Transcript

>> You're listening to All the Credit, a monthly podcast series brought to you by PGIM Fixed Income, an active global fixed income investment manager. And now you're host, Senior Portfolio Manager Mike Collins.

>> Hello. Welcome to episode seven of All the Credit, PGIM Fixed Income's monthly podcast. I'm Mike Collins, one of the many investment professionals of PGIM Fixed Income, and your host for All the Credit. One of the hottest topics in the bond market today, and actually across all financial markets, is the negative impact that this pandemic/recession is having on residential and commercial real estate markets and consumer and commercial loans. Whether it's due to the high unemployment rate, the expiration of certain government benefits, or the anticipated secular shift in the use of real estate, including office buildings. And there is no one better equipped to discuss these topics than PGIM Fixed Income's very own head of securitized products John Vibert. John oversees our entire team of securitized product investment [inaudible]. And the large amount of securitized products we own, and I'm personally responsible for across our multi-sector portfolios, are all collateralized by the type of loans that are seemingly most at risk. John Vibert and I are here to give you All the Credit. Welcome, John.

>> Thanks, Mike. Great to be here.

>> So, John, you're a relative newcomer at PGIM Fixed Income. You've been here a whole six years already, which is amazing that it's been that long. And you've already, you know, adopted a leadership role within the organization for sure in addition to running this large team of securitized product investment professionals. Why don't you give the audience a little bit of a background how you got to PGIM Fixed Income?

>> Sure. So, I have to admit to feeling slightly self-conscious about this portion of the festivities, cause I've known you've been here for over three decades building this business from the ground up. So, I feel like a real dilettante in comparison to that. But I started my career 27 years ago at Salomon Brothers. They were hiring people with quantitative backgrounds. I had an engineering undergraduate degree. And so, I was hired there in their mortgage research group. And I spent several years there before moving to Credit Suisse. And I spent about a decade at Credit Suisse, first in their research group, and then on the trading desk there. And I had a stint at Morgan Stanley in between. And then in 2007-2008 I was running the adjustable rate mortgage business at Credit Suisse, and I had an opportunity to move to the asset management industry, and ultimately, you know, took that opportunity. Blackrock was kind enough to hire me to run the [inaudible] business there, which I did for about six years. And then I was looking for a new opportunity, and I was connected to PGIM through a mutual friend. And I was hired to run the securitized products business here. And, you know, as you mentioned, just had my six year anniversary here last week.

>> Well, congratulations on that. Tell us about the team that you manage, John.

>> Sure. So, you know, currently the team is comprised of 20 analysts and portfolio managers. And we certainly continue to add people as the assets [inaudible] grow. That's divided up into six portfolio managers. And we have 14 research analysts presently. The PMs, as you know, are responsible for both portfolio construction and execution. I think you mentioned in previous podcasts that's something that we feel really strongly about that execution is really important, that it's combined with portfolio management. We think it's really critical to getting the right information to make portfolio construction decisions

understanding, you know, where the real inside market is, particularly in a niche sector like securitized assets. And then our research analysts are responsible for our issue of due diligence for our legal documentation review. Importantly our surveillance, which has probably never been more important than it's been in the last few quarters. But also, for determining the credit ratings that we put on bonds that feed our risk management system. And then, you know, lastly our ESG scoring, which feeds into our whole approach to ESG.

>> So, let's get to the nitty-gritty, right? Securitized Products. There is a lot going on. It's a very hot topic, as I mentioned, a lot of concern about the risks and the underlying collateral. But let's take a step back and talk about how we got to where we are. We came into this year with a really strong view on securitized products, mostly top of the capital structured AAA asset backs and collateralized loan obligations, commercial mortgage-backed securities. In fact, in our multisector portfolios, that are near and dear to my heart, we had large, and we continue have large, positions in these securities based on the, you know, analysis and recommendations recognitions of your team to a large extent. What was our, you know, view coming into this year, and why did we have such a big position in your mind?

>> Sure. Well, look, I think that our thesis has been for some time that the senior most bonds in securitization capital structure offer the best risk-adjusted returns. And so, you know, heading into March it's hard to remember now, but the fundamentals are actually, you know, really very good across all swatch [phonetic] of the prospective asset classes. And in particular I note that there was really strong, you know, employment across the economic [phonetic] spectrum. But at the same time risk assets were really very much priced to perfection. They really were pricing in all these very benevolent fundamentals. And so, you know, given that backdrop, given that we felt we're not really been indemnified for taking risks and going down into the more speculative parts of the securitization capital structure we chose, and you chose as part of the SNL casing [phonetic] decision to have larger structural overweight's to the higher-quality parts of the securitized assets capital structure. And so that was really the thesis. It wasn't necessarily a view that the fundamentals were going to dramatically worsen the way they did. It was more a risk-reward proposition decision.

>> And in fact, I mean, you know, we seem somewhat vindicated, because that thesis has, kind of, played out here. We were basically selling investment-grade credit at similar, or even tighter, spreads than some of the AAA securitized products we're investing in. We were selling agency mortgage-backed securities at much tighter spreads than are offered by, in our view, similar credit risk type of securities by being at the top of the capital structure. And sure enough, these things, even though there was a lot of volatility in mark to market vol [phonetic] in March they've really performed well here.

>> Yeah, I mean, I think that's a great point. I think that, you know, there was a lot of mark to mark volatility in March. But ultimately, you know, our belief was that if you've done good, solid, bottom up, you know, fundamental work, and you can weather the mark to mark volatility that ultimately, you know, where we were invested in the capital structure we can prevail and earn the return we expected to, you know, earn going in. And there are, kind of, two, you know, kind of, portfolio construction presets that are at play, right? You can go in, as you know, and take a big structural overweight to relatively conservative bonds. So just put some concrete numbers around that, right? You can underweight the agency mortgage component of the AG, which is, you know, roughly 30 percent. And you can own agency, or non-agency CMBS [phonetic] I should say, in lieu of that, and you'd pick, you know, 80 basis points on that 30 percent, you know, structural non-benchmark allocation. Ultimately, you know, another approach, right? Would be to have an allocation that was, you know, one-third that size. But then ultimately you need to have three times the spread. So, you know, the top of the capital structure in CMBS maybe trades 80 basis points wide to mortgages. If you're trying to earn three times that 80 base point pickup that really puts

you into a single-A class or a BBB type class. And the problem with that is that those securities are much more levered to the fundamental outlook. And as the fundamental outlook has deteriorated those securities have run into much more difficulty than the top of the capital structure. So nobody likes market to market losses, but I think the important thing is that these securities, you know, will stand the test of time and ultimately prevail, even though the fundamentals are much worse than we had anticipated heading into the crisis in March.

>> All right. So, let's dive into some of the individual areas within securitized products, and some of the risks. And let's start with the one that's really on the top of a lot of our clients' minds, John, that's commercial real estate, right? So commercial mortgage-backed securities are collateralized by dozens of commercial mortgage loans. And there's a lot of concern, not only about the retail sector, but the lodging sector. And recently, as I mentioned, the office sector, right? So, what is your view on those sectors? And how would that affect the positions that we have in our portfolios?

>> Sure. Well, look, I mean, I think that there, you know, there are definitely challenges across the spectrum, but -- Of commercial real estate. But there are real differences in terms of how these sectors have performed thus far. You know, one of the things that has been a long-held view is that, you know, hotel sector is probably one of the most vulnerable parts of the commercial real estate asset class. We think they are really [inaudible] from the pandemic. So two of our research analysts, Gary Horbacz and Jason Pan recently published a note on our fixed-income blog, which you can find at pgimfixedincome.blog. And the upshot of their narrative is that, you know, our long-held view is that hotels are not really a commercial real estate play as much as they are in some respects an operating company with a real estate angle. And, you know, unlike other parts of the commercial estate market where the leases sign, you know, multiyear leases, hotels really have the equivalent of an overnight lease, which makes them incredibly vulnerable to disruptions in the leisure and business travel. And this is really disruption like no other. One of the really striking exhibits in their research note is a graph of revenue per available room. And in previous disruptions, like the global financial crisis, this metric [inaudible] call declined, you know, 20 percent. After 9/11 it declined 25 percent. In this COVID crisis declined over 70 percent year-over-year. It's bounced back a little bit, but still is down, you know, in the most recent print 50 percent year-over-year. So really, you know, striking distress in that space. But I think it's important to put in context, you know, CMBS delinquencies over all are hovering at just under 10 percent total. And for hotels that number's more, like, 24 percent. So huge differences between how different subsectors in the commercial estate market are performing. And I think fortunately for us, you know, our CMBS research team, you know, has loads [phonetic] hotels as an asset class literally for decades. So, our direct exposure to this asset class was really light heading into this crisis. You know, just to complete that thought, you know, looking at delinquencies across commercial real estate, you know, hotels are probably the worst performer at 24 percent of delinquencies. And this is the August data, which just came out of the last couple days. You know, retail, which also gets a lot of play, as you know, is around 14 percent delinquent. But then when you get into multifamily, you know, delinquencies dropped to about three and a half percent. Office, as you mentioned gets a lot of headlines, because everyone's concerned that we're going to be working from home in perpetuity, and offices are going to become obsolete, you know, that's still only 3.4 percent delinquent. And then industrials, you know, performing fantastically. It's just two percent delinquent. So real, you know, the nice thing about securitized assets is people think of it as a monolithic asset class, but then when you look under the hood you realize that it's actually many, many different asset classes. And there are opportunities to pick and choose your spot, depending on what your fundamental outlook looks like.

>> And I always give kudos to you and your research team. And you mentioned some of your analysts. And my senses we have, and your team has generally a very conservative, disciplined underwriting style and approach, really looking at stress scenarios, and making sure we won't lose money in those stress scenarios. And I remember for years before the crisis, your team was really avoiding CMBS deals that had a disproportionate amount of lodging, as you said, and retail. Not that we're envisioning this kind of pandemic, but just the fundamentals, the secular deterioration in retail, and the fundamental challenges in lodging steered us away from those sectors, you know, way up front. So again, kudos to you. And I think you guys have done a great job. And I think the structures we have are going to hold up really well. So, let's shift to residential real estate. You mentioned forbearance. And that's definitely the big talking point in the resi-non-agency [phonetic] RMBS market, as we call it, where you've had this big wave of forbearance or forborne loans, as we call them now, gets a new word I've learned, where people don't have to pay their mortgages for an extended period. And there's a lot of concern that, you know, we'll lose principal as investors in these securities. What's our view on today's, you know, RMBS, Residential Mortgage Market, relative to let's say the housing crisis we had back in '08?

>> Yeah. It's a really good point. So, I think, you know, just talking about the forbearance numbers to begin with, right? So, if we just looked at the loans that have ultimately been securitized by Fannie Mae and Freddie Mac, the share of loans that are in forbearance there is around 5.4 percent. So again, we have significantly less than the type distress that we saw during the financial crisis. FHA/VA, which tends to lend to a slightly, you know, more at risk demographic, if you will, you know, the forbearance number is around 11 1/2 percent. But I think, you know, you make a bigger point, which I think is really critical is that the public policy response to this crisis has been, you know, very different than what we saw during the financial crisis. With the financial crisis, you know, mortgages really were, you know, really were the spark that, you know, lit that great conflagration. And because of that, the public policy response I think was really conflicted, right? We tried to come up with programs that basically didn't indemnify people who took stupid risks heading into that. You know, but also help peopled out who were in distress through no fault of their own. And it's very hard, you know, to do that with any degree of nuance. And so, I think a lot of the policies at that time were somewhat ineffective, because we're trying not to indemnify people who took bad risks. And so, we had a modification program, for example, that was really challenging to implement. And you may recall there were many bites at the apple while they tried to implement a modification, a loan modification program for borrowers that ultimately proved to be effective. And I think, you know, the response here has been very different, right? You know, this wasn't a crisis that was caused by irresponsible lending or irresponsible borrowing. It was caused by, you know, a virus and an ensuing pandemic. And I think public [phonetic] policy response has been, you know, overwhelmingly positive, right? The Fannie Mae and Freddie Mac came out and offered very aggressive forbearance terms, right? Effectively 12 months of forbearance, you know, for anyone suffering, you know, adverse impact from, you know, the COVID crisis. So I think we're going ultimately, you know, it remains to be seen, but I think we are going to avoid a widespread foreclosure crisis, because, you know, the response has been, you know, overwhelmingly positive in terms of making sure that people do not get foreclosed upon. You can't ask people to shelter in place, you know, if you ultimately take their shelter. And I think their response has been appropriate. And I think it's going to be a great success story.

>> And the fundamentals in the housing market, I would argue, are night and day today compared to where we were back then where home prices were down, you know, 20, 30, 40 percent in a lot of locales. And today home prices, especially in suburban markets, are going up. And, you know, housing numbers, we just had housing starts and building permits. And these numbers are above the levels they were at pre-COVID, so it's a much more robust housing market today.

>> Yeah, absolutely. And I think that, you know, we've been constructive on housing, for sure. And I think we were, it was unclear how, you know, employment, the change of the unemployment situation, that's obviously pretty grim, you know, in the wake of this crisis. We are unsure how the unemployment situation is ultimately going to manifest itself in the housing data. Thus far, as you say, it's been pretty benign. I think a big part of that has been the widespread forbearance. So, but I think, you know, looking out, you know, over the next decade I think one of the things it makes is really constructive on housing is the fact that the millennial generation is coming-of-age. And there's this huge cohort of people who are ultimately reaching peak. You know, years of household formation. And they're going to be looking, you know, to, you know, two purchase homes. And I think that makes this really constructive on housing longer term. So, you know, this is a headwind that we didn't ultimately expect, but I think, you know, given the fact that the forbearance is going to, I think, short-circuit what could be a negative feedback loop from [inaudible] the foreclosures, and then you have this demographic tailwind. You know, we feel relatively constructive on housing. Although definitely a concern for sure.

>> So, we can't talk about structured products without touching on CLO's, right? Collateralized loan obligations. We've been out there as a firm with a very opinion on these. We've had large positions across our portfolios, as much is 10 to 20 percent. And mostly AAA rated CLO's in a variety of our multisector portfolios. And they are not collateralized by consumer loans and commercial or residential mortgages. They're collateralized by effectively commercial loans to midsize and large companies, mostly in the US. And obviously the fault rates are high. Downgrades are pretty rampant. Companies are struggling here. What's your view on how we're positioned within the CLO market, and how those defaults will impact the AAA tranches that we own by and large?

>> Yeah, it's a good question. So I think that one of things that's noteworthy about the CLO space is that even though we had a large allocation to the sector, it was, as you say, at the top of the capital structures and AAA, and then to a lesser extent AAs, this was one of the spaces actually where we are quite negative on fundamentals. You know, as you know, we were pretty negative on leverage in the space. We were pretty negative on covenants on the space. And so --

>> Meaning the leverage loan space, the underlying collateral where we had a negative view on the collateral.

>> Yes, exactly. Thank you for clarifying, right? So it was our expectation that the next default wave, even though, you know, we weren't anticipating next default wave happening, you know, quite with the speed with which it has developed, you know, it was our expectation that recoveries, which, you know, historically were quite benign for the senior secured loan space, were going to be significantly worse this time around. Because of structural changes in market relative to last time we had a real default cycle there. So, we were quite negative on fundamentals here. And, you know, what we've seen is actually, you know, things have played out, you know, well, they're playing out may be a little bit better than we might have feared, you know, quite honestly. We saw CCC baskets ballooned, so you've seen, you know, a wave of downgrades come through. Then the prices on the underlying assets really declined pretty precipitously at the end of the first quarter. But, you know, the good news has really been twofold. One, you know, loan prices have bounced back really significantly from the depths of the first quarter. And secondly, the performance metrics of the clos themselves are actually showing some signs of improvement. And I don't want to, kind of, get into the nitty-gritty of the jargon around, you know, market value OC numbers and the like, but at the end of the day, those metrics, you know, suggest that collateral managers of the clos are managing to navigate their way through the prices. Now the jury is still out, I think that, you know, there's definitely the prospect of further downgrades, and the CCC percentages could worsen if the economic activity rolls over here over the next, you know, couple of quarters. But that isn't our based [inaudible] expectation. But that's something we are watching. I think the important

thing, Mike, to your point, is that at the top of the capital structure, even with this negative outlook that we had coming into this, and an outlook, which quite frankly hasn't changed in terms of, you know, some of our skepticism about the quality of loans, these securities are really robustly structured. And I mentioned AAs, and so we talked a little bit about AAAs, AAA CMBS, talk about AA clos for a second, you know, this is a sector that, you know, if you assume, you know, pretty benign path for, you know, for defaults on four recoveries, even a 40 percent recovery, you know, this is a sector that can withstand default rates of around 15 percent before, you know, before you even take a dollar of loss in the AA part of a capital structure, because they are structured with around, you know, 24 to 26 percent enhancement plus excess spread in the securitizations. So ultimately at that part of the capital structure that we're invested in we think they can weather a really severe default cycle.

>> Yeah. I mean, that default, cumulative default rate would be multiples of what we've seen in any past period. You'd almost need a Great Depression-like environment, or a really extended recession, I think, to see that kind of cumulative default rate. So that's a great point. So, before we wrap up, I want to give you a few other questions. One is what are your favorite trades today? So, the allocations you're make now, the best ideas right now, what are you buying for our client portfolios today?

>> Sure. So, look, we still think that the spread in higher-quality parts securitized products can continue here for a period of time. As you know, we've seen a big snapback and spreads broadly, given the desperation that clients have for spread and for yield. And I think that that's going to continue to be a really positive tailwind for spread typing of the top of the capital structure across a wide swath of the securitized space. We particularly like AAA CMBS here still. I mentioned they are around 100 over. We think that easily another 30, 40 basis points spread type. And from here we still like AAA and AA CLOs as well. [Inaudible] have come in here in recent weeks they went from, you know, 175 bps over, you know, and not that long ago it's been more like 150 basis points today. But that's still, you know, a lot of spread, you know, given the need for yield in this environment. If we wanted to look further out the risk spectrum, we'd like credit risk transfer securities that have been issued by Freddie Mac recently. Freddie Mac has been continuing to issue CRT, you know, despite some questions about the new capital regulations that have been promulgated by FHFA. But Freddie Mac has been issuing CRT, and they been removing some of the COVID forbearance loans from the reference pools. So, we've liked them at the spreads where they come, they [inaudible] the other day at 375 for our BM2 classes. We also like the credit risk transfer securities that have been issued from the mortgage insurance companies. It's a similar trade, but in some important respects we feel it has less catastrophe risk and has less environmental risk, if you will, what I mean by catastrophe risk. We also think it's more resilient in the current environment, because they don't end up paying claims on loan modifications, which is what we are likely to see at the tail end of this crisis. Lastly, we are seeing an enormous number of opportunities in the term funding markets, where we use securitization technology to finance assets that otherwise would be on repo or warehouses at various investment banks. And we are seeing banks pull back on this activity. But the need for financing is growing more as people use leverage to try and enhance their returns. And so, we've been able to land really attractive spreads with a lot of downside protection by being a financing provider via the securitized markets.

>> And that's a great example of how a shop of our size has access to those types of opportunities that look really attractive to us. How about, we haven't talked about global opportunities, right? We are a large global asset manager. I mean, do we see securitized opportunities in Europe? I know Edwin Wilches [phonetic], who is one of the CLO portfolio managers on your team, has done a great job, kind of, moving in and out of US dollar and euro-denominated CLO tranches of our portfolios. But how do you look at those markets?

>> Yeah. It's a great question. So, I think that the opportunity set in Europe has really ebbed and flowed. As you know, the central bank response in Europe has been, I think, a little bit stronger in terms of the support they've provided for asset-backed securities, whether it's the ECP or the Bank of England. And so that has caused spreads there I think to be, you know, sometimes a little expensive relative to the US. But you mentioned clos. That has been a sector that has not really benefited from a lot of official institution support. And so there have been opportunities there to buy attractive spreads. And in that sector that was [inaudible] particularly for European clients that need European [inaudible] tension compliance structures. We like AAA and AA clos in Europe. We are also seeing opportunities in UK RMBS as well. And I think it's important to know that UK RMBS perform far better than the US RMBS market did during the financial crisis. And so that's one of the sectors that we need to like over there. And then we've also seen opportunities in the commercial real estate space in Europe. It's a little more episodic there. But there's been some very interesting trades there in recent years. And is very property specific. But there are some opportunities there that have been very interesting.

>> All right. And finally, John, no podcasts these days is complete without a quick discussion on ESG, that is Environmental Social Governance issues. You referred to it earlier in your opening comments. I know we take it very seriously at PGIM Fixed Income. We actually have an ESG score on every single bond we own, even securitized products. How do you rate securitized products on an ESG basis? How do you think about it?

>> Yeah. Thanks for asking the question, Mike. So, we're, you know, philosophically I think this is something that is near and dear to our heart. So, you know, we've had for the third straight year an A rating from PRI for our securitized products approach to ESG. It's something we take very seriously. I think one of the great lessons of the financial crisis actually was the important of ESG to invest in successfully in the securitized space. So, you know, philosophically one of the core social principles that we try to adhere to is that whatever consumer receivable we're financing via the securitization that financial product, that receivable needs to be serving the interest of the consumer, and not just serving interests of us as the investor, or serving the interest of the issuer or the sponsor. And if you think about, you know, the financial crisis, you know, in retrospect many of those products that were at the forefront of precipitating that crisis, whether it was subprime mortgages or optional arms, you know, most notably I think you say today they were probably inappropriate financial products we offer to consumer. And what that ultimately led to was, you know, not just the default cycle, but also a public policy response that ultimately ended up being, you know, really unfortunate and adverse to investor interest as well, right? So effectively the aggregation of the contractual rights of investors, you know, to foreclose and service the assets, you know, in their interests. And so, we think it's really important from a social perspective to go up and perform due diligence on the issuers, and understand how they are originating the assets, how are they making sure the borrower has the wherewithal to actually pay back those loans. And also understand how they are servicing the assets. Does the borrower have a single point of contact? What is that ripe party contact? What does script look like when they're servicing the asset? So, we know what the borrower's experience is. And I think history has shown that, you know, a financial product that doesn't serve the borrowers has really adverse outcomes, not just from default but also, you know, the official response, the public policy response can be really adverse. So that's the social piece of it. I think governance piece is also worth talking about, if you will indulge me a little bit more. You know, it's really unique for securitized assets, right? You know, unlike other risk assets, such as corporates, where the governance is a dynamic thing and you could potentially influence it, the, you know, the government for securitized products in many respects is a one-shot deal. You really have one shot to get it right. And that's why, you know, we had this large research team. They're really diligent about pouring over the legal documentation package, which comes with all of these securitizations. And whether it's the indenture or the pooling and servicing agreement, the prospectus supplement, or

other governing docs, you know, they're reviewing those. Because that really determines, you know, ultimately how robust these securitizations are from a governance perspective. And I'll give you a couple of examples, right? The FCA [phonetic], you know, announced going back in 2017, that they're going to cease compelling [inaudible] submissions at the end of 2021. And so immediately we had to weave into our process a process to make sure that we had the best fall back provisions when [inaudible] goes away so that we could fall back to a different floating rate index. And, you know, similarly, amendment language is something we pay a lot of attention to. So, you know, there can be conflicts in securitizations between different tranches, and what's in the interest of a senior lender versus a more subordinate lender. And so, we have to make sure the amendment language that's in there doesn't allow people to amend the contracts in a way that would be adverse to our interests. And so, all of these things have to be negotiated. And they typically have to be negotiated upfront.

>> Well, that's really impressive, John, that ESG's spin on securitized products. I actually learned a lot from that discussion. And congratulations on achieving that A rating from PRI. I think that's really impressive. So, let's end it there. John, thank you very much. Great discussion. A lot to talk about. We could go on for hours. Obviously, this is a very top subject, top-of-mind subject for a lot of our clients. I hope everybody enjoyed it. And I just want to remind all of our listeners that we actually just rolled out a new version of our website, which is pgimfixedincome.com. It's much more high-tech, you know, fancy with all kinds of bells and whistles. It's really seamless, easier to use. We're really proud of it. So please, please take a look at that. And thank you, everybody, for listening to All the Credit.

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