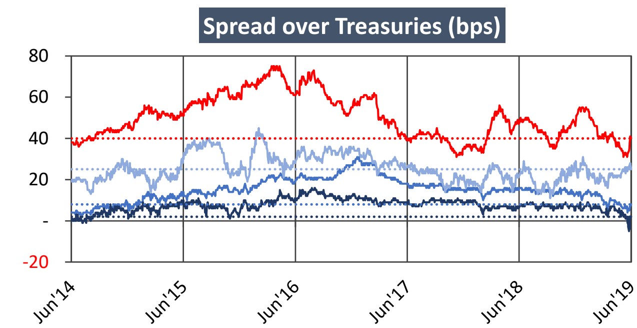
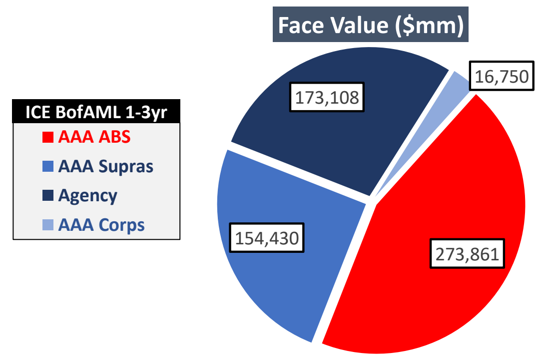
Insights

June 13, 2019

Consider AAA-Rated Consumer ABS in a Risk-off Environment

Market fallout from the unexpected announcement of Mexican tariffs highlights late cycle fragility to geopolitical uncertainty. While both sides have come to a compromise for now, the increase in volatility warrants rotation into higher quality risk-assets for investors who value liquidity and principal preservation. These assets include agency and supranational securities that benefit from implied or guaranteed government support which is reflected not only in their credit ratings, but also their paltry spread over the risk-free rate. AAA-rated corporates can offer better return, but as ratings standards have tightened, the selection of issuers has dwindled eliminating any portfolio diversification benefits. Idiosyncratic risks and shifts to more aggressive financial policies (e.g., shareholder returns) can also result in future downgrades. The AAA-rated consumer asset backed securities ("ABS") market, on the other hand, is much broader and has historically offered better risk-adjusted returns. And unlike senior unsecured corporate bonds, ABS transactions are structured so senior tranches are able to maintain AAA ratings even if there is material deterioration in fundamentals.





Source: ICE BofAML (as of 6/10/19) , Bloomberg, Clearwater Advisors

The assets backing these securities primarily comprise credit card and automotive related receivables. Consumer payments received are funneled to the securities based on a priority of payments with senior tranches receiving their payments first before lower rated tranches. Structural features commonly include overcollateralization (the collateral pool balance is greater than the balance of the securities), subordination (lower rated tranches absorb losses prior to the senior tranches), and excess spread (the interest rate of the collateral is greater than the coupon rate on the securities). Since the Great Recession, ratings agencies have become more cognizant of reputational risk and increased thresholds for achieving AAA ratings thus providing a greater margin of safety for investors.

Some investors are wary of structured products or dubious over their relative safety given the contribution that residential mortgages securitizations had on the Great Recession. For investors revisiting the sector or considering it for the first time, prime auto loan ABS is a good starting place. Assets within these transactions only include loans underwritten to borrowers with a FICO score of 620 or above. Given the creditworthiness of the borrowers and ample overcollateralization, no rated tranche of prime auto has ever experienced a loss even during the Great Recession. Auto manufacturers' captive finance subsidiaries, the primary sponsors of these transactions, maintain very conservative underwriting practices and have extensive experience servicing the loans which also limits losses on the underlying collateral. In addition, autos are the primary means of transportation for most Americans to their workplace so they are less likely to default on their auto loans versus their mortgage.