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Finding Differentiation in Securitized Assets

In this conversation with Henry Song, portfolio manager of the Short Duration Securitized Bond Strategy, he discusses the strategy's differentiated positioning and where it can fit in an investor's portfolio.

Can you provide an overview of the strategy and its goals?

I'd note first, both the Short Duration Securitized Bond and Core Bond Strategies that we manage include securitized assets and benefit from these ideas, but the former has a specific focus on it.

The Short Duration Securitized Bond Strategy typically holds at least 80% in various securitized product sectors, largely though not exclusively asset-backed securities (ABS) and non-agency commercial mortgage-backed securities (CMBS).

Our goal is to generate a meaningful yield over short duration indices. We feel the shorter duration nature of the securitized market, specifically within ABS, is a perfect fit for investors looking for additional yield on the shorter end of the curve. And it has been underrepresented in other short duration offerings for investors, which typically focus on corporate credit or government bonds. This is also an area that is harder for large managers trying to manage money at scale to have significant exposure. Because we believe we can add the most value in areas where capacity constraint matters, this is an ideal part of the market.

What is the benefit to investors of a focus on securitized markets? And what are the risks?

We believe there is potential for a meaningful yield pickup. In addition, when structuring these deals, issuers layer in credit enhancements to provide additional protections for investors relative to what the corporate or Treasury markets can offer. These generally fall under four categories.

Excess spread is the remaining net interest after all expenses are covered for an asset-backed security. This interest is deposited into an account and can be used to cover missed payments and is applied to all of a deal's tranches.



Henry Song, CFA
Portfolio Manager

The *reserve account* is an amount of cash set aside, usually a small percentage (typically 1%-2%) of an issue's market value. These assets can support an issue's outstanding tranches should any cash flow disruptions impact the trust's ability to pay monthly obligations.

Overcollateralization is a commitment to pledge collateral in excess of the value of the offered bonds.

Subordination is the process of using subordinated classes (B, C, etc.) as protective layers for the A tranche. If a loan in the pool defaults, any losses incurred are absorbed by the subordinated securities first. The A tranche is unaffected unless losses exceed the subordinated tranches' amounts. Interest payments are distributed to all tranches on a monthly basis, but principal payments are allocated to the tranche in the first pay position—meaning the A tranche principal balance is paid first, followed by the B tranche and so on until the deal is paid off.

The securitized market's structure provides investors the opportunity to select which tranche structure they will invest in. Investors looking for a longer duration security with more yield can invest in the lower tranches but take on risk associated with a longer paydown. Investors concerned about the underlying credit but comfortable with the credit enhancement may opt for the higher end of the tranche structure and with the intention of getting paid sooner.

Naturally, there are no free lunches. Extra yield isn't free, so what's the tradeoff? The securitized market, outside of mortgages, is much smaller and therefore less liquid than either the corporate or Treasury markets.

A recent example of that liquidity risk was March and April of 2020—extreme volatility in the securitized space was unmatched even by the market turmoil of 2008 and 2001. We likened it to a run on the bank as investors looked to sell high quality, short duration assets into a market that had completely shut down. We believe that was a rare occurrence—a once-in-a-century type of event. Interestingly, despite the price volatility, we now know the bonds themselves held up very well overall from a credit perspective. As long-term oriented investors, we believe that to be more important than nearer term liquidity risks. For investors not trying to time the market and who understand well the liquidity profile, we believe a focus on securitized assets can improve the risk/return of a bond allocation.

Are there opportunities in below-investment-grade rated securitized bonds?

The Short Duration Securitized Bond Strategy has the ability to invest up to 15% below investment grade. We believe that flexibility is important because ratings agencies look at securitized debt differently than corporate debt.

For corporate debt, a lower rating is reflective of the agency's opinion of the issuer's ability to repay. For securitized products, ratings are reflective of what the expected loss of the security is and how much coverage there is. Since the global financial crisis, we've seen rating agencies become much more conservative—they're applying a much higher multiple for a securitized bond to get a BBB rating than they had previously, meaning they assume the bonds would have higher losses than they'd typically experience.

A credit rating is an opinion, not a guarantee. We do our own homework to make assumptions about what we think the losses may be. Often, based on that work, we believe the agencies are being too conservative. Because we are willing to do the work that others won't, we believe we can find opportunities that are mispriced because they are mis-rated.

Are there other unique features of securitized debt that can benefit investors?

Many securitized products have monthly principal payment features—think mortgages, car payments, credit card payments. As such, these bonds can pay down quickly. That can impact the credit rating—a BB can become a BBB- or A-rated bond. That also produces cash flow. In a typical month, our strategy might get somewhere between 2% to 3% back just from principal payments—sometimes it can be as high as 5% or 6%.

That can be a real benefit to investors in a rising interest rate environment or when spreads are moving around—we can readjust the portfolio and redeploy cash flow opportunistically without necessarily having to sell securities.

The asset-backed securities market has evolved since the financial crisis. How has that evolution impacted opportunities in this space?

There are issuers that are a natural, longer term fit for this space, such as auto loans or credit cards—the short-term nature of the debt makes sense for them. Issuers like that tend to have longer track records, and many get AAA ratings—what we'd call benchmark issuers.

But for other issuers, the space is transitional by its nature—and that's where we've seen a lot of evolution. Think about a new business. The track record isn't long, but it still needs access to capital. That business may not even get a high yield corporate bond rating, or the high yield rates may be too costly to issue five- or seven-year debt. That business may securitize some of its best assets in exchange for lower rates, allowing it to continue growing. Once the business is at scale, the goal for many issuers is to get an investment grade rating so they don't have to continually seek short-term financing and tie up their best assets.

An example is single-family rental—a space that gained traction post financial crisis. We saw those issuers securitizing the houses they bought, and fast forwarding to now, a few have gotten investment grade ratings and are issuing 10-year, fixed-rate corporate bonds. They may never need to access to the securitized market again.

For us, the interesting opportunities can be with the newer issuers with great assets. They can offer a fairly nice yield concession because they don't have the AAA rating and they don't have a huge investor base. So, we think it's worth our time to be constantly talking to new issuers.

Given the challenges for malls and office buildings in the current environment, are there parts of the commercial mortgage-backed security (CMBS) sector where you're finding opportunity?

The CMBS space has not recovered at the same pace as other securitized markets since March. We anticipate long-term ramifications from the shift to working from home and ongoing concerns about large gatherings. Where we are spending more time has been on another troubled area—hospitality. After a record-setting 2019, many hotels are seeing very little income in 2020. Some properties haven't reopened yet. But we're interested in opportunities outside your typical, business travel hotel.

Business travel is likely not recovering to where it was anytime soon as more businesses realize the efficacy and cost savings of video conferencing. We don't think large gatherings are coming back soon either, and there will be continued downward pressure on business conference hotels. What is different is people's attitudes about personal travel. As soon as travel restrictions have been lifted, we've seen people willing to drive, fly and go on vacation for a few weeks. We believe there are opportunities among CMBS representing high-end properties, or what we call trophy properties.

For example, there are Hawaiian properties with unique land attributes that have been very profitable, renovating continuously over the last decade. Those properties are also trading at very depressed levels right now. Among them are properties we believe can be long-term winners. They are typically held by very strong equity holders that aren't going to let a 2020 cashflow depletion drive them away. Also, the leverage is typically low relative to the valuation. In fact, we would also argue it's hard to figure out what value to even use when assessing loan to value. Using a 2019 valuation, many of these AAA-rated CMBS representing trophy hotels are in a 25% range. Meaning, the hotel's value needs to drop about 75% for the AAA bond holders to take a loss—that's pretty extreme.

Looking back to where some of these hotels transacted post 2008, the cashflow drop still doesn't make much sense. What's more, even at 25% of 2019's valuation—albeit the highest valuation for some of these properties ever—that's still well below replacement cost. You couldn't build a hotel at some of these prices.

We think many of these trophy properties are here to stay. Maybe they will be challenged for a time, but people will likely still want to visit these places when we do get a vaccine—maybe that's the back half of 2021 or maybe it's 2022. It seems like a short-term, very painful carry for the owners, but for the bond holders, the situation appears much better.

A key difference in securitized bonds is the exposure to consumers. Can you discuss the experience of managing a portfolio of securitized assets amid the historic volatility in March and April of 2020, when consumers were expected to suffer significantly amid pandemic-related economic shutdowns?

Certainly there was significant investor fear. Our process involves using 2008 as our base case in underwriting—it's about loss multiples. Using the worst financial crisis since the Great Depression, we believe we know the level of stress our bonds can take and what the break points are. Our analysis for some of the higher rated bonds is they can take two or maybe three times the stress of 2008. The lower rated bonds may be able to handle one times or less—perhaps a quarter.

When the crisis hit, we knew forced shutdowns would immediately produce high unemployment—nothing to be done about that—so our focus shifted to what the recovery could look like. Bonds don't immediately default, so we looked past the noise, knowing the market was likely overreacting—particularly when it came to the more supported bonds. Plus, every month securitized products release a remittance report, detailing collection and loss data—we knew we'd soon see how consumers were actually faring in repaying short-term debt. Then, we saw the stimulus packages that were coming, and that added to our conviction that the market had overreacted and we were right to focus on the longer term.

It's also important to compare consumer health in general versus the bonds we hold. The issuers we talk to don't just issue a loan to anyone. They each have their own methods, analytics and criteria. Our job is to compare issuers and their underwriting—we want to invest with issuers who are skilled at managing their own risk, so our bonds can outperform the macro environment. That is the process that we have always utilized, and we believe that it provides keen insight into issuers and their securities. That our bond holdings overall were able to handle that extreme stress is a sign to us that they were, in fact, initially underrated.

How can investors fit a strategy focused on securitized assets into their portfolios?

It can play many roles, and investors may find it useful as diversification in a short duration allocation. As mentioned, most short duration strategies tend to focus on corporate and government securities. Our strategy provides diversification but also opportunity for additional yield. This strategy can also play a role in income generation tied to monthly cash flows—that can be hard to find in this very low rate environment.

A key point to consider based on what we saw in March and April of 2020: We hope that was an unusual event, but we recognize our strategy has a different liquidity profile than most short duration strategies. That is intentional—we believe the opportunities for yield justify that tradeoff. Still, timing the market is always difficult, and we'd advise against using the strategy to express a short-term view. For investors with an investment horizon one year or longer, this strategy could play multiple roles.

The views expressed are those of Diamond Hill as of December 2020 and are subject to change. These opinions are not intended to be a forecast of future events, a guarantee of results, or investment advice.

As of September 30, 2020, the Short Duration Total Return Composite was renamed the Short Duration Securitized Bond Composite. Investment Grade is a Bond Quality Rating of AAA, AA, A or BBB.