



Credit: Lipofsky Basketballphoto.com<sup>2</sup>

## Structured Products: The Sixth Man of a Fixed Income Portfolio<sup>1</sup>

ZAIS Insights

March 2019

Recently, we have seen a number of Requests for Proposals targeting investments in private or opportunistic credit strategies.

We believe that adding structured products and specialty finance (ABS, ABLs, RMBS, CMBS, CLOs, CSOs and the like) to such mandates can significantly enhance a strategy's risk-return profile.

Much like basketball's "sixth man,"<sup>3</sup> the addition of structured products to a broader fixed income portfolio can both reduce risk and enhance returns.

In this article, we discuss the versatility and benefits of structured products within a fixed income portfolio.

In particular, we focus on two key points about structured products in the context of a broader fixed income mandate. First, structured products offer diversification benefits that can help ameliorate portfolio risk; and second, structured products present an opportunity to increase portfolio returns.

In addition, we explore portfolio optimization by examining varying risk-return profiles within structured products.

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<sup>1</sup> As of March 22, 2019. This article represents our views as of the date of publication. We do not undertake to update the article if and when our views may change.

<sup>2</sup> Photo credit: Lipofsky Basketballphoto.com  
[http://www.basketballphoto.com/NBA\\_Basketball\\_Photos.htm](http://www.basketballphoto.com/NBA_Basketball_Photos.htm)

<sup>3</sup> For those of our readers who do not follow U.S. basketball, "sixth man" refers to a player who is not one of the starting five but is substituted in so often that he may play as many minutes of a game as a starter.

## Diversification

Structured products offer investors exposure to a multitude of underlying collateral types.

The broad menu of structured product collateral includes residential real estate, commercial real estate, consumer and commercial loans (auto loans, student loans, installment loans, equipment loans, container loans, etc.) and corporate credit, among others.

Many of these collateral types are further stratified into even finer sub-sectors. For example, Legacy RMBS offer investment opportunities in prime, alt-A and sub-prime credit grades. Similarly, auto collateral is tiered into prime and sub-prime. CRE collateral is segmented into conduit, agency, bridge and small balance.

Each of these gradations has different credit characteristics and may respond differently in various economic scenarios.

Diversification benefits can be sought by carefully constructing a structured products portfolio, within a broader fixed income mandate. This diversification, if properly implemented, can mute portfolio volatility and enhance the portfolio's risk-return profile.

A recent episode illustrates this point. From late 2014 to early 2016, the price of oil dropped by over 50%. This decline was felt most severely in the oil and mining sectors, but also severely affected broader corporate credit. The iShares iBoxx \$ High Yield Corp Bond ETF dropped by about 20% during this period while many structured product sectors held up better, due to tight post-

crisis underwriting and strong underlying fundamentals.

Shifting correlations enable investors to reshape their portfolios with an eye toward risk mitigation.

Investors can tailor their risk preferences via well-informed portfolio construction, including decisions about sector and sub-sector allocations, interest rate and credit spread duration, floating rate versus fixed rate products and where to position within a given capital structure.

## Return Enhancement

Today, many investors looking for a wider set of opportunities beyond core fixed income are considering an "opportunistic credit" allocation to enhance portfolio yield.

We believe "opportunistic credit" has become somewhat of a catchall phrase that captures investors' desire to enhance portfolio returns, while at the same time capturing the risk moderating benefits of diversification.

In our view, a risk premium (related primarily to complexity and illiquidity) is embedded in many structured products, and so structured products tend to offer higher yields per unit of risk compared to investment grade or high yield corporate credit.

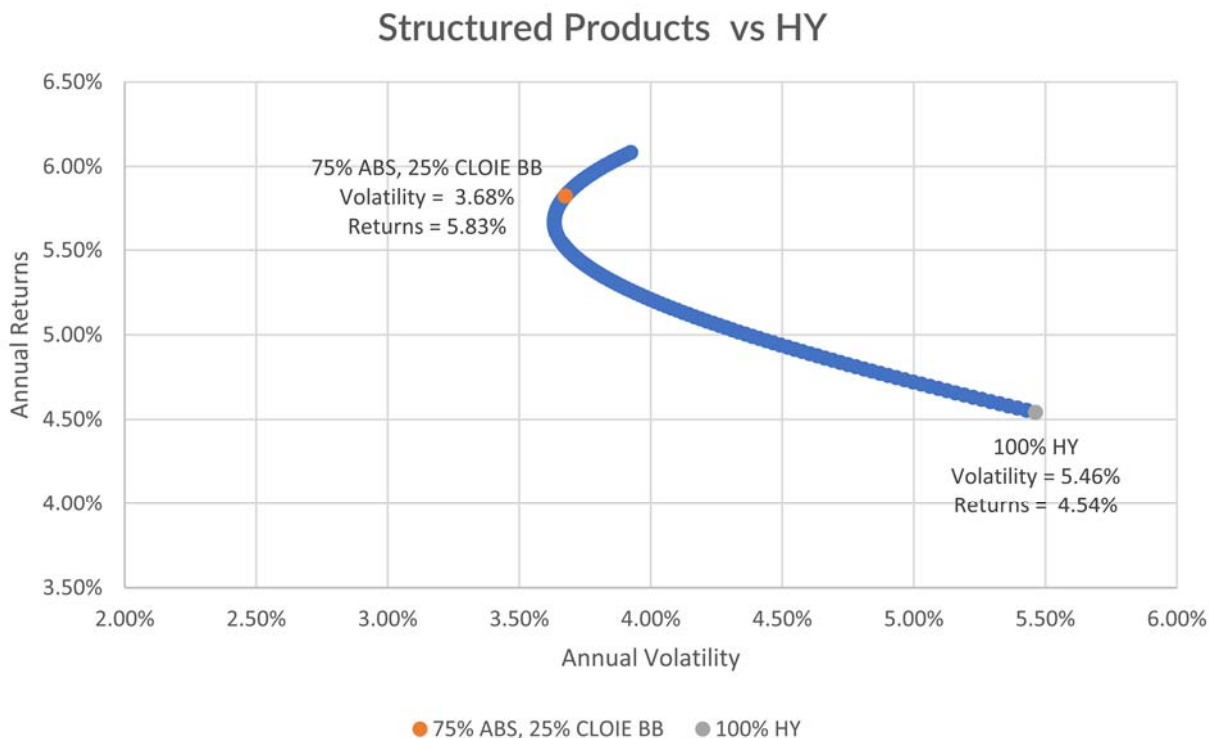
For example, an average CLO BB rated tranche, as of this writing, offers about 300 basis points more yield than a BB high yield bond, but, according to S&P research, has a much lower historical incidence of default.<sup>4</sup> Greater price volatility within the CLO BB sector explains some of the yield premium these instruments offer. However, the ability to differentiate between transitory

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<sup>4</sup> ZAIS analysis of data provided by Standard & Poor's Ratings Direct in the following publications: "U.S. CLO 1.0 Chapter To Close with Minimal Defaults", August 2, 2018; "2017 Annual U.S. Corporate Default Study And Rating Transitions", April 5, 2018; and "Twenty

Years Strong: A look Back at U.S. CLO Ratings Performance from 1994 through 2013, January 31, 2014.

**Figure 1: Visualizing Portfolio Optimization**



Source: ZAIS analysis based on five year return data for the BAML HY Index, HFRI ABS Index and J.P. Morgan CLOIE BB Index as of February 28, 2019.

bouts of price volatility and more pernicious fundamental credit deterioration presents investment opportunities.

Specialized product expertise in conjunction with a disciplined investment approach and thoughtful portfolio allocation are required to extract these risk premiums reliably over time in seeking the path to achieving superior risk-adjusted returns in the long run.

It is also important to consider the relative value trading opportunities presented by such a broad range of products. The ability to analyze these factors and continually reposition the portfolio toward opportunities that, in our view, offer

superior risk-return profiles can result in outperformance.

### Portfolio Optimization

The addition of structured products to a broader fixed income portfolio can provide investors with the opportunity to achieve lower levels of risk while enhancing portfolio returns.

As presented in Figure 1, altering the proportion of structured products to High Yield can create various risk-return profiles that can ultimately be tailored to meet the various objectives of specific investors. Investors also can target specific structured product asset classes based on risk parameters, regulatory constraints or

internal investment guidelines, to meet their specific needs.

Figure 1 examines the impact on return and volatility of combining structured products portfolio with a high yield index in varying proportions.

In Figure 1 we see that a 100% allocation to the BAML HY index over the past five years would have yielded a lower return with higher volatility than the mixed structured products portfolio we analyzed.

In conclusion, we believe an actively managed structured products portfolio can enhance core fixed income portfolios through diversification and higher returns, while mitigating certain risks.

Managers such as ZAIS that specialize in structured products can help investors tailor exposures to seek to meet their specific investment goals.

ZAIS has a vertically integrated platform, through which we invest in a broad array of loans and securitized products across the

corporate, consumer and real estate sectors.<sup>5</sup>

This platform provides us with a broad view, enabling us to identify those sectors and securities that we believe offer the best risk-adjusted returns across securitized products and private credit.

Further, we can tailor these exposures to meet the needs of particular investors.

ZAIS has been investing in structured products for more than 20 years, through many market environments. Our investment team has deep asset and loan-level expertise. We welcome you to contact us to discuss your fixed income investment goals.

### More information

As always, we are available to discuss our views with you. Please contact your client relations representative at +1 732 978 9722 or [zais.clientrelations@zaisgroup.com](mailto:zais.clientrelations@zaisgroup.com).

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<sup>5</sup> Since its inception in 1997, ZAIS has invested approximately \$13 billion across 4,000+ positions in CLOs, predominantly BBB's through equity, and over

\$26 billion across 11,000+ positions in Mortgage and Asset-Backed securities.

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