Securitized Credit: Enduring Value Amidst a Bleak Fixed Income Landscape

Trade and growth uncertainties drive a global rally in interest rates

In the second quarter, U.S. financial markets reacted to new uncertainties over trade policy with China and Mexico, as well as a softening in global growth. In late May, the Federal Reserve (Fed) indicated its readiness to ease monetary policy if risks to the U.S. economy intensify. U.S. interest rates dropped notably amid the ensuing flight to safety into U.S. Treasuries and increasing central bank dovishness.

Three- and 10-year Treasury yields rallied 50 and 40 basis points (bps), respectively, over the quarter. U.S. fixed income sectors performed well, generally in line with their interest rate durations (see the chart on the right).

Securitized credit benefited from the rate rally, with the shorter duration Bloomberg Barclays ABS index returning 1.7%, and the longer duration CMBS index returning 3.4%. The floating-rate JP Morgan CLO index returned 1.3%.

An inverted U.S. yield curve crimps investors’ options

Now, however, the U.S. yield curve is inverted (see the chart on the right), with the 10-year yield 12 bps below the 3-month Treasury bill. Fed Fund futures price in a 40%, 35%, and 10% likelihood of, respectively, one, two, or three rate cuts by year's end. Each of the last three U.S recessions has been preceded by a similar inversion; the implied probability of a recession within 12 months has risen to 50% (as estimated by the Fed and BBH internal models).

So, while the first two quarters of 2019 witnessed strong fixed income performance, the rally in rates and credit spreads, the inverted curve, and the possibility of a recession have all narrowed the range of appealing options for fixed income investors.

For duration owners, rolling up the yield curve is a drag

Holding medium and longer duration positions today is increasingly unattractive. Typically, owning longer duration Treasuries and corporate bonds has been rewarded with substantial return from rolling down the curve, from higher down to lower yields as bonds age. With the curve inverted, though, rolldown return is slim or negative (see the chart on the right). Furthermore, the level of Treasury yields is low from both a near- and long-term perspective, which poses asymmetric rate risk to investors, particularly at longer durations.

Corporate credit valuations are largely unattractive

Shorter duration alternatives are hardly more appealing. Two-year Treasury yields have plummeted from 3% last November to 1.75% today.

1 A unit that is equal to 1/100th of 1% and is to denote the change in price or yield of a financial instrument.
Corporate credit is no better. Index spreads for both investment-grade and high-yield corporate bonds are near post-crisis lows (see next figure), and only 8% of investment grade corporates pass BBH’s valuation criteria for new purchases, down from nearly 27% at year-end. The compensation available is insufficient, especially considering we may be late in the macroeconomic cycle.

The chart below quantifies the potential danger to owning a generic portfolio of corporate credit at today's low spreads and lateness in cycle. In instances when the modelled likelihood of recession has been high, like today, corporate credit has experienced large sell-offs. For instance, the average return drawdown relative to Treasuries was -4% for investment-grade credit and -11% for high-yield. While there are still a handful of individual value opportunities, including a few corporates owned in Structured accounts, corporate credit is generally not compensating investors for the risk today to valuations and credit at this point in the cycle.

ABS offers elevated compensation, short durations, and insulation from macro risks

In this challenging fixed income environment, many investors are finding securitized credit an attractive alternative. Compensation is much higher than comparably rated corporate credit, due to a stable U.S. institutional investor base coupled with little foreign participation. The tenors of asset-backed securities (ABS) are short, typically only 1 to 3 years, limited by the shorter maturities of the loans and leases that secure them. Finally, unlike longer duration corporate credit, ABS returns have tended to show less downside through periods of heightened macroeconomic concern (see chart directly above). Finally, since overseas participation is low, should flows reverse, as they did in the fourth quarter of 2018, ABS are likely to see less selling pressure.

BBH’s Structured Strategy (the “Strategy”) – an investment-grade portfolio of bonds constructed from a wide range of more than 20 ABS and CMBS subsectors – currently yields 4.5%, or a 234 bps spread over Treasuries, significantly higher than most credit alternatives. The Strategy has a short rate duration exposure of 2.1 years and a spread duration of just 2.8 years. Liquidity is good, from 10 to 30 bps on a bid/ask spread basis; 84% of the portfolio is rated investment grade. As the analysis above supports, the correlation to the broader credit market is low – the 6-month rolling beta of the Strategy to the Bloomberg Barclays U.S. Credit Index is less than 0.3.

When Recession Concerns Rise, ABS Avoid the Typical Credit Sell-Offs

Past performance does not guarantee future results
BBG IG Credit = Bloomberg Barclays Investment Grade Credit Index, BBG HY = Bloomberg Barclays High Yield Index, BBG ABS = Bloomberg Barclays ABS Index, BBG ABS (non-AAA) = Bloomberg Barclays ABS (non-AAA) Index
Sources: Bloomberg and BBH Analysis

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One leading explanation for this dislocation in credit spreads is technical. We have noted in our Strategy Updates that foreign investors seeking yield have, over the last decade, swamped U.S. rates, mortgage, and corporate bond markets. This has driven compensation for these sectors to levels incompatible with fundamental risks. Unfortunately, these foreign flows can rapidly reverse, as we saw in late 2018. This is the subject of this quarter’s Taxable Quarterly Strategy Update.

Strategy returns reported gross of fees.
Historic three-year returns for the Strategy are 5.8%, with a notably low 0.9% annualized return volatility (a Sharpe ratio of 5.0). The Strategy returned 4.3% in 2018 in what was a dismal year for fixed income. The Strategy returned 2.12% last quarter, and has returned 3.94% year to date.

The higher compensation on offer for most ABS and commercial mortgage-backed securities (CMBS) subsectors results from some enduring favorable technicals: a limited, but stable investor base of large institutional insurers that specialize in these products, coupled with steadily growing bond supply as more companies diversify their sources of financing away from bank borrowing to the ABS market. We expect these favorable aspects for the investor continue to hold in 2019.

**Near-record ABS and CMBS issuance in Q2 – spreads are mixed**

ABS and CMBS markets just experienced another near-record quarter of issuance (see the exhibits in the Appendix). Following issuance of $229 billion last year, the ABS market continued a record pace with $63 billion of issuance last quarter (first half issuance totaled $122 billion). The market’s rapid growth stems from the numerous ABS subsectors away from more traditional prime auto and credit card ABS. These other subsectors accounted for a remarkable 71% of the quarter’s issuance volume and 82% of individual issuers. These percentages underscore both the declining presence of “cars and cards” ABS and the growing prominence of ABS and capital markets in financing a broad range U.S. industries. Leading companies from more than 25 different industries flock to the ABS market (see the chart on the right). This sustains the supply of newer entrants to the ABS market, where investors can often find attractive compensation. Importantly, many of these new entrants are not new businesses, but rather decades old companies that are newly turning to the ABS market for financing.

Similarly, from a healthy $22 billion of CMBS issuance last quarter, a record $13 billion consisted of large-loan transactions, not the more traditional 100 loan conduit deals. As in the ABS market, commercial real estate owners are also turning away from banks and are increasingly looking toward the capital markets for their financing activity.

With the rally in spreads, corporates outperformed ABS in the second quarter. Spreads in the ABS sector, however, were more stable with AAA- and AA-rated notes tightening for the most part between 5 to 10 bps, and A- and BBB-rated notes widening slightly. CMBS kept pace with the rate rally, and spreads were flat to slightly tighter over the quarter. ABS and CMBS spreads remain 50 to 200 bps wider than comparably rated corporate bonds (see the exhibits in the Appendix).

**Second quarter offers ample opportunities in ABS issuance, selective value in CMBS**

BBH continues to find value across most subsectors of the non-traditional ABS market, as well as selectively in primary and secondary purchases in CMBS (in particular property types, such as retail, with limited investor focus or exaggerated concerns). These deals, many from long-standing industry leaders new to ABS issuance, exemplify the continuing expansion of the Strategy’s opportunity set. Accordingly, we made substantial attractive additions this quarter across accounts. Year-to-date, ABS and CMBS purchases totaled just over $2 billion.

**Saganaw, a subsidiary of Guggenheim Life and Annuity Company, issued its first ABS securitized by the commissions stream from a portfolio of fixed index annuities and paid by Security Benefit Life (A-rated by S&P). The primary risk to the commission stream would be an unusually high level of policyholder lapse on the annuity policies. Owing to surrender penalties in the policies, there is no impairment in even the most severe BBH stress scenario. These 1.8-year BBB-rated notes were issued in May and were attractively priced at a 320 bps spread to Treasuries and had a yield of 5.2%.**

**Melody Wireless Infrastructure Inc. issued its first ABS transaction, backed by cashflows from long-term rooftop lease and cell tower land rents paid by the five major wireless companies. The portfolio consists of 1,232 cellular sites in strategic locations across the U.S. The easements and leases have a utility-like stable return profile, benefit from the deployment of new 5G service, and the notes represent a low leverage of below 30% debt to market value. In April we participated in the 5-year senior tranche, rated single-A, at a spread over Treasuries of 150 bps.**

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^ Traditional ABS includes prime auto backed loans, credit cards and student loans (FFELP). Non-traditional ABS includes ABS backed by other collateral types.
BBH has not participated recently in collateralized loan obligations (CLOs), as valuations did not compensate us for option costs and a long 5- to 10-years of spread duration. Recently, however, the CLO market has shifted toward shorter reinvestment periods and note tenors. For example, Palmer Square this quarter issued its 11th and 12th static pool CLO. Palmer Square is a seasoned manager — established in 2009 with $9 billion in assets under management (AUM). The manager offers a static pool CLO program, with no reinvestment period. As a result, notes have little optionality and a very short 1 to 2-year tenor. There is minimal credit risk to investors in the more senior tranches of the securitization. For example, the single-A rated notes can withstand a multiple of seven times expected base case loss without impairment. Modest risk to investors lies just in the potential for moderate extension of tenor. We participated in the single-A and AA-rated classes in June at attractive spreads over 3-month London Interbank Offered Rate (LIBOR) of 210 and 160 bps, respectively.

BBH also participated in THL Credit’s Wind River CLO refinancing. The CLO has passed the end of its reinvestment period, so optionality is limited and the notes are short. THL Credit Advisors, founded in 2007, is an experienced CLO manager with $17 billion in AUM. This CLO refinancing is unusual in that the reinvestment period ended earlier, in January, and the CLO has begun to amortize, swiftly building credit enhancement. Its short, fully amortizing structure is thus similar to ABS. The single A-rated notes have ample credit support and can withstand a multiple of 10 times BBH’s expected base case loss without impairment. The 1.4-year senior AAA-rated notes were offered at an attractive spread of 88 bps over 3-month LIBOR.

BBH also participated in 11 other ABS transactions in the second quarter, including servicer advance, personal consumer loan, premium finance, sub-prime auto, and large-ticket equipment transactions.

In May, BBH also participated in HPLY 2019-HIT, a single asset, single borrower (SASB) CMBS transaction secured by a floating rate loan. Fully extended, the $870 million loan has a five-year term and is collateralized by 92 hotel properties spread across 30 states. The portfolio is diversified across 10 different hotel brands. The largest brand, Hampton, accounts for 29 of the properties and 25% of the portfolio. The sponsor, Hospitality Investors Trust (HIT), is a public non-traded real estate investment trust (REIT) that invests in premium-branded lodging properties across the United States. The senior tranche has very low leverage, with the debt accounting for only 25% of the appraised property value. The AAA-rated tranche priced at 110 bps over 1-month LIBOR.

BX 2019-RP is also an SASB CMBS transaction, secured by a $230 million five-year floating rate loan. Originated in June, the loan is secured by a 12-property, 2.2 million square foot anchored retail portfolio, spread across seven states. The primary sponsor is Blackstone, among the largest global investors in real estate with $140 billion in AUM. These notes also have low leverage, with even the BBB-rated notes representing just 41% of the appraised property value. We participated in the AAA-, A-, and BBB-rated tranches at spreads over 1-month LIBOR of 115, 210, and 270 bps, respectively.

Conclusion

Good values are scarce in the fixed income markets. The U.S. yield curve is now inverted, credit index spreads for both shorter and longer investment-grade corporate bonds, as well as high yield bonds, are near historically tight levels, and the implied probability of recession within 12 months has risen to 50%. However, we continue to find attractive investments among shorter tenor, high quality securitized credit. The Structured Strategy can enhance risk-adjusted portfolio returns in a wide range of environments, but it is particularly well-positioned for today’s more challenging fixed income landscape.

Sincerely,

Neil Hohmann, PhD
Head of Structured Fixed Income and Portfolio Co-Manager

Andrew P. Hofer
Head of Taxable Fixed Income and Portfolio Co-Manager
**Exhibit I: ABS and CMBS Spreads**

Spread Over U.S. Treasuries (bps) as of June 30, 2019

- March 2019
- June 2019

**Past performance does not guarantee future results**

Sources: Bloomberg, JPMorgan, and BBH Analysis

**Exhibit II: ABS Issuance**

Quarterly ABS Issuance ($ Billion)

Data reported quarterly from March 31, 2015 to June 30, 2019

Sources: Bloomberg, JPMorgan, and BBH Analysis

<table>
<thead>
<tr>
<th>Q2 2019 ABS Issuance</th>
<th>&quot;Non-Traditional&quot;</th>
<th>Traditional</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Subsectors</strong></td>
<td>20</td>
<td>3</td>
<td>23</td>
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<tr>
<td><strong>Issuers</strong></td>
<td>74</td>
<td>16</td>
<td>90</td>
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<tr>
<td><strong>Average Issuers Per Subsector</strong></td>
<td>3.7</td>
<td>5.3</td>
<td>3.9</td>
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<tr>
<td><strong>Issuance</strong></td>
<td>$45 billion</td>
<td>$18 billion</td>
<td>$63 billion</td>
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<tr>
<td><strong>Deals</strong></td>
<td>82</td>
<td>16</td>
<td>98</td>
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<tr>
<td><strong>Average Deal Size</strong></td>
<td>$553 million</td>
<td>$1.1 billion</td>
<td>$647 million</td>
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</table>

Source: BBH Analysis
Exhibit III: CMBS Issuance

Data reported quarterly from March 31, 2015 to June 30, 2019
Sources: Bloomberg, JPMorgan, and BBH Analysis
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The Composite is comprised of fully discretionary, fee-paying structured products accounts over $10 million that are managed in the Structured Fixed Income strategy. The target duration may range from 1 to 4 years. Investments are focused on asset-backed and related structured fixed income securities. Holdings are primarily investment grade but non-investment grade securities may be held. Investments may include non-dollar fixed income. Accounts are benchmarked to the Barclays Capital Asset-Backed Index or equivalent.

Standard deviation measures the historical volatility of a returns. The higher the standard deviation, the greater the volatility.

The Sharpe ratio is the average return earned in excess of the risk-free rate.

**Risks**

Investing in the bond market is subject to certain risks including market, interest-rate, issuer, credit, and inflation risk; investments may be worth more or less than the original cost when redeemed. Mortgage-backed and asset-backed securities have prepayment and extension risks.

Single-Asset, Single-Borrower (SASB) lacks the diversification of a transaction backed by multiple loans since performance is concentrated in one commercial property. SASBs may be less liquid in the secondary market than loans backed by multiple commercial properties.

The Structured Fixed Income Strategy Representative Account is a single representative account that invests in the Structured Fixed Income strategy. It is the account whose investment guidelines allow the greatest flexibility to express active management positions. It is managed with the same investment objectives and employs substantially the same investment philosophy and processes as the proposed investment strategy.

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**Performance**

<table>
<thead>
<tr>
<th>Total Return</th>
<th>Average Annual Total Returns</th>
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<tr>
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<tr>
<td>BBH Structured Fixed Income Composite (Gross of Fees)</td>
<td>2.12%</td>
</tr>
<tr>
<td>BBH Structured Fixed Income Composite (Net of Fees)</td>
<td>2.03%</td>
</tr>
<tr>
<td>Bloomberg Barclays US ABS Index</td>
<td>1.67%</td>
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</table>

*Returns are not annualized. BBH Structured Fixed Income Composite inception date is 01/01/2016.

Past performance does not guarantee future results, and current performance may be lower or higher than the past performance data quoted. The investment return and principal value will fluctuate, and shares, when sold, may be worth more or less than the original cost. The strategy is new with a limited operating history. Bloomberg Barclays ABS Index is the ABS component of the Bloomberg Barclays US Aggregate index and is comprised of credit and charge card receivables, autos loan receivables, and utility receivables with at least: An average life of one year, $500 million deal size and $25 million tranche size and an investment grade rating (Baa3/BBB- or higher) by at least two NRSROs. The index is not available for direct investment.