Transcript

PGIM FIXED INCOME

[Music]

>> Securitized credit is a $4 trillion fixed-income sector that can offer diversification relative to other fixed-income sectors and provide attractive, risk-adjusted returns. For some investors, securitized credit, which they may know better as RMBS, CMBS, ABS, and CLOs is synonymous with complexity and risk. However, once you move beyond the slew of acronyms, we believe this sector is simply an alternative approach to secured lending. Here's why. Suppose there's a pool of car loans, mortgages, or leveraged loans valued at $100. Regardless of the type, the loans themselves are assets that provide a series of scheduled principal and interest payments over their term. Now let's introduce two investors. Conservative Carl has $40 to invest, and Aggressive Aggie has $60. Carl wants a lower risk investment and is willing to accept a lower return in exchange. Aggie is more aggressive and willing to accept higher risk in exchange for a higher expected return. In fact, in her ideal scenario, Aggie would like to enhance her return by borrowing money to purchase the entire pool of assets. One option for Aggie is to borrow $40 from Carl to buy the full pool of assets, with a promise to repay Carl. A key challenge in this scenario is that Carl may want a form of security in case Aggie fails to pay. One solution, securitization, would take all of the underlying loans and deposit them into a trust that issues Class A and Class B securities with different levels of risk and return potential. Let's switch the lens and look at this from a cash flow perspective. If our pool of loans is paying a 6% rate, for example, we expect to get $6 of interest before any losses or principal repayments on the loan. The first class to be repaid, Class A, has a principal balance of $40. Conservative Carl buys this class and gets $2 of the $6 of interest. The Class B, or the subordinated class, has a principal balance of $60. Aggressive Aggie purchases this class and receives the remaining interest, which is initially $4. As principle is paid down on the underlying loans backing the securitization, Carl's investment is the first to receive that cash, while Aggie must wait until Carl's investment is completely repaid before she receives principal in her investment. If any loan incurs a loss, Aggie's class is the first to be written down, and the amount of interest that Aggie receives is reduced. So, although Aggie's Class-B security offers a higher potential return, it does come with more risk. As we've shown here, even if you previously viewed securitized credit as overly complex compared to, say, corporate bonds or emerging markets debt, the basic principles of securitization are actually quite simple. At PGIM Fixed Income, we specialize by asset type to understand collateral and structures. We conduct fundamental analysis and use quantitative methods to value the underlying assets and assess how much that value is likely to fluctuate. Our scale provides access to narrowly distributed opportunities, and we tailor the risk profile of these alternative lending investments to our investors' desired risk profiles, all with the goal of maximizing risk-adjusted returns. So, if you are thinking of investing in securitized credit, think PGIM Fixed Income.

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