OAKTREE INSIGHTS

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STRATEGY PRIMER: INVESTING IN STRUCTURED CREDIT

OAKTREE

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KEY POINTS

- Structured credit has long been an important component of institutional portfolios. Thanks to the growth and maturation of the $4 trillion structured credit market, investors now have the opportunity to access the asset class as part of their liquid, long-only allocation.

- While the asset class fell on hard times during the Global Financial Crisis (GFC), it is worth noting that there has been a fundamental transformation in the market since then, as regulatory and other changes have led to significant improvements in investor protection and market liquidity.

- With the goal of helping readers become more familiar with the asset class, this primer provides an overview of structured credit, covering the characteristics of the market today, the securitization process, and the potential benefits and risks to investors.

INVESTING IN STRUCTURED CREDIT

INTRODUCTION TO STRUCTURED CREDIT

Structured credit involves pooling similar debt obligations and selling off the resulting cash flows. Structured credit products are created through a securitization process, in which financial assets such as loans and mortgages are packaged into interest-bearing securities backed by those assets, and issued to investors. This, in effect, re-allocates the risks and return potential involved in the underlying debt.

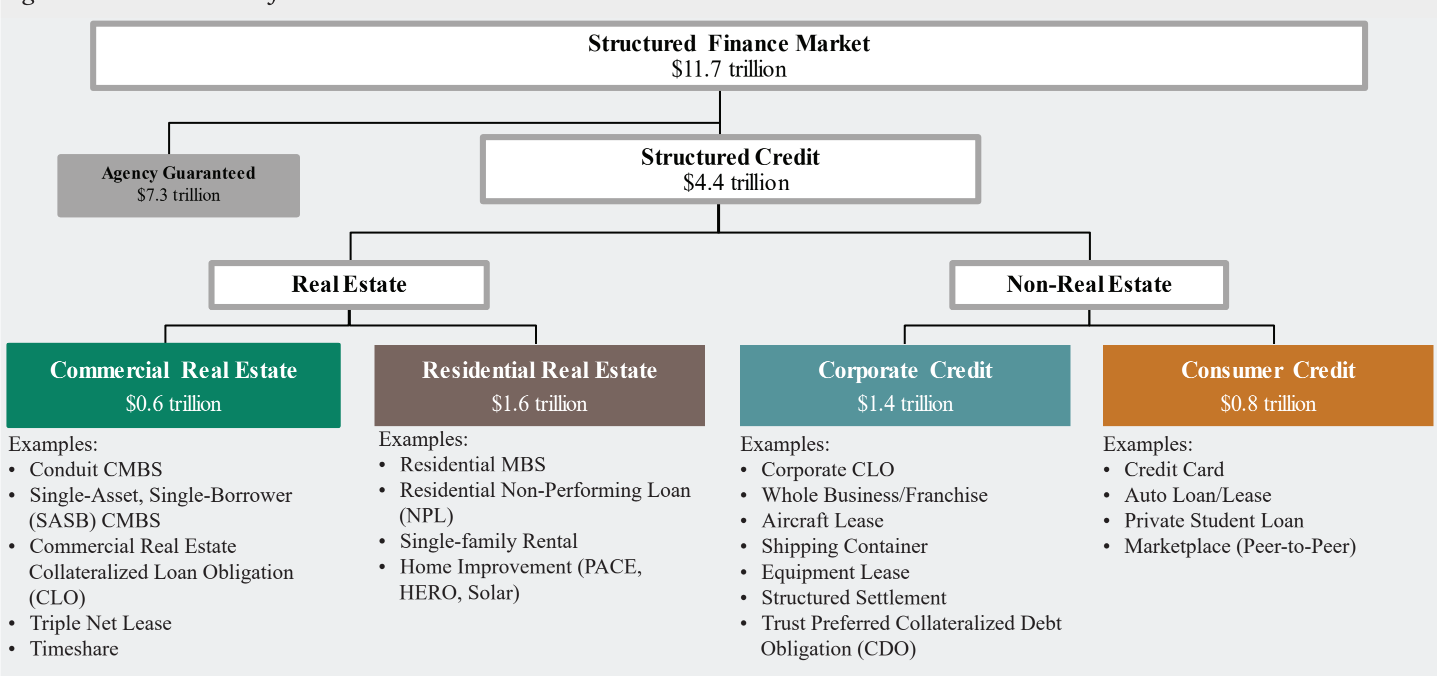
Issuers of structured credit products can range from lenders and specialty financial companies to corporate borrowers. The benefits of securitization for these parties include potential off-balance sheet treatment of assets, reduction of an asset-liability mismatch and lower financing costs. For instance, a BB-rated company can carve out AA-rated assets as collateral, enabling it to borrow at the lower rates reserved for higher-quality borrowers.

Investors in structured credit products can potentially earn higher returns, diversify their portfolios, and gain the ability to tailor credit risk exposures to best serve their investment goals. Repayment to investors is supported by the contractual obligation of the borrowers to pay. For example, an individual takes out a loan from a bank to buy a home, and this mortgage agreement – the contractual obligation to pay – can become part of a securitization pool. The payoff derived from the performance of the underlying asset (i.e., the loan as well as others in the same pool) in a sense replaces traditional fixed-income payment features such as interest coupons.

Structured finance is a decades-old concept dating from the 1970s, when home mortgages were bundled and sold off by U.S. government-backed agencies. The global structured finance market has grown significantly since then and today amounts to about $11 trillion, with agency-guaranteed mortgage-backed debt accounting for about $7 trillion. Since this agency debt is backed by the federal government, Oaktree generally excludes it from our consideration of the structured credit market, which emphasizes the bearing of credit risk in pursuit of substantial returns.

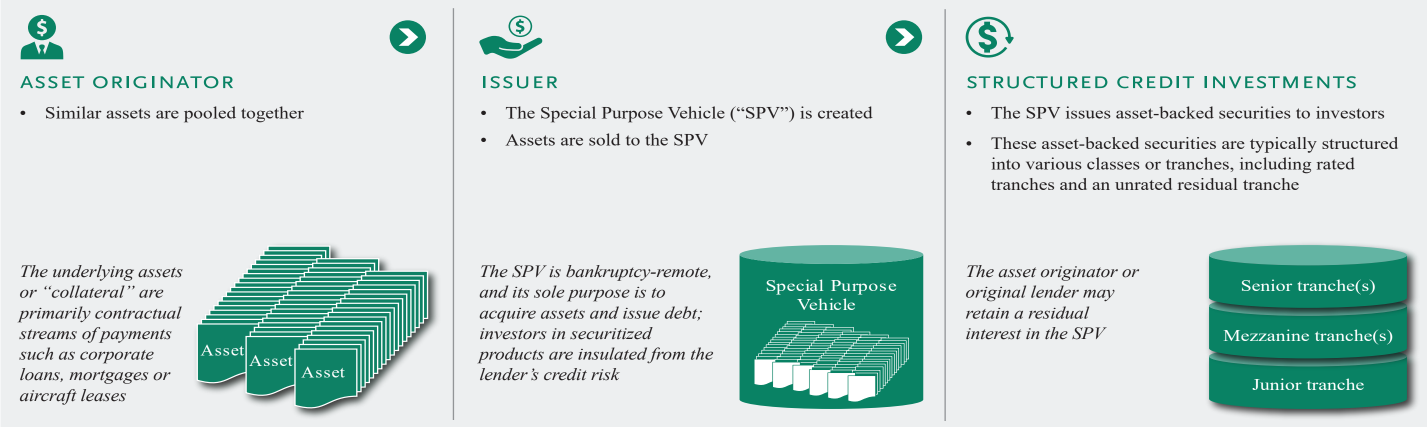
The structured finance market encompasses various types of products, with the underlying collateral generally determining the type of debt (see the breakdown in Figure 1).

Figure 1: A Breakdown of the Structured Finance Market



As of December 31, 2018
Source: SIFMA, AFME.
Note: Market size represents the total amount of outstanding issuance.

Figure 2: Creation of Structured Credit Investments



The most commonly created instruments include securities backed by mortgages for residential properties, called residential mortgage-backed securities (RMBS), and those backed by mortgages for commercial, income-producing properties, called commercial mortgage-backed securities (CMBS). In addition, debt related to consumer products (such as auto loans and credit card receivables), or to corporate contracts (such as aircraft leases and franchise fees), makes up the collateral for what are known as asset-backed securities (ABS). Finally, a security backed by a pool of corporate loans is defined as a collateralized loan obligation (CLO).

SECURITIZATION EXPLAINED

Securitization is a process that transforms a group of financial assets into a tradeable security (see Figure 2). The process involves the transfer of ownership of the assets from the original lenders to a special legal entity, commonly known as a special purpose vehicle (SPV), which has no purpose other than to acquire assets and issue debt secured by those assets. An SPV is legally independent and considered bankruptcy-remote from the seller of the loans, which means a bankruptcy of the seller will not directly affect those who hold securities issued by the SPV.

Each of the tranches is sold separately and has a different risk/return profile. Generally, the senior-most tranche has the first claim to any income generated by the collateral, and the riskiest tranche has the last claim. The order is reversed when it comes to bearing losses. We discuss tranching in further detail below.

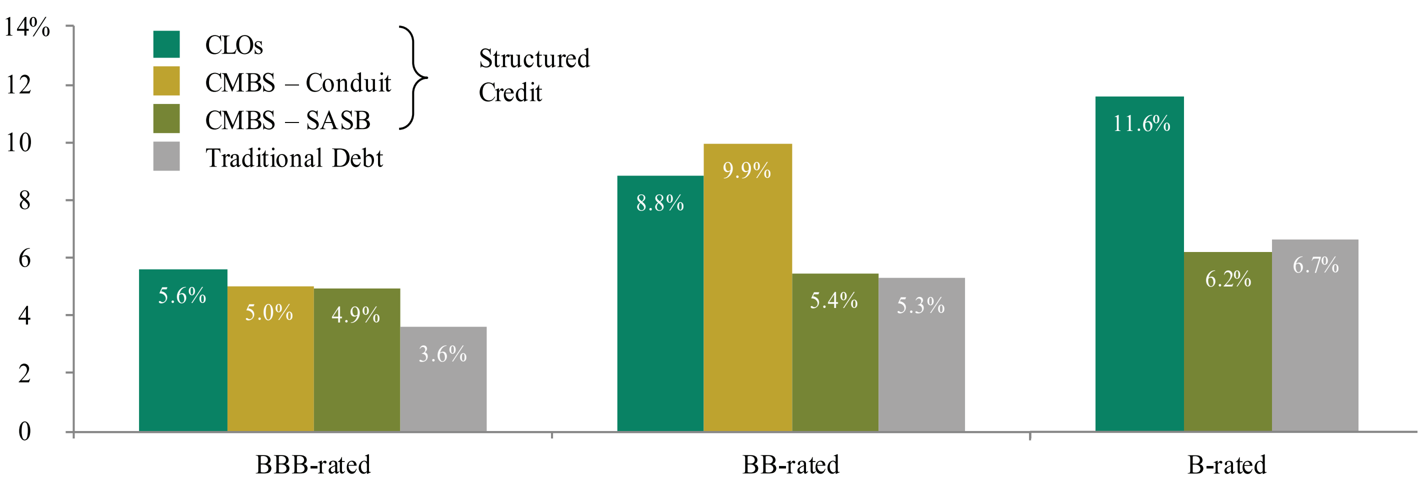
POTENTIAL BENEFITS AND RISKS OF INVESTING IN STRUCTURED CREDIT

Structured credit securities offer several potential benefits to investors. Chief among them are:

- Greater return potential: Structured credit products, such as CMBS and CLOs, typically offer attractive yield premiums relative to conventional fixed-income products owing to their increased complexity (see Figue 3).

- Low loss rates: Certain structured products, such as

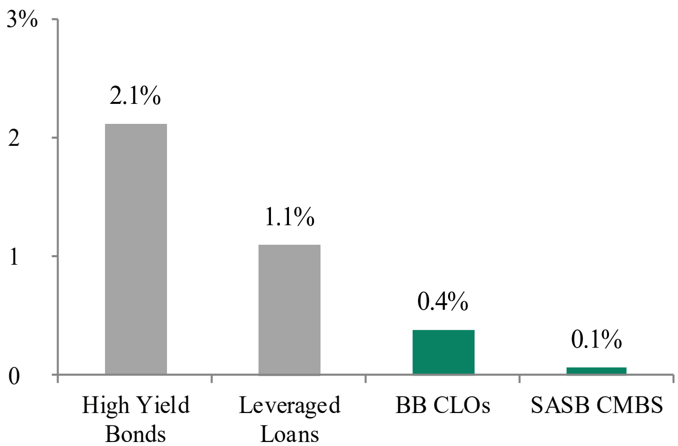
Figure 3: Higher Yields vs. Traditional Debt Alternatives[1]



As of May 31, 2019
Source: Bloomberg Barclays Index Services, FTSE Global Markets, Credit Suisse, JP Morgan Research

CLOs and categories of CMBS, historically have had lower loss rates than other credit investment products, as shown in Figure 4.

Figure 4: Long-Term Loss Rates[2]



As of May 31, 2019
Source: NYU Salomon Center (High Yield Bonds, 1978-2018), Credit Suisse Research (Leveraged Loans, 1995-2018), Moody's (CLOs, 1993-2017), J.P. Morgan research (SASB CMBS and large loan floaters, 1996-2018)

- Diversification:
  - At the loan level: Structured products are bundles of multiple contractual obligations, with many unique borrowers; a typical CLO, for instance, can have between 150 and 300 loans. This means there is significant diversification in the sources of cash flow and thus a high level of defense against potential losses.
  - In a portfolio: Subsectors within the structured credit asset class historically have had low correlation with one another, as well as with traditional fixed-income sectors. For example, as shown in the last row of Table 1, the returns from an ABS (e.g., a securitization of credit card receivables) have low correlation with returns on leveraged loans and are negatively correlated to returns on corporate investment grade debt. Further, the returns on CMBS bonds are little correlated with those of high yield bonds or CLOs.

- Structural protections: Securitization typically includes credit enhancement and various other safeguards that help reduce the credit risk of an issue. The following list highlights a number of important investor protections that may exist in these transactions.
  - Internal protections
    - Subordination: Also known as tranching, subordination refers to the creation of multiple classes of securities – typically senior, mezzanine, junior and residual – through a securitization process. These tranches are different slices of a pool of debt instruments, defined primarily by risk characteristics. Each tranche carries varying risks, rewards and maturities that allow investors the option to select the tranche that best serves their investment objectives. The senior tranches have the benefit of priority in any claims for repayment against the collateral, while the junior tranches are first to absorb losses in the case of default.
    - Overcollateralization: An SPV typically has more assets than liabilities. This practice of issuing less debt than the value of assets creates a cushion for debt investors.
    - Excess spread: In most securitizations, the income received from the assets (e.g., interest received on the mortgages or loans) is higher than what is owed on the liabilities. If all goes well, this additional cash flow, or "excess spread," is often distributed to the SPV's equity investor. But in the case of a covenant breach due for instance to deterioration of the quality of the loan pool, excess spread is diverted from equity investors to the senior-most tranche. As in the case of overcollateralization,

Table 1: Structured Credit Generally Has Had Low Correlation with Traditional Fixed-Income Sectors[3]

	10-year Treasury	IG Corporate Bond Index	CMBS Index	HY Bond Index	Leveraged Loan Index	CLO Index	S&P 500 Index	ABS Index
10-year Treasury	1.00							
IG Corporate Bond Index	0.75	1.00						
CMBS Index	0.77	0.88	1.00					
HY Bond Index	(0.06)	0.48	0.36	1.00				
Leveraged Loan Index	(0.26)	0.26	0.19	0.83	1.00			
CLO Index	(0.22)	0.26	0.25	0.66	0.78	1.00		
S&P 500 Index	(0.33)	0.13	0.05	0.71	0.63	0.48	1.00	
ABS Index	(0.21)	(0.05)	(0.08)	0.21	0.33	0.33	0.13	1.00

Note: Index returns data from January 2012 through May 2019. See Endnote 3 for index information.

this provides a cushion for those who invest in the debt of the structured product.

- External protections
    - Letters of credit: A third-party letter of credit is a commitment granted by that party to guarantee some degree of protection against losses on the underlying assets. A bank, for instance, can issue a letter of credit as a guarantee to reimburse the issuer for a specified amount of cash shortfalls.
    - Surety bonds: Often issued by insurance companies, surety bonds guarantee the principal and interest payments for specified investor classes. A product paired with surety bonds would typically have a credit rating close to or the same as that of the surety bond's issuer.
- Bankruptcy-remoteness: The securitization process starts with a lender. If this entity files for bankruptcy protection, the SPV that provided financing for the lender's asset pool is "remote" from this bankruptcy, meaning the bankruptcy protection measures for the lender do not extend to the assets of the SPV and investors in securitized products are insulated from the lender's credit risk.
- Professional servicing and management: The servicer, which can be the same as the seller of the collateral, acts on behalf of the debt holders and is responsible for collecting payments from the original borrowers; negotiating with any borrowers who may be delinquent; and recovering assets in the case of default, among other tasks.

Investors should be mindful of the following risks when approaching structured credit:

- Complexity: Securitization takes relatively simple debt contracts, such as mortgages or bank loans, and packages them into more complex structures. The process involves transferring ownership of the assets into a separate legal entity and the creation of a number of securitized tranches out of a single pool of assets, adding layers of documentation that could require greater investment understanding and resources.
- Credit risk, default risk: These pertain to the risk of loss due to adverse developments in the performance of the underlying collateral. Despite a high level of transparency into the individual loans, the risk of default cannot be eliminated. In certain market environments, heightened aggressiveness in lender assumptions could negatively impact the credit quality of the individual loans.
- Interest rate risk: Changes in interest rates may affect the value of a structured security prior to its maturity. In times of rising rates, floating-rate products, such as CLOs, may present an advantage or an offset by way of their increasing interest receipts. However, the market value of loans and the appeal of rising payments associated with rising interest rates can suffer when those higher rates start to weigh on economic growth. Finally, interest receipts can decline in times of falling rates. There may also be prepayment risk and extension risk. The former involves earlier-than-anticipated principal repayment, typically in a declining-rate environment (when one might want the instrument to remain outstanding), while the latter describes a slower-than-expected principal repayment, extending the deal's effective maturity, usually in a rising-rate environment.
- Reduced liquidity and marketability: The design of structured credit products by definition increases the liquidity of what were illiquid assets. Still, these are complex securities that may trade infrequently and therefore be difficult to price and liquidate.

CHANGES IN THE STRUCTURED CREDIT MARKET SINCE THE GLOBAL FINANCIAL CRISIS

The market for structured credit instruments has undergone significant changes since the GFC, making them more mature and investor friendly. Key factors that facilitated this shift include regulatory requirements that focus more sharply on investor interests; rating agencies determined to repair their reputation; and skeptical capital providers who no longer exclusively outsource credit diligence to conflicted sponsors, rating agencies or insurers.

Among the major changes is an overall increase in structural provisions and protections for investors, some forms of which we discussed above. Further, many of the riskiest instruments that were issued leading up to the GFC are no longer issued today due to the losses they generated in connection with the crisis.

Other changes include increased credit support at each tranche level; stricter inclusion criteria for underlying collateral; reduced reliance on pro-forma underwriting; and more standardized reporting to provide increased transparency to investors.

There are also greater restrictions that limit conflicts of interest with respect to affiliate transactions, and rating agencies are taking more conservative approaches. The present investor base has matured to include less-levered, more sophisticated buyers with long-term investment horizons. Additionally, "dry powder" dedicated to structured credit has been raised that may help provide price stability during periods of heightened volatility to the downside. (For an in-depth observation of the changes made to the asset class since the last recession, see Oaktree *Insights* publication Structured Credit: Then vs. Now.)

A COMPLEX BUT POTENTIALLY USEFUL COMPONENT OF A PORTFOLIO

Investing in structured credit warrants careful due diligence, especially given the complex technical aspects of the asset class and its various products. Developing a deep understanding of the underlying collateral is key to investing in this asset class. When analyzed and utilized correctly, structured credit can be a useful fixed-income allocation regardless of market environment, due in part to its complexity premium, floating interest rates, improved liquidity and diversification.

Endnotes

[1] The data depicted is for illustrative purposes as an indication of the relevant opportunities in each asset class represented. The indices indicated are unmanaged and it is not possible to invest directly in an index. The traditional debt alternative represents a similarly rated asset class for each rating category and includes the Bloomberg Barclays Investment Grade Corporate Bond Index (BBB ratings), the FTSE High Yield Cash-Pay Capped Index (BB rating) and the Credit Suisse Leveraged Loan Index (B rating).

[2] Updated annually.

[3] Indices shown in analysis include the Bloomberg Barclays U.S. Corporate Investment Grade Index, the Bloomberg Barclays CMBS 2.0 Index, the FTSE High Yield Cash-Pay Capped Index, the Credit Suisse Leveraged Loan Index, the J.P. Morgan CLO Index and the Bloomberg Barclays U.S. ABS Floating-Rate Index.

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