Commentary | 3Q23

Voya Securitized Credit Fund

Tap into Voya's Flexible "Through-the-Cycle" Approach

Strategy overview

Invests in fixed income sectors collateralized by distinct asset types: commercial real estate (CMBS), residential housing (RMBS) and non-mortgage assets such as asset-backed securities (ABS).

Key takeaways

- Rates marched higher as strong data kept the U.S. Federal Reserve in a hawkish position.
- The Fund outperformed its benchmark, the Bloomberg U.S. Securitized MBS/ABS/CMBS (the Index) on a net asset value basis.
- The end of the Fed tightening is within sight, but rate cuts are still a way away.

Portfolio review

Rates marched higher as strong data kept the Fed in a hawkish position. The third quarter of 2023 contained an abundance of strong data, casting aside thoughts about a recession in the near-term and the prospect of a soft landing, which seemed like a dream at the start of the year, gained credibility. Inflation continued to trend in the right direction. Core Personal Consumption and Expenditures (PCE), which peaked at year over year rate of 5.6%, fell to 3.8% by the end of August. Meanwhile, the US economy continued to add jobs at a fast pace. The combination of falling inflation and a strong labor market allowed consumers to continue spending which is important since consumption is the largest component of U.S. gross domestic product. The Fed maintained a data dependent stance and responded to the better-than-expected data by hiking rates at their July meeting. At the same time, they continued to stress that monetary policy would need to remain in restrictive territory until the economy softens and inflation is clearly in the rearview mirror. In September, the Fed resisted delivering another hike, however their updated dot plot reinforced their "higher for longer" message. As a result, rates resumed their march higher. By quarter-end the 10-year Treasury yield had risen by 73 basis points (bp), to 4.57% as the market continued to digest the higher for longer message, with the 2-year rising modestly by 18 bp, to 5.05%. This set the stage for negative total returns across most fixed income markets, with the Bloomberg US Aggregate Bond Index falling by –2.54% for the period.

Credit sectors broadly outperformed U.S. Treasuries, mitigating some of the pain inflicted by higher rates. Responding to the economic data, collateralized loan obligations (CLO) posted strong returns for the quarter. While our allocation here remains on the lower end, the sector was still a notable contributor to excess returns. Non-agency residential mortgage-backed securities (RMBS) and credit risk transfer securities (CRTs) also posted strong returns, supported by the resilient economy, low unemployment and continued strength in home prices. Our allocation to this sector helped drive a majority of the outperformance for the quarter. Higher quality sectors such as asset-backed securities (ABS) also produced positive excess returns, albeit to a lesser degree. Even commercial mortgage-backed securities (CMBS) participated in the rally, however rising delinquency rates and declining property values remain a concern dogging the sector. That said, security selection decisions had a greater impact on performance than the sector overweight decision. Lastly, duration detracted from results in absolute terms, however with a shorter profile relative to the Index, our positioning contributed to relative performance.

Notable changes in our allocations included further reductions in below-investment grade (IG) CLOs, and an increase in IG. In aggregate, our allocation to CLOs increased around 2%. Similar story in CMBS, where we added a few high-quality single asset single borrower (SASB) deals.

Current strategy and outlook

The end of the Fed tightening is within sight, but rate cuts are still a way away. While market participants debate whether the Fed has a 'final' rate cut on the horizon, we think the discussion on rate increases has run its course and investors should focus on how long the Fed might maintain official rates. We think moderating inflation allows the Fed to pause, yet a clear downturn in labor and the economy will be required for the Fed to pivot to substantive cuts. As a result, we expect the timeline for a rate cut is further out, reflecting the robustness in labor markets. We expect growth will slow and continue to monitor threats for a possible recession. With households well supported by higher wages, moderating inflation and a liability structure that is primarily fixed rate and corporations exercising discipline with regard to balance sheet management, we see the limited scope for a sharp downturn in the U.S. economy.

Allocating capital in this environment requires an intense focus on maintaining quality without giving away yield. CMBS is an area we find attractive; however, the sector is unlikely to move tighter in the face of notable headwinds. Instead, security selection opportunities within this sector are abundant. For example, deals collateralized by multifamily properties (high occupancy rates, low delinquency rates) are likely to experience much different outcomes than deals backed by office properties (declining rents, high delinquency rates). Within CLOs, we prefer high quality tranches that provide more protection in the event that a corporate default cycle emerges. With an array of factors creating risks to a soft landing materializing, overall credit quality across the portfolio is higher than it has been in the recent past, but as opportunities present themselves, we will look to adjust.

The **Bloomberg U.S. Securitized MBS/ABS/CMBS and Covered Index** includes the MBS, ABS, and CMBS sectors. Indexes do not reflect fees, brokerage commissions, taxes or other expenses of investing, and investors cannot directly invest in an index.

All investing involves risks of fluctuating prices and the uncertainties of rates of return and yield inherent in investing. **High-Yield Securities,** or "junk bonds", are rated lower than investment-grade bonds because there is a greater possibility that the issuer may be unable to make interest and principal payments on those securities. To the extent that the Fund invests in **Mortgage-Related Securities**, its exposure to prepayment and extension risks may be greater than investments in other fixed-income securities. The Fund may use **Derivatives**, such as options and futures, which can be illiquid, may disproportionately increase losses and have a potentially large impact on Fund performance. **Foreign Investing** does pose special risks including currency fluctuation, economic and political risks not found in investments that are solely domestic. As **Interest Rates** rise, bond prices fall, reducing the value of the Fund's share price. **Other risks of the Fund include but are not limited to: Credit Risks; Credit Default Swaps; Currency; Interest in Loans; Liquidity; Other Investment Companies' Risks; Prepayment and Extension; Price Volatility Risks; U.S. Government Securities and Obligations; Sovereign Debt; and Securities Lending Risks. Investors should consult the Fund's Prospectus and Statement of Additional Information.**

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