Securitized Credit

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INVESTMENT MANAGEMENT
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Executive Summary

- Securitization is a process by which pools of assets are repackaged into fixed income securities that can be efficiently distributed into the capital markets.
- The securitized credit asset class includes asset-backed securities (ABS), commercial mortgage-backed securities (CMBS) and non-agency residential mortgage-backed securities (RMBS).
- Securitized assets may benefit from “credit enhancement,” which creates securities with higher ratings than the issuing company and helps protect invested principal.
- Securitized markets offer generous credit spread premiums relative to other fixed income sectors, which, when combined with the fundamental backdrop, make opportunities apparent.
- The low correlation of securitized assets with other risk assets has provided diversification benefits over time.
- Securitized products historically have outperformed in rising-interest rate regimes.
- Securitized assets have delivered a higher return-to-risk ratio than other fixed income assets.

Introduction to Securitization

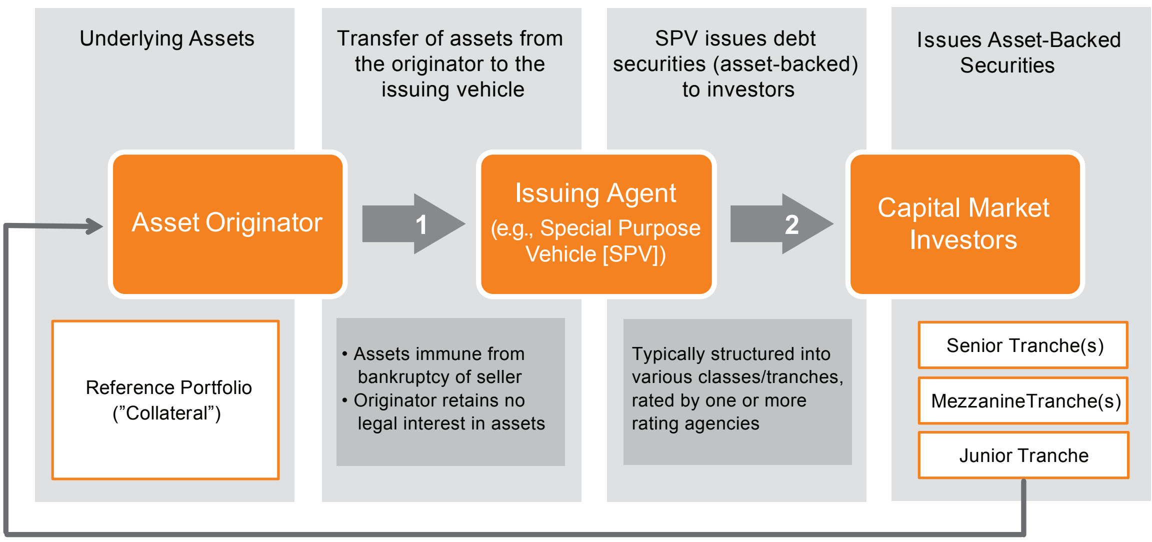
Years removed from the credit crisis, the securitized credit markets continue to trade at premiums relative to competing fixed income asset classes. This is despite a fundamental backdrop that reflects a firmly entrenched economic recovery in the U.S. and a mix of buyers that has consistently been tilted heavily toward those comfortable with the risk inherent in this multi-faceted, opportunity-rich asset class.

This paper introduces the securitized asset class, focusing on the evolution of the market as a whole as well as the key characteristics of its major subsectors. These include asset-backed securities (ABS), commercial mortgage-backed securities (CMBS) and non-agency residential mortgage-backed securities (RMBS). We seek to equip readers with additional appreciation for the attributes of securitized products and how those qualities may make the asset class an attractive one for investors.

Securitization refers to the process by which pools of assets are repackaged into interest-bearing fixed income securities that can be efficiently distributed into the capital markets. Investors in securitized bonds rely on principal and interest payments from the asset pool for repayment — not the creditworthiness of the entity that originated the underlying assets.

The securitization process enables lenders to finance assets outside of traditional unsecured corporate debt markets and do so in a manner that does not increase the company's liabilities. Pools of assets compiled by these lenders are segregated into a special purpose entity that is immune to bankruptcy.

Figure 1. How Securitization Works



Source: Voya Investment Management

In executing a securitization, the lender transfers the economics (i.e., all payments and losses, as depicted in step 1 of Figure 1) associated with the asset pool in exchange, ultimately, for financing via the securitized markets (step 2). Interim steps involve structuring the newly issued securities that are collateralized by the asset pool (grouped into step 2 above). The vehicle that accommodates this exchange (a "special purpose vehicle," or SPV) is extremely limited in its scope, structured to be independent of the asset originator and to be considered remote from a potential bankruptcy over the course of its life. These steps and considerations are vital to the success of a transaction, both in terms of efficiently pairing issuers with investors at the time of issuance as well as over the entire life of a securitization.

A crucial structural ingredient is imparted in the securitization process: credit enhancement. Credit enhancement seeks to 1) mitigate credit risk associated with repayment of the underlying assets and 2) provide returns high enough to attract investors but low enough to make the securitization an efficient form of financing for the issuer. We discuss credit enhancement in detail on page 5 after reviewing the history and development of securitized markets.

A Brief History of Securitized Markets

The birth of securitization can be traced back to 1970 with the issuance of a security by the Government National Mortgage Association (GNMA or "Ginnie Mae"), a transaction collateralized by a pool of residential mortgages. This was followed by securitizations of mortgages by other government-sponsored entities (GSEs): Federal Home Loan Mortgage Corporation (FHLMC or "Freddie Mac") and Federal National Mortgage Association (FNMA or "Fannie Mae"). These initial securitizations were relatively simplistic, merely "passing through" cash flows of the underlying mortgages. In the early 1980s, additional structuring of the resulting cash flows came into vogue with issuance of "tranched" interests in securitizations of mortgage portfolios. This technology proliferated to private-sector banks that financed their non-government guaranteed mortgage portfolios.

In 1985, securitization technology migrated to non-mortgage asset classes via a securitization collateralized by leases, followed shortly by a securitization of auto loans and, later, credit card receivables. The product continued to develop and proliferate across issuers, asset classes and countries. Geographically, securitization was solely a U.S. innovation for the first 15 years, until this financing technology was utilized in the U.K. in 1985 and more broadly across Europe in the 1990s. Securitization markets have continued to evolve, but the U.S. remains the largest user of this technology.

The private mortgage securitization market continued to grow alongside the evolving ABS market. In 2004 the commercial banks, thrifts and investment banks caught up with Fannie Mae and Freddie Mac in securitizing home loans and by 2005 they overtook them. Private MBS grew, at least in part, by issuers capitalizing on investor risk appetite for mortgage credit risk, regarded as benign given the uninterrupted run of house price appreciation in the U.S. economy. This risk was not available in agency MBS, as the GSEs immunized the investor from the exposure. As investor risk appetite expanded, increasingly lower-quality, higher-risk mortgages were securitized. The GSEs also relaxed their credit underwriting standards for mortgages during this period.

In combination, these trends fueled a broader distortion — i.e., bubble — in the U.S. housing market. Until the financial crisis, the vast majority of non-agency RMBS were highly rated and regarded as high-quality investments with strong liquidity and tight credit spreads. The bonds were considered attractive because they could be tailored through the securitization structuring process to satisfy specific investor needs for duration and interest rate sensitivity. Before the credit crisis, cash flow volatility from potential prepayment rates — rather than credit quality — was the main risk evaluated by investors. In this setting, securitization of lower-quality mortgages increased, accelerated through 2007 and was a significant contributor to the credit crisis that followed.

In parallel with this growth in risk appetite, leverage in the global financial system grew significantly through the 1990s and the early 2000s. The shadow banking system — loosely defined as the collective universe of non-bank financing markets and considered a good proxy for financial system leverage — reached its historical highs during this period. Beginning in 2007, this peak in financial system leverage and securitization issuance coincided with the burst of the housing market bubble. Thereafter, tremendous forced de-leveraging drove the collapse of the private label RMBS market and major disruption across the other securitized markets. The fallout was significant: The landscape of private sector participants in the securitized markets has been reshaped, the regulatory regime has been rewritten (and mostly implemented), and the evaluation of risk by market participants has been forever changed.

A longstanding recovery has followed in the securitized markets, highlighting their resilience and fundamentally necessary role in global financial markets. While the recovery has been uneven across major subsectors and challenges remain, investors in ABS, CMBS and non-agency RMBS profited meaningfully from properly selected investments in the aftermath of the credit crisis as liquidity normalized and the fundamental recovery got underway.

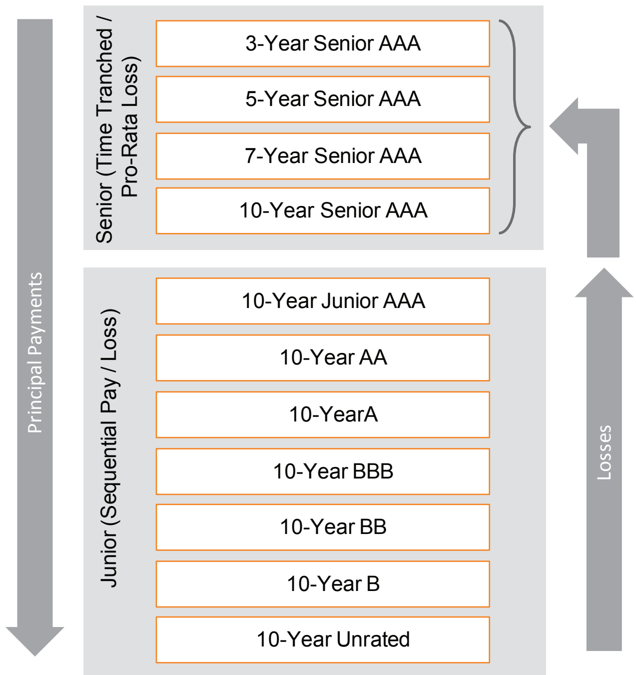
Credit Enhancement Aids Borrowers and Investors

Credit enhancement is an integral part of the securitization structuring process and can be provided in several forms by issuing entities. Credit enhancement creates a security that can have a higher rating than the issuing company, thus allowing the issuing company to monetize its assets more efficiently. From an investor's perspective, credit enhancement helps protect invested capital by mitigating credit risk associated with the underlying assets. Major forms of credit enhancement are explained below.

- **Subordination.** Senior/subordinated security structures are the most common form of credit enhancement. A securitization is divided into tranches in order to prioritize the cash flows from the underlying assets; investors in senior tranches of a transaction have higher-priority interest than investors in subordinated tranches. Since the effect of each dollar of loss from the underlying asset pool is disproportionately impactful to subordinated tranches, these investors typically are paid higher coupon payments than senior tranche investors to compensate for this additional risk.

As discussed above, senior/subordinated structures consist of several prioritized layers of interest in the underlying assets and their cash flows. Cash flows from the underlying assets are distributed “top down” and losses are allocated “bottom up” across tranches into what can be referred to as a “waterfall” of payment distributions with the subordinated tranches functioning as protective layers for the more senior tranches. If and when defaults in the underlying asset pool occur, the senior tranche is expected to be unaffected unless losses exceed the total amount of the subordinated tranches. The bottom-most tranche is in a “first loss” position and can be considered akin to equity capital in a corporate entity.

Figure 2. A Sample CMBS “Waterfall”



Source: Voya Investment Management

Senior bonds are typically structured with sufficient subordination to command the highest credit ratings and are usually rated AAA; subordinated tranches span a wide range of credit ratings and may even be available below investment grade (BBB- and lower). Senior bonds have first right to repayment of principal — sooner than subordinated bonds, which are often “locked out” of principal amortization for some period of time.

- **Excess spread.** Excess spread refers to the difference between the interest rate received on the underlying collateral and the weighted average coupon paid to investors. When included in a securitization, excess spread is typically one source of cash flow used to absorb credit losses. In most cases, excess spread is of a sufficient amount such that coupon payment still can be made even if some portion of the underlying payments is delinquent.

- **Overcollateralization.** Overcollateralization exists when the outstanding principal balance of assets underlying the securitization is greater than the principal balance of the bonds issued by the special purpose vehicle. Thus, the transaction has "cushion" to absorb some amount of potential losses from the underlying asset pool while still returning full principal and interest payments to investors.
- **Reserve account.** In some transactions, a reserve account is established with assets prioritized to absorb potential losses from the underlying asset pool before being allocated to bondholders. These accounts can be increased or decreased over time, fund when certain performance "triggers" are hit or are structured to be non-declining for the life of the transaction. With a non-declining reserve account, investors benefit increasingly as underlying bonds repay over time since a growing proportion of the principal balance is protected from losses.

The Role of Securitization in the Economy

Though much-maligned in the wake of the global financial crisis, securitized markets are an important part of the economy.

- **Increases capital for lending.** A significant contributor to the "shadow" banking system, securitization allows financial institutions to access financing without increasing their liabilities, thereby expanding the capital available to be loaned out, helping keep borrowing costs down and making loans available to more borrowers. Lower, stabilized lending positively impacts credit creation and stimulates economic growth.
- **Generates liquidity from otherwise illiquid asset pools.** Structuring new securities collateralized by securitized asset pools increases the liquidity of previously illiquid asset types. As the securitization market has evolved, market participation has broadened, building the depth of liquidity across a growing range of asset types. Reliable access to liquidity is attractive to both issuers and investors, improving stability within the capital markets.
- **Enhances diversification and reduces risk.** Pooling and distribution of structured assets enhances diversification, diffusing concentrations of risk and, in principle, reducing the vulnerability of the economic cycle to recession. Moreover, as securitization technology has evolved, investors' ability to tailor the risk profiles of their portfolios has been improved, providing enhanced return potential, new options in the endless quest for yield and a wider range of mandate types.

Securitized Credit Product Sectors

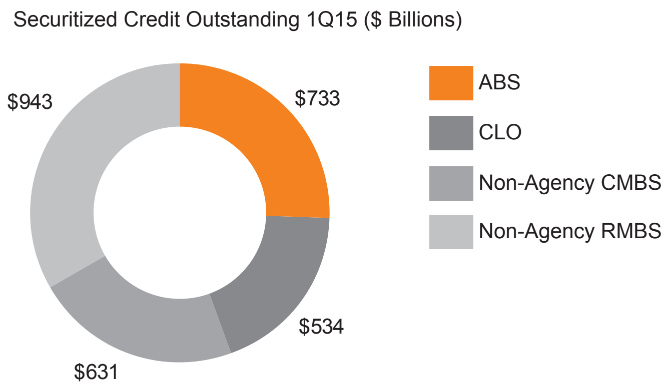
The securitized credit asset class can be segmented into three main categories: asset-backed securities, commercial mortgage-backed securities and residential mortgage-backed securities. Each sector offers a unique array of fundamental drivers that impact performance and, accordingly, each serves varying purposes in a fixed income portfolio. While collateralized loan obligation (CLOs) are typically included in the ABS universe, they are identified separately in Figure 3 given the unique, non-consumer-based attributes of this sizeable ABS subsector.

Figure 3. A Comparison of the Key High-Level Drivers and Attributes of Securitized Subsectors

	ABS	CLO	CMBS	Non-Agency RMBS
Primary Fundamental Driver	Consumer	Corporate credit cycle	Commercial real estate market	Housing market
Secondary Fundamental Driver	Access to credit	Manager skill	Labor market	Labor market
Key Sector Specific Risk	Student loan market dynamics	Regulatory compliance	Maturity wall	Mortgage servicing risk
Typical Credit Rating	High investment grade	Mid to high investment grade	Low investment grade	Below investment grade
Weighted Average Life	<= 5 years	<= 10 years	3-10 years	4-6 years
Fixed or Floating	Mixed	Floating	Primarily fixed	Mixed
Typical Benchmark	ABS portion of Barclays U.S. Aggregate Index	Not in Barclays U.S. Aggregate Index; senior loan indexes	CMBS portion of Barclays U.S. Aggregate Index	Not in Barclays U.S. Aggregate Index; Agency RMBS

Source: Voya Investment Management

Figure 4. Credit Outstanding Is Broadly Spread Across Securitized Sectors

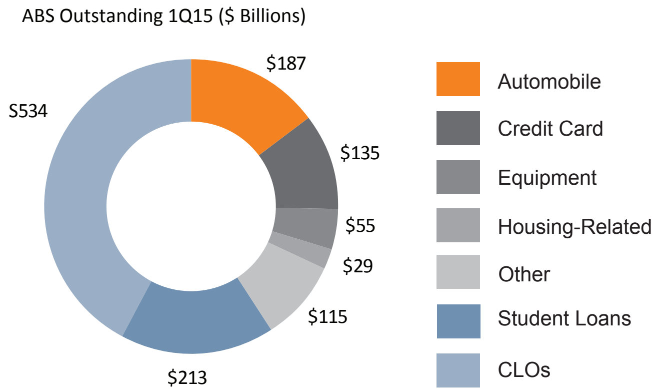


Source: Securities Industry and Financial Markets Association

Asset-Backed Securities

Since the first lease deal in the 1980s, the ABS sector has continued to innovate and to encompass additional asset classes over time; it now includes corporate loans, student loans, leases, credit card lines and auto loans.

Figure 5. CLOs Dominate ABS Sector



Source: Securities Industry and Financial Markets Association

Characterized by high credit quality and stable performance, ABS was the first major securitized sector to see liquidity normalize and new issuance rebound after the credit crisis. While issuance has yet to fully return to pre-crisis levels, the relatively steady issuance each year since the crisis is indicative of its strong recovery.

ABS is a component of the Barclays U.S. Aggregate Index, and the core ABS asset classes command strong liquidity from a relatively broad range of investor types while exhibiting less sensitivity to changes in interest rates (i.e., lower duration).

Definition. An asset-backed security was defined in the Dodd-Frank Act as "…a fixed-income or other security collateralized by any type of self-liquidating financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset." It is this non-mortgage nature of the underlying asset class, rather than the transaction structure, that best differentiates ABS from its mortgage-backed siblings.

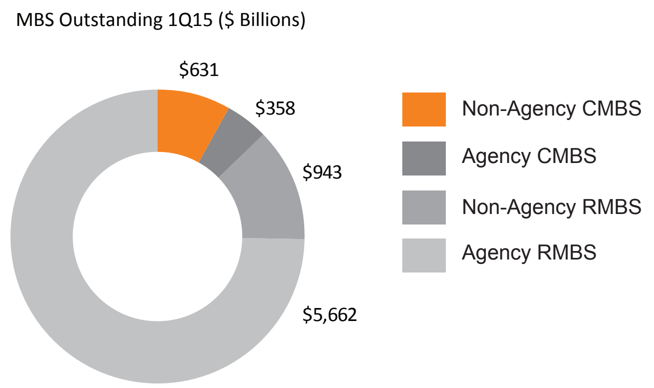
Investors. The ABS market commands perhaps the deepest and most stable investor base across the securitized products landscape. Dominated by the money management community, investors in ABS generally speaking are attracted by the sector's high credit quality and stable price profile. Specifically, banks and insurance companies are meaningful investors in ABS transactions, with relatively efficient capital requirements — an additional motivation. The CLO sub-segment has unique collateral (corporate loans) and structural attributes (manager, floating rate assets/cap structure, refinance/call windows) that entice different buyers, such as individual investors, asset managers and, for the more subordinated tranches, hedge funds.

Current View. While ABS sectors are not immune from idiosyncratic risks, the majority justify their relatively stable price profiles with fundamentally-driven performance. Overall, the sector trades with steady liquidity, reflective of a supportive fundamental backdrop. For more detail, please refer to the Appendix, "Securitized Markets: Current Sector Highlights."

Mortgage-Backed Securities: Commercial and Residential MBS

Securitizations collateralized by mortgages are best bifurcated by the nature of the real estate securing the mortgage — i.e., commercial (CMBS) or residential (RMBS). These markets are further divided by issuer — i.e., those issued by a government-sponsored entity (GSE or "agency") and those that are not ("private label"). The repayment of agency MBS is guaranteed by the GSEs, while private label MBS transfers credit risk of the underlying mortgages to investors.

Figure 6. Agency Issuance Dominates MBS Market



Source: Securities Industry and Financial Markets Association (SIFMA)

Commercial Mortgage Backed Securities

Definition. Using the previously cited definition of an asset-backed security from Dodd-Frank as a basis, commercial mortgage-backed securities are repaid by payments in respect of commercial mortgage loans. Common property types found collateralizing CMBS include retail properties (regional malls, strip centers, etc.), office properties, industrial properties (warehouses, manufacturing facilities, etc.), multifamily housing (apartment buildings) and hotels. Unlike owner-occupied single-family housing, commercial properties are income producing and operate for economic profit.

Investors. The CMBS market features a relatively broad mix of investor types, a mix that has evolved meaningfully since the credit crisis. The sector continues to be dominated by insurance companies, attracted by the longer-duration, less prepayment-prone and fixed-rate cash flows provided by commercial mortgage loans. Insurance company investors have been further attracted by the relatively efficient capital requirements associated with these investments. The asset management community and some hedge funds have also been attracted to different parts of the CMBS complex and remain meaningful investors today.

Current View. Like ABS, CMBS has a constantly evolving mix of catalysts for performance of the underlying asset pools and, consequently, valuations. However, these catalysts tend to be more idiosyncratic in nature, unique to specific properties/commercial mortgages. Therefore, high-conviction investing within CMBS requires loan-level analysis as part of the investment process, regardless of the macroeconomic backdrop. Nevertheless, broader trends can act as catalysts for performance in CMBS. For more detail, please refer to the Appendix, "Securitized Markets: Current Sector Highlights."

Residential Mortgage Backed Securities — Private Label/Non-Agency

Definition. A residential mortgage-backed security is a securitization of mortgage loan payments received from homeowners of single-family housing units. Residential mortgages were the first to be securitized and remain the largest securitized market, despite the distortions resulting from the credit crisis. Private-label — or non-agency — RMBS refer to those that are not guaranteed repayment by the government-sponsored entities.

Investors. Private-label RMBS command the attention of each of the major investor types that traffic in securitized markets. Asset managers are the largest such investing segment, attracted by the sector's relatively high loss-adjusted yields and fundamental backdrop. Insurance companies have also returned as a meaningful investor in private-label RMBS, attracted by the same general drivers as asset managers, but also influenced by an improved regulatory capital regime afforded by the National Associations of Insurance Commissioners (NAIC). Hedge funds have also been a meaningful source of demand since the credit crisis, capitalizing on the illiquidity in certain subsectors to generate outsized profits.

Current View. The non-agency RMBS markets were at the forefront of the credit crisis, and the entire sector has been completely reshaped. As a result, this subsector has been the slowest to recover. Opportunities, while lesser in magnitude than in the first years after the credit crisis, are still available as the recovery in the U.S. housing market continues. For more detail, please refer to the Appendix, "Securitized Markets: Current Sector Highlights."

Potential Benefits of Investing in Securitized Credit Now

Strong Market Dynamics. The global credit crisis left opportunities for investment in securitized credit, as markets have remained inefficient and dislocated. Regulatory capital pressures and other directives levied on domestic and European financial institutions have prompted sales of large pools of non-agency RMBS and CMBS — sales that have periodically distorted market technicals and temporarily impaired liquidity. On balance, these factors have conspired to leave securitized products offering significant yield premiums versus other fixed income markets.

When weighing these yield premiums against today's fundamental backdrop, opportunities become apparent. As the U.S. economy has recovered, liquidity and investor demand for securitized credit have followed suit. In particular, the ongoing recovery in real estate directly supports the performance of MBS. The sizeable and resilient recovery in the U.S. labor market has directly supported consumers' fiscal strength, which bodes well for ABS. Direct access to these risks is uniquely available through investment in securitized credit markets. Moreover, leveraged exposure to specific fundamental risks through securitization technology allows portfolios with a particularly focused combination of risks to be constructed.

Increased Liquidity and Regulation. As the preponderance of potential mass-sellers has declined, liquidity across securitized credit markets has solidified and deepened from the depths of the credit crisis. While the willingness and capacity of broker/dealers to bear inventory risk has decreased across fixed income markets in general, the vast majority of bonds across securitized credit markets trade with same-day liquidity and do so across a relatively wide range of market conditions. Existing regulation, while punitive across a wide range of market participants, does promote prudent risk taking, increased transparency and sustainability, which should lengthen market cycles and support a durable recovery.

Diversification/Correlation. As shown by their respective indices, both ABS and CMBS have historically provided diversification benefits due to their low correlation with other risk positions held in an investor's portfolio. Even among MBS, ABS and CMBS, low correlations may reduce risk and support performance across a broader range of scenarios.

Figure 7. Correlation of Securitized Credit to Fixed Income and Other Markets Is Relatively Low

Correlation Matrix

Asset	Senior Loan	U.S. Investment Grade	High Yield	U.S. Treasuries	S&P 500	U.S. Aggregate	ABS	CMBS	Non Agency RMBS
Senior Loan	1.00	0.29	0.78	-0.37	0.65	-0.08	0.36	0.59	0.42
U.S. Investment Grade		1.00	0.55	0.63	0.07	0.87	0.29	0.47	0.24
High Yield			1.00	-0.19	0.77	0.18	0.41	0.56	0.40
U.S. Treasuries				1.00	-0.52	0.91	0.04	0.01	-0.14
S&P 500					1.00	-0.24	0.30	0.40	0.25
U.S. Aggregate						1.00	0.18	0.26	0.07
ABS							1.00	0.43	0.41
CMBS								1.00	0.63
Non Agency RMBS									1.00
3/2011 – 3/2015									

Source: Barclays, Voya Investment Management

Less Interest Rate Sensitivity. The overall securitized market and corresponding underlying sub sectors offer attractive yields at relatively short durations. Less interest rate risk relative to other sectors — especially if/as the Federal Reserve begins to remove policy accommodation — makes the securitized credit asset class less sensitive to value declines from rising rates and increasing volatility. The disproportionate influence of credit risk on securitized market valuations dovetails positively with the bullish fundamental backdrop typically associated with rising-rate environments.

Comparing credit rating and yield further demonstrates the relative attractiveness of the securitized sectors. Figure 8 illustrates the duration of various Barclays U.S. Aggregate Index sectors, along with their weighted average credit rating and yields. The highest yield-to-duration ratios in the benchmark are exclusively securitized sectors, which also boast the highest credit ratings.

Figure 8. Yield, Duration and Quality Comparison Shows High Yield-to-Duration Ratio

Sub-Index	Yield to Worst (%)	Modified Duration	Quality	Yield-to-Duration Ratio
Barclays MBS	2.40	3.54	AAA/AAA	0.68
Barclays Securitized	2.36	3.58	AAA/AA1	0.66
Barclays ABS	1.36	2.53	AAA/AA1	0.54
Barclays CMBS	2.15	4.47	AAA/AA1	0.48
Barclays Corporate Investment Grade	2.91	7.41	A3/BAA1	0.39
Barclays Aggregate	2.06	5.45	AA1/AA2	0.38
Barclays U.S. Government	1.25	5.55	AAA/A1	0.23
Non-Agency RMBS	4.75	1.50	CCC/Caa	3.17

Source: Barclays, Voya Investment Management

Conclusion

While it is broadly expected — both within the FOMC and among market participants — that the Federal Reserve will begin to hike its target federal funds rate in the not-too-distant future, uncertainty around the timing and magnitude of rate hikes creates total return risk for holders of duration. If improving economic momentum and Fed consensus ultimately push interest rates higher, securitized products may be favored, as they have outperformed historically during periods of rising interest rates as Figure 9 shows.

Figure 9. Securitized Assets Performed Well in Rising-Rate Conditions

Periods of Rising Interest Rates			Returns			
Begins	Period (Months)	Change in U.S. 5-Year Treasury Yields (bps)	Investment Grade Bonds (%)	U.S. Gov't Bonds (%)	U.S. Aggregate (%)	Securitized (%)
Nov-98	19	210	0.22	0.68	1.20	2.69
Jul-03	37	250	2.39	1.66	2.44	3.16
Apr-08	3	89	-0.69	-1.91	-1.02	-0.42
Nov-10	5	110	-0.88	-2.36	-1.23	-0.01
Jun-13	3	63	-2.64	-1.66	-1.92	-1.33

Source: Barclays, Voya Investment Management

Past Performance is no guarantee of future results. Performance shown is historical and not indicative of any specific product and does not account for fees and expenses associated with investing in funds. An investor cannot invest directly in an index.

Regardless of the interest rate environment, the securitized market has proven over time to offer a higher return-to-risk ratio relative to other fixed income indices, as shown in Figure 10. With only one exception among the assets and periods considered (the three-year high yield profile) the securitized market has outperformed over intermediate to long-term periods.

Figure 10. The Bottom Line Is Solid Risk-Adjusted Performance Over Time

Return-to-Risk Profiles (periods ended 06/30/2015)

	3 Year	5 Year	10 Year	15 Year
Barclays U.S. Securitized	1.158	1.821	1.873	2.039
Barclays U.S. Aggregate	1.069	1.557	1.492	1.602
Barclays U.S. Government Long	0.723	0.903	0.727	0.803
Barclays U.S. Corporate Long	0.992	1.198	0.739	0.857
Barclays U.S. Treasury	0.763	1.136	1.084	1.161
Barclays U.S. Municipal	1.101	1.308	1.107	1.256
Barclays U.S. High Yield	1.668	1.349	0.810	0.788

Source: Barclays, Voya Investment Management

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Appendix
Securitized Markets: Current Sector Highlights

The securitized credit market can be segmented into three main categories: asset-backed securities (ABS), commercial mortgage-backed securities (CMBS) and residential mortgage-backed securities (RMBS). Each features a constantly evolving mix of catalysts that drive performance of the underlying asset pools and, consequently, valuations of the security. Below are some of the things we're currently watching within each sector.

Asset-Backed Securities

- **Student Loans.** Student loans are increasingly under pressure. The rapid increase in student loan debt in the U.S. has made unsustainable consumer leverage profiles more common, driving uncertain repayment profiles for ABS backed by student loans.
- **Subprime Auto Loans.** The relatively rapid pace of growth in subprime auto loans since the credit crisis has drawn the attention of U.S. legislators and regulators, increasing compliance costs and uncertainty about the viability of the smaller operators in the space.
- **Collateralized Loan Obligations.** Risk-retention rules prescribed by the Dodd-Frank legislation create uncertainty around the ability of less-well capitalized CLO managers to comply with these requirements.

While ABS sectors are not immune from idiosyncratic risks, the majority justify their relatively stable price profiles with fundamentally-driven performance. Overall, the sector trades with steady liquidity reflective of a supportive fundamental backdrop.

Commercial Mortgage-Backed Securities

- **Commercial Real Estate Valuations.** Commercial real estate has appreciated significantly since the credit crisis. While gains have been uneven across property types and geographic areas, Moody's/RCA Commercial Property Price Index shows valuations up 11.5% above November 2007 peaks, which compares favorably with residential valuations that have yet to reclaim their highs.
- **Maturity Wall.** Commercial mortgages frequently feature ten-year loan repayment terms. After a significant run-up in CMBS lending volumes from 2005–07, these ten-year loan terms will require significant capital to be refinanced without disrupting the market.
- **Retail Property Segment.** E-commerce has created uncertainty around demand for traditional shopping destinations. Beyond bankruptcies and general pressure on retailers, many property owners face new challenges and considerable uncertainty about the future.
- **New-Issue Ratings.** Credit rating agencies remain important in certain situations. Conversely, CMBS issuers are economically incented to minimize the costs and structural requirements imposed by rating agencies. Some issuers have been "cherry picking" ratings to achieve the most efficient capital structure. Both regulatory action and negative reactions from investors are credible threats here.

As the macroeconomic backdrop continues to evolve, drivers will change and CMBS valuations will adjust. Today, the sector trades with stable liquidity, reflective of a supportive fundamental backdrop and an investor base seeking the higher yields associated with this securitized credit market.

Non-Agency Residential Mortgage-Backed Securities

- **U.S. Housing Market.** Residential real estate has appreciated significantly since the credit crisis, but remains about 15% below peak values. Momentum is steady and broad-based but uneven across home price cohorts and geographies. The unevenness translates into investment opportunities based on fundamental analysis of mortgage pools underlying non-agency RMBS.
- **Mortgage Servicing.** RMBS require proper loan servicing to maximize performance of the underlying loans. The intensity of servicing efforts increases as the creditworthiness of the underlying borrowers declines. Since

the credit crisis, relatively few servicers of private-label borrowers remain, producing consolidation and rapid growth in the portfolios of the survivors. Questions about the overall effectiveness of these servicers have generated price volatility in the non-agency RMBS market.

- **New-Issue RMBS Market.** Newly issued non-agency RMBS have yet to resume since the credit crisis. The lack of mortgage credit availability from private-sector participants has hindered the production of new non-agency RMBS outside of the highest quality "jumbo"-sized mortgages. This lack of new supply has contributed to meaningful declines in outstanding issues through time, creating a significant supply-demand imbalance, which benefits sellers and has contributed to a favorable technical environment for this asset class.
- **Broker-Dealer Support.** No fixed income market has been immune from the drop in liquidity due to declining broker-dealer support. However, non-agency RMBS, given its significant history of credit-rating downgrades, has been particularly susceptible to declining support from broker-dealers. The increase in capital and liquidity requirements has disproportionately impacted non-agency RMBS holdings for broker-dealers, influencing their decision to actively invest in these holdings as clients look to sell through time.
- **New, Non-Traditional Non-Agency RMBS.** Since the credit crisis, several new markets have evolved, capitalizing on new opportunities/needs that have become apparent. These include 1) securitizations of non- or re-performing mortgages loans, 2) securitizations of non-agency prime jumbo loans (those mortgage loans with greater than conforming loan size limits imposed by the GSEs), 3) pools of single-family rentals securitized by institutional investors and 4) credit risk transfers of GSE mortgage loan production. Each of these markets is relatively new and small, making them more susceptible to bouts of illiquidity and price volatility. However, they each offer investors exposure to a unique flavor of private-label housing and yields reflective of newer, smaller risk markets.

The non-agency RMBS markets were at the forefront of the credit crisis, and the entire sector has been completely reshaped. As a result, this subsector has been the slowest to recover. Opportunities, while lesser in magnitude than in the first years after the credit crisis, are still available as the recovery in the U.S. housing market continues.

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All investing involves risks of fluctuating prices and the uncertainties of rates of return and yield inherent in investing. **High Yield Securities**, or "junk bonds", are rated lower than investment-grade bonds because there is a greater possibility that the issuer may be unable to make interest and principal payments on those securities. As **Interest Rates** rise, bond prices may fall, reducing the value of the share price. Debt Securities with longer durations tend to be more sensitive to interest rate changes. High-yield bonds may be subject to more **Liquidity Risk** than, for example, investment-grade bonds. This may mean that investors seeking to sell their bonds will not receive a price that reflects the true value of the bonds (based on the bond's interest rate and creditworthiness of the company). High Yield Bonds are also subject to **Economic Risk** which describes the vulnerability of a bond to changes in the economy.

Diversification does not guarantee a profit or ensure against loss. **Past performance is no guarantee of future results.**

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