# INTRODUCING EUROPEAN ABS STRATEGY

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FOR FULL LEGAL DISCLAIMERS PLEASE REFER TO THE LAST PAGE OF THIS DOCUMENT. Since Asset Backed Securities played a role in the 2007/2008 global financial crisis, the landscape has massively evolved. Although loses were induced by US sub-prime issuances, regulators in Europe clamped down heavily on ABS structures and introduced numerous regulatory and policy initiatives (capital .requirements, liquidity, governance, due diligence, leverage requirements,…).It is now generally recognised that well regulated, high quality and transparent ABS can play an important role in capital markets and help stimulate real-economy funding. The structured nature of well-designed and well understood ABS could help efficiently transfer risks across the financial system and build a resilient asset allocation in the new markets' cycle.

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## I. INTRODUCTION

Asset Backed Securities are bundles of loans, such as mortgages, car loans, credit cards debt, etc. that are packaged and sold to investors. The process allows banks to reduce balance sheet risks, to free capital and to gain the possibility to extend credit across the economy, by lending to Corporates and individuals.

ABS fell strongly out of favour in the aftermath of the 2007 / 2008. Although loses were induced by US sub-prime issuances, the European regulators were swift to react, clamping down heavily on European securitization structures, leading to a total freeze of this market for years. More recently, in a lucid move to reignite the credit market, the European Central Bank included ABS in the list of eligible assets to its QE effort. In doing so, the ECB recognised that well regulated, high quality and transparent ABS could play an important role in capital markets and help stimulate real-economy funding, offering a substitute to the QE as the normalisation process continues.

Almost simultaneously, the EU Capital Market Union initiative landed the framework of a restrictive, yet solid, regulation for ABS. The so-called STS securitisation introduced strict rules for simplicity, standardisation and transparency of ABS issuances. In light of all the changes and market conditions, the appeal of European ABS has massively improved, with better credit worthiness and more resilient structures.

*Main advantages of European ABS*

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| Superior returns | European ABS offer a higher yield than traditional government or Senior bonds for the same rating and over identical maturities. |
| Floating rates | While increase in interest rates is on investors mind, European ABS offer near-zero interest rate risk, thanks to no correlation between ABS prices and market interest rates. |
| Diversification | ABS allow for fragmentation of risk and offer access to a large (circa Eur 500 billion) investment universe and a diversification across industries. |

## II. EUROPEAN ABS ADVANTAGES OVER US ABS

Today global investors need to acknowledge that European ABS structures are fundamentally different to their US counterparts. Higher capital requirements, liquidity, governance, due diligence, lending standards etc. (not to mention that there are no European subprimes), all play well to the advantage of European ABS.

*Main differences between European and US ABS*

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| Higher lending standards | Borrowers are required to hold significant equity in the property and demonstrate proof of income before loans are granted. Unlike in the US, there is no true "sub-prime" market in Europe. |
| Alignment of interest | In the majority of European ABS deals, the first loss piece is retained by the issuer of the ABS. Historically, in most US RMBS, all the risk was fully transferred from issuer to the bondholder, encouraging the issuer to focus on increasing volume to earn origination fees rather than maintaining quality. |
| Recourse | The US mortgage market is a non-recourse market. Borrowers in default can hand the keys for a property back to the bank with no threat of further action to enforce repayment. In European mortgage markets, the lender can continue to pursue borrowers for recovery after default for a multi-year period. |

## III. European ABS as part of a Fixed Income Asset Allocation

European ABS can add diversity to a fixed income portfolio, as well as providing additional yield. ABS is probably one of the most flexible part of the fixed income universe, with a large investment universe, offering the ability to invest across the full spectrum of ratings from triple-A to single-B and even unrated. By selecting bonds carefully, a highly liquid profile can be created, or alternatively a yield premium can be earned for less liquid positions.

When building a portfolio, asset allocators can consider European ABS on the basis of their various characteristics:

*European ABS characteristics*

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| Attractive yields | European ABS offer larger spreads than corporate bonds having the same rating |
| Improving fundamentals | The credit risk of European ABS has been improving thanks to falling unemployment and a recovering housing market. ABS has performed consistently well through a number of market cycles and during the depths of the financial crisis, outperforming other asset classes from a default and a loss point of view. |
| Limited supply | Traditional ABS issuers have always had a number of sources of funding ranging from retail client deposits to equity issuance. However, with the readily available supply of cheap funding from central banks, new ABS issuance has dropped materially. This dynamic of low supply will support price performance due to the scarcity of product. |
| Low default rate | Historically, expected cumulative lifetime loss rates are 1.0% for the entirety of European ABS, whereas US loss rates are 7.3%. (*Structured Finance Losses 2000-2014, Fitch Global, 7th February 2015*) |

## IV. Why invest in European ABS with AZIMUT

Investing in ABS requires a specific, technical expertise, in order to select not only the best underlying collateral but also the best part of the capital structure where to invest. Therefore, highly specialised managers are a must to access ABS investments and to analyse all variables related to the asset class.

Thanks to the specialised Italian boutique, P&G SGR, Azimut group offers access to the European ABS markets via a seasoned investment team enjoying an outstanding track record.

P&G SGR SPA in an independent asset manager founded in 2004 and specialised in the management of alternative investment products. The management team has a 16-year expertise in the Structured Credit market, and is well known for having been able to perform positively in all market phases, even during the crises.

*Overview of P&G SGR*

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| Stability | The management team has a <u>13 year track record</u> and manages approx. Eur 1.5 billion in total return Real Estate, ABS, CDO of ABS funds |
| Specialisation | Since 2001, all members of the investment team have had an <u>exclusive focus on total return ABS related investments</u> |
| Innovation | The team has launched one of the first CDOs of ABS in Europe and has developed a proprietary analysis and portfolio management system |
| Recognition | The team has a wide network of relationships with market players and originators and serves as <u>Bank of Italy's advisor on technicalities and market themes on ABS</u> |

## V. INVESTMENT PROCESS

| Investment Universe | |
|---|---|
| Mainly European Asset Backed Securities | |
| **Fundamental Research** | |
| **Top Down approach** | **Bottom up approach** |
| • Screening of market opportunities<br>• Analysis of the ABS deals<br>• Risk/return ranking<br>• ABS Investment Committee<br>• Monitoring and Whatch List | SECURITY SELECTION<br>1. Portfolio analysis<br>2. Participants analysis (originator, lead manager of the deal, etc.)<br>3. Protection mechanisms of the deal (reserve, waterfall of interests and capital, etc)<br>4. Stress test analysis to get a breakeven default rate to be compared with the expected default rate of the tranches. The result will be a multiple representing an absolute score |
| **Monitoring** | |
| • **Portfolio construction:** the deals are compared on the basis of the multiples for the relative value analysis<br>• **Liquidity:** each security is assigned an internal liquidity rating which is constantly monitored and updated on the basis of market coverage, frequency of trading and pricing and bid/ask spreads<br>• **Risk Management** embedded in the daily portfolio monitoring | |
| **Trading** | |

## VI. PORTFOLIO CONSTRUCTION

Valuing and managing liquidity risk are an important part of the investment process of P&G. Each security is assigned an internal liquidity rating. The liquidity profile of each security is constantly monitored and updated to take into account market coverage, bid/ask spreads and frequency of trading and pricing. Securities are then classified as Core or satellite, following the below definitions:

| Type | Definition | % |
|---|---|---|
| Core 1 | This bucket is made of securities whose price is highly resilient to market events. Securities in this bucket are characterised by high liquidity, extremely good historical performances and high levels of credit enhancement. The bucket is made of seasoned deals in an advanced amortisation phase. | 39% |
| Core 2 | This bucket aims at taking advantage of market mispricing and extra yield on securities with good liquidity conditions, a low credit risk and a good level of credit enhancement in relation to the risk of the underlying collateral | 44% |
| Satellite | This bucket is made of rare securities with a low level of liquidity and a high return to compensate for the restricted universe of potential investors. A high percentage of this bucket is made of very seasoned, mezzanine tranches, of European CDOs of ABS. | 17% |

## VII. AZIMUT EUROPEAN ABS FUND

| | Fund characteristics | |
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| Exposure | Primarily senior tranches of European ABS | Exposure to sub investment grade securities is limited to a maximum of 15%. |
| Diversification | High diversification in terms of countries, sectors, and issuers | About 80/150 positions in the portfolio |
| Liquidity | Core portfolio: Highly liquid and low volatile securities | Satellite portfolio: Small bucket of highly yielding securities |
| Objectives | Yield target: extra-yield versus money market rates, positively correlated with EURIBOR | Volatility target: 2.5% |
| Expertise | More than **13 years track record** and U$D 1.5 billion of assets | Highly experienced and focused management team |
| | A multinational asset manager, with U$D 60 billion of AuM | **UCITS V, Luxembourg** domiciled mutual fund |
| Practical information | Inception date:<br>- Italian domiciled fund: 2009<br>- Lux. Replication: Jan. 2017 | Fees: 1.50% |
| | Weekly liquidity | Initial Share (Euro): LU1407730347 |

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