Structured Products

OUR BEST IDEAS FOR INSURANCE COMPANIES | MARCH 2023

Key takeaways

- Now may be a good time for insurance companies to consider structured products such as asset-backed securities (ABS). Historically, they have increased yield and improved credit quality, using a quantifiable risk assessment, while lowering volatility in a core fixed income portfolio.
- The esoteric ABS market has grown steadily since the early 2000s and more rapidly since the 2008 financial crisis, providing tremendous opportunities to increase income and diversification for asset managers of the right size and credit expertise.
- Fixed-rate esoteric ABS provide an opportunity to lock in higher all-in yields, as we approach the peak of the interest rate cycle.
- Esoteric ABS can be a great alternative to diversify away from fundamentally challenged sectors such as commercial mortgage-backed securities (CMBS).

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After a historically sharp rise in interest rates in 2022, we believe now may be a good time to take advantage of the great opportunities within the structured products market—particularly within the esoteric ABS sector.

Structured products represent a compelling asset class for insurance companies within the investment-grade fixed income market. They provide an attractive yield advantage and capital protection through structural protections and diversification. They have been resilient through multiple market cycles, due to structural protections, and have been less correlated to other fixed income sectors.

What are structured products?

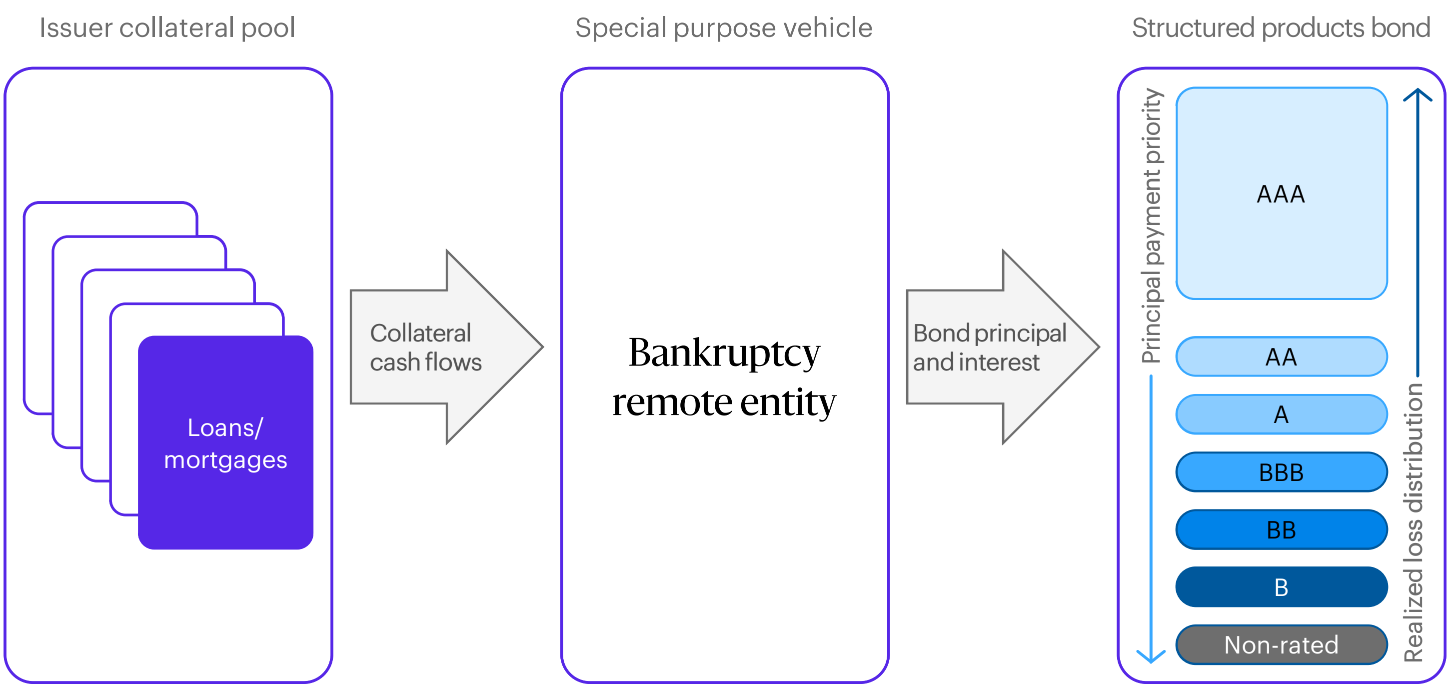
Structured products—also known as securitized or structured debt—are fixed income instruments backed by some sort of receivable, including:

- ABS
- CMBS
- Agency mortgage-backed securities (MBS)
- Residential mortgage-backed securities (RMBS)
- Collateralized loan obligations (CLOs)

A typical securitized bond is backed (or, collateralized) by individual loans, mortgages, or other types of payment streams that are pooled together into a bankruptcy remote trust. Due to structural protections provided by the trust, the risks are quantifiable; valuations, therefore, have tended to be less susceptible to headline or idiosyncratic risk. Principal payments and loss amounts are distributed across tranches, according to the cash flow waterfall. In general, the highest-rated tranches are supported by the subordinate tranches, receiving principal payments first and taking realized losses last (Figure 1).

FIGURE 1

Illustrative structure of a typical securitized bond



Source: Allspring Global Investments. For illustrative purposes only.

Historically, the investment-grade structured bond universe has experienced fewer defaults and downgrades as a percentage of issuance than the corporate bond universe. For example, in Figure 2, over 9% of corporate bonds rated AA were downgraded to A or BBB versus almost 7% for AA-rated ABS and just over 7% for AA-rated CMBS. This is primarily due to the structural protections and the collateralized nature of the bonds. More importantly, nearly 13% of AA-rated ABS and 14.4% of CMBS were upgraded versus 0.8% of corporate bonds. This is because some structured products can often benefit from de-levering—as senior tranches pay down, credit support increases across the entire structure, making upgrades more likely.

FIGURE 2

Average one-year rating transition rates have compared favorably with corporates

FROM/TO	AAA	AA	A	BBB	% UPGRADES
AAA					
ABS	96.7%	1.4%	1.0%	0.6%	---
CMBS	97.3%	1.4%	0.8%	0.2%	---
Corporates	91.2%	8.1%	0.6%	0.1%	---
AA					
ABS	12.7%	78.9%	4.6%	2.2%	12.7%
CMBS	14.4%	76.7%	4.6%	2.6%	14.4%
Corporates	0.8%	89.7%	8.9%	0.4%	0.8%
A					
ABS	2.3%	4.3%	87.4%	4.2%	6.6%
CMBS	3.9%	9.1%	75.4%	5.7%	12.9%
Corporates	0.1%	2.6%	91.2%	5.4%	2.7%
BBB					
ABS	1.1%	1.7%	5.5%	83.8%	8.3%
CMBS	1.2%	1.5%	6.7%	77.3%	9.3%
Corporates	0.0%	0.1%	4.2%	90.8%	4.4%

Average one-year rating transition rates as of 31-Dec-21

Source: Moody's Annual Default Study: Corporate Default and Recovery Rates, 1993–2021 (February 2022), Moody's Impairment and Loss Rates of Structured Finance Securities, 2009–2020 (June 2020). *Securities not rated or that had ratings withdrawn were omitted and percentages were adjusted accordingly.

Diversification benefits

Structured products comprise several subsectors and collateral types. The asset class has had low correlation to U.S. Treasuries, which can help hedge interest rate risk in a rising-rate environment (Figure 3).

FIGURE 3

Structured products have had low correlation with other asset classes

Correlation of total returns

31 Dec 2007–31 Dec 2022	TREASURY	AGENCY MBS	CMBS	CORPORATES	MISC. ABS	PRIME ABS	AA CLO
Treasury	100%						
Agency MBS	80%	100%					
CMBS	14%	24%	100%				
Corporates	48%	60%	58%	100%			
Miscellaneous ABS	27%	42%	44%	69%	100%		
Prime ABS	15%	34%	55%	62%	67%	100%	
AA CLO	-14%	-3%	37%	14%	27%	28%	100%

Sources: ICE BofA Indices, Bloomberg, and Allspring, 31-Dec-07 to 31-Dec-22.

Opportunities in structured products

The esoteric ABS sector has been a growing segment of the securitized market. It has offered a shorter duration profile than other fixed income sectors, significant yield advantage, and excellent diversification benefits. The asset class may be particularly compelling for fixed income investors due to strong structural protections and robust liquidity premiums. Bid/ask spreads have generally ranged from 5 basis points (bps; 100 bps equal 1.00%) to 15 bps, depending on the subsector and position in the capital stack. The asset class tends to be a less efficient part of the structured products market due to the out-of-index nature. It represents one of our best ideas within Allspring Global Investments' Structured Products team.

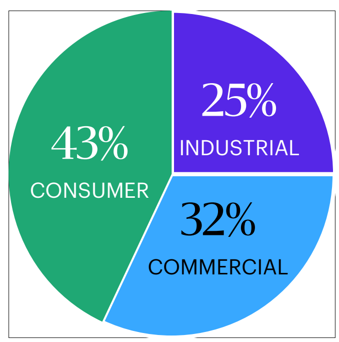
Esoteric ABS comprise more than 20 subsectors or asset types, which have provided diversified investment opportunities throughout the economic cycle. Asset types are categorized as consumer, commercial, or industrial (Figure 4). Consumer receivables include unsecured consumer loans, private student loans, time share receivables, tax lien receivables, and others. Commercial receivables include triple net leases, recurring revenue, franchise/whole business loans, and data centers. Industrial receivables include shipping container leases, equipment leases, stranded utility receivables, railcar leases, and others.

FIGURE 4

The ABS sector is diversified among subsectors and collateral types

CONSUMER

Auto lease
Consumer loan
Credit cards
Fiber
Floorplan
PACE
Prime auto
Purchasing power
Rental
Small business
Structured settlements
Student loans
Solar
Subprime auto
Tax lien
Timeshare



INDUSTRIAL

Agriculture
Container
Equipment
Fleet lease
Life sciences
Oil & gas
Railcar
Stranded utilities

COMMERCIAL

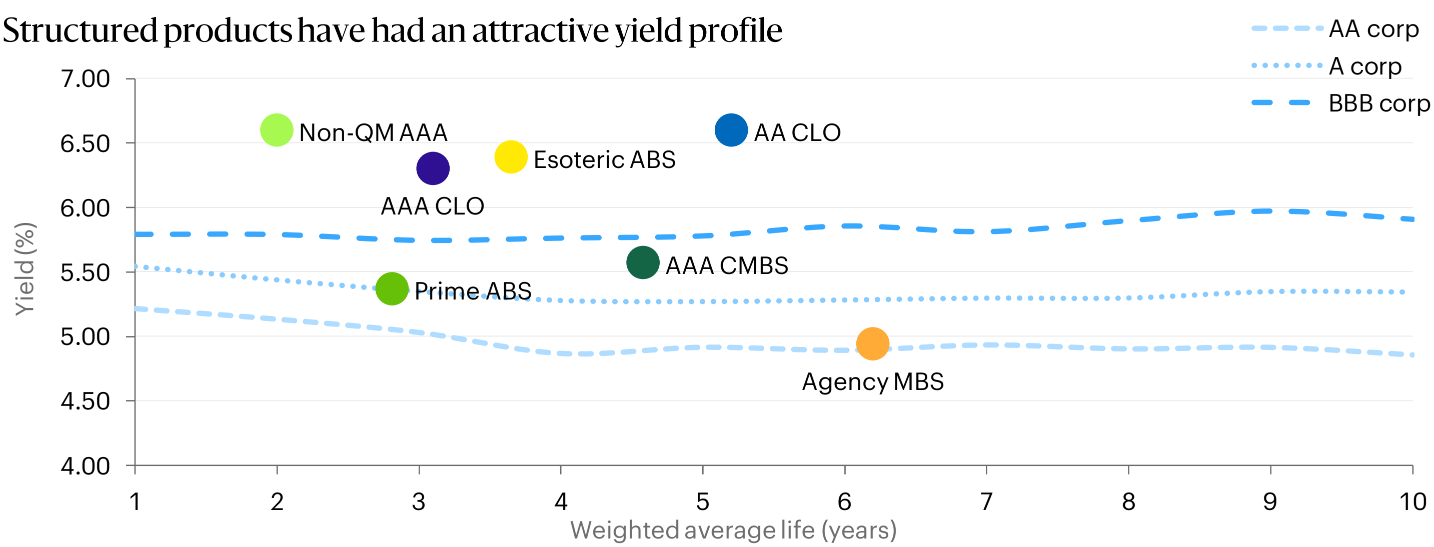
Aircraft
Cell tower
Data center
Franchise
Music rights
Recurring revenue
Triple net lease

Source: Allspring.

Investment-grade esoteric ABS have provided an attractive yield advantage, currently ranging from approximately 6% (small-ticket equipment) to 8% (recurring revenue) and mostly concentrated on the front end of the yield curve (five years and in). They have offered a significant yield pickup versus short corporates and plain-vanilla consumer ABS, such as prime auto loans/leases and credit cards (Figure 5).

FIGURE 5

Structured products have had an attractive yield profile



Sources: Bloomberg, BofA Securities, and JPMorgan, as of 28-Feb-23.

Due to structural protections, including credit enhancement and oftentimes amortization, esoteric ABS have historically experienced low credit loss and strong ratings stability.

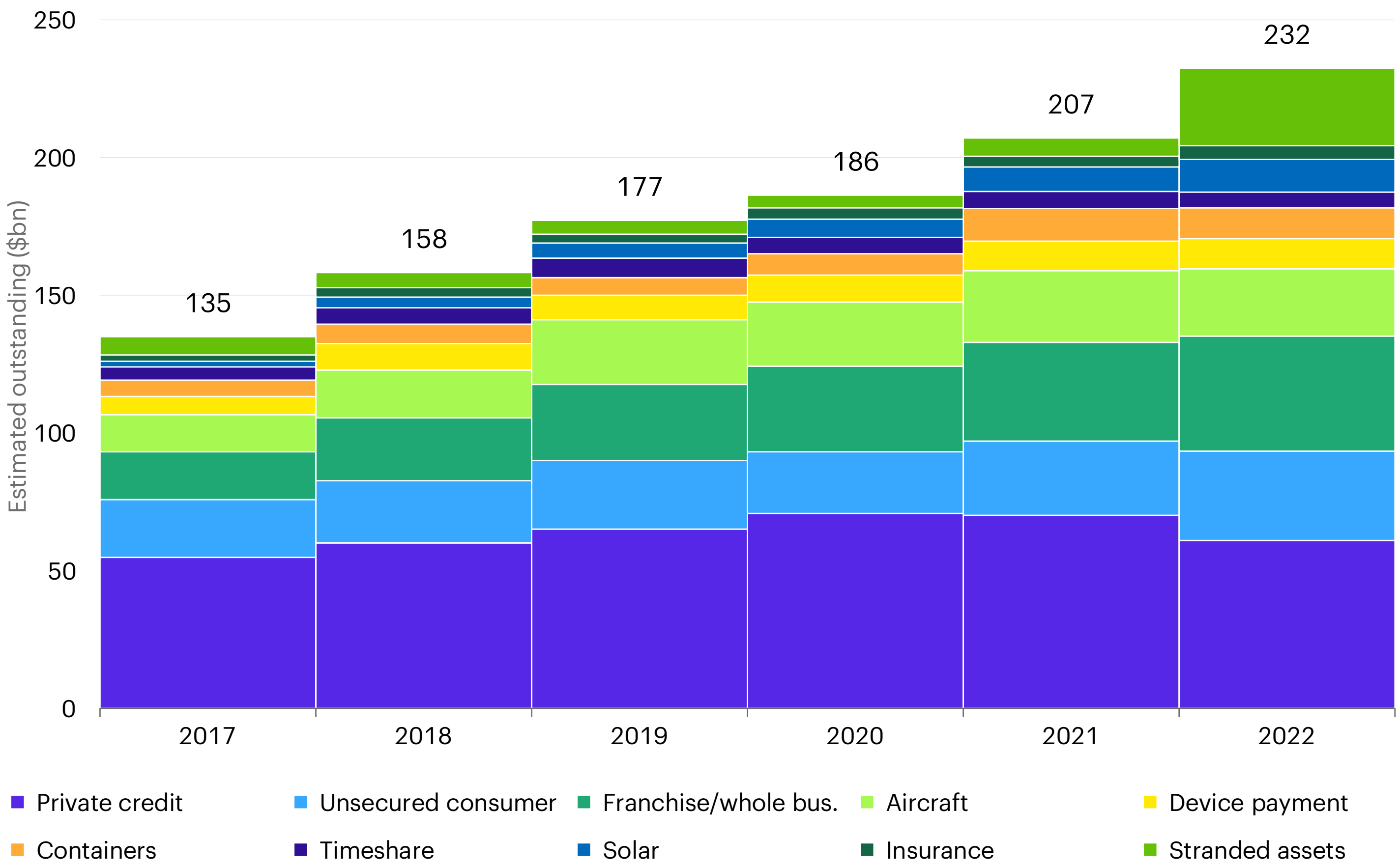
Collateral-backing esoteric ABS are more of a niche market than plain-vanilla ABS collateral such as credit card receivables and auto loans and leases. Deals are issued less frequently, and deal sizes can be smaller than plain-vanilla ABS offerings. Esoteric ABS structures are similar to other ABS structures with a senior class and some form of credit enhancement, normally in the form of overcollateralization, subordination, or excess spread.

The esoteric ABS market has grown steadily since the early 2000s. The market has expanded more rapidly since the 2008 Global Financial Crisis as investors have become more comfortable with the asset class (Figure 6).

FIGURE 6

The esoteric ABS sector has grown substantially in recent years

Estimated ABS outstanding



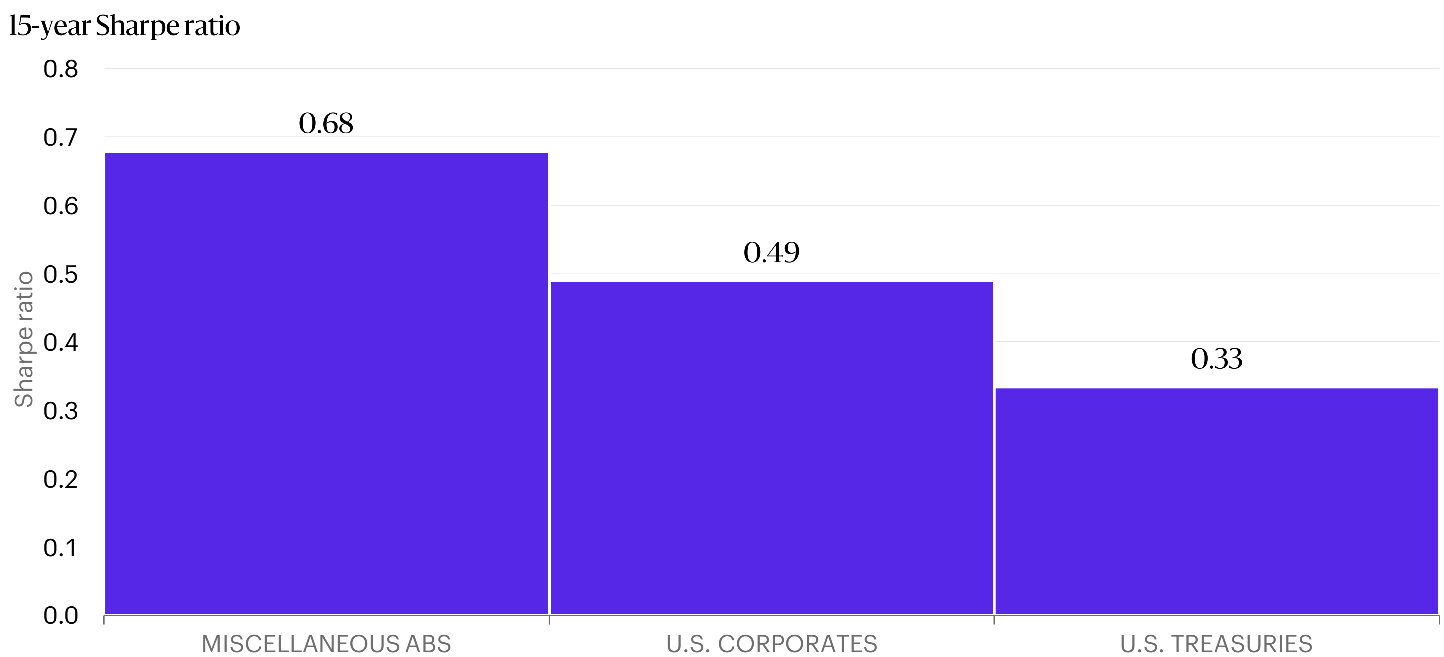
Source: JPMorgan, as of 12-Dec-22.

Growth of the esoteric ABS market has resulted in additional opportunities for insurance companies to pursue higher risk-adjusted returns. However, not all esoteric ABS sectors may be appropriate due to lower liquidity and higher spread volatility versus their plain-vanilla, traditional ABS counterparts—nor does Allspring deem all parts of the esoteric market investible. One example of a sector the team has historically avoided is aircraft ABS, due to poor collateral transparency and diversification, legal complexity, and heightened lessee risk. Our approach is to participate in sectors of the market we view as optimal in achieving maximizing income, ratings stability, capital preservation, and liquidity.

Finally, esoteric ABS have historically provided compelling risk-adjusted return opportunities compared with other high-quality sectors in the investment-grade market, as indicated by the Sharpe ratio. The Sharpe ratio measures excess return above the risk-free rate for the extra volatility or risk as measured by the standard deviation of returns. Figure 7 presents monthly returns over the past 15 years.

FIGURE 7

Structured products have offered higher risk-adjusted returns



Sources: Bloomberg and ICE BofA Indices as of 30-Dec-22.

Allspring's approach to securitized investing

The idiosyncrasy of collateral and diversity of deals requires a disciplined framework for credit analysis. We strongly believe that credit due diligence is paramount to consistent income generation and capital preservation. Furthermore, our team regards relative value and stress scenario risk assessment as inseparable. Credit due diligence is multi-level, with comprehensive understanding and stress testing at the collateral, loan, and transaction levels. We believe stress testing over a full economic cycle, including recessionary shocks, is crucial to capturing the full income and return potential of a security.

We look for opportunities across available sources, including the primary new issue market and secondary bid lists. We often leverage strong and longstanding relationships with our sell-side counterparts, gaining early access to primary deals.

Over the past three years, we've observed insurance companies increasing allocations to CLOs to take advantage of the higher income and floating-rate feature in a rising rate environment. This served insurers well, as front-end rates rose 369 bps in 2022. The Federal Reserve (Fed) has signaled that interest rates will be higher for longer in the battle against stubbornly high levels of inflation. Higher all-in yields and a flat yield curve make the intermediate part of the curve attractive. Esoteric ABS offer an attractive duration profile of about three years. A pause by the Fed later this year would support a normalization in the shape of the yield curve with a move lower in Treasury yields led by the front end and the belly of the curve.

Esoteric ABS may also be an appropriate alternative to fundamentally challenged sectors such as CMBS. Now may be an opportune time to consider allocating to a high-quality fixed-rate sector to lock in higher rates and return opportunities (Figure 8).

FIGURE 8

Fixed-rate esoteric ABS have had attractive high-quality yields

Esoteric ABS yield is similar to AAA/AA CLOs that are typical for insurance companies

	AVERAGE QUALITY	DURATION	YIELD
ICE ABS Master	AA	2.21	6.09%
ICE Miscellaneous ABS	AA-	3.12	6.58%
JPM AAA CLO	AAA	Floating	6.52%
JPM AA CLO	AA	Floating	6.77%
JPM A CLO	A	Floating	7.60%
JPM BBB CLO	BBB	Floating	9.37%

Source: ICE, JPMorgan, Bloomberg. As of 09-Mar-23.

A matter of time

Structured products have historically offered significant opportunities to increase yield and credit quality while lowering volatility in an investment-grade fixed income portfolio.

The esoteric ABS sector, in particular, has grown substantially in recent years, adding opportunities to increase income, credit quality, and diversification. The asset class tends to be a less efficient part of the structured products market due to the out-of-index nature. Its diversification benefits have the potential to insulate a portfolio from secular headwinds, leading to outperformance and higher risk-adjusted returns. Now may be a good time to move forward to take advantage of these opportunities.

For more information

We want to help clients build for successful outcomes, defend portfolios against uncertainty, and create long-term financial well-being. To learn more, investment professionals can contact us.

allspringglobal.com

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