secured finance?

Secured finance is a multi-trillion dollar global market place incorporating a range of public and private investments which share the common feature that they are secured by collateral and a recurring income stream.

This sweeping definition covers a wide range of assets, but there are three categories that we focus on at Insight and see particular value in. These include assets that are secured against:

➤ **Consumer cash flows:** these can include debt such as household mortgages and credit card and utility bills.

➤ **Asset-based cash flows:** these may include buildings that are rented out, and infrastructure such as hospitals, railways and motorways.

➤ **Corporate cash flows:** these include various types of corporate lending secured against company assets.

Consequently, secured finance can provide substantial diversity across risk and market types, enabling investors to model outcomes depending on what yield pick-up is available among the different sectors. We believe that an unconstrained strategy that seeks the most valuable investments across the spectrum of public and private investment opportunities is the optimal method of constructing a portfolio.

These opportunities exist across both private and public debt markets. This means that they can exist in the form of large deals that are widely sold to mainstream investors, or they can be smaller debt arrangements made on a bilateral (or one-to-one basis) only to specialist fixed income investors.

What are the potential benefits of secured finance?

We believe that a secured finance portfolio could offer a yield premium of 200bps to 400bps above comparably-rated credit if carefully constructed and managed. It could also look to deliver greater cash flow certainty. By tailoring the strategy, credit quality, maturity and payout profiles, investors can construct solutions to meet their specific long-term objectives.

There are also potential benefits in the form of structural protections in the form of robust loan-to-value ratios on residential or commercial mortgage debt or debt covenants on corporate debt requiring borrowers to maintain certain financial metrics. By comparison, investment grade corporate bonds contain few if any structural protections.

High quality secured finance investments can also provide significant seniority. They are often backed by physical assets which can dramatically increase recovery rates in the worst case scenario of a default. By contrast, investment grade corporate bonds are almost exclusively unsecured investments.

Another key benefit is that secured finance assets typically pay floating rate cash flows. Therefore, they would be expected to preserve their value in an environment in which interest rates are increasing.

What drives the returns in secured finance assets?

Considering that secured finance assets can offer a credit spread premium over corporate bonds despite equivalent credit risks, investors may wonder what drives this additional yield. In our view there are two factors:

1. The complexity premium. This reflects the fact that a high level of expertise is necessary across a range of specialisms from legal to accounting to portfolio management as well as access to a broad network of market relationships. Unlike the corporate bond market, where investors can lean on credit ratings and a swathe of public information, the secured finance market is only open to adequately skilled investors, resulting in lower eligible demand.

2. The illiquidity premium. This represents an additional return that investors require for having their capital tied up. Private credit markets are emerging areas of fixed income with no functioning secondary market. Therefore, a number of secured finance assets need to be held until maturity. As such, investors demand additional compensation for risks.

Securing the extra yield

In order to adequately capture the complexity and illiquidity premia available in secured finance, investors need access to a wide range of specialist skills. They need to have the market relationships that allow them to source appropriate deals. They also need to be able to underwrite and structure the deals in a manner that offers adequate returns and appropriate structural protections.

This approach allows investors to negotiate better investment terms, but they need the requisite financial, legal and investment experience. A robust investment process incorporating top-down credit strategy and bottom-up underwriting is best equipped to navigate the market.

A prudent approach to higher yields

While a number of investors feel compelled to invest in riskier assets to meet their yield requirements, the results could be painful. The current environment is characterised by political uncertainty across the developed world. Furthermore, developed market central banks are stepping away from monetary policy expansion, which has been supportive of credit markets. Investors also have to contend with the prospect of rising interest rates in the US.

These ingredients will likely result in episodes of volatility over the foreseeable future. Therefore, the possibility of improving an investor's yield while opting for increased security, more robust structural protections and the benefit of contractual floating rate cash flows could be a compelling prospect.

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