

# Asset-backed securities in multi asset portfolios

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## What are asset-backed securities (ABS)?

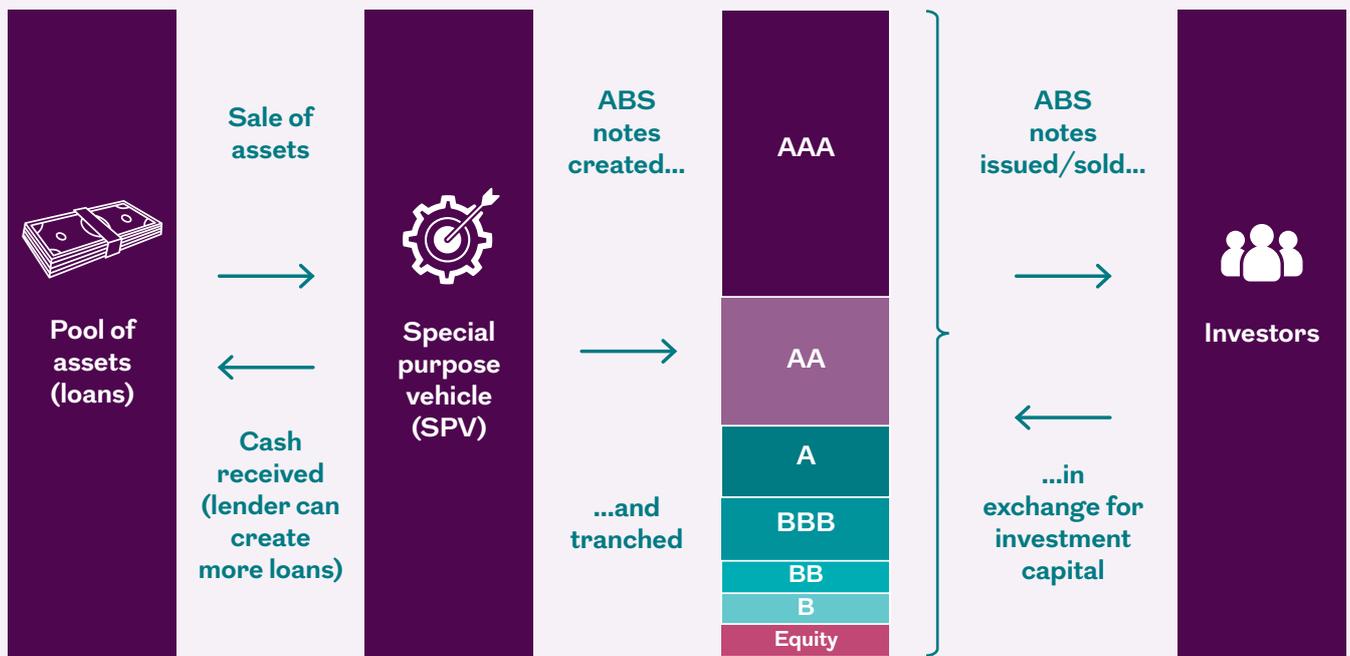
Asset-backed securities are a type of bond, typically created by banks or other lenders. Unlike conventional bonds, ABS are backed by a group of loans – like mortgages, car loans, student loans or credit card debt. The money people pay back on these loans is used to pay back the investors who have bought the ABS, along with interest.

## How are ABS created?

ABS are created through a process called securitisation, which can be broken down into five stages:

- 1. Offering loans:** A bank or lender issues loans to people and these loans generate regular interest and principal payments.
- 2. Pooling:** The bank bundles these loans together into a pool and creates a **special purpose vehicle (SPV)**. The SPV is a separate legal entity from the bank, meaning if the issuing bank fails, the SPV won't be impacted. The SPV then buys the pool of loans from the bank.
- 3. Issuing ABS:** The SPV sells bonds to investors. These are backed by the money people pay back on their loans. The SPV organises the bonds into different risk levels (called tranches) based on risk and return, such as AAA, AA, BBB, and equity tranches. Investors can choose tranches based on the amount of risk they want to take.
- 4. Returns for investors:** As people pay back their loans, the SPV uses that money to pay the investors who bought the bonds, according to the structure of the tranches.
- 5. Investor protection:** If borrowers stop paying, investors have a claim on the original loans, which gives them extra protection compared to regular bonds.

**Figure 1. The securitisation process**



Source: Royal London Asset Management (RLAM). For illustrative purposes only.

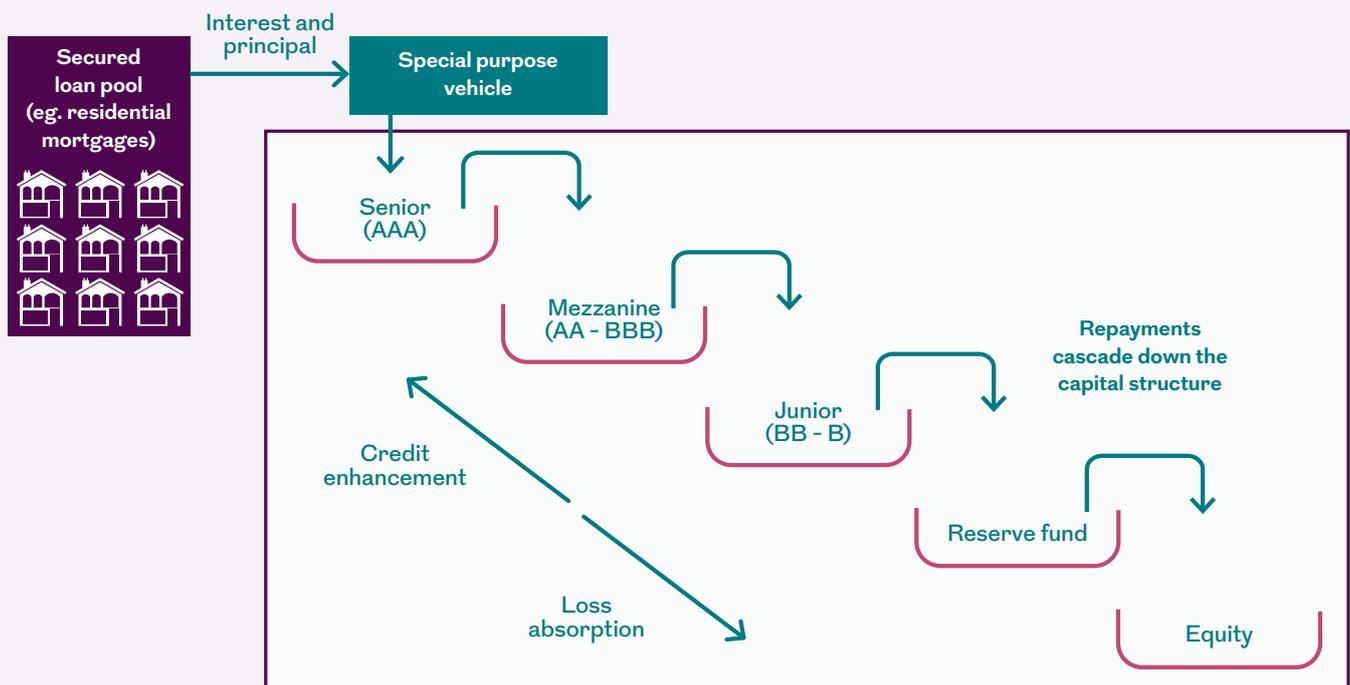
## Understanding ABS tranches

ABS bonds are split into tranches with different levels of risk and return – AAA, AA, A, BBB, BB, B and equity. The safest tranche is usually rated AAA. The AAA tranche gets paid first, so it has the lowest level risk but also offers the lowest yield.

After the AAA investors are paid, the next safest tranche gets paid, and so on, down to the riskiest tranche (often called the equity tranche). This process is called a waterfall – payments flow from the top (safest) to the bottom (riskiest). This means that although the equity tranche gets paid last, its investors are offered the highest yield.

If there are losses (if people don't pay back their loans, for example), the losses are taken from the bottom up. The riskiest tranche loses money first and the safest tranche only loses money if all the lower tranches have already lost everything.

**Figure 2. ABS waterfall payments**



Source: Royal London Asset Management (RLAM). For illustrative purposes only.

## Why include ABS in multi asset portfolios?

**Higher yield:** ABS often pay investors more than regular bonds for the same amount of risk.

**Low default rates:** Historically, ABS have had a very low default rate, through several economic cycles. Past performance is not a guide to future performance.

**Interest rate protection:** Almost all UK and European ABS are floating rate, which makes them less volatile to interest rates movements.

**Diversification:** ABS can include thousands of individual loans from different geographical locations, helping to spread risk in a portfolio.

**Flexibility:** Investors can select the level of risk that matches their preferences. They can also choose the specific type of asset (such as mortgages, car loans or credit card debt) and decide in which geographic region they want to invest.

**Investor protection:** As the underlying assets of ABS sit within a separate legal entity (the SPV), investors are protected if the issuing bank or lender fails. This additional layer of protection can give a degree of comfort to investors who have perhaps misunderstood or mistrusted ABS in the past due to their association with the 2008 global financial crisis.

**Transparency:** Issuers regularly share updates about the loans and assets behind the bonds. This helps investors understand how these assets are performing and potentially make better decisions about their investments.

## ABS in the Governed Range

The Governed Range portfolios invest in a range of fixed income strategies, including government, investment-grade and high-yield corporate bonds. The addition of ABS to this mix brings a number of advantages.

- **Attractive returns and stability:** ABS can offer higher returns, especially in today's environment where central banks are adjusting interest rates in different ways. Because many ABS have floating-rate coupons, they are less sensitive to interest rate movements and can help maintain portfolio stability.
- **Diversification:** ABS allow investors to diversify beyond traditional corporate bonds. They provide access to different types of loans that would otherwise be unavailable to most investors.
- **Enhanced protection:** ABS come with strong investor protections. If loan payments are missed, investors have a claim on the underlying assets, which adds a layer of security.
- **Improved risk management:** By including ABS, the Governed Range portfolios can spread risk more effectively while still managing credit risk carefully.

Overall, we believe introducing ABS as a distinct asset class within the Governed Range will help boost expected returns and improve the portfolios' overall diversification.

Royal London Asset Management has two ABS-focused funds which the Governed Range portfolios invest in:

- **RLS Global Senior ABS Fund:** targets a mixture of AAA and AA-rated assets, aiming for returns of around 1.25% above SONIA.
- **RLS Global Mezzanine ABS Fund:** targets AAA to BB-rated assets, aiming for returns of around 2.25% above SONIA.

Both these funds offer floating rate returns and access to diversified consumer credit risk. They're used across the Governed Range portfolios, apart from in the two highest-risk Governed Portfolios – Governed Portfolio Dynamic and Governed Portfolio Total Equity.



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