Structured credit: a compelling risk-reward proposition

In our last blog, we took a look at the potential benefits offered by distressed debt – a high-risk, high-return segment of the alternative credit market. This time we turn our attention to structured credit, which is a lower-risk area but one that is still providing much higher yields than traditional bonds at present.

What is structured credit?

Structured credit consists of a range of fixed-income securities backed by various types of loans and mortgages, many of which are linked to consumers. At Kempen we allocate to four different parts of the structured credit market: residential mortgages, commercial mortgages, consumer loans and leveraged loans.

Some compelling reasons to invest

The percentage of bonds in the global fixed income markets currently providing a yield above 1% is very low. Structured credit yields are far higher. At Kempen, we invest across the structured credit markets to produce a portfolio that's yielding 4–5% at present[1] – despite its high average credit rating of BBB+. To put that into perspective, a similar traditional US corporate bond would have a spread of around 125bp at the moment[2].

Due to the nature of its underlying exposure – like exposure to private individuals - structured credit can represent a useful source of diversification in an existing bond allocation. Another benefit is that it generally has no interest rate sensitivity due to its floating-rate nature. Many investors are concerned about an eventual return of inflation, but they don't need to worry when allocating to this asset class as its coupon payments will rise in line with inflation.

Strong consumers mean further strong performance potential

After suffering badly in the turbulence of last March, structured credit has performed well – its current yield of 4–5% is lower than it was in the spring[3]. But we don't think it's too late to invest.

Yields of other bonds are so low because of quantitative easing measures, but central banks didn't buy structured credit so its yields are undistorted. What's more, the consumers that structured credit is linked to generally used last year's government handouts to pay down their debts, so we believe they're in good shape for 2021. This makes structured credit yields look highly attractive for the level of risk the asset class involves.

Case study: solar ABS – helping with the energy transition

A relatively new area of the structured credit market but one that's growing rapidly is solar asset-backed securities (ABS).

Lots of people have been looking to reduce both their energy bills and their carbon footprints by installing solar panels on the roofs of their homes. But doing so isn't cheap.

They often don't want to or can't afford to pay for the panels upfront, so they take out a loan that they pay back in monthly instalments instead.

Several firms offer these loans, and it's possible to invest in these receivables via the ABS market. Doing so provides a number of benefits for investors. Of course it means helping the transition towards a low-carbon world, and the loans provide exposure to the strong US consumer. What's more, the bill for paying back solar panel loans is viewed as a utility bill, which means it's a high priority payment obligation that people can't skip payments on easily.

A good long-term investment

Structured credit does involve some drawbacks: it's relatively illiquid, it can suffer sharp sentiment-driven drawdowns like in March last year, and it's more complex than traditional bonds.

But we believe it's still a compelling proposition for long-term investors able to weather short-term volatility, and that the attractive yield it's providing more than compensates for its illiquidity and complexity.

Tune into our webinar on alternative credit

To find out more about the benefits of structured credit and those of other alternative credit asset classes, please register for our webinar on 5 March **here.**

[1] Source: Kempen, yield of Diversified Structured Credit Pool was 4.4% per 30-Nov-2020

[2] Source: Citigroup, 125bps is credit spread on BBB USD Corporate Bonds per 8-Jan-2021

[3] Source: Kempen, yield of Diversified Structured Credit Pool peaked at 8.4% in 2020 per 31-Mar

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