



Is now the right time to consider diversifying into securitised credit?

Date: May 2025

Author: Chris Whitcombe

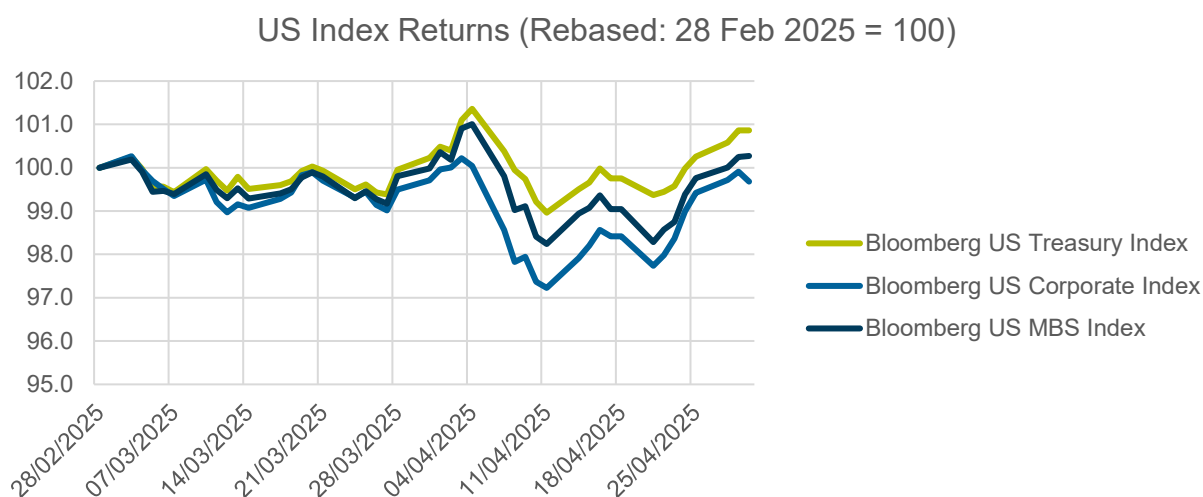
Challenger Investment Management

Given current market volatility and downside risks to credit spreads, is now the right time to consider diversifying into securitised credit?

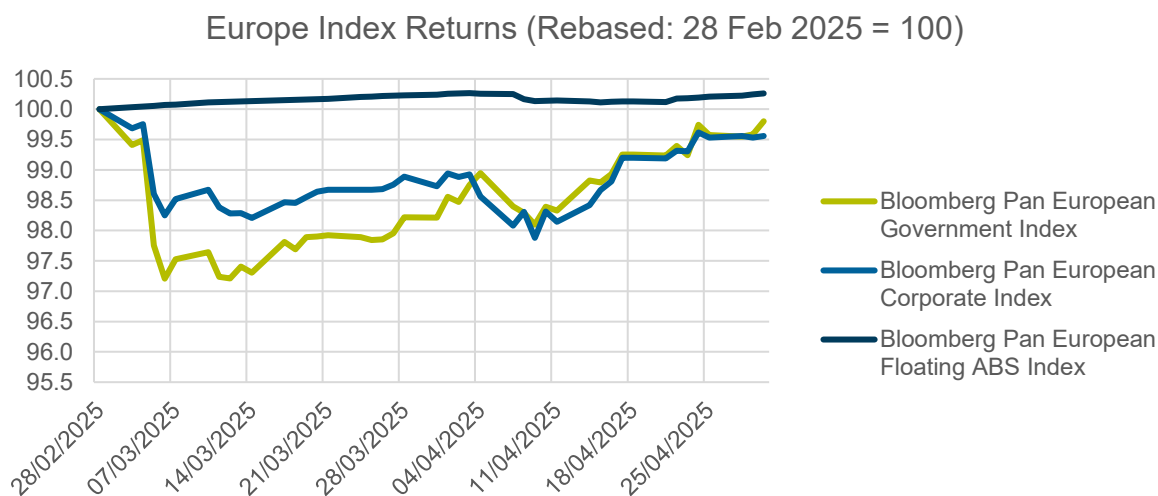
Market volatility has been high during March and April

With credit spreads towards post GFC tight across sectors at the end of February, markets have proved particularly volatile during March and April with the impact of the “Liberation Day” tariff announcements. Credit spreads widened slightly in March in the run up to the announcements, while there were sharp falls in European government bonds on the back of German plans to loosen fiscal rules. April saw sharper moves wider credit spreads as the Tariff announcements were harsher than market participants expected. Following the 90day pause in implementation for most tariffs, spreads rebounded during the month to post positive returns during April, despite the concerns around economic and credit outlook, and the potential for a continued volatile near term environment.

In securitised credit, volatility was lower than corporate credit given lower credit spread duration and higher average ratings. This was further dampened in European (and Australian) securitised credit by the low exposure to rate volatility as assets are predominantly floating rate.



Source: Bloomberg, 30 April 2025



Source: Bloomberg, 30 April 2025

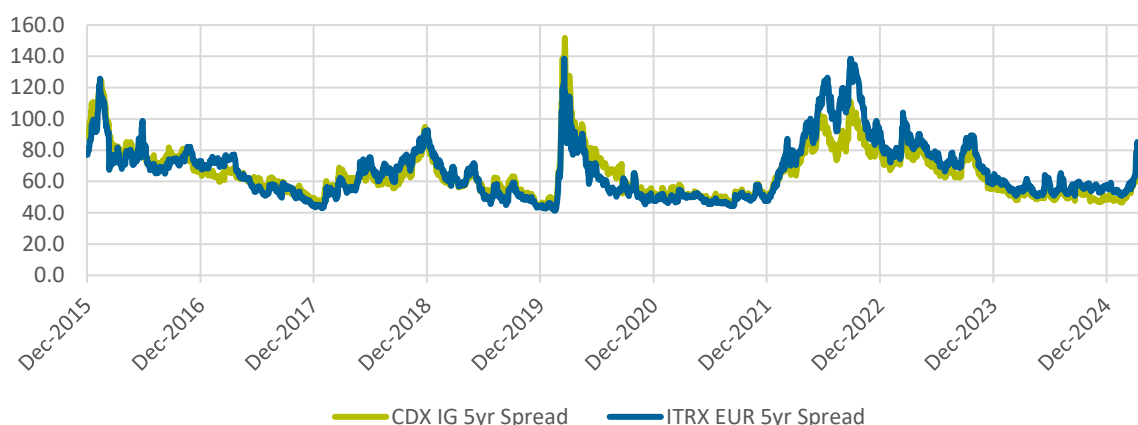
March and April have again shown the benefit of floating rate securitised assets naturally having lower market volatility through not being directly exposed to material interest rate risk. Although the best demonstration of this in recent years was the LDI crisis in 2022. Securitised products provided a great source of liquidity for UK LDI strategies given the relatively low price discounts to par compared to alternative government and corporate bond sale candidates following the steep shift in interest rate curve following the UK budget.

Compensation for the credit component is low versus historic levels

Focusing on IG corporate credit specifically, the compensation for bearing credit risk – as measured by credit spreads – started 2025 towards historically low levels. The spread widening seen in March and April took spreads to higher levels than seen throughout 2024, but spreads have since retraced nearly all of that widening by mid May.

Even if positive on credit fundamentals, or at least understanding that periods of stable/low spreads can persist, the risk vs. return trade-off is now asymmetrically poor for long credit duration, offering limited upside from potential further spread compression vs the risk of large downside in adverse scenarios.

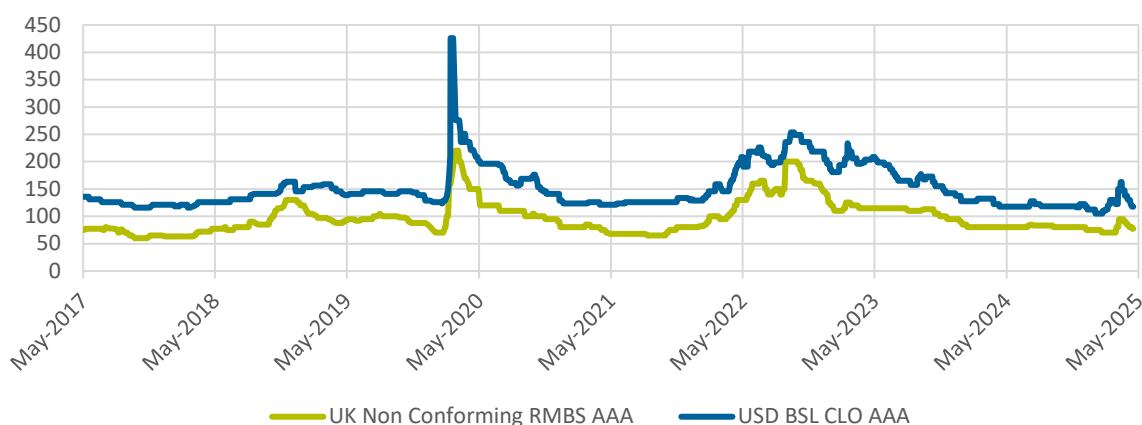
Credit Index Spreads



Source: Bloomberg, 16 May 2025

A similar situation is seen in securitised products, with both RMBS and CLO spreads towards the tight end of historical levels.

RMBS/CLO AAA spreads



Source: Citi, 16 May 2025

Characteristics of securitised assets contributing to reduced volatility

There are a couple of key characteristics that securitised assets have that can reduce price volatility for these assets compared to typical corporate credit exposures:

1. Credit duration of new issue ABS investments is typically significantly lower than that of corporate credit, reflecting shorter expected credit widows for these assets, and reducing price volatility for similar spread moves
2. European (and Australian) securitised assets are also predominantly floating rate, reducing volatility due to low interest rate exposure.

In a more volatile market environment, having these features can dampen volatility across a fixed income portfolio.

Some key high level differences between benchmark US and European corporate and securitised indices are shown below, highlighting the higher interest rate duration and credit spread duration typically seen in corporate credit:

Index	Bloomberg US Corporate Bond Index	Bloomberg US MBS Index	Bloomberg Pan-European Aggregate: Corporate	Bloomberg Pan European Floating ABS Bond Index
Currency	USD	USD	EUR	EUR
Yield (%)	5.1	4.9	3.4	2.9
Credit spread over swaps (bps)	156	97	106	72
Interest rate duration	5.8	6.0	4.6	0.1
Credit spread duration	5.8	5.6	4.8	2.2
Average rating (S&P equivalent)	A-/BBB+	AA+	A-/BBB+	AA+

Source: Bloomberg 30 April 2025

Credit spread pick up shown above is higher for corporate credit but the lower ratings should be noted. Credit spreads for equivalent rated securitised credit are significantly higher at the same rating level. So a greater spread pick up in securitised products could be achieved, without a substantial increase in credit duration, by adding mezzanine exposure rather than focusing on senior securitised as shown in the below table:

UK Non Conforming RMBS (indicative levels)					
Rating	AAA	AA	A	BBB	BB
Yield (%)	5.3	5.9	6.3	6.7	8.3
Credit spread over swaps (bps)	85	140	180	220	380
Interest rate duration	0.1	0.1	0.1	0.1	0.1
Credit spread duration	2.5	3.5	3.5	3.5	3.5

Source: Challenger IM, 30 April 2025

Conclusion

In conclusion, for investors focusing on reducing credit duration and potential market volatility in the current environment, while still maintaining accretive spreads, securitised credit remains a valuable tool for downside volatility management in portfolio construction. Securitised products are often highlighted as a higher risk asset class although their performance in these spells of volatility continues to highlight their defensive nature.

Contact Us

E: FidanteEuropeSales@fidante.com

W: challengerim.com.au



Important Information

This material has been prepared by Challenger Investment Partners Limited (Challenger Investment Management or Challenger), ABN 29 092 382 842, AFSL 329 828.

This document does not relate to any financial or investment product or service and does not constitute or form part of any offer to sell, or any solicitation of any offer to subscribe or interests and the information provided is intended to be general in nature only. This should not form the basis of, or be relied upon for the purpose of, any investment decision. This document is not available to retail investors as defined under local laws.

This document has been prepared without taking into account any person's objectives, financial situation or needs. Any person receiving the information in this document should consider the appropriateness of the information, in light of their own objectives, financial situation or needs before acting.

This document is provided to you on the basis that it should not be relied upon for any purpose other than information and discussion. The document has not been independently verified. No reliance may be placed for any purpose on the document or its accuracy, fairness, correctness, or completeness. Neither Challenger Investment Management nor any of its related bodies corporates, associates and employees shall have any liability whatsoever (in negligence or otherwise) for any loss howsoever arising from any use of the document or otherwise in connection with the presentation.