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# Are ABS spread levels justified?

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Since the start of the credit crisis in 2007, European asset-backed security (ABS) spreads have remained at historically high levels.

There are two possible explanations for this:

1. Current spread levels are a result of compensation for an increase in risk premia and are therefore justified; or
2. The asset class is cheap as current spread levels more than compensate for the increase in risk premia.

Insight believes that the latter explanation is correct and that ABS offer compelling value on a risk-adjusted basis. This paper attempts to prove this by deconstructing the risk premium to its individual constituent parts and showing how those risk factors are not materially higher than they were before the current credit crisis. The analysis focuses on senior ABS, the primary asset held within Insight's Libor Plus Fund.

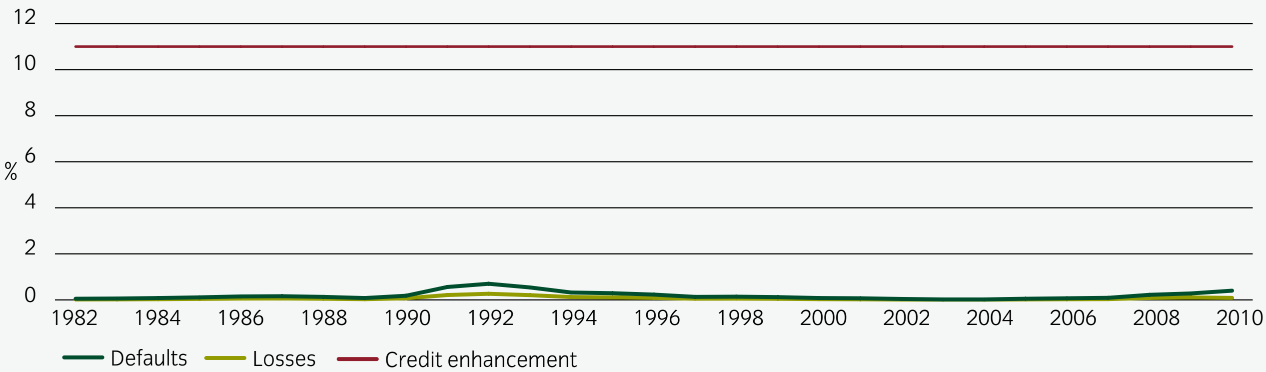
## 1. Credit risk

All else being equal, the primary risk behind every credit asset is credit risk (i.e. the probability that an asset defaults and recoveries are insufficient to return the full principal). In considering ABS, the key performance statistics used to measure credit risk are numerous and depend on the individual ABS sub-sector. In general terms they can be summarised as:

- **Total defaults**: where the underlying borrower (i.e. a mortgage borrower in residential mortgage backed securities (RMBS) or a credit card borrower in credit card ABS) is behind on making their payments;
- **Total losses**: where the underlying borrower is in such deep arrears that they default with insufficient capital (i.e. equity in residential properties for RMBS deals) to repay the principal.

An increase in credit risk premium in the ABS market would, by definition, require one of the two factors highlighted above to have increased. Chart 1 plots these two factors for the largest ABS market: the UK prime RMBS market.

Chart 1 – Total defaults and losses in the UK prime RMBS market




Source: Insight, Bloomberg.

As illustrated in chart 1, total RMBS arrears and losses have not seen material increases over the last two decades. This leads to the conclusion that although there has been some increase in credit risk, it is not one which can explain the significant widening of spread levels.

Furthermore, ABS are structured to be financially separate from the banks and the governments in the countries in which they are located, which is beneficial given the current climate of heightened bank and sovereign credit risk.

## 2. Liquidity risk

A second key risk associated with investing in credit assets is liquidity risk (i.e. the risk that liquidity conditions deteriorate and its costs an investor more than originally expected to exit a position). This risk is heightened in periods of financial turmoil, with fewer marginal buyers of risk.

Like all credit markets, the ABS market suffered from increased liquidity risk in the final quarter of 2008, the result of risk-averse investors and impaired financing ability. The situation was not unique to credit: lending generally was reduced to the overnight markets following the Lehman bankruptcy and only a global policy response was able to thaw financial markets and reduce the liquidity premium required by investors.

The current sovereign crisis has seen liquidity risk rise in many markets. Unlike 2008, however, the ABS market has remained largely immune to this increase in liquidity risk premium. In early October, bid-offer spreads (the best measure of liquidity risk) have ranged between 0.05% and 0.14% for the various bonds. This is extremely low and reflects sustained global demand for ABS products, particularly from risk-averse investors.

While yields on ABS bonds are considerably higher than pre-crisis levels, the bid-offer spreads for the ABS market are far tighter than those seen in other markets (for example financials) with spreads in line with pre-2008 crisis levels. This indicates that current spreads are not elevated as a result of heightened liquidity risk.

## 3. Interest rate risk

Historically, one of the core risks associated with fixed income instruments has been interest rate risk, which led to the creation of floating-rate notes. Floating-rate notes are instruments which see their coupon reset with changes in Libor. Investors in these instruments are effectively hedged from all interest rate risks and as such the instrument should trade tighter than a fixed-rate note from the same issuer.

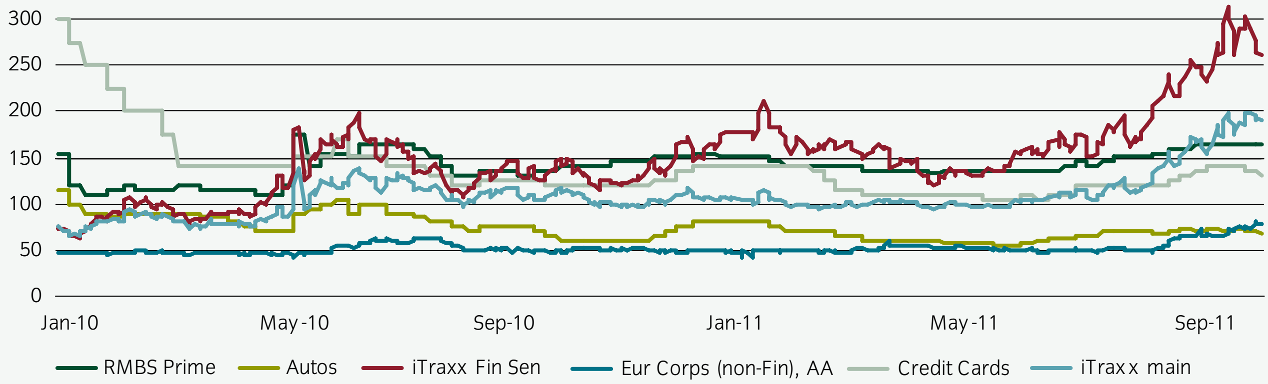
The vast majority of ABS have floating-rate notes, which leads to the conclusion that current spread levels are not elevated due to an increase in interest rate risk. Given their floating rates, a rising rate environment would see returns on ABS increase.

## 4. Mark-to-market risk

All else being equal, the greater the price volatility exhibited by a credit asset, the greater spread levels need to be to compensate for the additional mark-to-market risk. Chart 2 compares ABS markets to financials and investment grade corporate indices.

As the chart illustrates, the recent sovereign debt crisis (May 2011 to the present) has seen a widening of spreads in all credit markets. What is noticeable, however, is that highly-rated investment grade corporate credit and the index of senior financials have widened considerably more than the ABS markets. This leads to the conclusion that, compared to other markets, current ABS spread levels are not elevated as a result of heightened mark-to-market risk.

Chart 2 – Comparing recent spreads across credit markets




Source: Merrill Lynch.

## 5. Complexity risk

Complexity risk focuses on how difficult an asset class is to access and analyse. By its nature, investing in ABS involves complex transactions. To access the market requires a deep investment in infrastructure which is typically only suited to large investment managers which can benefit from economies of scale.

Furthermore, analysis of an average prime RMBS bond in the UK is complex and includes analysis of thousands of borrowers, properties and individual cash flows. This requires a dedicated team specialising in the analysis of ABS. These two factors combined mean that complexity risk is high when investing in ABS markets.

## Current complexity risk premium shows there is value in ABS

It would appear from this analysis that complexity risk premium is the primary cause of the current elevated spread levels in ABS. With a diversified portfolio of senior ABS yielding Libor + 320bps, it would appear that these assets represent good value provided that investors can manage the complexity (either themselves or with the use of a specialist investment manager). It is Insight's position that the asset class is undervalued and that the complexity premium will be arbitraged away over time as investors increasingly focus on the asset class.

The value of investments and any income from them will fluctuate and is not guaranteed (this may be partly due to exchange rate fluctuations). Investors may not get back the full amount invested.

For more information on our Libor Plus Fund, including the prospectus and simplified prospectus, or any of our other alternative fixed Income solutions please visit www.insightinvestment.com or contact us on the number overleaf.

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