BEYOND TRADITIONAL INCOME:

THE CASE FOR CLOs AND SELECTED SECURITISED FIXED INCOME OPPORTUNITIES

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Janus Henderson
INVESTORS

INTRODUCTION

Hubbis and our exclusive partner for the event, Janus Henderson Investors, held a private discussion event on November 21 in Singapore to highlight the appeals of the US securitised debt market, and specifically the attractions of their US ETF strategies, covering AAA CLOs, as well as Agency Mortgage-Backed Securities (MBS).

Janus Henderson Investors is perhaps best known for its skills around equity strategies, but has been running Fixed income portfolios for a long time, and counts a very credible USD83bn in Fixed Income AUM across all major asset classes. The firm is bottom-up, and its fundamental research-driven mindset equally applies to everything they do in Fixed Income as well as Equities.

JHI also has a well-respected securitised fixed-income team and are leaders in the CLO ETF space. Alexis Lavergne, Investment Specialist, Fixed Income, was their nominated specialist attending and speaking at the event.

His mission was to explain why, despite the huge rise in inflation and rates since early 2022, traditional fixed-income assets remain trapped at uncharacteristically tight spread levels. Meanwhile, he explained that securitised assets, particularly AAA-rated CLOs – as illustrated by the success of JHI's AAA CLOs ETF – have emerged as a bright spot for investors by delivering relatively attractive spreads, high income, and lower correlation to traditional fixed-income instruments.

And he told guests that, recognising the broader potential of securitised assets, Janus Henderson was also actively promoting its Agency MBS ETF.

This is a summary of his key input and observations, some of which are based around his supporting research material on their funds and strategies, and some of which he elucidated in response to the dialogue with the attendees, all decision-makers, gatekeepers and CIOs at private banks and wealth management institutions. Also in attendance was Roger Thompson, Chief Financial Officer at Janus Henderson Investors, and a member of the firm's Executive Committee.

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View Alexis Lavergne's LinkedIn Profile
Find out more about the Janus Henderson Investors

ALEXIS LAVERGNE'S INSIGHTS IN BRIEF:

The fixed income and other specialists at Janus Henderson Investors consider that the US Federal Reserve is 'done' with its rate hiking for this cycle, but 'high for longer' remains the storyline as they do not want to risk the inflation genie escaping and there are underlying factors about which to remain cautious, such as stubbornly high employment and wage growth in the US. JHI anticipates that on today's data and outlook, rate cutting might start in the Spring of 2024, but the pace of declines will be frustratingly slow for many who still expect lower and faster.

In the US, traditional fixed-income spreads remain stubbornly tight despite concerns over rates, especially as corporations refinanced huge volumes of debt in 2021 at low rates. As supply is not expected to rise again until 2027, there are significant shortages in the market, keeping spreads tighter than might be expected at this stage of the cycle. Meanwhile, key areas of the vast US securitised debt market – which in total is worth a humungous USD15 trillion (compared to a USD10 trillion corporate debt market) - offer considerably higher spreads and more potential upside.

Collateralised Loans Obligations (CLOs) are most definitely not to be associated with the CDOs, or Collateralised Debt Obligations that were at the epicentre of the global financial crisis of 2008 onwards. CLOs are of dramatically higher quality, constructed with far greater integrity, and the AAA CLO paper has an impeccable, totally default-free track record of 30-plus years already. Moreover, the spreads on AAA CLOs are highly appealing today, with a yield-to-worse on AAA CLOs of 7.3% as of mid-November, and with capital uplift upside as well.

As CLOs are carefully structured into multiple tranches, investors buying the AAA CLO paper are virtually immune from credit risk, while even for the lowest rated strips (essentially the equity pieces), historical default rates are modest to low. Indeed, AAA CLOs have never suffered a default event in the more than three decades since the first such paper was created in the US.

JHI's USD4.7 billion JAAA CLO ETF is actively managed, it is unique, liquid and at a yield to worse of 7.41% at the end of September and also has significant potential, even after factoring in withholding tax for non-US investors. To put it in context, AAA CLOs offer roughly 1.7% above the current 5.5% cash rates and a roughly 50bp of yield pick-up compared to US Corporate IG paper of up to 3 years.

JHI is also a keen advocate of Agency MBS, which currently offers an attractive entry point and is essentially de facto a US Federal obligation. Agency MBS trades somewhat out of kilter with historic levels this year, following what was a flood of supply emanating since March from US regional banks amidst the US regional banking debacle. Agency MBS paper today offers investors a somewhat unique opportunity as a yield-enhanced substitute for traditional duration exposures.

Agency MBS has many outstanding qualities for investors and market pricing anomalies in 2023 have opened the door to additional opportunities and value. Specifically, refinancing risk – which is typically one of the key risks associated with Agency MBS – is also minimal at present, as 80% plus of mortgages in the US were issued at 4.5% or lower and refinancing costs are now above 7%. This means that the refinancing risk for Agency MBS is merely a distant spectre on the far horizon.

The JHI fixed income team manages more than USD80 billion in strategies, with securitised assets representing more than USD22 billion of the total. They collectively have both great expertise and a long track record of rigorous discipline.

The teams are especially excited about the opportunities and believe that the demand for AAA CLOs and Agency MBS is fully justified and still expanding. As JHI offers both AAA CLOs and Agency MBS via its ETFs, investors have straightforward access, and liquidity is strong, while the opportunities ahead are significant.

JHI's current view on rates and the US Federal Reserve – the hiking is done but 'high for longer' remains the headline

Alexis explained that they agree largely with the firm's view expressed some few months ago that the hiking phase is over, but the US Fed will not retrace quickly. He said the early widespread views in the market that inflation would be tamed quickly, and the US would then revert to very low rates were clearly erroneous.. Inflation looks more established, running at 4% in numbers released in mid-November, and he noted that with some 2-1/2 years left at the helm of the Fed, there is a feeling in the 'street' that Jay Powell does not want to be known as the chairman who did not get inflation fully back in the bag.

"Our view in general is progressive cuts, perhaps two of them in 2024, one of which might emerge in March," he reported. "They need inflation back to the 2% level to declare victory, and unless we somehow see dramatic progress on that mission, we won't get much lower rates earlier."

Traditional fixed-income spreads remain stubbornly tight despite concerns over rates and the economic outlook, and meanwhile, securitised assets offer considerably higher spreads and more potential upside on a soft landing

Alexis noted that traditional fixed-income assets such as corporate bonds (both IG and HY) are still trading surprisingly tight - on November 20, IG traded at 114bp, compared to a long-term average of 125-130bp. Meanwhile, securitised assets offer far higher spreads and are trading well above their long-term averages, which means there is upside potential.

Alexis added that mainstream corporate spreads are so tight partly because corporates refinanced hugely in 2021 while rates were so low and primary supply contracted, meaning investors and asset managers are struggling to find good investment-grade paper and solid high-yield paper to put in portfolios. He said that demand for primary corporate bond issuance is not likely to rise again until 2026-2027.

"We consider that corporate paper and a lot of fixed income today has few barriers from a bumpier ride ahead, which is why JHI has been de-allocating from corporate bonds, and going way more into the securitised universe," he explained. "Securitised spreads such as in Agency MBS have widened this year, due to unforeseen events like the US regional banking crisis, but fundamentals remain supportive and some of the key idiosyncratic risks are more removed, hence we believe that we can make money off of that."

As to this potential upside, Alexis observed that the pandemic had a dramatic effect on the economy, but since the Fed began tightening, the overall impact had not yet been

felt as strongly as what might have been anticipated in some ways, as there remains stubbornly high employment and sticky inflation in the US economy at large.

"As we see things, a recession or another significantly bad event cannot be excluded, so we might want to allocate to assets that will help us mitigate that," Alexis explained. "We believe the right types of securitised paper are valuable additions to portfolios. For example, AAA-rated CLOs offer close to 170 basis points on top of 5.5% returns in cash for zero duration as they are floating rate instruments, and they have very limited credit risk. And we also like the Agency MBS, which offers an appealing alternative to treasuries to extend duration."

Alexis reported that the US securitised debt market stands at USD15 trillion, roughly 50% larger than the US Corporate bond markets and a key portion of the total USD55 trillion US debt market.

CLOs are most definitely not CDOs; they are of far higher quality, constructed with far greater integrity and have an impeccable track record

Alexis went deeper into his thesis. He explained that CLOs are collateralised loan obligations and comprise what used to be known as bank loans, and now generally referred to as leveraged loans. These loans are taken out by relatively smaller, high-yield type companies that do not issue at the scale or regularity required to issue in the main high-yield markets.

He explained that much of this debt comes about in M&A transactions,

recapitalisations, and corporate restructuring, with much derived as part of private equity business reorganisations. The bulk of this debt ends up in the CLO market, where tranches are created that cater to different investor needs and expectations. Often CLO managers keep the highest returns themselves as they have such a strong handle on the risks while selling the risk-mitigated senior tranches to the market.

This all means that CLOs are completely different from CDOs that were constructed out of subprime mortgages (that Alexis said should have never been issued in the first place). "It was CDOs, and certainly not CLOs, that blew up in the financial crisis of 2008," Alexis explained. "CDO were built using the sub-prime mortgages as collateral. The people who got these sub-prime mortgages had no credit rating, and the idea was that as long as you

have an official ID, almost anyone could get a mortgage!"

However, AAA-rated CLOs represent packages of loans issued by companies, CLOs have been around for roughly three decades, and AAA and AA tranches have never recorded a default in any of those 30-plus years.

Yes, exposure to floating rates is risky if rates come tumbling down, but that is not the scenario that JHI sees ahead, and spreads on CLOs and securitised assets are highly appealing today

He also responded to a question about exposure to floating rates, stating that their view that rates are high for longer mitigates those dangers.

"It will take a year or two at least to get rates back down," he reported. "And meanwhile you're getting a yield to worse on the AAA-rated assets currently of 7.3%, and upside – our JAAA triple-A-rated CLO is up over 7% in 2023 and you are achieving this return in a straight line with a Sharpe ratio of 2.8, which is remarkable. Moreover, CLOs tend to be the best well-behaved spread products out there - 85% of daily returns for AAA-rated CLOs are between 0 and 3 basis points."

He added that as CLOs are floating rate instruments, and limited credit risk as they are AAA-rated, investors virtually only face spread risk, resulting in the yield to worse being quite close to actual returns. "As I mentioned earlier, the distribution of daily returns is heavily skewed towards the zero to plus three basis points on a day-to-day basis, and by way of example, in 2022, when almost every single fixed income asset was down the drain, with US treasuries down around -15%, AAA rated CLOs returned a 1% positive performance, and that was including some widening in the spreads."

And today, investors get 170bp over cash rates of 5.5%, while there is a roughly 50bp pick-up over 1-3 year IG corporate paper. "But remember that IG paper has more credit risk, more spread risk, and they have duration risk," he reported. "Even AAA-rated corporate bonds historically present about a 1% to 2% default rate, which is not the case for default-free AAA-rated CLOs. This means the 50bp pickup from CLOs comes as a real added bonus."

CLOs are carefully structured and split into multiple tranches so that investors buying the AAA paper are virtually immune from credit risk

The structuring of CLOs into different tranches means that the medium to lower tranches, typically BB and below, have higher default rates, but Alexis reported that even those defaults are actually very small, historically.

"You would need three GFCs on top of one another, before a AAA tranche defaults," he said. "But we are not saying every tranche of lowly rated CLO paper is right for investors – we are allocating to the AAA tranche. The equity tranche might offer much higher returns, but we are not opening investors up to any of those risks whatsoever - the beautiful thing with the structure is that the guys at the bottom of the pile take the hit first. If there are ever any gaps and the over-collateralisation test for lower tranches fail, the money that is due to those lower tranches is automatically redirected to the AAA tranche."

Alexis said that, in turn, means your 'risk' of sitting at the top on the AAA-rated tranche is that you might receive accelerated repayment because if there is cash that is supposedly due to the lower tranches but overcollateralization tests fail, investors in the top tranches will have priority over it.

And he said that while default rates within the CLO structures might rise somewhat due to higher rates after decades of falling or low rates, JHI a) expects this, b) expects any rise to be very muted, and c) that there would have to be truly massive trouble for the AAA tranches to be affected.

JHI's JAAA CLO ETF is actively managed and unique and has significant potential amongst foreign (non-US) investors

Turning specifically to the 3-year-old "JAAA" triple-A CLO ETF strategy, Alexis explained that it has enjoyed a surge in demand this year, rising from below USD1 billion in AUM at the end of 2022 to more than USD4.7 billion in AUM to date and dominating the space.

"With so many appeals, as I have explained, AAA-rated CLOs are a great way to diversify away from cash and money markets and generate higher returns for investors," Alexis stated. "We have seen massive demand this year for this ETF, which investors can buy into for USD50 or so a share, whereas to buy CLOs like this directly requires a minimum ticket of USD 250k."

He noted that JAAA only has US exposures, is actively managed, and is a US-domiciled ETF fund, mostly with US investors. If foreign-registered investors buy, they

would likely be subject to dividend withholding tax that applies to any US-listed product that distributes dividends or coupons. However, as Alexis explained, based on the past year's data, that would still return better than cash or money market instruments over the past 12 months.

"That is still considerably better than cash," he said. "And JHI is currently thinking about how to make this JAAA CLO ETF more accessible for clients overseas, from outside the US."

Moreover, he added that AAA CLOs are also lowly correlated to traditional fixed-income assets – the correlation between AAA-rated CLOs and US aggregate is 0.06, and the correlation with US Treasuries is -0.02, meaning close to zero correlation to traditional duration fixed income assets.

He summarised his key points by reporting that AAA CLOs are therefore a very attractive option for investors for essentially three reasons. One, because they help clients to increase their income compared to what they currently hold in cash, and in the money markets. The second element is quality, with AAA ratings from rating agencies supported by rigorous analysis by the JHI teams. Additionally, AAA CLOs offer diversification with minimal correlation and a highly appealing Sharpe ratio.

The appeals of Agency MBS, which stands tall in the world of securitised paper, having been oversold in the US regional bank crisis, and today offers investors a yield-enhanced substitute for traditional duration exposures

Alexis also turned his spotlight on Agency MBS. "All securitised assets are not created equal," he stated. "Agency MBS are mortgage-backed securitises built upon mortgages issued by the big three agencies in the US, and they basically have zero

credit risk, because they're backed by the full faith of the US government. As long as you believe that the US government will still be standing, there will be no default."

Agency MBS offer what he calls a 'fair amount' of duration, the average being around seven years on the index, so it can be compared to Treasuries. Alexis explained that their JHI Mortgage-Backed Securities ETF (JMBS), the firm's Agency MBS ETF product, can be seen as a replacement vehicle for traditional duration.

"In fact, JHI this year actually reduced a lot of our allocation to Treasuries and, seeing the opportunity unfurl, we bought a lot of agency MBS instead," he reported. "Agency MBS offer duration plus a premium that is comparable to what you would get from investment grade corporate bonds, plus a top-up."

The opportunity he referred to came about in March onwards this year when the US regional banking crisis emerged. A lot of Agency MBS were held by those regional US banks that, then, had to scrabble around to shore up their balance sheets and sold their treasuries and agency MBS assets. "This led to pricing anomalies that have been making Agency MBS so appealing for the first time in over a decade, as the market became over-supplied with Agency MBS paper, resulting in wider than usual spreads," he explained.

Agency MBS has many outstanding qualities for investors and market anomalies in 2023 have opened the door to additional opportunity and value

Alexis explained that the credit risk of Agency MBS is negligible, while the main drawbacks are the rate risk (which he had already addressed) and the refinancing risk.

"Refinancing happens when the rates in the market drop, but 80% plus of mortgages in the US were issued at 4.5% or lower and refinancing costs are above 7%, meaning that the refinancing risk for Agency MBS is almost non-existent," he elucidated. "Even if the Fed was to cut 50 basis points suddenly, we only expect that about 6% of mortgages would be economically viable to refinance."

He elaborated further on the key reasons why Janus Henderson is so positive about Agency MBS today. First, Agency MBS is widely considered as having virtually zero credit risk, as these are issued by government agencies which are backed by the "full faith and credit" of the US government, just like US Treasury bonds. Second, refinancing risk – one of the main risks associated with Agency MBS – is also far removed today, as more than 80% of mortgages in the U.S. were issued at rates at or below 4.5%, hence removing the economic incentive to refinance given current levels (more than 7.5% at present).

And thirdly, the paper became oversold earlier this year through no fault of its own. "It was suddenly oversold as the market flooded with supply from those US regional banks, making it especially appealing for portfolios," he stated. "This is a good time to be buying in, and it offers

duration with a little bit of a plus in terms of running returns," he stated.

The JHI team is highly experienced and deeply analytical. Demand for AAA CLOs and Agency MBS is robust and expanding in the US, and access to both via the JAAA ETF and JMBS ETF is simple and easy, while liquidity in both is robust.

JHI's fixed-income and securitisation experts offer great experience and expertise. JHI is a rigorous and disciplined manager conducting extensive analysis and due diligence and has a robust portfolio construction process seeking to provide consistent risk-adjusted returns.

The experienced JHI CLO team, for example, consists of three portfolio managers with almost 60 years combined experience, supported by a Global Securitised team managing USD22.2 billion of securitised assets globally, as of 30 June 2023.

In brief, the JAAA ETF provides access to AAA-rated CLOs, historically available only to institutional investors, with the lower cost, transparency, and liquidity characteristics of the ETF structure. JHI's disciplined process involves extensive due diligence, and a robust portfolio construction process seeks to provide consistent risk-adjusted returns and low correlation to traditional fixed-income asset classes.

As to liquidity, Alexis reiterated that the ETF is daily traded and the underlying CLO market itself is one of the most active in the US, after US Treasuries and Agency MBS. "As our Head of Securitised, John Kerschner, would tell you, our ETFs are very liquid, and not only do have the liquidity of them trading on exchanges, but the underlying securities are far more liquid than what they are usually given credit for. For example, US Treasuries are the most liquid fixed income market, but few people realize that Agency MBS are probably the second most liquid market, and we would argue that the CLOs – particularly at the AAA level – is probably the third".