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The Evolution of Securitized Credit:

Why the Asset Class has become a Through-Cycle Allocation

Executive Summary

- As we approach the latter innings of the credit cycle, balancing the need for current growth with the risks that lie ahead is becoming the primary focus for many investors.
- Securitized credit has historically delivered higher yields than similarly rated corporate and municipal bonds.
- With floating rate instruments and embedded structural protections, securitized credit also has the potential to deliver attractive returns while providing the ballast portfolios need to weather future market turbulence.
- Despite these potential benefits, most investors remain significantly underexposed to securitized credit.

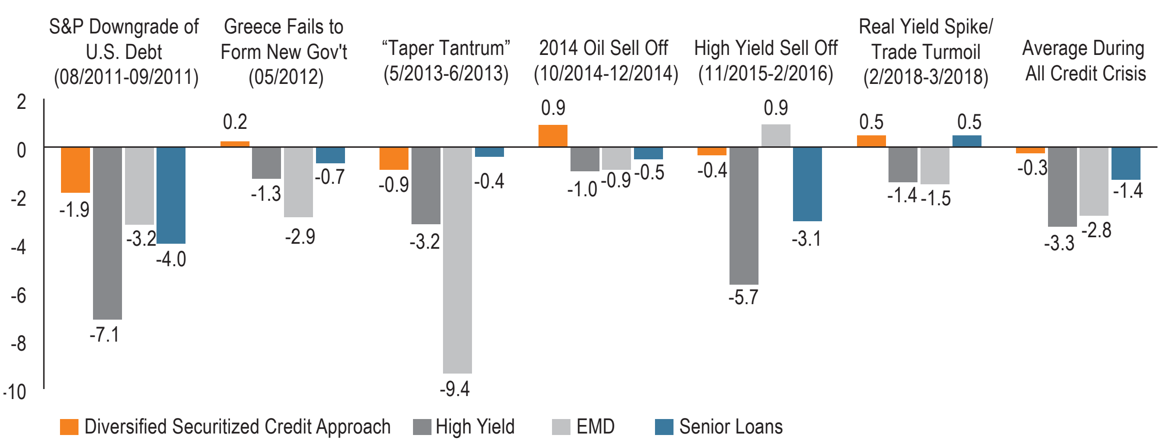
Securitized Credit: A Potential Remedy for Current Market Conditions

A gradual increase in risk-free rates and an expected tightening of credit spreads creates the potential for range-bound yields in the growth seeking fixed income allocations of plan sponsor portfolios. Facing this challenge, we believe plan sponsors need to expand the potential investment opportunity set to lean against this persistent market headwind and improve risk-adjusted returns.

However, expanding the search for attractive yield and total return potential in the latter innings of a credit cycle is especially difficult, as investors must balance the need for current growth with the risks that lie ahead.

Against this backdrop, we believe the current yield potential, floating-rate instruments and structural protections of securitized credit are particularly valuable. Yet despite these potential benefits, many institutional investors remain underexposed to securitized credit, preferring other spread sectors like high yield, senior loans and emerging market debt for standalone allocations within their broader fixed income portfolios. However, as Figure 1 shows, a broadly diversified securitized credit approach has significantly outperformed other spread sectors during major credit events in the last six years.

Figure 1. Historical Outperformance through Volatility: Securitized Credit versus Other Spread Sectors



Source: Voya Investment Management, J.P Morgan and Bloomberg Barclays. Diversified Securitized Credit approach based on Voya's Securitized Credit – Core Plus carve out composite. High yield = Bloomberg Barclays U.S. Corporate High Yield. EMD = JPMorgan EMBI Plus Index. Senior loans = the S&P/LSTA Leveraged Loan Index. **Past performance is no guarantee of future results.**

Figure 2. Securitized Credit: Historically Low Correlation to Broader Fixed Income Sectors and Individual Securitized Sub-Sectors

	S&P 500	Barclays Agg	EMD	High Yield	Securitized Credit	Senior Loans	Munis	Inv Grade Credit	MBS	CMBS	ABS	U.S. Gov	Securitized Benchmark
S&P 500	1												
Barclays Agg	-0.16	1											
EMD	0.41	0.56	1										
High Yield	0.73	0.20	0.64	1									
Securitized Credit	**0.34**	**0.23**	**0.33**	**0.53**	1								
Senior Loans	0.26	0.27	0.33	0.56	**0.26**	1							
Munis	-0.16	0.83	0.50	0.12	**0.30**	0.16	1						
Inv. Grade Corp.	0.14	0.87	0.67	0.55	**0.42**	0.42	0.70	1					
MBS	-0.15	0.91	0.54	0.13	**0.20**	0.18	0.78	0.71	1				
CMBS	0.24	0.72	0.59	0.51	**0.60**	0.30	0.61	0.80	0.62	1			
ABS	-0.27	0.85	0.44	0.06	**0.20**	0.36	0.74	0.66	0.79	0.63	1		
U.S. Gov	-0.41	0.93	0.34	-0.12	**0.03**	0.13	0.78	0.67	0.83	0.54	0.85	1	
Securitized Benchmark	-0.12	0.92	0.56	0.17	**0.24**	0.20	0.78	0.74	1.00	0.68	0.80	0.83	1

From 3/31/2011 – 3/31/2018. Source: Voya Investment Management and Bloomberg Barclays. Munis = BBGBarclays US Municipal Index. Inv. Grade Corp = BBGBarclays Corp Inv Grade Index. MBS = BBGBarclays MBS Index. CMBS = BBGBarclays CMBS Index. ABS = BBGBarclays ABS Index. U.S. Gov = BBGBarclays US Government Index. Securitized Benchmark = BBGBarclays Securitized. Diversified Securitized Credit approach based on Voya's Securitized Credit – Core Plus carve out composite.

In addition to this relatively attractive historical downside protection, a broadly diversified securitized credit strategy has delivered historically low correlation to other fixed income sectors, as well as low correlation to the individual securitized sub-sectors (Figure 2). As the asset class continues its evolution into a significant component of the global economy, we believe it is time for investors to rethink how they use securitized credit in broader portfolio strategy.

Time for Change: Common Applications of Securitized Fixed Income are too Narrow

While securitized credit has become an increasingly important component of multi-sector strategies like core and core plus fixed income, standalone exposure to the asset class has not been broadly adopted by the investment and consultant community as it has with other spread sectors like EMD, high yield and senior loans.

The small subset of investors who have embraced standalone securitized allocations have tended to favor the opportunistic niche strategies that emerged to capitalize on the extreme market dislocation created by the financial crisis. In the years that followed the financial crisis, each sub-sector of the securitized credit market significantly outperformed through the market recovery — where and what you invested in made little difference. This environment led to outsized returns for many of these opportunistic hedge funds. However, many of these alternative securitized strategies are concentrated in just one segment of the securitized market.

When that niche opportunity ultimately becomes less attractive, these concentrated strategies looking to deploy cash could be driven down one of two paths – they can continue allocating to their original opportunity set albeit in a much less attractive environment or pivot into areas of the market where the manager lacks expertise. This is a potential scenario that could lead to unexpected outcomes and underperformance for investors who enjoyed such strong returns in past years.

Perhaps most commonly, investors gain exposure to securitized fixed income via their core and core plus fixed income portfolios. However, the dominant securitized sector in most core and core plus strategies is agency residential mortgage-backed securities (RMBS), which accounts for more than a quarter of the Bloomberg Barclays U.S. Aggregate Index. Due to the nature of the agency guaranty in agency RMBS, there is minimal exposure to credit risk.

As a result, interest-rate risk is the dominant driver of return for agency-backed residential mortgages. While it's true that non-agency RMBS, commercial mortgage-backed securities (CMBS) and asset-backed securities (ABS) have become more common in core and core plus fixed income portfolios, the total amount allocated to these sectors is still small, leaving most investors underexposed to a market that has become a significant component of the global economy. Furthermore, transparency into the securitized credit risks taken by the multi-sector manager is likely to be lower than available in a dedicated strategy.

Figure 3. Securitized Credit Represents Broad Diversification

	ABS	CLO	CMBS	Non-agency RMBS	Credit Risk Transfer
Primary Fundamental Driver	Consumer	Corporate credit cycle	Commercial real estate	Housing market	Housing market
Secondary Fundamental Driver	Access to credit	Manager skill	Labor market	Labor market	Labor market
Key Sector Specific Risk	Student loan market dynamics	Regulatory compliance	Maturity wall	Mortgage servicing risk	GSE reform
Typical Credit Rating	High investment grade	Mid to high investment grade	Low investment grade	Below investment grade	Below – low IG
Weighted Average Life	<= 5 years	<= 10 years	3-10 years	4-6 years	2-10 years
Fixed or Floating	Mixed	Floating	Fixed	Mixed	Floating
Market Size ($ Billions)	$753	$534	$517	$776	$43

Source: Voya Investment Management, SIFMA and Bloomberg. Market size represents outstanding balances as of 03/31/18.

The Many Flavors of Securitized Credit: Why the Asset Class is a "Through-the-Cycle" Allocation

We believe common applications of securitized credit in portfolio strategy narrow the opportunity set too significantly or otherwise diminish its potential positive impact in the portfolio. For investors to fully benefit from the asset class on a sustained, through-the-cycle basis, transparent access to the broader opportunity set in securitized credit markets is necessary.

Securitized markets have evolved to become an important part of the global economy. For example, securitized credit increases capital for lending, allowing institutions to access financing without increasing their liabilities, thereby expanding the capital available for loans. This in turn helps lower borrowing costs and makes loans available to more borrowers. In addition, structuring new securities collateralized by securitized asset pools increases the liquidity of previously illiquid asset types.

As the securitization market has evolved, market participation has broadened, building the depth of liquidity across a growing range of asset types. As a result, securitized credit offers a diversified menu of exposures, from the residential housing market, U.S. consumer, the corporate credit cycle and commercial real estate market. Figure 3 highlights the major risk types available in the securitized credit market. In addition to these main categories, smaller sub-sectors of asset-backed securities exist, creating additional opportunities for diversification. Examples of these smaller sub-sectors include ABS backed by collateral pools of franchise and royalty agreements, auto loans, equipment lease agreements, wireless tower leases, billboard leases, aircraft lease and maintenance agreements, and shipping container lease agreements.

Securitized investments also offer a spectrum of structural protections, yield profiles and coupon structures. The weighted average life of securitized credit investments also varies within and across subsectors, providing additional diversification benefits in a broader portfolio. As a result of these different risk types, a broad securitized credit allocation can provide diversification from other asset classes, and benefit from the robust diversification within the individual securitized sub-sectors.

Securitized credit managers with the appropriate expertise across sub-sectors can tactically adjust allocations based on the most attractive opportunities and perceived relative value at any given time, which creates the potential for consistent outperformance as market conditions change during and through market cycles.

Portfolio Strategy: How Should Plan Sponsors Think About Securitized Credit Allocations?

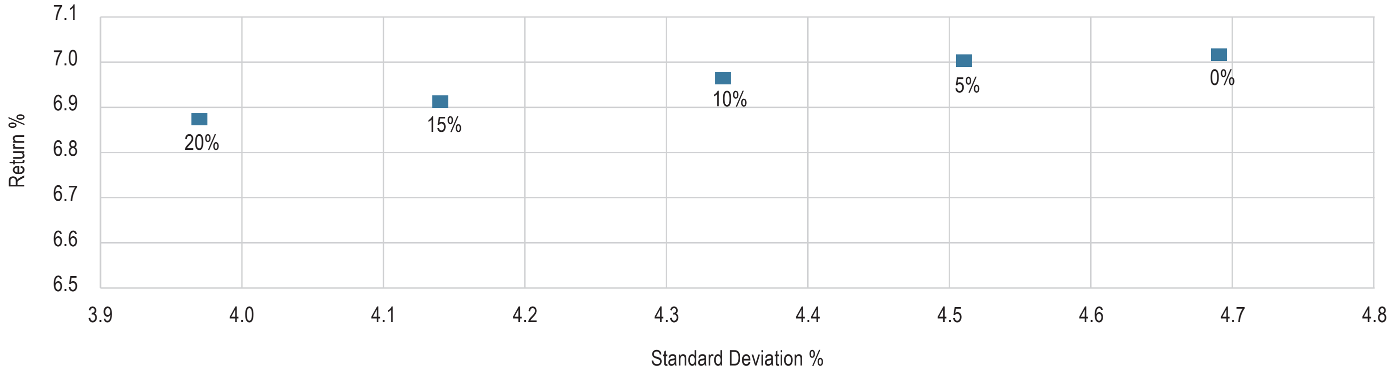
While certain sub-sectors of the securitized space like high quality collateralized mortgage obligations make sense to include in liability-hedging allocations, we believe broader standalone securitized allocations are more appropriate and effective in a plan sponsor's return-seeking portfolio.

To illustrate the potential benefits of a securitized allocation, consider a plan that has embraced standalone high yield and emerging market debt allocations. Earlier, we highlighted the outperformance of a broadly diversified securitized approach versus these spread sectors during specific credit events of the last six years.

Further analysis of the recent market environment shows that replacing these allocations with securitized credit enhances the risk profile of the overall portfolio without materially affecting returns. Figure 4 uses a model corporate pension plan growth portfolio and charts the impact of adding securitized credit in 5% increments.

Figure 4. Securitized Credit: Enhancing a Portfolio's Risk Profile without Sacrificing Returns

The Effect of Adding Securitized Credit Exposure to Portfolio, 03/2011–12/2017



Hypothetical Corporate Pension Plan Portfolio

	20% allocation to securitized	15% allocation to securitized	10% allocation to securitized	5% allocation to securitized	0% allocation to securitized
U.S. Equities	24.5	26.0	27.5	29.0	29.0
Global Equities	8.0	8.5	9.2	9.7	9.7
Core Fixed Income	34.2	36.4	38.6	40.7	40.7
EMD	0.0	0.0	0.0	0.0	2.6
High Yield	0.0	0.0	0.0	0.0	2.6
Securitized Credit	20.2	15.2	10.2	5.2	0.0
Senior Loans	1.5	1.5	1.6	1.7	1.7
Munis	1.5	1.5	1.6	1.7	1.7
Hedge Funds	5.1	5.4	5.6	6.0	6.0
Private Credit	5.1	5.4	5.6	6.0	6.0
STD DEV	4.0	4.1	4.3	4.5	4.7
AVG RETURN	6.9	6.9	7.0	7.0	7.0

From 03/2011 – 12/2017. Source: Voya Investment Management, Bloomberg Barclays and J.P. Morgan. To examine the effect of investing in securitized credit, we assumed five hypothetical portfolios. The first hypothetical portfolio is a baseline portfolio based on average pension allocations using data from J.P. Morgan and Towers Watson – in the baseline portfolio we also added standalone allocations to high yield and emerging debt. We then made a series of allocation adjustments to incorporate the securitized credit investments. The initial portfolio assumed a 0% allocation to securitized credit. We then increased the allocation in 5% increments up to a maximum of 20%. The first 5% of the securitized credit allocations were financed by a reduction in the assumed high yield and emerging market debt allocation; thereafter, additional allocations were funded by pro rata reduction of all other asset types in the portfolio. Diversified Securitized Credit approach based on Voya's Securitized Credit – Core Plus carve out composite.

Conclusion: What's Next for Securitized Credit?

The securitized credit market has grown to more than $2.5 trillion and has evolved to become an integral component of the global economy—yet most investors remain significantly underexposed to this growing and important asset class.

It was not too long ago that most investors and consultants viewed bank loans as an esoteric asset class with limited applicability in broader portfolio strategy.

With floating rate instruments and embedded structural protections, we believe securitized credit is poised to take off in a similar fashion.

As consumers inevitably re-lever and mortgage credit availability potentially thaws, opportunities from higher net new supply may fall in place to help accommodate a truly transformative status for securitized markets.

Given current spread levels for corporate credit and the impending turn in the credit cycle, we believe securitized credit provides even more attractive relative value in the current market environment. As demonstrated in recent periods of volatility, securitized credit has the potential to deliver attractive returns while providing the ballast portfolios need to weather future market turbulence across a wide range of economic scenarios.

Investment Risks

There are no guarantees a diversified portfolio will outperform a non-diversified portfolio

All investing involves risks of fluctuating prices and the uncertainties of rates of return and yield. Price volatility, liquidity and other risks accompany an investment in equity securities of foreign, smaller capitalized companies. International investing does pose special risks including currency fluctuation, economic and political risks not found in investments that are solely domestic. Risks of foreign investing are generally intensified for investments in emerging markets.

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