How UK pension schemes are allocating to ABS

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Over the past seven years we have welcomed a growing number of UK pension clients into our European ABS strategy, managed by our specialist team in The Hague. In this paper we discuss the attractions of asset-backed securities (ABS), and explain the different ways in which our UK clients are incorporating ABS within their portfolios.

Defining ABS

Asset-backed securities are loans that are covered by specific collateral pools. The European asset-backed securities market is large and diverse. At over £1 trillion it is comparable to the size of the European investment-grade corporate credit market. It offers a broad range of potential allocations across countries and underlying sectors, including residential mortgages, consumer loans (credit card and auto), commercial mortgages and loans to corporations.

ABS offers institutional investors distinct benefits, including exposure to a range of mainly consumer-backed risks; a transparent view of collateral quality; the prospect of premium returns; and low correlations with other assets.

Why European ABS strategies have become so popular

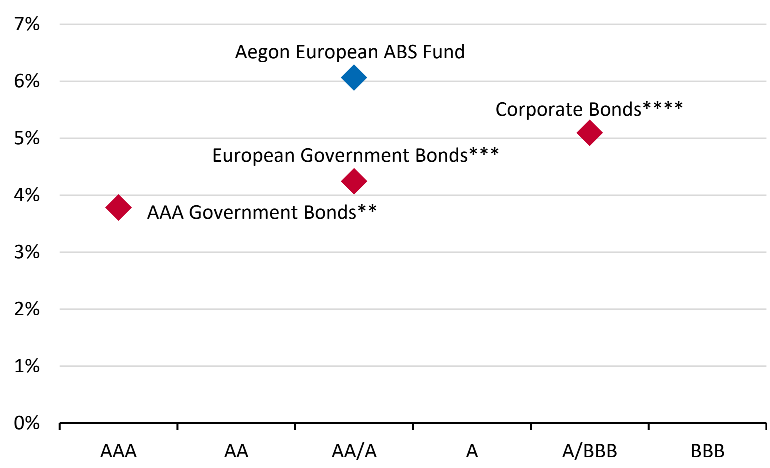
Investing in ABS offers institutional investors benefits, which we summarise below and on the following page.

An attractive yield

European securitised debt offers investors a structural spread-premium relative to fixed income assets with comparable levels of credit risk.

Past performance does not predict future returns.

Yields of selected asset classes (in GBP)



Current yield*	
Currency	**Spread**
EUR	€ EURIBOR +174 bps
Hedged to GBP	£ SONIA +194 bps
Hedged to USD	$ LIBOR +210 bps

1-year total return expectation*	
Currency	**Total return**
EUR	5.50% - 6.00%
Hedged to GBP	7.00% - 7.50%
Hedged to USD	7.25% - 7.75%

Source: Aegon Asset Management, Barclays, Bloomberg (as of 29 March 2024). All yields are in GBP and gross of fees. * Yields and Total Return Expectations with hedging to stated currency using 1-month FX forwards, ** Barclays Euro AAA Government Bond Index, *** Barclays Euro Aggregate Government Bond Index, **** Barclays Euro Aggregate Corporate Bond Index.

Low interest-rate sensitivity

Unlike conventional bonds with fixed coupons, the bulk of ABS bonds are floating-rate notes with a very short duration. This makes them less sensitive to interest rate changes.

Effective risk diversification

ABS offers exposure to direct consumer risk, which is complementary to sovereign and corporate exposure, both of which tend to be well-represented within institutional portfolios. ABS has a low, or even negative, correlation with many traditional asset classes.

Diverse exposure by geography and sector

ABS bonds are fixed income investments secured with reserved asset pools, such as residential mortgages, car loans and consumer credit. Below we illustrate the breadth of the European ABS asset pool, which represents a diverse opportunity-set for active managers.

	Consumer risk		Corporate risk		Commercial property	
	Mortgages (RMBS)	Consumer loans	SME loans	Corporate loans	Mortgages	Total
Pan Europe				21%		21%
UK	12%	4%			3%	18%
Italy	3%	5%	4%			12%
Netherlands	7%		2%			10%
Spain	7%	2%	1%			10%
France	13%	3%	1%			16%
Belgium	2%		2%			5%
Germany	3%	3%	1%			7%
Ireland	2%					2%
Portugal	1%	1%				1%
Other		1%	1%			1%
Total	48%	17%	10%	21%	3%	100%

Source: AFME, end of Q4 2023. Any difference is due to rounding.

European vs US and global ABS

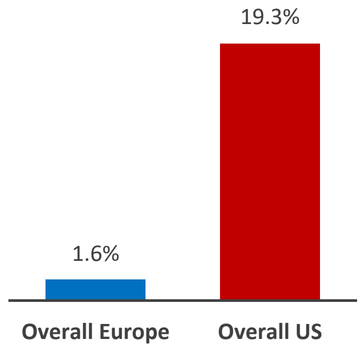
European ABS offers a highly diverse opportunity set by country and collateral type. Contrary to its reputation, default rates on European ABS during the financial crisis were significantly lower than similarly rated corporate bonds.

Aggressive sub-prime mortgage lending practices and synthetic securitizations that led to large losses in the US were far less common in Europe.

Similarly, in the 10 years following the Financial Crisis, the default rates of European ABS were significantly less than the US, as illustrated in the chart on the right.

We believe that the fundamental differences between European and US ABS favour a regional approach managed by regional specialists.

Cumulative default rate of ABS bonds



Source: S&P. 10 years to 31 Dec. 2017.

How our UK pension clients are incorporating ABS into their asset allocation

It has been interesting to learn about the different ways in which our UK pension clients are incorporating ABS into their portfolios. We highlight several of the most common themes.

Seeking a yield pick-up	Many pension schemes have been drawn to ABS because of the yield pick-up it offers over traditional credit and cash. A yield premium exists due to the following factors: • **Complexity premium** – ABS is often overlooked by investors as it structurally more complex to understand and is also misunderstood by many who tend to associate it with the GFC. • **Solvency II -** Due to Solvency II regulations, European insurers are typically unable to invest in ABS (due to capital requirements) • **ECB asset purchases** – The ECB's asset purchasing program has concentrated on buying sovereign bonds and corporate credit, with little focus on the ABS market
Lower inflationary sensitivity	Interest rate volatility is likely to persist given the current levels of inflation. ABS bonds are floating rate securities and hence have low interest rate duration.
Seeking alternative investments	A lot of clients are seeking to build allocations to alternative fixed income or illiquid asset classes. The ABS strategy is a relatively liquid alternative fixed income strategy that compares favorably with other potential options such as hedge funds (too volatile) or traditional fixed income such as high yield.
Diversifying credit exposure	At times of stress many similar asset classes tend to become highly correlated. While the ABS market is not immune to this type of stress, it does offer clients a degree of diversification compared to traditional fixed income markets. As global markets swing from risk-on and risk-off, some of our clients have invested in ABS to help diversify their fixed income exposure.
Access to the consumer	The cash-flows produced by ABS bonds are typically generated by the underlying consumers paying their mortgages, car loans and credit cards. These tend to follow a different cycle to sovereign and corporate markets, providing a different return profile. For example, while government bonds were largely written down during the Greek financial crisis, ABS bonds backed by pools of Greek mortgages generally paid back at par. This diversification is attractive to many investors.

Our approach to managing ABS

To capture inefficiencies across ABS markets, we believe it is essential to have genuine and committed asset-class expertise, coupled with an inquisitive attitude.

The demanding nature of ABS markets and instruments requires a disciplined and thorough analysis of various investment dimensions. Our proprietary 'meso' or middle view, for example, goes beyond the usual 'macro' (top-down) and 'micro' (bottom-up) inputs to rank the most attractive ABS sectors. Furthermore, each investment idea undergoes in-depth scrutiny from a multitude of research angles prior to approval.

We believe in the value of our in-house tools and models. They offer clear advantages over off-the-shelf systems: there is no 'black box' to interpret; our own solutions give us full control; we have conviction around the inputs and outputs; and our models enable us to simplify multiple dimensions and extensive sets of data into clear decision parameters. Most importantly, our proprietary tools help us quantify risks and opportunities.

About Aegon Asset Management

Aegon AM is an active global investor. Our 385* investment professionals manage and advise on assets of £264 billion* for a global client-base of pension plans, public funds, insurance companies, banks, foundations, wealth managers, family offices and individuals. We are a global business with approximately 1,170* employees across Europe, the Americas and Asia.

We organise our investment capabilities around four focused investment platforms where we have deep asset-class expertise: fixed income, real assets, equities, and multi-asset & solutions. Each platform has dedicated teams, organised globally and committed to maximising client benefit from their specialist areas. These platforms are supported by teams dedicated to responsible investing and multi-management.

Aegon Asset Management is a wholly owned subsidiary of Aegon N.V., a leading global financial services business. Aegon N.V.

For more information visit **www.aegonam.com** or contact **institutionalbusiness@aegonam.com**.

* Source: Aegon Asset Management as of 31 December 2023. Note: Assets under management for Aegon Asset Management group companies includes the advisory services performed by various affiliates or their investment advisory business units and joint ventures. Aegon Asset Management is comprised of the following entities: Aegon AM US, Aegon Real Assets US, Aegon Asset Management UK plc, Aegon Asset Management Asia Ltd, Aegon Asset Management Central and Eastern Europe, Aegon Asset Management Pan-Europe BV, Aegon Asset Management Spain, Aegon Industrial Fund Management Co. Ltd, Aegon Investment Management BV, La Banque Postale Asset Management SA, Pelargos Asset Management BV and Saemor Asset Management BV. Mongeral Aegon Investimentos (Mongeral) is a Brazilian based joint venture that is partially owned by an Aegon Asset Management affiliate.

Investment policy and risks

Investment policy

This fund is actively managed. The Fund will seek to achieve its investment objective by investing at least 70% of its net assets in asset-backed securities. Asset-backed securities are a type of debt securities such as bonds or notes whose value and income payments are derived from an underlying pool of assets held by the issuer. The underlying pool of assets is referred to as 'collateral'. The Fund may hold bonds and notes with various types of collateral, but some examples include residential mortgages, commercial mortgages, consumer loans, car loans, credit card loans, student loans and corporate loans, such bonds will not embed any leverage.

The Fund will invest at least 70% of its net assets in bonds with a credit rating which is deemed to be 'investment grade', defined as meeting one or more of the following rating criteria: Baa3 or higher by Moody's Investor Services (Moody's); BBB- or higher by Standard & Poor's Rating Services (S&P) or Fitch Ratings Inc (Fitch).

The Fund will invest predominantly in bonds or notes issued by issuers located within Europe, but may also invest in bonds or notes issued by issuers located outside Europe.

The Fund will invest in assets denominated both in Euros and in other currencies. Where non-Euro denominated assets are held, the Investment Manager will seek to hedge the associated currency risk back to Euros.

The benchmark of this fund are Bloomberg Barclays Capital Euro Asset Backed Securities Floating Rate Note Composite Index and the Bloomberg Barclays Capital Euro Asset Backed Securities Fixed Coupon Composite Index.

The Fund's (cash) benchmark is used as a reference to measure the Fund's performance.

Risks

The main risks are:

- **Credit risk:** The Fund is subject to credit risk in respect to its investments and with regard to its contractual counterparties (such as hedge providers).
- **Liquidity risk:** The secondary market for sub-investment grade bonds is typically much less liquid than the market for investment grade bonds, frequently with significantly more volatile prices and larger spreads between bid and asked price in trading.
- **ABS risk:** The value of an asset-backed security can be affected by various factors, including:
  - changes in the market's perception of the pool of underlying assets (or collateral) backing the security.
  - economic and political factors such as interest rates and levels of unemployment and taxation, which can have an impact on repayments and default rates on the collateral.
  - changes in the market's view of the creditworthiness of the issuer.
  - the speed at which loans which form the collateral are repaid.

For more details on the risks for this fund please see the KIID or Prospectus at www.aegonam.com/document.