Securitized Q&A

Longfellow Investment Management Co.

Why does LIM invest in securitized products (ABS, RMBS, and CMBS)?

Securitized products have several attractive features, including various risk and duration profiles, diversification benefits, and exposure to a pool of specific collateral in a liquid manner that otherwise would be considered singularly illiquid. Additionally, the monthly amortizing nature of structured securities allows us to provide clients with customized cash flows.

How are securitized products different from other fixed income sectors?

The securities are typically sold as bonds with additional structural features like "tranching" where each slice, or tranche, comes with different risk and duration characteristics. This distribution of risk is made possible via a waterfall feature that specifies beforehand the allocation of interest, principal, and losses among tranches. Credit enhancement is the first line of defense for investors and typically takes the form of overcollateralization, where the asset balance is greater than the liability balance, or subordination, where tranches lower in the capital structure are allocated losses before the senior tranches. Unlike a corporate bond, multiple parties are involved in a securitization, including the originator of the collateral, the servicer that handles borrower collection, and rating agencies that rate each tranche of every new issue based on the credit enhancement available. These multiple parties must be taken into consideration during the analysis.

What are the major risks specific to securitized products?

The principal risks of investing in fixed income securities in general is how their prices respond to changes in interest rates, creditworthiness, prepayment or call risk, market risk, liquidity risk, and risks of political, social and economic developments. A securitized bond is typically backed by a pool of loans where borrowers have the ability to pay off or refinance their loans without incurring large penalties. This particular feature can cause the life of the bond to either shorten or extend more than what is expected at the time of issuance. Most residential mortgage-backed (RMBS) and asset-backed (ABS) securities are at a higher risk of cash flow variability. Loans backing a commercial mortgage-backed (CMBS) security, on the other hand, have a higher penalty for unscheduled cash flow, which acts as a strong deterrent. Additionally, the tranching feature of a securitized bond provides credit enhancement to investors in a senior tranche higher in the capital structure by directing additional leverage towards investors in the "subordinate" tranche, thereby exposing them to higher risk of loss.

What are the key points of evaluation for securitized products?

Analysis is conducted on key risk areas, which include: the underlying collateral, tranche structure, sponsor strength, servicer habits, underwriting quality, and types and level of credit enhancement. Special focus is paid to analyzing the timing of cash flows, as well as the likelihood and timing of borrower defaults, to arrive at an expected loss assumption. Since this analysis relies heavily on availability of historical performance data, we prefer deals and/or collateral with a long track record of consistent performance through market cycles. Furthermore, it is our view that the ultimate performance of a bond relies heavily on collateral characteristics such as aggregate borrower quality, geographical diversification, underlying leverage, and loan and borrower concentrations.

What is LIM's investment strategy/approach in securitized products?

Our approach entails fully utilizing the diversification and amortization benefits of investing in securitized bonds. A typical allocation would include a mix of asset-backed, commercial mortgage-backed and residential mortgage-backed securities with a bias toward higher quality and lower volatility. Our objective is to build a balanced allocation to these securities that best meets our client's risk, return, and liquidity goals.

Disclosure:

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