Pensions&Investments

BY P&I CONTENT SOLUTIONS

July 27, 2020 01:00 AM

Institutional investors could be missing opportunity in securitized credit

As institutional investors reevaluate their holdings amid coronavirus-related volatility and economic uncertainty, one area that merits consideration is an allocation to securitized credit.

Published July 27, 2020

Dave Goodson
Head of Securitized Credit, Voya

As institutional investors reevaluate their holdings amid coronavirus-related volatility and economic uncertainty, one area that merits consideration is an allocation to securitized credit.

Securitized credit has grown to be an important component of the global economy, yet many institutional investors have been slow to embrace stand-alone securitized strategies. The fragmented nature of the securitized credit universe helps explain why. The few indexes that exist only cover a portion of the market, which limits the ability of investors and asset allocators to model and identify appropriate strategic allocations.

New research from Voya Investment Management, which modeled the performance of an optimized securitized credit portfolio from January 2013 through March 2020, found that while most institutional investors are underweight the asset class, an allocation could have helped a fixed-income portfolio hold up during the pandemic-induced volatility spike.

DOWNLOAD NOW

INVESTMENT INSIGHTS PDF >

"Both pre- and post-COVID results showed that securitized credit ultimately adds value in a fixed-income context," said Dave Goodson, Voya's head of securitized credit.

The Voya research found that correlations between securitized credit and the high-yield and bank loan markets had been historically low leading up to the COVID crisis, which Goodson said showed the merits of using securitized credit to increase a fixed-income portfolio's diversification.

"You add in a tail event, no matter how concentrated — the volatility we saw in securitized credit markets at the peak of market instability in the first quarter was concentrated in a two-week period — and it can really have a dramatic impact in what those correlations can go to," he said.

But even as correlations converged in that two-week period, Goodson said investors would have benefited from an allocation to securitized credit. And, given the current dislocation, implementing a securitized credit allocation today has added benefit.

"The space warrants an allocation from a long-term strategic standpoint," he said, adding, "You can feel good about an allocation now, not only from that long-term strategic perspective — which is what the study gets into, about optimization over a long period of time — but also on a tactical basis, that today you can take advantage of what appears to be an extremely generous risk-return ratio."

While securitized credit can play an important role in a portfolio, many investors haven't seriously considered it in part because of a stigma that stems from the 2008 global financial crisis.

"Securitized was at the heart of that crisis, and it scarred people," Goodson said. "Even if they didn't have exposure, they're thankful that they didn't have it. That's continued to color their thinking going forward."

But the sector has evolved significantly since the financial crisis — and often outperformed the broader market — to encompass a similar range of diverse but more heavily regulated opportunities. These include residential mortgage-backed securities, commercial mortgage-backed securities, asset-backed securities and collateralized loan obligations.

Diversity of opportunity

In each of those subsectors, there are opportunities in investment grade, below investment grade and nonrated securities, and in fixed- and floating-rate coupons. These allow investors to customize an allocation strategy across several dimensions that make sense for them.

“There are multiple subsectors,” Goodson says. “Within these and across subsectors you can go up and down the rating spectrum, and you can traverse the entire duration perspective as well.”

That diversity is part of the appeal of securitized credit, allowing investors with different tolerances for risk or volatility to allocate to the sector.

“Sometimes people have a very strong view about certain subsectors, thinking ‘Hey, I’m nervous about collateralized loan obligations or CMBS (commercial mortgage-backed securities), and I don’t want an allocation that might have some exposure there.’ When investors consider an allocation to the sector overall, having this exposure to certain sub-sectors can make implementing it more of a leap. This is why a relative value approach that appreciates that different sub-sectors are at different points in their cycles is so important. Ultimately, in the long run, diversification across the full securitized spectrum is a way to lower your risk.”

Another challenge is the fact that there hasn’t been a reliable data set for investors to rely on for portfolio optimization. “The investment system that’s out there doesn’t really enable people to effectively consider an allocation to the space,” Goodson said. “You really have to go outside the realm of your normal day-to-day to find data and measure things like volatility and correlations.”

That was one of the main drivers behind Voya’s research effort. To build an index for its analysis of securitized debt, Voya had three requirements for potential constituents: a dedicated securitized strategy, a multisector approach and institutional visibility.

Before and after COVID

Voya's analysis began prior to the COVID-19 crisis, so after it was completed, the researchers decided to break out the findings into pre- and post-COVID performance to get a more usable measure of optimization that was equally transparent. Perhaps predictably, correlations changed materially in the two weeks after the coronavirus began to deeply impact markets and the U.S. economy.

"No matter how complacent you may be feeling about the world, or how many years you've experienced relatively innocuous volatility for a particular part of the market, there are tail scenarios that will emerge inevitably over time," Goodson said.

"None of us has a crystal ball to know when that tail scenario is going to hit, and the degree to which markets dislocated in March reflects that," he said. "One of the best and most efficient ways to manage that risk is to diversify your portfolio. That will inherently lower that expected tail loss."

Making the allocation

Asset owners who have historically been underexposed to securitized credit should not view recent volatility as a reason to continue to be underweight, Goodson said. But "a key reminder from this most recent tail event is to emphasize diversification, considering other sectors that perhaps you hadn't implemented in the past," he said. "Our research efforts suggest that this should include securitized credit."

Such a shift makes sense both from the long-term strategic perspective, as analyzed in the Voya study, and tactically, to reap the short-term tactical benefits in today's market.

As Voya's work demonstrates, an allocation to securitized credit most naturally could come from an existing fixed-income exposure. However, some investors might also consider reallocating from other parts of their portfolio. Asset owners who are overweight equities following the post-trough run-up might consider securitized credit as part of their allocation if they are increasing exposure back to fixed income in an income-starved world.

"It doesn't have to be just about keeping the fixed-income allocation the same and reallocating within it to securitized," Goodson said. "It could also be part of the normal, dynamic approach to managing equity versus fixed income, or alternatives versus equities and fixed income. Bottom line: Securitized has enough attributes to be part of the overall investment portfolio conversation as well." ■

Nothing contained herein should be construed as (i) an offer to buy any security or (ii) a recommendation as to the advisability of investing in, purchasing or selling any security. Voya IM assumes no obligation to update any forward-looking information which is subject to change. Past performance is no guarantee of future results.

Inline Play

Source URL: