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The Case for Structured Products

When one thinks of fixed income securities, corporate and government bonds most often spring to mind since these sectors dominate the fixed income market. Structured products (Asset Backed and Mortgage Backed Securities) can be an afterthought, overlooked perhaps due to their complexity and the stigma associated with their performance through the credit crisis of 2008.

Structured products have some unique and attractive characteristics which result in high quality, stable cashflows and a performance potential that can diversify a portfolio of corporate and government bonds. In this memo we will highlight some of the features of structured products, and contrast them with other sectors, corporate bonds in particular.

High Level Comparison versus Corporates

As shown in Figure 1, structured product deals offer diversification in the form of multiple borrowers with the loans secured by collateral. Monthly payments of principal allow bonds to pay down steadily. This is in contrast to bullet maturities, which pay investors' principal back in one payment at maturity. As discussed in the next section, steady paydowns incrementally decrease exposure to default. The structured products universe also offers higher average quality ratings than many other alternatives and low correlation with other sectors.

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Figure 1: Corporate versus Structured Bonds

	Corporates	Structured Products
Claims on Capital	Unsecured	Secured by collateral
Obligor	Single borrower: one company	Diverse collateral: 100-50,000 borrowers
Payment Schedule	Semi-annual interest and bullet principal final	Monthly payment of amortizing principal and interest
Default Risk	Corporation can always make decisions that could impair the bondholder	Independent servicing and multiple obligors

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Amortization and the Power of Steady Cashflows

Residential Mortgage Backed Securities (RMBS), Commercial Mortgage Backed Securities (CMBS) and many Asset Backed Securities (ABS) are amortizing bonds; they have a schedule of periodic payments, typically monthly, of both principal and interest.

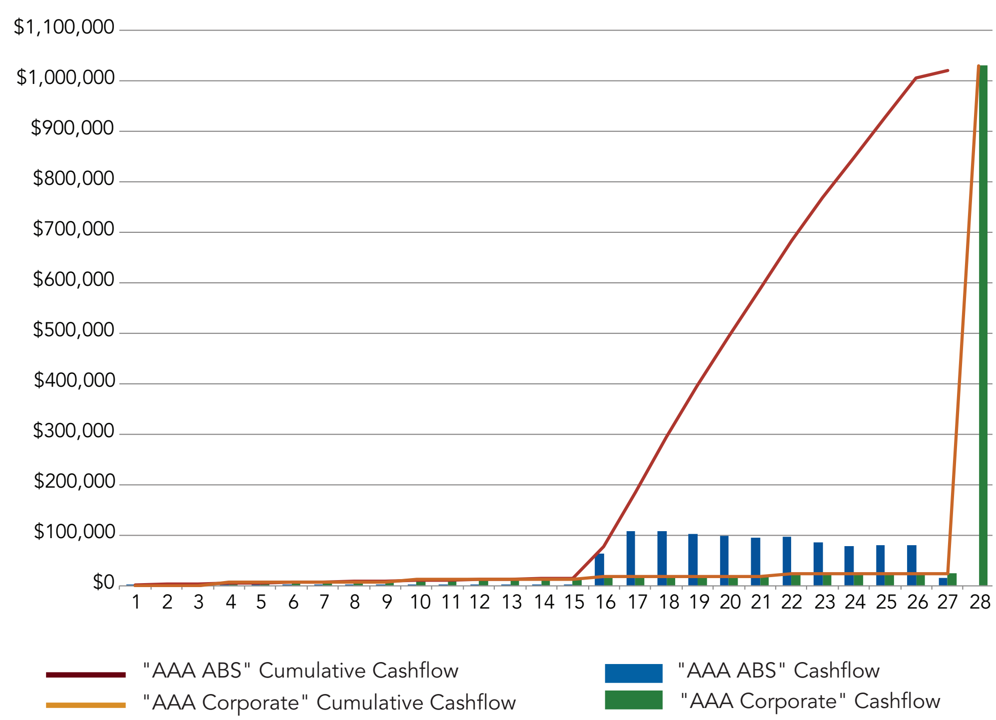
A key benefit of amortization is the steady reduction of credit risk as the principal pays down. Investors receive payments of principal over the life of the security or within a projected repayment window. This minimizes the uncertainty of whether the borrower will be able to pay one large lump sum at the maturity date, i.e., less principal at risk over the life of the security.

To illustrate this, in the figure below, we compare the cashflows of two actual securities with similar average lives and quality ratings, one a corporate bond, "AAA Corporate", and one an ABS, "AAA ABS"; both have $1 million face value, maturing in the second quarter of 2014.

The "AAA ABS" collateral is secured by a pool of over 44,000 automobile loans. It is an amortizing security, paying monthly interest since its origination and will begin to pay principal beginning in May 2013, with a final principal payment in May 2014.

Amortizing bonds, such as ABS, steadily reduce outstanding principal at risk.

Figure 2: Cashflow Comparison



The "AAA Corporate", a bullet security, is an obligation of a large U.S. industrial corporation. The security pays interest on a semi-annual basis and full principal in one lump sum payment in May 2014. The investment is unsecured, so the investor is making a bet that the company will still be willing and able in two years time to pay off the $1 million obligation to the bondholders. For corporate bonds with even longer maturities (10-30 years), uncertainty is even greater. The cumulative cashflows received for interest payments accrue very slowly, with the bulk of the investment recovered only at maturity.

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On the other hand, investors of the "AAA ABS" begin to receive principal payments just after halfway through the remaining life of the security. This leaves less uncertainty that the borrowers will be able to pay each time because the payments are in much smaller increments.

Amortization and Interest Rates

The larger cashflows beginning halfway through the remaining life of the bond frees up capital to be opportunistically reinvested. Investors' money in the "AAA ABS" is not locked up as long as in the "AAA Corporate." This is especially beneficial in an increasing interest rate environment during which monthly cashflows can be continuously reinvested at higher yields. Figure 3 presents total return in various rate scenarios; cashflows are assumed to be reinvested at the prevailing future rate. For example, the "AAA ABS" is reinvested at 1.82% in the "Up 50 basis points" environment.

Even though they have the same final maturity, the ABS's amortizing cashflows make for a slightly shorter duration (1.74 years compared to 2.25 years), which makes the security less sensitive to interest rate changes. That, paired with higher yield, makes for a better total return profile over 6 and 12 month periods. The difference becomes especially telling over the 12-24 month period because the principal cashflows denoted in Figure 2 above can be reinvested at the higher rates.

Investors' money in the "AAA ABS" is not locked up as long as in the "AAA Corporate" which is especially beneficial in an increasing interest rate environment.

Figure 3: Corporate Bond versus ABS Bond Performance*

	"AAA ABS Bond" ABS Characteristics	"AAA Corporate Bond" Corporate Characteristics
Maturity	Q2 2014	Q2 2014
Price	$99.73	$101.75
Yield	1.32%	0.43%
Duration	1.74 years	2.25 years

Excess Return of "AAA ABS" over "AAA Corporate" in Various Rate Environments

	6 months	12 months	24 months
Down 25 bps	0.71%	0.80%	1.16%
Unchanged	0.88%	0.89%	1.18%
Up 50 bps	1.24%	1.08%	1.27%
Up 100 bps	1.56%	1.25%	1.36%
Up 200 bps	2.22%	1.60%	1.54%

*Cashflow analysis details available upon request.

Stable Ratings

An additional benefit of structured products is their stable, high quality ratings. Agency RMBS, which makes up 32% of the Barclays Aggregate, carries the implicit guarantee of the U.S. government. Excluding Agency RMBS, the majority of the structured universe in the index is rated AAA by the three major rating agencies. Specifically, 88% of ABS and 63% of CMBS are rated AAA. This is predominantly explained by the existence of credit enhancement supporting the AAA tranches provided by lower rated tranches, and the fact that structured products are secured while corporate paper is typically unsecured. By comparison only 1% of the corporate universe is rated AAA.

Further benefits include decreased downgrade risk. Because payments are spread out over a longer period in smaller amounts and therefore less risky than bullets, the

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Ratings volatility of structured products has been tempered even through the credit crisis.

Figure 4: Current Ratings for Original AAA Super Senior Bonds

investment is exposed to less ratings volatility. Ratings volatility of structured products has been tempered even through the credit crisis. For example, as shown in Figure 4, approximately 97% of super senior CMBS tranches originally rated AAA by Fitch in 2006-2008 are still currently rated AAA and 100% of deals rated AAA in 2005 are still AAA today. S&P and Moody's rating actions, albeit more volatile during the 2005-2008 period, remain primarily investment grade today. Structured products offer the added benefit of secured risk generally not found in corporate bonds. ABS and CMBS bonds are secured by loans of multiple obligors.

The "AAA ABS" bond for example, as noted above, is made up of over 44,000 individual loans. Hence, it is unlikely that any one of these borrowers' decisions to prepay or default will have a significant impact on the performance of the entire security. In the case of the "AAA Corporate," the single U.S. industrial company that is the obligor has discretion to make unilateral decisions that could impair bondholder value, such as increasing leverage after bonds are issued, or using cash on unprofitable investments thereby limiting cash available to pay bondholders. This is of course mitigated by the fact that corporate issuers will be unable to efficiently access debt markets if their company actions impair bondholders.

Benefits of Portfolio Diversification

Structured products such as ABS, CMBS and RMBS offer good diversification from other bond classes such as corporates and Treasuries. Diversification benefits are quantified by the low correlation of structured products' option adjusted spreads to other asset classes. This was especially meaningful during the credit crisis of 2008, at a time when diversification was arguably most needed. During the period of 2007 to 2009, ABS were 38% correlated with corporate spreads, 23% with CMBS spreads and 20% with RMBS spreads. During this same period, CMBS and RMBS were 61% and 28% correlated with corporates, respectively.

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Conclusion

Structured products like ABS and CMBS are a potentially attractive addition to a portfolio of corporate and government bonds. They have high and stable ratings, offer competitive excess returns to Treasuries and their smooth cashflows stabilize portfolio performance, notably in a rising rate environment. Merganser has a long track-record and proven strength of constructing well-diversified portfolios that benefit from including structured products.

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