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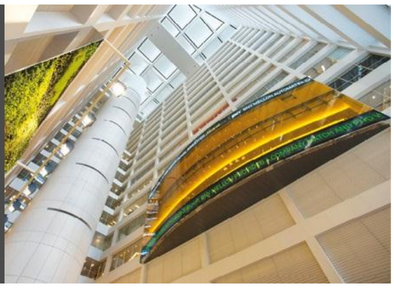

WHY IT'S TIME FOR INVESTORS TO STOP STRETCHING FOR YIELD

Investors don't necessarily have to climb the risk ladder during the hunt for yield in fixed income markets.

Liquidity is more fluid in secured finance than many assume and while it is still a buy-and-hold area of fixed income, access has improved with increased issuance, Insight Investment head of credit Alex Veroude says.

Marketplace lending securitisation volumes increased by almost 50% in 2015 to US$6.2bn, he says, noting this is comprised of US$3.5bn of consumer asset-backed securities (ABS), US$2.1bn of private student loan ABS and US$0.7bn of small business ABS. Approximately half of the market is investment grade and half un-rated, he adds.

While conventional corporate bonds aren't nearly as liquid as they once were following years of increased regulation, secured finance (assets financed through public securitisation markets or bilateral private loans) has been growing in size and trade volumes, he says. "Illiquid debt is hard to transfer but not impossible. We've been able to both buy and sell 'illiquid' debt" in the secondary market."

Veroude says investors shouldn't have to "stretch for yield" and in doing so move up the risk spectrum. He likens the current high yield market as one such example, noting defaults are likely to rise given the economic picture today and questioning whether the compensatory yields on offer in this space are sufficient. "Over the past decade there have been fewer high yield defaults than has historically been the case because of central bank intervention. If you think central banks will continue to bail out the system then sure, expect defaults to remain low. It all depends on what you think – will the next 10 years be better than the last or equal? Our thinking is that the next 10 years will not be too pretty."

Insight Investment believes there remain several risks to debt markets. Veroude says key among these risks are:

1) Changing demographics globally, leading to older working populations;

2) The growing anti-globalisation trend resulting in extremism in Europe and protectionist sentiment (eg "US jobs for US people");

3) Too much debt – for consumers and governments.

As to the last point, Veroude asks: "Can it be paid back? We believe it will either be inflated or defaulted away."

However, against this backdrop is the rising need of investors for income and consequently they are being pushed to take greater risks for yield. As an alternative, Veroude points to the increasingly popular secured finance area of the market. Here, he classifies assets such as commercial real estate loans, residential financing and asset backed securities, as being at the "lower risk" end of the securitised market. He adds: "Risk/reward opportunities here are compelling and additional reward can be accessed without sacrificing credit quality."

Insight believes exposure to this market could be increased but that diversification is important given the various "vintages" of private debt on offer today. For instance, at the end of the risk spectrum Insight believes to be lower, credit spreads can be lifted some 340bps over the 150bp spread on offer on the average BBB-rated investment grade corporate bond.

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