



How Asset-Backed Securities Can Benefit Your Portfolio

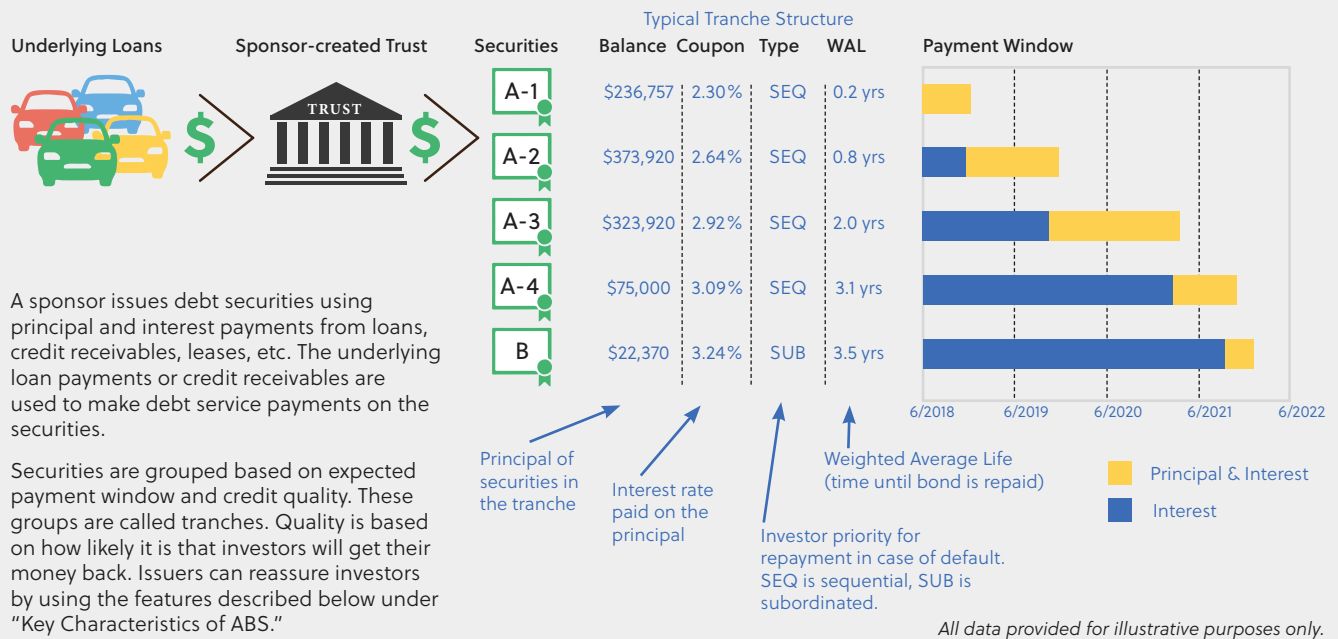
InvestEd August 2018

What Are Asset-Backed Securities (ABS)?

ABS are notes backed by underlying pools of assets, commonly consisting of automobile loans and leases, credit card receivables, equipment leases, student loans and others. Most ABS deals comprise multiple classes of securities, or “tranches,” each with its own coupon, expected cash flows and risk characteristics. They can serve as a component of fixed-income portfolios, offering investment diversification and the opportunity for higher yields relative to comparable-duration U.S. Treasuries and federal agencies.

ABS structure includes three key parties: the sponsor, the trust and the investor. In most cases, the sponsor — a bank, credit card issuer or retail finance company — transfers the loans or receivables to a separate trust, which is established to legally own and securitize the assets. The trust then issues the ABS notes and is responsible for paying investors principal and interest in a timely manner.

HOW DO ABS WORK?



Key Characteristics of ABS

1. Credit enhancements. Unlike most corporate securities, ABS are typically credit-enhanced, which means they contain features that raise their credit quality above that of the underlying assets. These characteristics increase the likelihood that investors will receive the promised cash flows. The following are examples of credit enhancements:

- **Excess spread** — the difference between the interest rate on the underlying collateral and the bond coupon and deal costs.



- **Cash reserve account** — additional funds set aside by the issuer to provide extra internal liquidity for ABS investors.
- **Overcollateralization** — the amount of collateral in excess of ABS issued.
- **Senior/subordinate structure** — subordinated tranches absorb losses due to defaulted loans up to their value before senior tranches are affected. As a result, subordinate tranches typically offer investors higher yield due to their increased credit risk. This feature provides investors with the option to invest in a tranche that best suits their preferences and risk tolerance.

2. Added value over time. ABS is an asset class that can offer a high degree of safety with returns in excess of those of government bonds and higher risk-adjusted returns compared to other sectors.

3. Large and liquid market. ABS issuance totaled \$559.1 billion in 2017, a 73% increase over 2016, and \$194.3 billion in the first two quarters of 2018.¹ The market overall has more than \$1.5 billion outstanding and has been slowly but steadily increasing over the past few years.

PFM's Approach to ABS

PFM has a rigorous credit review and monitoring process specifically for ABS, going beyond simply accepting assigned ratings and instead focusing on the structure, collateral quality, credit enhancements, and history of the parties to the deal. This includes a review of the sponsor, historical performance of similar deals (especially the default and recovery rates), an analysis of the collateral, underwriting criteria and geographic diversification of the pools. We also conduct or review stress tests that assess the effectiveness of credit enhancements in protecting the tranches we are interested in purchasing. After a purchase is made, we monitor the issue to ensure its performance meets expectations, and we conduct monthly surveillance on all ABS owned in our client's portfolios. We focus on deals that offer the combination of features desired by our clients: high-quality credit profile, safety characteristics, and relative value to other sectors.

Example	Example Issuers/Sponsors
Prime auto loans and leases	Ford, Toyota, Honda, Nissan
Credit card receivables	American Express, CapitalOne, Chase, Citibank
Equipment loans and leases	John Deere, Volvo, Dell

Why Is PFM Recommending ABS Now?

For decades, investors have considered ABS a secure and profitable addition to fixed-income portfolios. With the significant reduction in the supply of federal agency securities (including Fannie Mae and Freddie Mac), which have long been a mainstay of public sector portfolios, high-quality alternative investments like ABS are rising in popularity. At the same time, yield spreads on federal agencies, corporates and most other asset classes are below historical averages. Adding ABS provides another investment option for high-quality portfolios, allowing PFM another opportunity to enhance returns for our clients.

¹ "US ABS Issuance and Outstanding," Securities Industry and Financial Markets Association (August 1, 2018). <https://www.sifma.org/resources/research/us-abs-issuance-and-outstanding/>

The views expressed constitute the perspective of PFM at the time of distribution and are subject to change. The content is based on sources generally believed to be reliable and available to the public; however, PFM cannot guarantee its accuracy, completeness or suitability. This material is for general information purposes only and is not intended to provide specific advice or a specific recommendation. PFM is the marketing name for a group of affiliated companies providing a range of services. All services are provided through separate agreements with each company. Investment advisory services are provided by PFM Asset Management LLC, which is registered with the SEC under the Investment Advisers Act of 1940. For more information regarding PFM's services or entities, please visit www.pfm.com.