Asset-Backed Securities for Enhanced Return-to-Risk Potential

Andrew Hsu, Fifi Wong, Stephan Diaz Ellinghaus and Michael Fine

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Introduction

- Asset-backed securities (ABS) are fixed income bonds secured by a pool of predefined diversified assets and contractual cash flows generated by those assets.
- With a yield to maturity of 5.8%[1] and an investment grade (IG) risk profile, ABS are a compelling sector for investors seeking income and potential safety through structural protections.
- The sector continues to evolve, adding new subsectors to its already rich diversification opportunities.
- 2024 was a record year for the ABS primary market, with new-issue volume of $335 billion marking a new high in the post-Great Financial Crisis (GFC) era. Continued growth is forecast for 2025.

ABS are debt instruments within the structured products category of fixed income[2] that are secured by contractual cash flows and assets. Within the broader securitized debt market, ABS do not include residential or commercial mortgage-backed securities or collateralized loan obligations. Classic examples of ABS, which have been members of the Bloomberg US Aggregate Bond Index (the "Aggregate") for over 20 years, are securitizations of auto loans, credit card receivables and commercial aircraft leases.

Over time, and particularly in the last decade, growing investor demand has caused the asset class to evolve to offer new and diverse investment opportunities. Issuance has expanded across a broad spectrum of economic activity (e.g., data centers, renewable energy and transportation assets). Opportunities in new subsectors and issuers have emerged frequently. For example, 2024 delivered the first securitization of IP addresses and the first ground-mount community solar ABS. This growth propelled ABS to a post-GFC record last year with $335 billion in new issuance across 600 deals.

The depth, diversity and demonstrated resilience of the ABS sector have attracted steadily larger allocations by institutional investors. Interest in ABS has been growing from a diverse investor base, which already includes asset managers, insurance companies and corporate pensions as well as financial advisors, registered investment advisors and model strategist-allocator investors.

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Advantages of Asset-Backed Securities

ABS can potentially offer attractive investment attributes, notably:

I. Diversification

II. Excess yield with low default rates

III. Investor-friendly structural protections

I. Diversification

One of the more powerful attributes of ABS is their diversification potential. The first place this can be observed is within bond-level diversification. As an example, an aircraft lease securitization comprises a collateral pool of dozens of aircraft that are leased to different airlines across diverse jurisdictions. A consumer loan securitization is diversified by tens of thousands of consumers across different locations, income levels, FICO scores, age cohorts, etc.

ABS also allow investors to diversify a portfolio by owning different subsectors (sector-level diversification). The ABS sector has evolved to allow investors to diversify investments across different types of consumer receivables (e.g., auto loans, credit cards, student loans, consumer loans, solar rooftop, etc.), infrastructure assets (e.g., digital infrastructure, energy, oil and gas, transportation, etc.) and business cash flows (e.g., insurance, restaurants, fitness, education, vacation rentals, music royalties, litigation receivables, etc.). *(Figure 1)* The breadth of this asset class allows an investor to build a portfolio of different subsectors that are boosted by different economic environments.

ABS Investable Universe Evolution

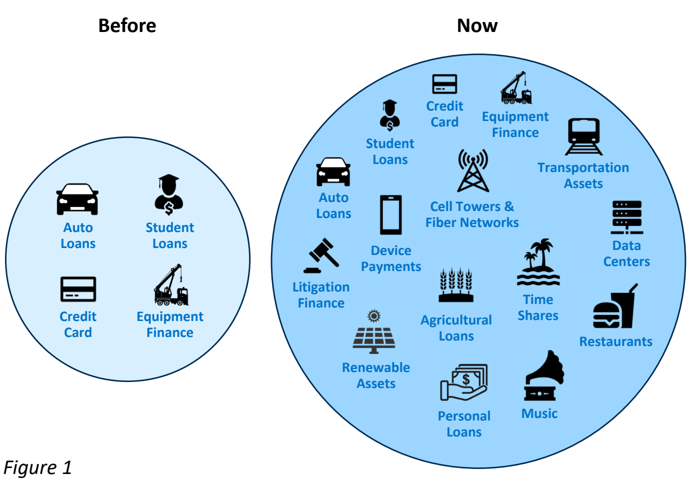

Figure 1
Source: DoubleLine
For illustrative purposes only.

II. Excess Yield With Low Default Rates

IG-rated ABS, which yielded 5.8%[3] in March, were providing attractive income and diversification when compared to traditional corporate credit tied to the balance sheet of a single business issuer. This yield premium in ABS is not an anomaly; the asset class has historically exhibited higher yields than comparably credit quality-rated fixed-income investments such as unsecured corporate bonds. *(Figure 2)*

ABS Yields vs. Corporate Bond Yields 2015 to March 31, 2025
As of March 31, 2025

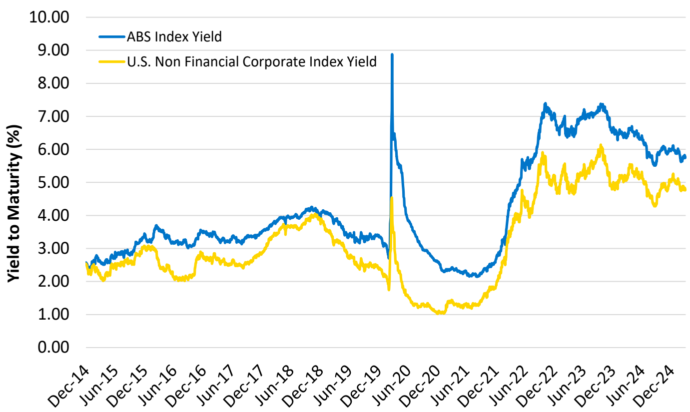

Figure 2
Source: DoubleLine, Bloomberg

This could lead investors to conclude that the underlying credit risk must be higher, but empirically that is not the case. One simple way to measure this is by looking at default rates. Per S&P Global Ratings, no IG-rated ABS bond has defaulted since 2010.[4] Moreover, during the GFC, the default rate for all ABS, including high yield (HY), remained below 0.50%.[5] *(Figure 3)*

ABS vs. Corporate Bond Default Rates
As of Dec. 31, 2024

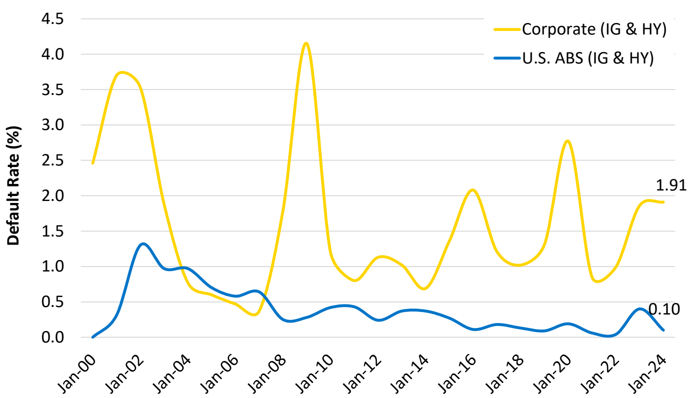

Figure 3
Source: DoubleLine, S&P Global
Most recent data available.

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Despite lower default rates and similar credit risk, as of March 31, 2025, the representative ABS index[6] (weighted average rating A, three-to-four-year duration) had a spread over U.S. Treasuries of 177 basis points and a yield to worst of 5.8%, compared to a representative corporate index[7] (weighted average rating BBB, three-to-four-year duration) with a spread over Treasuries of 82 basis points and a yield to worst of 4.8%.

One potential reason for the excess yield in ABS is a more limited investor base than prevails for corporate bonds. The sector has historically been available only to institutional investors. Another potential reason is that investors might perceive ABS as complex to analyze. To invest in the asset class, investors need tools to analyze collateral pools that consist of hundreds or even thousands of borrowers. In addition, investors must understand the nuances and risks associated with deal structuring. This takes dedicated, specialized teams, which, among other qualifications, must understand the use of deal structure to protect investors. Experienced asset managers with these qualifications can help investors access ABS and navigate opportunities and risks.

III. Investor-Friendly Structural Protections

The ABS sector offers investors multiple structural protections and benefits that set it apart from other fixed-income products.

1. Collateral Security and Overcollateralization

ABS bonds are secured by a collateral pool of cash-flowing assets, and ABS bondholders have a right to the pledged collateral if an issuer defaults. Importantly, the entity that issues the ABS bonds will be structured as a bankruptcy-remote special purpose vehicle (SPV).[8] The ABS assets will be ring-fenced from other assets, and a company's bankruptcy filing should not extend to the SPV or impact interest or principal payments on the ABS bonds.[9] In contrast, unless a corporate borrower is solvent, payments to unsecured corporate bondholders are suspended upon the borrower's bankruptcy filing. In addition, most ABS deals benefit from an additional cash reserve to cover any unforeseen liquidity shortfalls. This cash reserve also serves as supplemental collateral for ABS bondholders.

For example, in 2017, the casual dining chain TGI Friday's issued SPV ABS bonds secured by royalties, franchise fees and intellectual property. In November 2024, certain TGI Friday's entities filed for bankruptcy but not the ABS issuers. Despite the bankruptcy filing, the ABS issuers, their assets and their liabilities remained separate from the entities in bankruptcy, and their assets were specifically excluded from the assets available to secure the companies' debtor-in-possession financing as well as the ultimate sale of the companies' assets. While ABS bond performance has also deteriorated, so far, the ABS bondholders have continued to receive principal and interest payments, and their collateral should not be available to satisfy claims of creditors of the TGI Friday's entities in bankruptcy.

At issuance, the value of the collateral pool (assets) exceeds the total par value of the ABS bond (liability), which is referred to as overcollateralization. *(Figure 4)* Overcollateralization ensures that investors have a buffer in case the bond's underlying cash flows do not perform according to base-case projections and ensures that the issuer who holds the equity has skin in the game, i.e., stands to lose value if the collateral performs worse than expected. Naturally, the amount of overcollateralization varies by subsector and over time, reflecting what the investment community considered at the time of issuance an appropriate level of additional protection.

Illustrative ABS Capital Structure

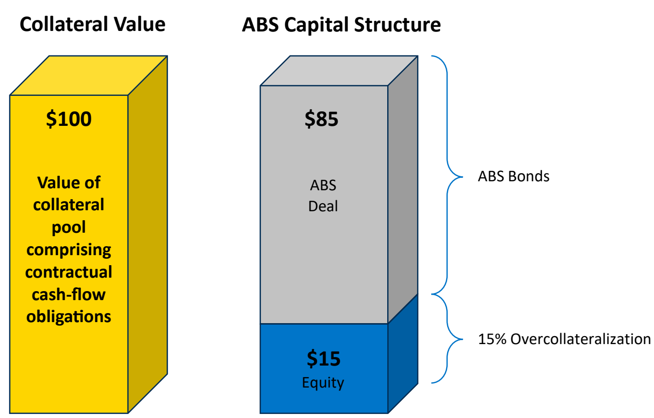

Figure 4
Source: DoubleLine

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2. Subordination

Most ABS deals are structured into tranches ranked by seniority. *(Figure 5)* The most senior tranche (referred to as Class A) enjoys the highest credit quality because it is the first tranche to be paid off. Class B enjoys the second highest quality being the second tranche to be paid off, and so forth sequentially. This structuring feature is referred to as the subordination benefit: Class A benefits from the subordination of Class B, et al. (in addition to the benefit from overcollateralization). Similarly, Class B benefits from the subordination of Class C, et al. (in addition to the benefit from overcollateralization). The senior most tranche is structured to withstand the most-severe stress scenarios and is often rated between A and AAA. Junior tranches gradually go lower in rating quality. Subordination structures give investors the benefit of selecting the desired return-to-risk profile for any given bond.

Illustrative ABS Capital Structure and Subordination

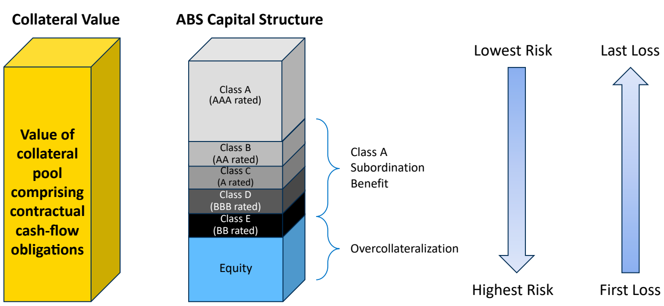

Figure 5
Source: DoubleLine

3. Amortization and Performance Triggers

ABS are amortizing bonds. Amortization appeals to investors for several reasons. First, as a bond's principal amount amortizes, its loss exposure decreases and the overcollateralization buffer increases, resulting in a gradually improving credit. Second, principal amortization provides heftier recurring cash flow and results in higher cash-on-cash yield to investors.

During the life of an ABS deal, if the collateral performs according to expectations, bondholders receive scheduled interest and principal-amortization payments (*Figure 6*, top chart), and equity holders receive distributions from excess cash flows. ABS benefit from a built-in mechanism – collectively called performance triggers – to protect bondholders and flash warning signals that collateral is deteriorating. If a performance trigger is breached, regular distributions to equity holders cease, and cash flows are typically redirected to accelerate the amortization of the bonds, typically starting with the Class A tranche. (*Figure 6*, bottom chart)

Illustrative Amortization Profile of ABS
(Base Case and Performance Trigger Breach)

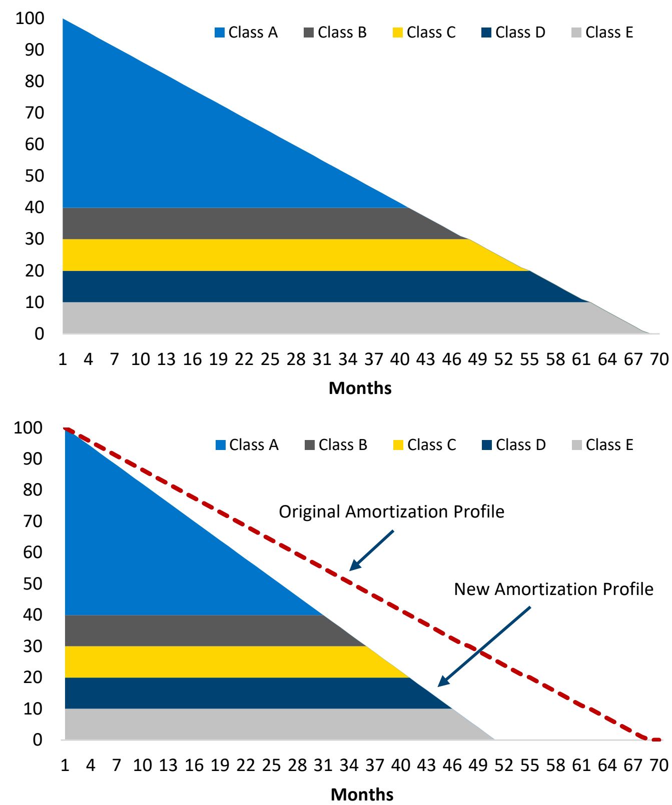

Figure 6
Source: DoubleLine

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Enhancing Fixed Income Portfolios With ABS

Incorporating ABS into a fixed income portfolio can add diversification and enhance the return-to-risk profile. To quantify diversification potential, we calculated the correlation between a diverse list of fixed-income asset classes compared to the Aggregate. *(Figure 7)* The ABS sector exhibits one of the lowest correlations when compared to the Aggregate. Including ABS in a portfolio has the potential to enhance return and lower volatility.

Historical Correlation by Asset Class to the Aggregate
Ten Years as of March 31, 2025 (Annualized)

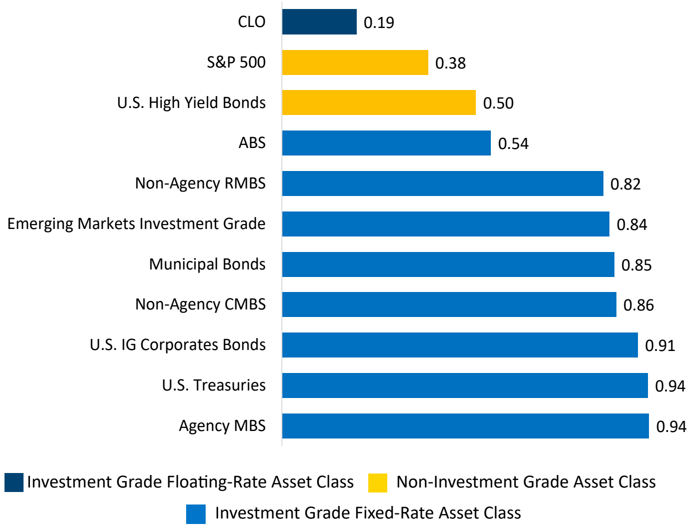

Figure 7
Source: DoubleLine, Bloomberg, J.P. Morgan
For a full list of indices, see disclosures.

ABS have the potential not only to diversify a portfolio but also to enhance the return-to-risk profile. To illustrate this idea, we calculated the efficient frontier for two hypothetical portfolios. *(Figure 8)* One portfolio (blue plotline) comprises a mix of ABS proxied by the ICE BofA U.S. Fixed-Rate Miscellaneous ABS Index and of equities proxied by the S&P 500 Index. The other portfolio (yellow plotline) comprises a mix of investment grade bonds proxied by the Aggregate and of the S&P 500. The plotlines from lower left to upper right plot the portfolio exposures from 100% ABS (blue plotline) or 100% investment grade bonds (yellow plotline) to 100% equities. The resulting returns and volatility of returns from the different asset mixes are measured over the 10 years ended March 31, 2024. For that period, the hypothetical ABS-S&P 500 portfolio shows a higher return from the same unit of risk than did the hypothetical Aggregate-S&P 500 portfolio.

Historical Efficient Frontier
Ten Years as of March 31, 2025 (Annualized)

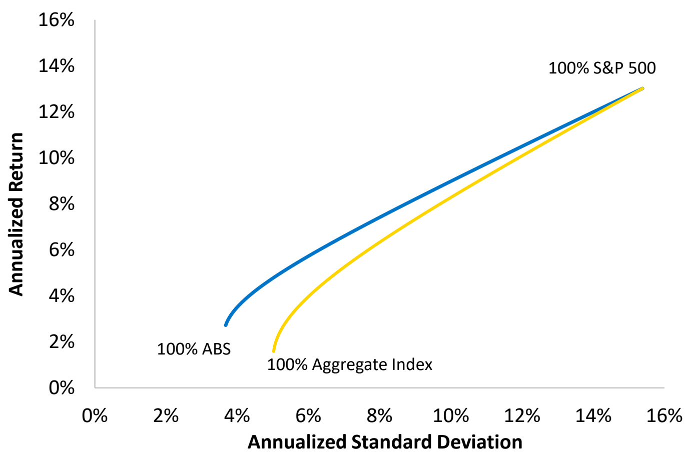

Figure 8
Source: DoubleLine, Bloomberg

Of course, a credit portfolio or the credit allocation within a broader fixed-income portfolio should not only comprise ABS but rather a well-rounded mix of credit products. But the exercise shows that adding ABS to a portfolio can potentially improve overall risk-adjusted returns.

Concluding Points

- The ABS sector is experiencing growing interest from and adoption by investors, fueled by the potential to generate excess yield and consistent cash flows through defensive structural features.
- ABS allocations offer meaningful diversification and enhanced return potential to an income-focused investment portfolio.
- ABS are structured to mitigate potential collateral deterioration in challenging economic environments.
- The increasing breadth and depth of the ABS issuance opportunity set is supported by the investment options the asset class offers a wide range of borrowers.

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About the Authors

Andrew Hsu, CFA
Portfolio Manager, Structured Products

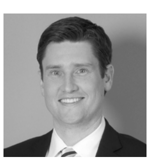
Mr. Hsu joined DoubleLine at its inception in 2009. He oversees the Asset-Backed Securities team and serves as a Portfolio Manager for the DoubleLine Total Return and ABS/Infrastructure Income strategies. Mr. Hsu is a permanent member of the Fixed Income Asset Allocation and Structured Products committees. Prior to that, he was responsible for analysis and trading of structured products, where his focus included residential MBS and ABS transactions. Mr. Hsu's responsibilities have also included structuring and negotiating terms on new-issue transactions and forming strategic partnerships with issuing entities in order to participate in key transactions. Prior to DoubleLine, he worked at TCW from 2002, where he focused on credit analysis for structured product securities and co-managed two structured product funds centered on debt and equity investments. During that time, Mr. Hsu was actively involved with portfolio management decisions and investment analysis, including reverse-engineering complex CDO/CLO structures. He holds a B.S. in Finance from the University of Southern California. Mr. Hsu is a CFA® charterholder.

Fifi Wong
Portfolio Manager, Structured Products

Ms. Wong joined DoubleLine at its inception in 2009. She is a Portfolio Manager on the Asset-Backed Securities team and a contributing member of the Structured Products Committee. In her previous role at the firm, Ms. Wong was a Manager on the Risk Management team, focusing on credit research, risk analytics and portfolio surveillance, especially in relation to securitization-oriented strategies. Prior to DoubleLine, she was an Assistant Vice President at TCW, where she was a Structured Products Risk Analyst. Ms. Wong holds a B.S. in Mathematics/Economics from the University of California, Los Angeles.

Stephen Diaz Ellinghaus
Specialist, ABS, Structured Products

Mr. Diaz joined DoubleLine in 2021 as a Specialist, ABS, on the Global Infrastructure Investments/ABS team. He is also a member of DoubleLine's Responsible Investment team. Prior to DoubleLine, Mr. Diaz was with Nomura Securities International as an Executive Director. Prior to that, he was with Norddeutsche Landesbanak Girozentrale as a Director. Mr. Diaz holds a B.A. in Economics from the Instituto Tecnologico Autonomo de Mexico and an MBA in Business Administration from New York University.



Michael Fine
Trader, Asset-Backed Securities

Mr. Fine joined DoubleLine in 2015 and is currently a Trader on the Asset-Backed Securities team. Previously, he was an Analyst on the Risk Management team focusing on credit research and trading. Prior to DoubleLine, Mr. Fine was with Western Asset Management Co. as an Analyst performing structured credit research and providing portfolio analysis on multisector fixed-income portfolios. Prior to that, he was member of the Analytics team. Mr. Fine holds a B.A. in Political Science from the University of California, Los Angeles.

Endnotes

[1] ICE BofA AA-BBB U.S. Asset-Backed Securities Index, as of March 31, 2025

[2] Structured products comprise four sectors: residential mortgage-backed securities, commercial mortgage-backed securities, collateralized loan obligations and asset-backed securities.

[3] ICE BofA AA-BBB U.S. Asset-Backed Securities Index yield to maturity, as of March 31, 2025

[4] S&P Global Ratings: "Default, Transition and Recovery: 2024 Annual Global Structured Finance Default and Rating Transition Study," February 21, 2025

[5] Idem.

[6] ICE BofA AA-BBB U.S. Asset-Backed Securities Index

[7] ICE BofA 3-5 Year US Non-Financial Corporate Index. We chose these ICE BofA indices because they have a comparable credit risk and duration profile.

[8] A special purpose vehicle follows principles of corporate separateness, and assets should be transferred to it in accordance with true sale principles.

[9] This was tested in 2009 when General Growth Properties and its solvent special purpose entities filed for bankruptcy in the Southern District of New York. The bankruptcy court declined to dismiss the entities' Chapter 11 cases as a bad faith filing, instead considering the collective circumstances of all the debtors. Despite refusing to dismiss the special purpose entities' Chapter 11 cases, the special purpose entities' creditors received post-petition interest and fees, and their assets were not substantively consolidated with the other debtors.

Indices for *Figure 8*: IG CLOs: J.P. Morgan Collateralized Loan Obligation Index, **S&P 500 Index, U.S. HY Bonds:** Bloomberg US Corporate High Yield Bond Index, **ABS:** ICE BofA AA-BBB US Asset Backed Securities Index, **Non-Agency RMBS:** J.P. Morgan, **Emerging Markets IG:** Bloomberg Emerging Markets USD Aggregate Index, **Municipal Bonds:** Bloomberg US Municipal Bond Index, **Non-Agency CMBS:** Bloomberg US Non-Agency Commercial Mortgage-Backed Securities Index, **U.S. IG Corporate Bonds:** Bloomberg US Corporate Index, **U.S. Treasuries:** Bloomberg US Treasuries Index, **Agency MBS:** Bloomberg US Mortgage-Backed Securities Index

Asset-Backed Securities (ABS) – Investment securities, such as bond or notes, that are collateralized by a pool of assets, such as loans, leases, credit card debt, royalties or receivables.

Basis Points (bps) – Basis points (or basis point (bp)) refer to a common unit of measure for interest rates and other percentages in finance. One basis point is equal to 1/100th of 1%, or 0.01% or 0.0001, and is used to denote the percentage change in a financial instrument. The relationship between percentage changes and basis points can be summarized as: 1% change = 100 basis points; 0.01% = 1 basis point.

Below Investment Grade (IG)/Non-Investment Grade (Non-IG) – Term indicating a security is rated below investment grade (IG). These securities are seen as having higher default risk or being prone to other adverse credit events. They typically pay higher yields than higher-quality bonds in order to make them attractive. They are less likely than IG bonds to pay back 100 cents on the dollar.

Bloomberg Emerging Markets (EM) USD Aggregate Index – This index tracks fixed- and floating-rate, investment grade U.S. dollar-denominated debt issued from sovereign, quasi-sovereign and corporate EM issuers.

Bloomberg US Aggregate Bond Index – This index (the "Aggregate") represents securities that are SEC registered, taxable and U.S. dollar denominated. It covers the U.S. investment grade, fixed-rate bond market, with components for government and corporate securities, mortgage pass-through securities and asset-backed securities. These major sectors are subdivided into more specific indices that are calculated and reported on a regular basis.

Bloomberg US Corporate High Yield (HY) Bond Index – This index measures the U.S. dollar-denominated, HY, fixed-rate corporate bond market. Securities are classified as HY if the respective middle ratings of Moody's, Fitch and S&P are Ba1, BB+ or BB+ or below. The Bloomberg US HY Long Bond Index, including bonds with maturities of 10 years or greater, and the Bloomberg US HY Intermediate Bond Index, including bonds with maturities of 1 to 9.999 years, are subindices of the Bloomberg US Corporate HY Index.

Bloomberg US Corporate Index – This index measures the investment grade, fixed-rate taxable corporate bond market. It includes U.S. dollar-denominated securities publicly issued by U.S. and non-U.S. industrial, utility and financial issuers.

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Bloomberg US Mortgage-Backed Securities (MBS) Index – This index measures the performance of investment grade, fixed-rate, mortgage-backed, pass-through securities of the government-sponsored enterprises (GSEs): Federal Home Loan Mortgage Corp. (Freddie Mac), Federal National Mortgage Association (Fannie Mae) and Government National Mortgage Association (Ginnie Mae).

Bloomberg US Municipal Bond Index – This index covers the U.S. dollar-denominated, long-term tax-exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds and pre-refunded bonds.

Bloomberg US Non-Agency Commercial Mortgage-Backed Securities (CMBS) Index – This index measures the market of non-Agency investment grade conduit and fusion CMBS deals with a minimum current deal size of $300 million.

Bloomberg US Treasury Index – This index measures U.S. dollar-denominated, fixed-rate nominal debt issued by the U.S. Treasury with a remaining maturity of one year or more. Treasury bills are excluded by the maturity constraint but are part of a separate Short Treasury Index.

FICO Score – This credit score, created by the Fair Isaac Corp., is used by lenders along with other details on a borrower's credit report to assess credit risk and determine whether to extend credit.

High Yield (HY) – Bonds that pay higher interest rates because they have lower credit ratings than investment grade (IG) bonds. HY bonds are more likely to default, so they must pay a higher yield than IG bonds to compensate investors.

ICE BofA AA-BBB U.S. Asset-Backed Securities (ABS) Index – This index, a subset of the ICE BofA U.S. Fixed-Rate ABS Index, tracks the performance of U.S. dollar-denominated, investment grade (IG) ABS rated AA-BBB publicly issued in the U.S. domestic market. Qualifying securities must have an IG rating based on an average of Moody's, S&P and Fitch.

ICE BofA 3-5 Year U.S. Non-Financial Corporate Index – This index, a subset of the ICE BofA U.S. Non-Financial Corporate Index, tracks the performance of corporate credit, excluding financial companies, with a maturity of three to five years.

ICE BofA U.S. Fixed-Rate Asset-Backed Securities (ABS) Index – This index tracks the performance of U.S. dollar-denominated, investment grade (IG) ABS publicly issued in the U.S. domestic market. Qualifying securities must have an IG rating based on an average of Moody's, S&P and Fitch.

Investment Grade (IG) – Rating that signifies a municipal or corporate bond presents a relatively low risk of default. Bonds below this designation are considered to have a high risk of default and are commonly referred to as high yield (HY) or "junk bonds." The higher the bond rating the more likely the bond will return 100 cents on the U.S. dollar.

J.P. Morgan Collateralized Loan Obligation Index (CLOIE) – This market value-weighted index comprises U.S. dollar-denominated collateralized loan obligations (CLOs).

Overcollateralization (OC) – Provision of collateral that is worth more than enough to cover potential losses in cases of default.

Par – Short for "par value," par can refer to bonds, preferred stock, common stock or currencies, with different meanings depending on the context. Par most commonly refers to bonds, in which case, it means the face value, or value at which the bond will be redeemed at maturity.

S&P 500 Index – This unmanaged capitalization-weighted index of the stocks of the 500 largest publicly traded U.S. companies is designed to measure performance of the broad domestic economy through changes in the aggregate market value of the 500 stocks, which represent all major industries.

Special Purpose Vehicle (SPV) – Legal entity created to serve a specific business or investment purpose. SPVs are often used in real estate and finance transactions, and in large lending scenarios.

Spread – Difference between yields on differing debt instruments, calculated by deducting the yield of one instrument from another. The higher the yield spread, the greater the difference between the yields offered by each instrument. The spread can be measured between debt instruments of differing maturities, credit ratings or risk.

Standard Deviation – Measure of the variation or dispersion of a set of data from its mean or expected/budgeted value. A low standard deviation indicates that the data points tend to be very close to the mean, whereas a high standard deviation indicates that the data is spread out over a large range of values. A measure of an investment's volatility.

Yield to Maturity (YTM) – The total return anticipated on a bond if the bond is held until it matures. Yield to maturity is considered a long-term bond yield but is expressed as an annual rate.

Yield to Worst (YTW) – The lowest yield of a bond that can be received short of default.

You cannot invest directly in an index.

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