Why Consider Asset-Backed Securities Now?

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pfm asset management

Defining Asset-Backed Securities (ABS)

ABS are notes backed by underlying pools of financial assets such as automobile loans and leases, credit card receivables, equipment leases, student loans and others used by a diverse investor base. Some investors prefer securities with a longer duration or a higher yield that might be more esoteric in nature with lower liquidity. Meanwhile, others may prefer securities with shorter cash flows, higher credit quality and a higher degree of liquidity. In this discussion, we will focus our comments on the latter, which includes prime auto, credit card and equipment receivables.

While some ABS might have a “bulleted” structure, where the principal is paid at maturity, most ABS deals comprise multiple classes of securities, or “tranches,” each with a different coupon, expected cash flows, and risk characteristics and they pay principal and interest on a monthly basis. Asset-backed securities can serve as a component of fixed-income portfolios, offering investment diversification and the opportunity for higher yields relative to comparable-duration U.S. Treasuries and other government securities.

An ABS structure includes three key parties: the sponsor, the trust and the investor. In most cases, the sponsor — a bank, credit card issuer or retail finance company — transfers the loans or receivables to a separate trust, which is established to legally own and securitize the assets. The trust then issues the ABS notes and is responsible for paying principal and interest in a timely manner.

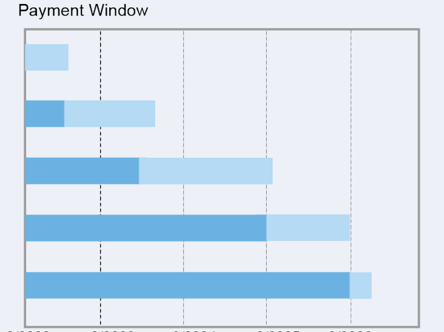
HOW DO ASSET BACK SECURITIES WORK?

Underlying Loans

Sponsor-created Trust

	Ratings		Typical Tranche Structure			
Securities	Fitch	Moody's	Balance	Coupon	Type	WAL
A-1	F1+	P-1	$231,810	2.37%	SEQ	0.2 yrs
A-2	AAA	Aaa	$256,690	3.50%	SEQ	1.1 yrs
A-3	AAA	Aaa	$356,200	3.64%	SEQ	2.4 yrs
A-4	AAA	Aaa	$133,300	3.71%	SEQ	3.6 yrs
B	AA	AA	$19,530	4.42%	SUB	4.1 yrs

Payment Window



Principal & Interest

Interest

Principal of securities in the tranche

Interest rate paid on the principal

Investor priority for repayment in case of default. SEQ is sequential, SUB is subordinated.

Weighted Average Life

A sponsor issues debt securities using principal and interest payments from loans, credit receivables, leases, etc. The underlying loan payments or credit receivables are used to make debt service payments on the securities.

Securities are grouped based on expected payment window and credit quality. These groups are called tranches. Quality is based on how likely it is that investors will get their money back.

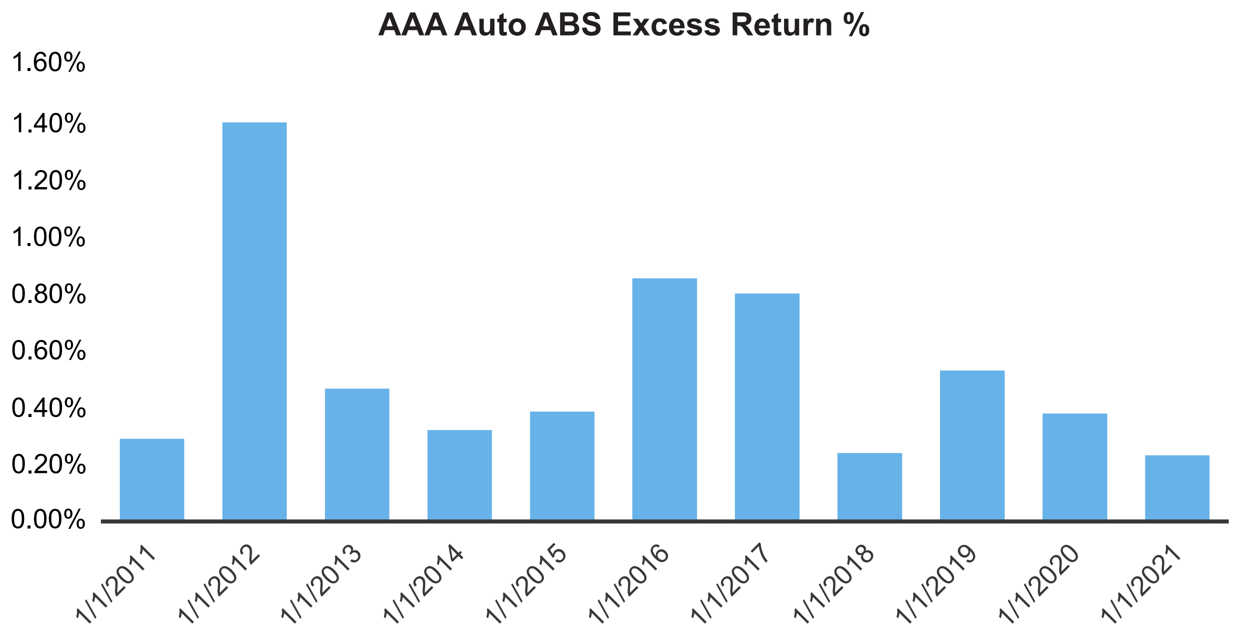
All data provided for illustrative purposes only.

Key Characteristics of ABS

1. **Credit Enhancements.** Unlike most corporate securities, ABS are typically credit-enhanced, which means they contain features that raise their credit quality above that of the underlying assets. These characteristics increase the likelihood that investors will receive the promised cash flows. The following are examples of credit enhancements:

- Excess Spread — the difference between the interest rate on the underlying collateral and the bond coupon and deal costs.
- Cash Reserve Account — additional funds set aside by the issuer to provide extra internal liquidity for ABS investors.
- Overcollateralization — the amount of collateral in excess of ABS issued.
- Senior/Subordinate Structure — subordinated tranches absorb losses due to defaulted loans up to their value before senior tranches are affected. As a result, subordinate tranches typically offer investors a higher yield due to their increased credit risk. This feature provides investors with the option to invest in a tranche that best suits their preferences and risk tolerance.

2. **Added Value Over Time.** ABS is an asset class that can potentially offer a high degree of safety with returns in excess of those of duration-matched Treasury bonds and higher risk-adjusted returns compared to other sectors. The chart below shows excess returns (or the additional return over a comparable duration treasury) for an index of AAA rated autos:



Source: Bloomberg, ICE BofA AAA U.S. Fixed Rate Automobile Asset Backed Securities Index.

3. **Large and Liquid Market.** ABS issuance was $582 billion in 2021 of which $192 billion came from autos, credit cards and equipment, which was the highest level in the post-financial crisis era.[1] Overall, the ABS market has more than $1.5 trillion outstanding and has been slowly but steadily increasing over the past few years.

1 "U.S. Asset Backed Securities Statistics," Securities Industry and Financial Markets Association (August 2, 2022). https://www.sifma.org/resources/research/us-asset-backed-securities-statistics/.

Our Approach to ABS

PFM Asset Management (PFMAM) conducts a rigorous credit review and monitoring process specifically for ABS, going beyond simply accepting assigned ratings and instead focusing on the structure, collateral quality, credit enhancements and history of the parties to the deal. This process includes a review of the sponsor, the historical performance of similar deals (especially the default and recovery rates), an analysis of the collateral, underwriting criteria and geographic diversification of the pools.[2]

Additionally, the firm conducts or reviews stress tests that assess the effectiveness of credit enhancements in protecting the tranches we would consider purchasing. After a purchase is made, we monitor the issue to ensure its performance meets expectations, and we conduct monthly surveillance on all ABS owned in our clients' portfolios. We focus on deals that offer the combination of features desired by our clients: high-quality credit profile, safety characteristics, and relative value to other sectors.

Why Is PFMAM Recommending ABS Now?

Example	Example Issuers/Sponsors
Prime auto loans and leases	Ford, Toyota, Honda, Nissan
Credit card receivables	American Express, CapitalOne, Chase, Citibank
Equipment loans and leases	John Deere, CNH, Kubota

For decades, investors have considered ABS to be a secure and profitable addition to fixed-income portfolios. With the reduction in the supply of some high-quality sectors like agency debt, which have long been a mainstay of public sector portfolios, high-quality alternative investments like ABS are rising in popularity. At the same time, yield spreads in ABS may be attractive relative to federal agencies, corporates or other sectors, depending on market environments.

Recently, some have expressed concern about an increased probability of a recession. Rising unemployment could lead to increased delinquencies or defaults on certain types of receivables, such as auto loans or credit cards. We do expect some normalization of losses from the extremely low levels we have seen recently. That said, credit enhancements discussed earlier should provide enough protection to avoid impairment on senior tranches of these securities.

Adding ABS provides another investment option for high-quality portfolios, allowing PFMAM another opportunity to help enhance returns and diversify portfolios for our clients.

For more information about this report, please contact your PFMAM representative or James Sims at simsj@pfmam.com.

2 Credit research is a shared service, consisting of resources from U.S. Bancorp Asset Management, as well as PFM Asset Management. Credit related activities include participation from Compliance, Legal, and Risk personnel.

To learn more or discuss in greater detail, please contact us:

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