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# Why securitized products can enhance fixed income diversification

*Securitized bonds may be used to create diversified portfolios through various risk exposures.*

*Fixed income investors tend to be underallocated to funds that exploit securitized opportunities, preferring more familiar sectors like high yield, bank loans, and emerging-market debt.*

*The securitized sectors are attractive for constructing portfolios because they offer diverse asset types and structures, attractive return potential, and low correlation to other asset classes.*

## Securitized debt offers underlying fundamental diversification

We believe investors should diversify their portfolios across the fixed income risk spectrum to seek to manage risk and optimize returns, and that securitized debt can play an important role in this framework. Within fixed income, there are four primary risk premiums: term structure, credit, prepayment, and liquidity. Government securities provide investors' exposure to the term structure risk premium; corporates provide exposure to both the corporate credit risk premium and term structure.

In contrast, securitized debt derives its returns from other risk premiums, primarily mortgage credit and prepayment risk (see illustration below). Investing in portfolios with securitized debt can be an attractive way to complement exposure to corporate, government, and other types of traditional fixed income sectors. By adding securitized debt into a broader asset allocation framework, investors can diversify and potentially reduce the volatility of their portfolios over business cycles (see illustration on next page).

# The securitized universe gives investors exposure to a unique set of risk premiums

| | Term-structure risk | Credit risk | Prepayment risk |
|---|---|---|---|
| **Government debt** | | | |
| U.S. 10-year Treasury note | High | — | — |
| Brazil 10-year Treasury note | High | High | — |
| **Corporate debt** | | | |
| AA-rated corporate bond | Moderate | Low/Moderate | — |
| B-rated high-yield bond | Low | High | Varies |
| **Securitized debt** | | | |
| Agency 30-year MBS | Moderate | Low | Low/Moderate |
| Agency interest-only (IO) strip | High | Low | High |
| AAA-rated 5-year CMBS | Low/Moderate | Low/Moderate | Low |
| BB-rated CMBS | High | High | Low |

For illustrative purposes only.

Source: Putnam.

## Investors avoided securitized products post-crisis

In the aftermath of the global financial crisis, many retail and institutional investors shunned the securitized sectors. Non-agency residential mortgage-backed securities such as sub-prime, Alt-A, and pay option ARMs became synonymous with the crisis itself, and other securitized sub-sectors such as commercial mortgage-backed securities (CMBS), mortgage derivatives (agency IO/POs), and asset-backed securities (ABS) suffered from serious liquidity issues.

In subsequent years — the era of persistent quantitative easing — investors flocked toward higher yielding assets, but preferred exposure to high-yield corporate credit, bank loans, and emerging-market debt. Although these sectors had also sold off meaningfully during the crisis, investors' familiarity with corporate and sovereign debt made them more comfortable in extending allocations to these areas. Meanwhile, during the same period in which many preferred to stay away from securitized investing, changes in U.S. regulation governing how residential mortgage loans are underwritten, packaged, and securitized served to make the overall housing finance system safer.

In more recent years, sophisticated allocators such as pension plans, foundations, and investment consultants have taken the view that securitized sectors are effective building blocks of a diversified fixed income portfolio.

The diversity of loan types that can be packaged into securitized bonds and the bond structures that can be created via the securitization process allow for an opportunity set that cuts across a broad risk/return spectrum and therefore creates a valuable tool for portfolio construction.

Pension plans typically place securitized strategies within their dedicated credit sleeve or within a non-traditional or opportunistic fixed income allocation. For some, these strategies fall into the alternatives bucket. Within a traditional core/core plus allocation, pension plans expect securitized sectors to play a meaningful role in alpha generation. Meanwhile, the consultant-outsourced CIO (OCIO) channel, which manages money on behalf of institutional clients , utilizes dedicated securitized strategies as part of a broader multi-asset solution, whether income or total return based.

Given the opportunity that we see in securitized strategies, we think it is worth asking whether investors, both institutional and retail, have adequate allocations. We have found several ways in which securitized debt offers competitive return potential and sometimes superior diversification potential relative to high yield, bank loans, and emerging-market debt, areas that investors have typically favored for diversifying a fixed income portfolio.

## Valuation and diversification benefits

We currently find various securitized sectors to be attractive from an overall valuation perspective, as well as versus competing risky fixed income assets. Even though the global financial crisis has been over for a decade, liquidity risk is still priced into valuations. Meanwhile, yields and expected returns compare favorably with high-yield corporate credit and emerging-market debt. Just as importantly, the sectors have demonstrated a diversification benefit, particularly when comparing the excess returns of the securitized sectors with other asset classes (see illustration below).

As shown below, the relationship of excess returns between high yield, loans, EM, and equities is quite strong (see numbers boxed in red in table below). However, correlations of these sectors to securitized are meaningfully lower (see numbers boxed in green) due to exposure to fundamentally different risk exposures: household/commercial versus corporate. Additionally, the correlations between each of the securitized sectors are particularly low. Although these assets are exposed to the same homeowner balance sheet, they are also subject to the optionality that homeowners have each month to either 1) pay their mortgage, 2) default on their mortgage, or 3) refinance their mortgage — only one of which they can do at any given time. As a result, the primary risk embedded in these securities differs — mortgage credit risk in non-agency RMBS, and prepayment risk in agency.

## Securitized investing within Putnam Fixed Income

In summary, we believe allocating to portfolios with securitized debt exposure is an effective strategy to meet investor needs. We utilize securitized sectors to be meaningful alpha drivers across our Fixed Income suite. For example, Putnam Income Fund, which competes in the Lipper Core Bond space, derives much of its active risk in prepayment risk strategies like agency IO as well as in mortgage credit areas like mezzanine commercial mortgage-backed securities (CMBS) and agency credit risk transfer (CRT) securities. These allocations are driven by a belief in the fundamental diversification they bring to a core bond portfolio in excess of what is represented in benchmarks. Additionally, we believe that, at this point in the economic cycle, spreads in many sub-sectors of the securitized market look favorable compared with other fixed income assets. As the securitized markets continue to evolve and grow, we expect to continue to exploit these new opportunities to add value in our portfolios.

# Sectors with attractive liquidity premiums also provide diversification

Correlation of monthly hedged excess returns since 2009

| | IG | HY | LOANS | EM USD | S&P | MSCI World | NA RMBS | Agency IO | CMBS | Agency MBS |
|---|---|---|---|---|---|---|---|---|---|---|
| **IG** | — | | | | | | | | | |
| **HY** | 0.90 | — | | | | | | | | |
| **Loans** | 0.82 | 0.88 | — | | | | | | | |
| **EM USD** | 0.85 | 0.88 | 0.73 | — | | | | | | |
| **S&P** | 0.54 | **0.65** | 0.42 | **0.62** | — | | | | | |
| **MSCI World** | 0.63 | **0.71** | 0.49 | **0.71** | 0.97 | — | | | | |
| **NA RMBS** | 0.43 | 0.35 | 0.35 | 0.32 | **0.16** | **0.22** | — | | | |
| **Agency IO** | 0.36 | 0.43 | 0.48 | 0.39 | **0.23** | **0.25** | 0.20 | — | | |
| **CMBS** | 0.58 | 0.48 | 0.49 | 0.39 | **0.26** | **0.31** | 0.38 | 0.01 | — | |
| **Agency MBS** | 0.22 | 0.25 | 0.24 | 0.25 | **0.11** | **0.14** | 0.21 | 0.19 | 0.29 | — |

**Higher correlations: ≥ 0.6**

**Credit sectors commonly used for equity diversification do not achieve that goal**

**Lower correlations: < 0.6**

**Lower correlations: < 0.6**

Sources: Barclays, Putnam, as of 3/31/19. For illustrative purposes only. Indices used in the above calculation include the BBG Barclays U.S. Corporate Index, BBG Barclays U.S. High Yield Index, S&P/LSTA Leveraged Loan Index, and the BBG Barclays EM USD Sovereign Indices. Where there is no available representative index, data is based on a universe of securities selected by Putnam that are representative of various fixed income sectors and subsectors within the mortgage market.

Numbers less than 1 indicate a diminishing correlation. The maximum correlation is 1 and the minimum is 0, with values between 0 and -1 indicating negative correlation.

Diversification does not assure a profit or protect against loss. It is possible to lose money in a diversified portfolio.

The views and opinions expressed are those of the authors as of April 2019, are subject to change with market conditions, and are not meant as investment advice.

**Consider these risks before investing:** Funds that invest in government securities are not guaranteed. Mortgage-backed investments, unlike traditional debt investments, are also subject to prepayment risk, which means that they may increase in value less than other bonds when interest rates decline and decline in value more than other bonds when interest rates rise. Bond investments are subject to interest-rate risk (the risk of bond prices falling if interest rates rise) and credit risk (the risk of an issuer defaulting on interest or principal payments). The fund may have to invest the proceeds from prepaid investments, including mortgage-backed investments, in other investments with less attractive terms and yields. Interest-rate risk is generally greater for longer-term bonds, and credit risk is generally greater for below- investment-grade bonds. Risks associated with derivatives include increased investment exposure (which may be considered leverage) and, in the case of over-the-counter instruments, the potential inability to terminate or sell derivatives positions and the potential failure of the other party to the instrument to meet its obligations. Unlike bonds, funds that invest in bonds have fees and expenses. Bond prices may fall or fail to rise over time for several reasons, including general financial market conditions, changing market perceptions (including perceptions about the risk of default and expectations about monetary policy or interest rates), changes in government intervention in the financial markets, and factors related to a specific issuer or industry. These and other factors may lead to increased volatility and reduced liquidity in the fund's portfolio holdings. You can lose money by investing in the fund.

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