



## Structured Credit: Seeing the Forest for the Trees

**Though only introduced a few decades ago, structured credit has evolved into one of the largest segments of the US fixed income market.**

Structured credit typically refers to the process by which groups of similar, income-generating assets are pooled together into marketable fixed income securities. The assets comprising these pools may include traditional debt instruments (like residential mortgages and corporate loans), more esoteric cash streams (like airplane leases and music licensing revenues) or derivatives contracts (like swaps and options).

From a macroeconomic perspective, the securitization process effectively transfers the risk of a large amount of mostly illiquid debt from the original provider of capital—typically, banks or specialty finance companies—to investors, providing the seller with term, non-recourse financing while also increasing the supply of credit in the system and promoting broader price discovery. For investors, structured credit offers the potential for higher returns, portfolio diversification and tailored credit-risk exposure.

While certain risks typical of structured credit—such as complexity, illiquidity and volatility—suggest a yield premium over traditional credit investments is warranted, we believe other factors also may play a role. Perhaps most notable among these is what we view as a persistent disconnect between the ratings assigned to the structured products and their realized default rate. By consistently applying more punitive criteria to the evaluation of structured credit investments compared to traditional corporate or consumer debt, rating agencies historically have created durable opportunities for investors experienced in the asset class to harvest meaningful incremental yield with manageable incremental risk. Given the attractive risk-adjusted returns structured credit has generated over time, we believe the asset class may represent a compelling strategic allocation for many long-term portfolios, as appropriate.

### KEY TAKEAWAYS

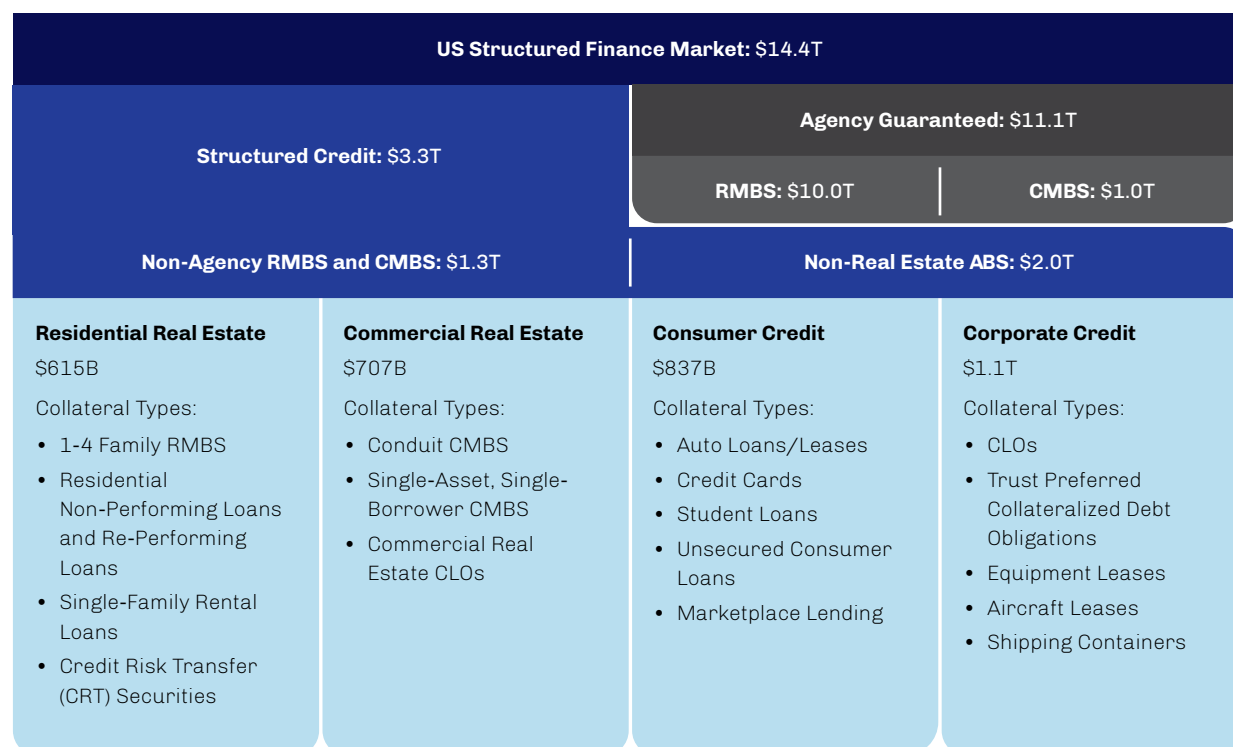
- Structured credit historically has offered investors the potential for attractive risk-adjusted returns, diversification benefits and bespoke credit-risk exposure over multiple cycles. The assets may be particularly appealing currently in light of today's high base interest rates and the attractive spreads offered by certain product types.
- Despite lower credit default rates, structured credit historically has offered higher yields than similarly rated traditional fixed income products. Fundamental investors able to differentiate between an instrument's rating and its actual credit risk, in our view, may take advantage of agency mis-ratings to seek incremental income.
- In our experience, the ability to analyze, value and actively manage structured credit assets is key to accessing the durable incremental returns offered by this asset class. First Eagle's Napier Park unit has a team of professionals who have been actively managing structured credit risk and investment for over 30 years.

## A Large and Diverse Asset Class

Structured credit instruments most commonly start with the bundling of income-producing credit assets and subsequent issuance of multiple debt securities collateralized by their cash flows. Also gaining popularity in recent decades have been synthetic structures in which a basket of derivative contracts (like credit default swaps, or CDS) are grouped together and issued as an exchange-traded security (the credit default swap index, or CDX). Claims on these cash flows or derivative payments are divided into tranches that stratify credit risk based on seniority, providing investors the opportunity to target a range of risk/return profiles. Investors higher in the capital structure have a priority claim on the asset pool's cash flows and receive a relatively lower yield as a result, while those further down in the structure are most susceptible to impairments and defaults but also receive greater compensation for these risks. In addition to multiple debt tranches, securitizations typically include a first-loss equity tranche—often owned in part by the originator to promote an alignment of interests—that has a claim on all residual cash flows once interest and principal is paid in full to debtholders.

The market for structured credit is vast and varied. As of June 2024, structured credit outstanding in the US alone amounted to over \$14 trillion across a range of instruments and backed by a variety of collateral; this represents about 25% of all debt outstanding in the US, second only to Treasuries.<sup>1</sup> Highlighted in shades of blue in Exhibit 1, the nearly \$3.3 trillion of securitized debt outstanding in the non-agency-guaranteed structured credit market is divided between securities backed by loans on real estate (both residential and commercial) and those backed by other forms of consumer and corporate credit. Collateralized loan obligations (CLOs), which are backed by pools of broadly syndicated corporate loans, and asset-backed securities (ABS), backed by consumer debt such as student loans and credit card balances, are the most prominent forms of the latter category. But more esoteric products also are available, with cash flows backed by everything from aircraft and shipping containers leases to music royalties (aka “Bowie Bonds” in honor of the first musician to participate in such a securitization).

### Exhibit 1. Structured Credit Is a Large and Diverse Subset of the US Bond Market



Source: BofA Global Research; data as of June 30, 2024.

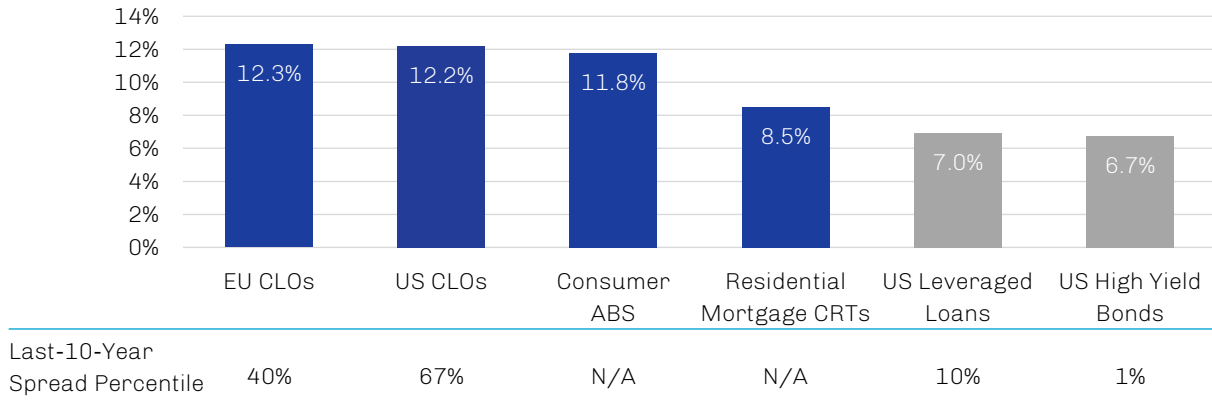
The growth in structured credit since its emergence in the 1980s should not come as a surprise. For banks and other originators, securitization provides a conduit through which they can manage credit risk and serves as an

1. Source: BofA Global Research; data as of June 30, 2024.

efficient alternative source of term, nonrecourse financing for a wide range of commercial and consumer loans. For investors, structured credit offers a number of features potentially beneficial to diversified portfolios, not the least of which is an attractive risk-adjusted yield. As shown in Exhibit 2, yields on certain structured credit instruments appear quite appealing thanks to normalized base rates and attractive spreads.

### Exhibit 2. Structured Credit Markets Currently Offer Attractive Yields and Spreads

Illustrative Yields Across Non-Investment Grade Credit Markets



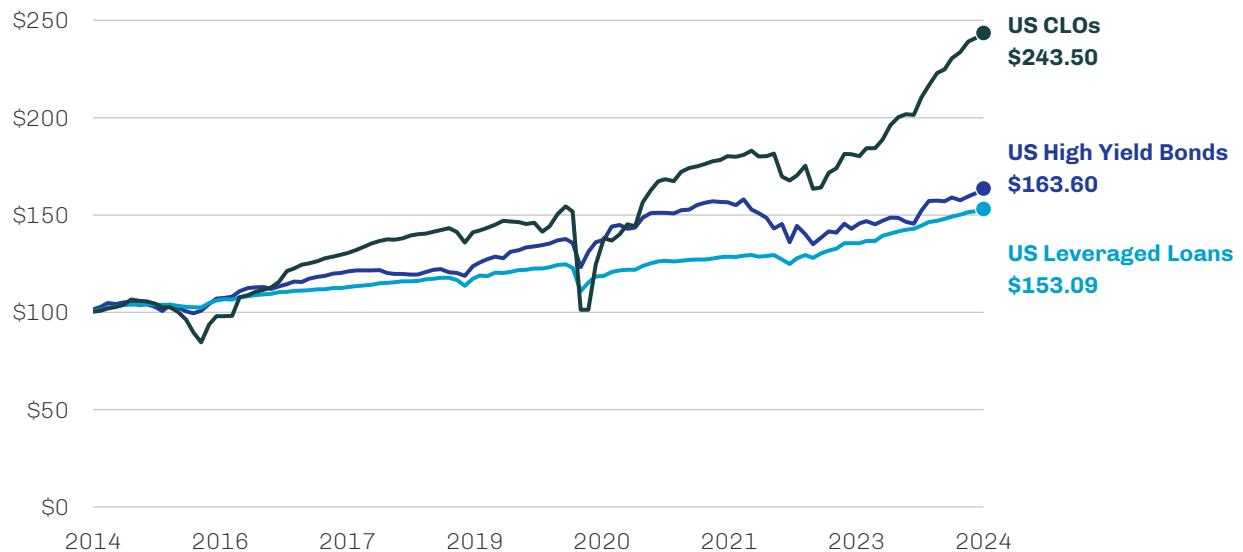
Note: EU CLOs = midpoint pricing levels of BB rated EU CLOs observed by the JPMorgan trading desk, with yield hedged to US dollar; US CLOs = BB rated US CLOs from PricingDirect; Consumer ABS = BB rated marketplace consumer loans of benchmark names (LendingClub, SoFi, etc.) observed by the JPMorgan trading desk; Residential Mortgage CRTs = Agency CRT B2s from PricingDirect; US Leveraged Loans = BB rated loans with pricing data from PricingDirect; US High Yield Bonds = BB rated bonds with pricing data from PricingDirect.

Source: JPMorgan; data as of June 10, 2024.

Historical total returns have been compelling as well. Exhibit 3 illustrates the cumulative growth of selected assets over the past 10 years, a period during which structured credit (as represented by BB rated US CLOs) more than doubled the performance of BB rated high yield bonds and leveraged loans—and highlighted that all ratings are not necessarily equal.

### Exhibit 3. Structured Credit Has Delivered a Compelling Cumulative Return over the Past 10 Years

Growth of \$100, July 2014 through July 2024



Note: US CLOs = BB rated subindex of the JPMorgan Collateralized Loan Obligation Index (CLOIE); US High Yield Bonds = Bloomberg US Corporate High Yield Index; US Leveraged Loans = Return from Pitchbook | LCD. Please refer to Index disclaimer at the end of document.

Source: JPMorgan, Pitchbook | LCD, Bloomberg; data as of July 31, 2024.

**PAST PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS. ACTUAL RESULTS MAY VARY.**

## Yield Premia of Structured Credit Belies a Track Record of Limited Defaults

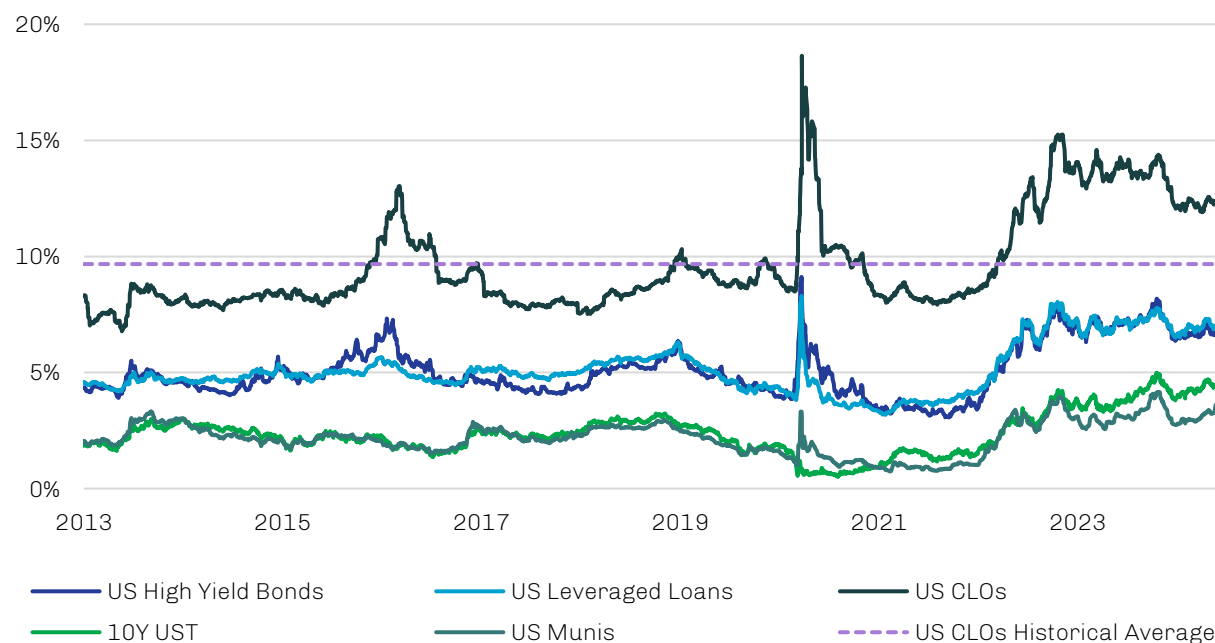
Though the yield differential between structured and traditional credit currently is wider than typical, the existence of such a gap is far from novel; as shown in Exhibit 4, structured credit instruments historically have offered an attractive yield pickup relative to traditional fixed income investments. While there are a number of valid reasons for the structured credit premium—including greater complexity, reduced liquidity and pronounced price volatility, as we'll discuss—greater credit risk is not one of them.

In fact, as depicted in Exhibit 5, certain structured products historically have realized significantly lower defaults than their like-rated traditional counterparts—including, in many cases, none at all. Even among non-investment grade tranches, the difference is stark; the 16.4% default rate on BB rated corporate bonds is about seven times greater than the 2.2% default rate of BB rated CLOs and infinitely greater than zero-default ABS of the same rating. The fact that corporate bonds pay a significantly lower yield despite much higher levels of historical default suggests to us a persistent mis-rating of structured credit by the ratings agencies—one that has promoted an ongoing yield premium in the markets and a potential corresponding opportunity for investors experienced in the space to generate attractive risk-adjusted returns over the long term.

Structured credit instruments historically have offered an attractive yield pickup relative to traditional fixed income investments, with fewer defaults.

### Exhibit 4. Structured Credit Historically Has Offered Higher Yields than Traditional Fixed Income and Corporate Debt Investments...

Yields of Select Fixed Income Sectors, January 2013 through June 2024



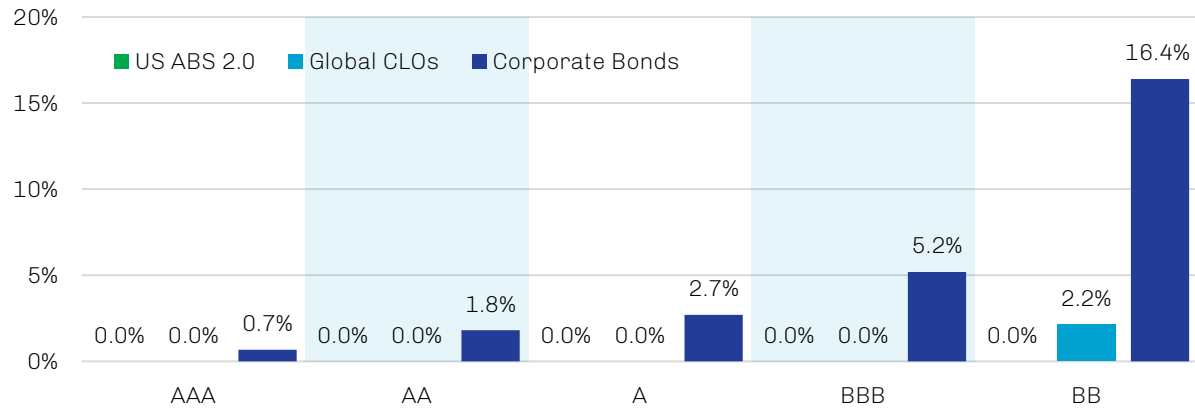
Note: 10Y UST = 10-Year US Treasury Bond; US Munis = Bloomberg 10-Year Municipal Bond Index; US High Yield Bonds = JPMorgan High Yield BB Index; US Leveraged Loans = JPMorgan Leveraged Loan BB Index; US CLOs = BB rated CLO spreads from PricingDirect plus five-year US Treasury yields. Refer to Disclaimer for index information at the end of the document.

Source: JPMorgan, Bloomberg; data as of June 26, 2024.

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## Exhibit 5. ...Despite Meaningfully Lower Default Rates

Cumulative 10-Year Impairment/Default Rate by Original Rating



Note: US ABS 2.0 and Global CLOs reflect originations over 2009–22 (i.e., after the global financial crisis) and are not adjusted for issuers whose ratings were withdrawn. US ABS 2.0 data exclude home equity loans. Corporate bonds data reflect issuer-weighted defaults over 1920–2022.

Source: BofA Global Research, Moody's Investors Services; data as of June 30, 2023.

The ratings scales employed by S&P Global Ratings, Moody's Investors Services and others are intended to be comparable across issuers; that is to say, a BBB rated CLO is considered as capable and willing to meet its financial commitments as a BBB rated corporate or BBB sovereign bond. Referring back to the default rates depicted in Exhibit 5, however, it seems ratings agencies have been more conservative in assigning ratings to structured credits than they have been with generic credit instruments. In our opinion, one could argue that the BB rated cohorts of ABS and CLOs depicted in the chart likely were deserving of investment grade ratings given realized default rates less than that of both BBB and A rated corporates. We believe investors able to differentiate between an instrument's rating and its actual credit risk through detailed underwriting of the underlying collateral and vigorous structural analysis may take advantage of agency mis-ratings to seek incremental income.

Though often collateralized by the cash flows of the non-investment grade and unrated debt that comprise their reference pools, structured credit securities are issued with ratings across the spectrum, including investment grade (AAA to BBB). There are several key—and, in our view, generally underappreciated—elements in these securities' design that contribute to this transformation and have been factors behind their lower default rates.

**Diversification.** By design, each structured credit security is backed by a pool of hundreds or even thousands of individual credits, spreading out the risk of any single default. We believe such broad diversification helps cushion the impact of potential losses, assuming the underlying assets are somewhat independent of each other.

**Subordination.** As noted earlier, cash flows from the collateral pool are divided into different levels of priority, with senior tranches receiving payments before junior ones. This "waterfall" structure means that junior tranches are the first to absorb losses in case of defaults, while senior tranches have a larger cushion.

**Overcollateralization.** Typically, the value of the underlying pool of assets exceeds the debt issued by the securitization, which serves as a cushion for investors. Regular checks are also conducted to ensure this cushion remains sufficient, and a failure to meet minimum levels may result in cash flows being redirected to more senior securities from junior ones.

**Excess spread.** Structured credit products usually are designed such that the income generated by the assets exceeds the obligations to debtholders. This surplus (aka excess spread) serves as another buffer against defaults. While often distributed to equity investors, it can be diverted in support of the debt tranches if necessary.

**Amortization.** Many structured assets benefit from amortization through the distribution of excess spread during the life of the securitization. This results in a steady reduction of exposure and leverage, which can lead to credit rating upgrades for the issue's mezzanine bonds as its senior debt is retired.

## Guilt by Association

So if credit risk isn't driving the yield differential between structured credit and traditional corporate bonds and loans, what is? While there are a number of concrete reasons why investors might demand additional compensation for investing in a structured credit product, as we will discuss below, we can't help but think the reputation of these acronymic products has been tarnished by their perceived association with the global financial crisis.

The swiftly growing popularity of structured credit during the early 2000s may have proved a double-edged sword for the instruments. While the ability to decouple lending from risk inspired considerable innovation and the development of new and useful financial instruments, it also fostered an environment of lax oversight, deteriorating underwriting standards and the mis-assessment of risk—factors that many believe helped stoke the global financial crisis. Certain types of structured assets that emerged in this period were consigned to history just as fast they were created; this included products that purchased and re-securitized the lower-rated tranches of outstanding subprime mortgage-backed securities, which are often identified as being among the key archetypes of the crisis.<sup>2</sup> Others, however, like CLOs, performed very well when held to maturity even while displaying extreme interim price volatility. And while the post-crisis regulatory overhaul—most notably through provisions within the Dodd-Frank Act of 2010—further bolstered investor safeguards embedded in structured assets, many market participants, both investors and ratings agencies, continue to approach all structured credits with trepidation. (See text box below for more information.)

### CLOs ≠ CDOs

It's perhaps not surprising that investors less familiar with the space can get lost amidst the alphabet soup of products that comprise the structured credit landscape. One unfortunate byproduct of this tendency is the potential conflation of fundamentally different products, including collateralized loan obligations (CLOs) and collateralized debt obligations (CDOs). Though their names are differentiated by only one word, the vast practical differences between CLOs and the CDOs are widely attributed as ground zero of the global financial crisis.

CLOs are backed predominantly by pools of first-lien, senior-secured syndicated bank loans, a mature, well-regulated asset class whose breadth supports the construction of broadly diversified CLO portfolios. Experienced CLO investors can perform detailed credit analyses on individual underlying loans in the portfolio. CLOs provide extensive diversification by name and industry and historically have rarely suffered extreme correlation events. CLOs are also actively managed, providing an additional layer of oversight and adaptability. As a result of these features, CLOs have exhibited relatively low default rates; notably, not a single AAA or AA rated CLO tranche issued between 1993 and 2022 defaulted.<sup>3</sup>

In contrast, CDOs consist of various forms of consumer debt organized into blind pools, denying potential investors of granular detail on the thousands of underlying assets. The trouble in CDOs began in the mid-1990s when creative bankers began to pool BBB rated subprime mortgage-backed securities into new CDOs. Though these new CDOs were structured such that certain tranches carried investment grade ratings, the high correlation of the underlying assets ultimately led to defaults that resonated throughout the liability structure, including AAA paper. Because of this, ratings agencies were among those assigned blame for the financial crisis—one report referred to them as “essential cogs in the wheel of financial destruction”—which may explain the subsequent conservatism the agencies appear to have applied when rating structured credit in the years that followed.<sup>4</sup>

2, 4. United States Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States* (2011).

3. Source: Moody's Investors Service; data as of June 26, 2023.

This is not to say there aren't a number of risks that are more pronounced in a structured credit product relative to a similarly rated bond or loan. These risks are the primary source of incremental return, and experienced investors can seek to manage them as part of an active portfolio strategy. Perhaps most notable among the risks of structured credit are complexity and illiquidity.

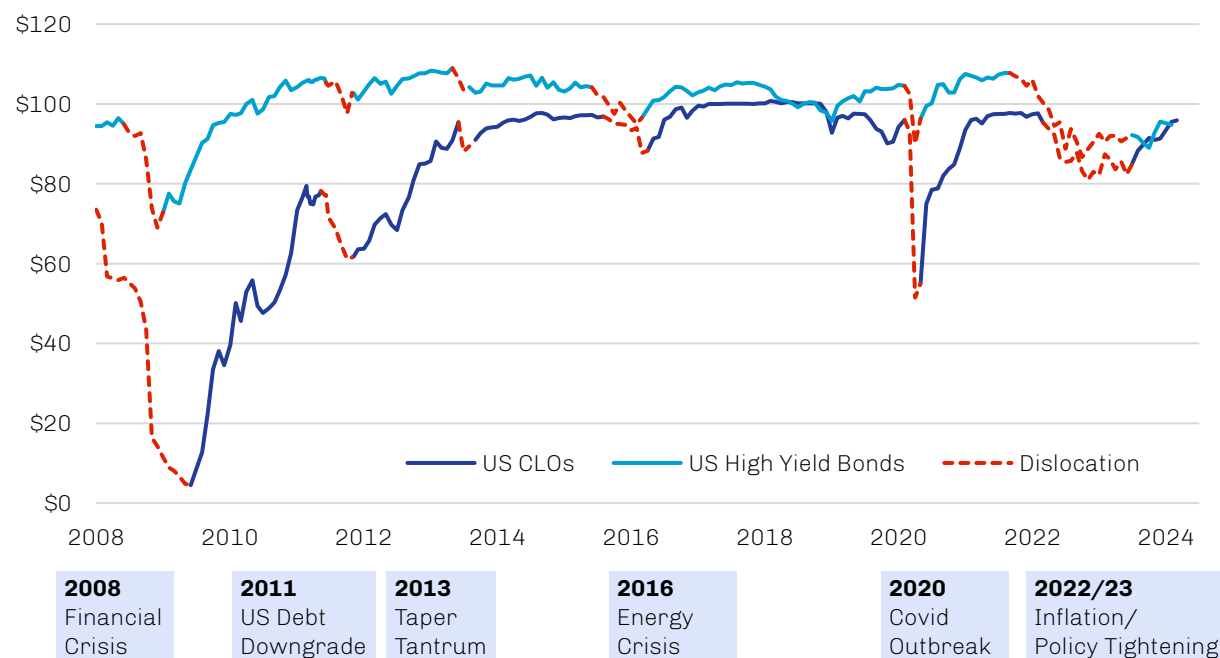
**Complexity.** While the structural characteristics described earlier in this paper have helped support the strong performance of these assets over time, they also introduce a level of complexity that many investors find daunting. A structured credit product comprised of hundreds or even thousands of individual collateral assets and subject to a range of idiosyncratic deal terms and contractual obligations is far more difficult to appraise than the generic bond of a single corporate issuer. The required investment of time, resources and technology, not to mention the necessary real-world expertise needed to invest successfully, serves as a hurdle for many institutional investors and constrains the buyer base for structured credit despite the large size of these markets.

**Liquidity.** With an active investor base already narrowed by the inherent complexity of structured products, particularly for non-investment grade or mezzanine issuance, liquidity has been further impaired by regulatory changes following the global financial crisis that forced banks to curtail their market-making activities. Of course, these rules have not been limited to structured credit, and trading activity across fixed income markets at the onset of the Covid-19 pandemic in 2020 serves as a good example of how even assets viewed as conservative can be impacted by liquidity concerns when turmoil strikes.

Illiquidity in any asset tends to amplify its price movements to both the upside and downside. While the volatility in structured credit can be disquieting for some investors in challenging markets, it historically has proven transitory. Not only has the impairment of principal in structured credit been infrequent, but market price dislocations often have also been followed by meaningful recoveries. While drawdowns in structured credit assets in response to macroeconomic events over the past 15-plus years typically have been around double that of same-rated high yield bonds, as depicted in Exhibit 6, the recoveries have been far more substantial. We believe this price action creates periodic opportunities for active managers like ourselves to acquire assets at a discount and potentially generate alpha through active portfolio rotation.

### Exhibit 6. Structured Credit Prices Have Been Marked by Deep Selloffs and Furious Rebounds

Asset Prices, January 2008 through July 2024



Note: US CLOs = BB rated CLO prices from PricingDirect plus five-year US Treasury yields; US High Yield Bonds = Bloomberg High Yield BB Index.

Source: Citi, Bloomberg; data as of July 31, 2024.

## Incorporating Structured Credit into a Diversified Portfolio

Though a relatively new asset class compared to traditional fixed income assets, structured credit has become an integral part in the financial system, offering potential benefits for borrowers, lenders and investors alike. While the complexity of the structured credit opportunity set can be daunting to some, we believe experienced, research-driven managers are well-positioned to generate meaningful incremental yield with manageable incremental risk as well as key diversification benefits.

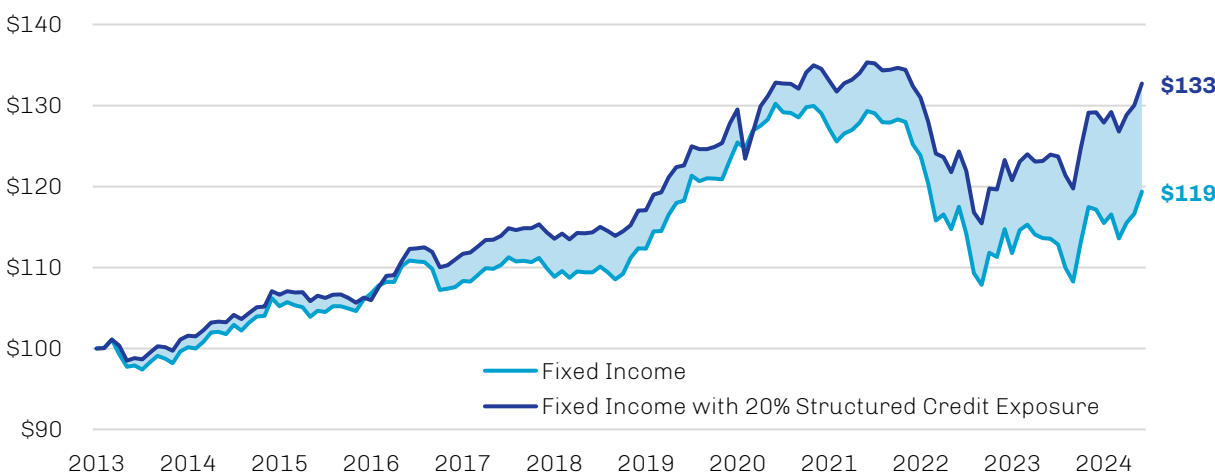
When it comes to asset allocation, there are multiple ways to position structured credit in a diversified portfolio.

**Fixed Income Plus.** We believe structured credit may represent a compelling option for portfolios seeking to enhance the return potential of their fixed income bucket without potentially adding significant marginal risk. Not only has structured credit historically offered higher yields than traditional fixed income assets, the credit exposures underlying these securities—which as we noted earlier includes everything from consumer and commercial mortgages to consumer credit and more esoteric corporate cash flows—provide an avenue to diversify the interest rate and corporate risk that dominates traditional fixed income portfolios.

To illustrate how this might work in practice, consider a hypothetical pension fund seeking to enhance the returns of its fixed income bucket by apportioning 20% of its fixed income allocation to investment grade structured credit. The example depicted in Exhibit 7 demonstrates a 74% improvement in cumulative returns over the 10-year-plus period.

### Exhibit 7. An Allocation to Structured Credit May Meaningfully Enhance the Performance of a Fixed Income Portfolio

Growth of \$100, January 2013 through July 2024



Note: Fixed Income = Bloomberg US Aggregate Bond Index; Structured Credit = JPMorgan Collateralized Loan Obligation BBB Index.

Source: Bloomberg, JPMorgan; data as of July 31, 2024.

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**Opportunistic Credit.** Structured credit can be an attractive complement to traditional sponsor-backed direct lending exposure for certain investors, as appropriate. Access to a diversified range of credit assets with a track record of high returns—both private and public—provides the flexibility to rotate among credit sectors opportunistically in response to changing market conditions, giving portfolios the potential to generate return profiles that may not be available to either direct lending or structured credit alone.

**Absolute Return.** A portfolio's absolute return bucket typically seeks to leverage manager skill to generate positive returns over time across different market conditions. As noted earlier, the relative illiquidity of many structured credit markets often provides potential opportunities for skilled managers to capitalize on mispricings and structural inefficiencies among performing credit assets and generate total returns in excess of the yields of the underlying assets through active rotation. Moreover, the design elements of structured credit may help mitigate credit losses during challenging periods and thus promote higher rates of capital appreciation over the long term.



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**Past performance is not indicative of future results.**

## Risk Disclosures

All investments involve the risk of loss of principal.

Diversification does not guarantee investment returns and does not eliminate the risk of loss.

Alternative investments can be speculative and are not suitable for all investors. Investing in alternative investments is only intended for experienced and sophisticated investors who are willing and able to bear the high economic risks associated with such an investment. Investors should carefully review and consider potential risks before investing. Certain of these risks include:

- Loss of all or a substantial portion of the investment;
- Lack of liquidity in that there may be no secondary market or interest in the strategy and none is expected to develop;
- Volatility of returns;
- Interest rate risk;
- Restrictions on transferring interests in a private investment strategy;
- Potential lack of diversification and resulting higher risk due to concentration within one or more sectors, industries, countries or regions;
- Absence of information regarding valuations and pricing;
- Complex tax structures and delays in tax reporting;
- Less regulation and higher fees than mutual funds;
- Use of leverage, which magnifies the potential for gain or loss on amounts invested and is generally considered a speculative investment technique and increases the risks associated with investing in the strategy;
- Below investment grade loans, which may default and adversely affect returns.

## Definitions

**Alpha** is the excess return of an investment relative to a comparative market index or other broad benchmark.

**Asset-backed securities (ABSs)** are securitizations backed by cash flows from pools of income-generating credit assets, such as auto loans, credit-card receivables and student loans.

**Broadly syndicated loans** are a form of corporate financing provided by a group of lenders.

**Collateralized debt obligations (CDOs)** are securitizations backed by cash flows from pools of bonds, loans or other securitizations.

**Collateralized loan obligations (CLOs)** are securitizations backed by cash flows from pools of corporate loans, most commonly broadly syndicated loans.

**Commercial mortgage-backed securities (CMBS)** are securitizations backed by cash flows from pools of mortgages on commercial properties.

**Credit-default swaps (CDS)** are derivative contracts that transfer the default risk of a particular fixed income security from the swap buyer to the seller in exchange for a fee.

**Credit-default swap indexes (CDX)** are tradable baskets of single-name credit-default swaps.

A **credit rating** as represented here is an assessment provided by a nationally recognized statistical rating organization (NRSRO) of credit worthiness of an issuer with respect to debt obligations, including specific securities, money market instruments or other bonds. Ratings are measured on a scale that generally ranges from AAA (highest) to D (lowest); ratings are subject to change without notice. Not Rated (NR) indicates that the debtor was not rated and should not be interpreted as indicating low quality.

**Credit-risk transfer (CRT) securities** are synthetic securitizations that reference the credit risk of a designated group of mortgage loans guaranteed by Fannie Mae and Freddie Mac.

**Residential mortgage-backed securities (RMBS)** are securitizations backed by cash flows from pools of mortgages on residential properties.

A **tranche** is a portion of a security issue with its own unique risk/reward characteristics and credit rating.

Indexes are presented merely to show general trends in the markets for the periods presented and are not intended to imply that any fund is comparable to any index in composition or element of risk. Indexes are provided for comparison purposes only and a variety of factors may cause a benchmark to be an inaccurate benchmark for a particular fund. Investors cannot invest directly in an index.

**Bloomberg 10-Year Municipal Bond Index** measures the US municipal tax-exempt investment grade bond market with maturities of 10 years.

**Bloomberg US Corporate High Yield Index** measures the US dollar-denominated, high yield, fixed-rate corporate bond market.

**Bloomberg US High Yield BB Index** is a subindex of the Bloomberg US Corporate High Yield Index that measures the performance of bonds rated BB.

**JPMorgan Collateralized Loan Obligation Index** is an unmanaged index that measures the performance of US dollar-denominated cash, arbitrage floating-rate collateralized loan obligations backed by broadly syndicated leveraged loans.

**JPMorgan Leveraged Loan Index** is designed to mirror the investable universe of the US dollar-denominated institutional leveraged loan market.

**JPMorgan Leveraged Loan BB Index** is a subindex of the JPMorgan Leveraged Loan Index consisting of loans rated BB.

**JPMorgan US High Yield Index** is designed to mirror the investable universe of the US high yield corporate debt market, including issues of US and Canadian domiciled issuers.

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