

The Case for European Asset-Backed Securities

March 2011

The Insight LIBOR Plus Fund is an actively managed fixed income fund targeting an attractive premium over three-month sterling LIBOR. The Fund takes a defensive approach to asset selection, investing primarily in asset-backed floating rate notes, the majority consisting of high quality, conservatively structured securities, with the intention of ensuring minimal credit risk.

The global asset backed securities (ABS) market became known for all the wrong reasons in 2007, when investor confidence collapsed in the wake of the US subprime mortgage crisis. For a number of reasons, all types of ABS suffered significant falls in value – irrespective of type, quality and jurisdiction. The forced selling of quality senior European ABS by levered investors has provided a once-in-a-generation opportunity which, despite a significant increase in valuations since the peak of crisis, still persists to this day (chart 1).

Here, we explain why the senior European ABS market, the highest quality subset of the global market, provides compelling value opportunities, even for the most defensive of investors.

Chart 1: Value in the European AAA RMBS market



Source: Markit.

Strong fundamentals

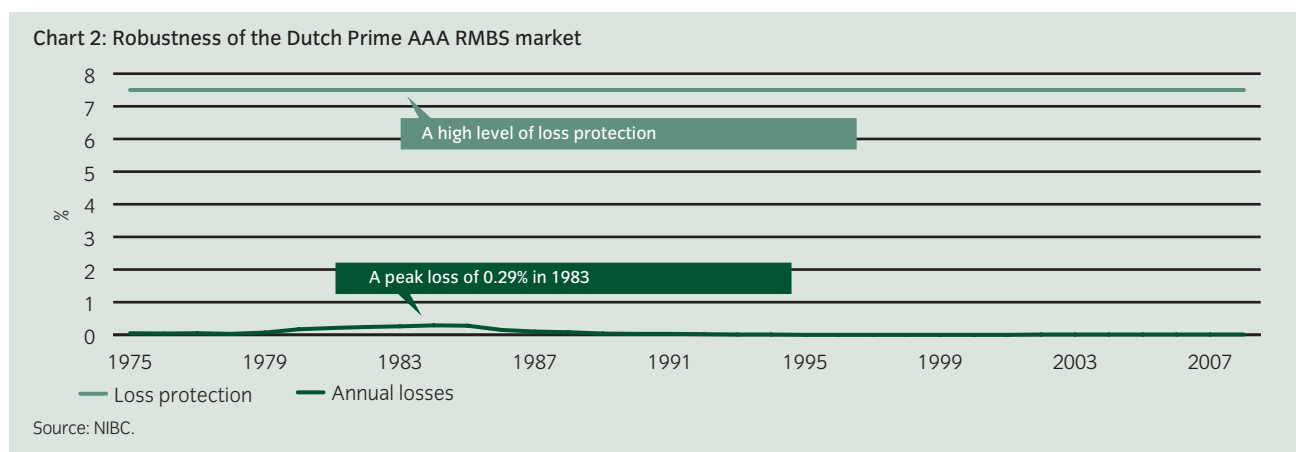
The primary reason for investing in senior European ABS remains fundamental. This is an asset class that has come through the most recent crisis totally unscathed from a credit performance perspective – there were no rating downgrades, nor defaults, on AAA rated residential mortgage-backed securities (RMBS), which constitute the majority of the ABS market. The European RMBS market has performed very well since the peak of the crisis – indeed it has outperformed its US counterpart – supported by a number of factors including better-quality, more robustly structured deals, and tougher regulations for debtors.

There is strong historical precedent for this performance. The Dutch mortgage market (around 17% of the European RMBS market) suffered its most difficult period in the late 1970s/early 1980s, when the Dutch economy contracted substantially. House prices fell by 40%, unemployment exceeded 10% and interest rates were also above 10%. However, in terms of mortgage losses, this situation translated into a peak loss of 0.29%, experienced in 1983¹. This remains the highest level of annual loss ever experienced by Dutch mortgage lenders. In the UK, the figures are similar, with a peak loss of 0.27% experienced in 1992. To put it into context, we expect losses in both the Dutch and UK markets to peak at 0.10%-0.15% in this current economic cycle, despite the difficult economic conditions.

Dutch senior ABS are typically structured with 7-8% of total credit enhancement – i.e. annual mortgage losses would need to exceed 7-8% to result in a principal loss to the senior note holder. This is 30-37 times higher than the worst annual loss ever seen in the market (chart 2) and more than 50 times more than what we expect to happen.

European ABS currently trade at a very attractive yield of 120-200bps over 3-month LIBOR depending on factors such as origination, originator, jurisdiction etc. We believe that this is a very attractive return for the limited credit risk highlighted earlier. A key point to note is that since the reference rate is LIBOR, investors will benefit from a rising LIBOR environment, which is different to many other types of investment of this quality. Today, the all-in yield of this asset class at around 3% already exceeds the yield on 10-year gilts.

Finally, we believe that there is a window of opportunity with respect to the quality of new issuance. September 2010 saw £10 billion of new issuance with the highest levels of credit enhancement, the most defensive of collateral, and the most conservative structures yet seen. A combination of proven performance, high LIBOR-based returns and the most defensive new issues in the history of the market provides for a strong strategic investment case.



Favourable technicals

The central reason for the fall in senior European ABS valuations during the height of the credit crisis was the forced selling activity of leveraged investors and **not the credit underperformance of the asset class**. This forced selling activity is now over, helping the market to recover significantly from the dark days of 2007/8.

¹ Source: NIBC.

The investor universe is now dominated by real money (asset managers, pension funds, insurance companies) and by banks that are making higher levels of return on capital by buying low risk weighted AAA ABS than any other investment activity. The removal of leverage as a funding tool for the purchase of ABS assets means there is no longer a material dependence on short-term funding markets or leverage providers. This has greatly reduced the volatility in valuations of senior European ABS assets and has been the core reason why the asset class has seen less volatility than other areas of the credit market in the recent sovereign crisis.

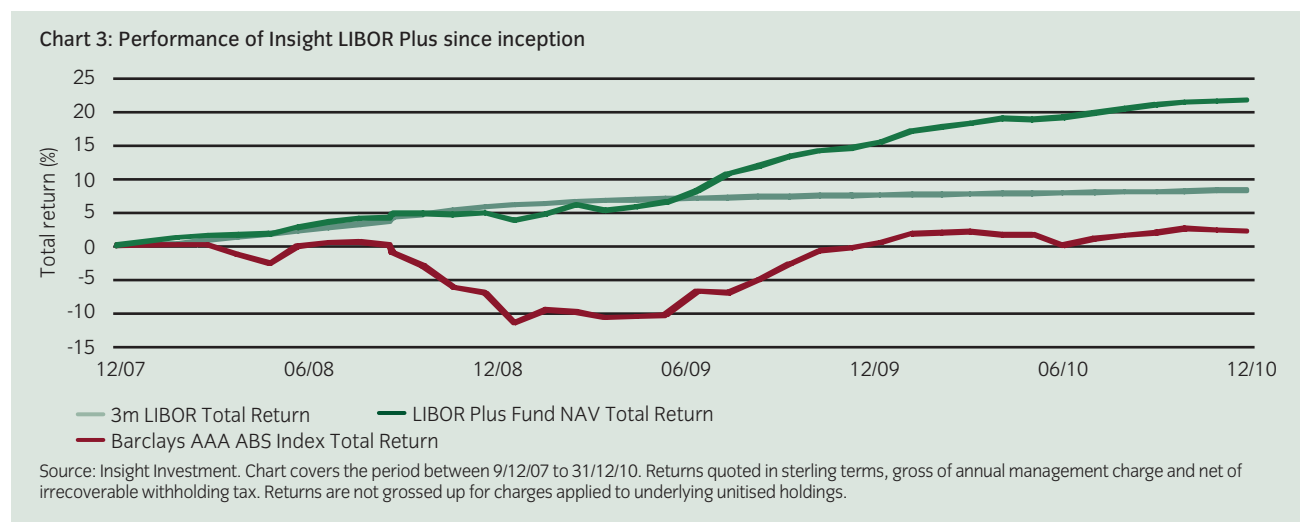
A combination of strong strategic value and the heavy reduction of leverage in the asset-backed market has also had a strong impact on market liquidity. Bid-offer spreads for prime ABS collateral are close to their pre-crisis norms and compare favourably to bank paper and other credit markets generally while new issue spread levels are over ten times what they were pre-crisis. The number of dealers and end investors is growing all the time while market volumes are now in excess of £25 billion per month.

Insight's capability

We believe the optimal way to extract the best value in European ABS is to appoint a strongly-performing specialist team employing a rigorous investment process. Insight has a dedicated team of credit analysts supporting the managers of all our funds, and this team evaluates bonds and bond issuers independently of any credit ratings company. Indeed, we assign bond issuers our own credit ratings.

We believe Insight has one of the strongest credit teams in the European market and we already manage a number of bespoke segregated ABS mandates for clients who are keen to invest selectively in this part of the credit market. We also manage a strong-performing pooled ABS fund – the Insight LIBOR Plus Fund. This Fund was launched in December 2007 and as such has operated throughout the worst financial crisis since the 1930s. Against this economic backdrop, the Fund has demonstrated:

- **Strong performance.** The Fund has returned almost 22% since launch² compared to LIBOR which has returned just over 8% cumulatively over this period. The ABS market returned 2.1% over the same time (chart 3). However, please remember that past performance is not a guide to future performance. In addition, the value of investments and any income from them will fluctuate and is not guaranteed; therefore you may not get back the full amount invested.
- **Strong credit quality.** The LIBOR Plus Fund has never experienced a default from any of its ABS assets, nor has experienced a downgrade.



² Source: Insight Investment. Return figure quoted from launch date 9/12/07 to 31/12/10 in sterling terms, gross of annual management charge and net of irrecoverable withholding tax. It is not grossed up for charges applied to underlying unitised holdings

- **Strong liquidity management.** A core allocation to the portfolio remains in a cash equivalent type product, meaning that no withdrawal has ever been restricted.

We believe the Fund's success is down to three key factors:

- **Robust asset screening.** Our defensive philosophy and the scope of the opportunity set means we can decline around 80% of the available investments and still generate strong risk-adjusted returns.
- **Qualitative analysis.** Our access to proprietary macro economic forecasting tools and our deep understanding of mortgage originating practices allows us to select the highest quality investments.

From niche to mainstream

ABS first appeared in the US in the 1960s as a method for retail banks to fund their growing credit card portfolios. This allowed the banks to keep some of the risks and returns associated with these portfolios, but the provision of capital relief and physical funding importantly raised the maximum credit limit they could extend to consumers. The funding enabled the banks to continue to grow their assets by accessing the capital markets while investors in these products could gain given exposure to an asset class in which they were previously unable to invest.

This concept evolved in the 70s/80s to allow the funding of prime US mortgage portfolios. By the early 1990s, securitisation was embraced by European banks and applied initially to mortgages and then increasingly to all types of consumer products such as credit cards, auto loans and student loans. ABS became a core funding tool for all types of banks and by 2006, the market had grown to such a point that over 60% of all UK mortgages were funded by various RMBS funding platforms.

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