Manulife | CQS
Investment Management

Opportunities in ABS Markets

June 2024

Summary

Against a backdrop of ongoing uncertainty and volatility, we believe ABS markets offer the potential for high stable income opportunities and strong capital protection.

ABS' main benefits can include:

- High, stable income
- Loss protection
- Relative value
- Short duration
- Ability to tailor and diversify

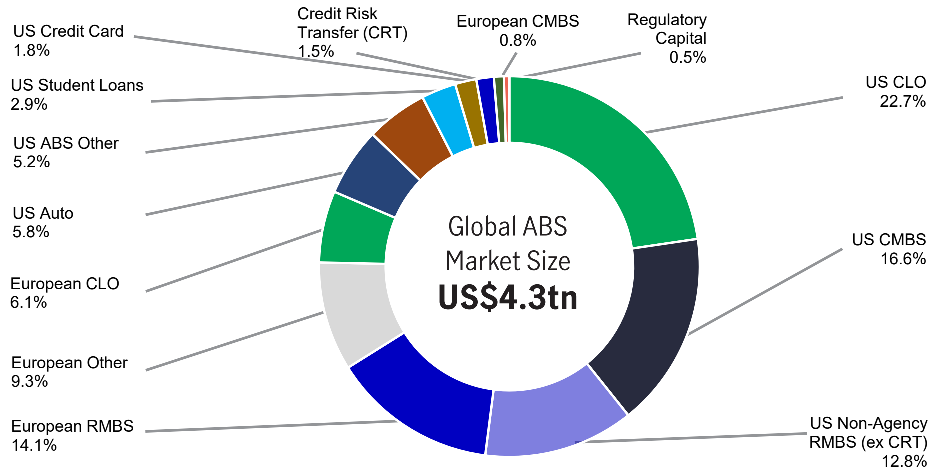
At present, we see the following opportunities in:

- Bank Regulatory Capital
- Global CLOs
- US Residential Mortgage-Backed Securities
- Defensive US Commercial Real Estate

Asset backed securities (ABS) markets allow investors to gain exposure to real economy assets offering a range of risk profiles which have the potential to produce relatively high, stable yields and offer capital protection due to their collateralized nature.

The ABS universe is large enough to give investors geographic and sector diversity. Figure 1 below shows the sector split across this US$4.3 trillion market in the US and Europe. This sector variety allows sophisticated investors to tailor risk and return levels to match a range of investment objectives and time horizons.

Figure 1: The Global ABS Market: Depth and Breadth Gives Investors Choice



Source: CQS analysis, SIFMA(www.sifma.org), AFME (www.afme.eu) and CitiVelocity as at 31 December 2023.

The main benefits traditionally offered by ABS include:

- **High, stable income:**
  ABS sub-sectors such as Residential and Commercial Mortgages, Corporate Loan pools and Bank Regulatory Capital transactions, can offer predictable contracted cash flows (i.e. steady income streams) in a way that corresponds to the chosen risk profile.
- **Loss protection:**
  In ABS, most risk is collateralized with often moderate loan-to-values. Investors are offered the choice of risk profiles by virtue of tranching which ensures those who are willing to assume the highest amount of credit risk will be paid the highest return and vice versa.
- **Relative value opportunities:**
  ABS currently offers attractive relative value to equivalently-rated corporate credit, primarily to compensate investors for structrual complexity.
- **Short duration:**
  The majority of ABS are floating rate securities which helps mitigate interest rate risk.
- **Ability to tailor and diversify:**
  Investors have choice across different geographies, sectors and parts of the capital structure. This flexibility helps investors access the precise exposure that best suits their income needs and their risk appetite.

“Regulatory Capital Relief is an exciting, growing asset class that has the potential to provide attractive and stable income, from primarily investment grade corporate loan risk.”

Current Opportunities

At present, we see compelling opportunities for investors across ABS sectors. Critically, the asset class, and its various sub-sectors require detailed bottom-up credit analysis and sophisticated analytics capabilities to identify opportunities, and actively risk manage them. As an established ABS manager, we focus on strong credit quality that can help to protect against potentially deteriorating macroeconomic and borrowing conditions, high stable income to buffer portfolios against volatility, lower beta to broader market metrics and sectors that exhibit lower market correlation.

Bank Regulatory Capital Relief

Regulatory Capital Relief is a risk sharing strategy that has taken shape as a direct result of increased capital requirements for large banks following the 2007-8 Global Financial Crisis (GFC). In our view it is an exciting, growing asset class that has the potential to provide attractive and stable income from primarily investment grade corporate loan risk. More stringent bank regulation following the 2007-8 GFC requires banks to increase their capital buffers. To improve their capital positions (free up capital), banks can share credit risk of core high quality loans through a securitization process and pay coupons to investors. The issuing banks remain invested; banks keep their most senior tranches with assets remaining on balance sheets – this is key for alignment with investors. In these structures, banks include their best risk to achieve capital relief, and then can lend more.

European banks have been faster to take up the issuance of capital relief instruments, but we are now seeing a growing number of issuances in North America and Asia. The sector is expected to continue to grow and develop as capital requirements for large banks increase. The sector is enjoying annual growth of 20-25%; issuance is currently ~US$22bn per annum.[2]

Regulatory Capital Relief trades are at the intersection of ABS private credit and bank lending; two seemingly competitive forces brought together by the regulators. As illustrated below, we believe Regulatory Capital Relief offers a number of potential benefits for investors, particularly the striking combination of high income, high credit quality and stability of returns.

The Potential Benefits of Regulatory Capital Relief[1]

Stable Income

Transactions have historically produced stable income with low correlation to broader markets.

12-15%

Historic Regulatory Capital asset class-level yields[2]

Low Beta

Historically low beta performance versus broader market

~0.12

Beta to high yield over the last twelve months[3]

Low Default Rate

Historically exhibits low default rates given positive credit selection of underlying collateral

<0.1%

Cumulative credit losses since inception of the Strategy in 2014[4]

Quality Collateral

Majority of underlying collateral is Investment Grade

BBB-

Average credit rating of underlying collateral

Growing Market

Increasing issuance from large and established banks across a wide set of jurisdictions

+25%

Year-on-year growth of the Regulatory Capital Market in 2023[2]

Diversified Asset

Wide numbers of borrowers, diversified geographically and by asset class

65-4,000

Unique borrowers per Regulatory Capital deal

Source: **1** CQS as at 31 March 2024. **2** Structured Credit Investor (SCI) database. **3** CQS Regulatory Capital Beta is based on CQS Regulatory Capital strategy monthly returns versus CDX HY 5YR on-the-run. **4** Final Credit loss as percentage of tranche: 0.048% since inception.

"In our view, CLOs offer the potential to generate strong risk-adjusted returns with robust credit protection, even in a scenario of sharp increases in corporate default rates."

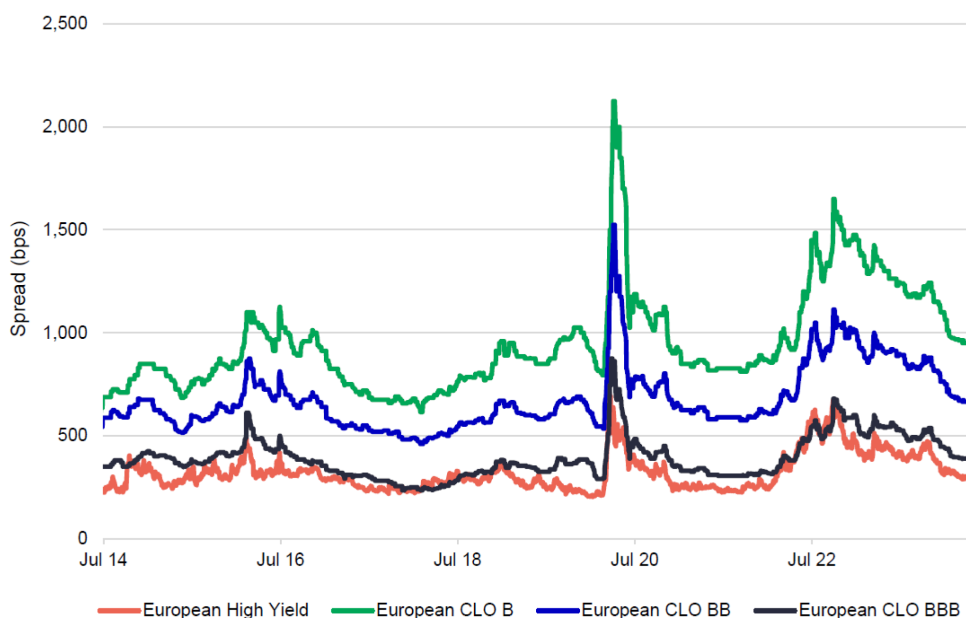
Global Collateralized Loan Obligations (CLOs)

In our view, CLOs offer the potential to generate strong risk-adjusted returns with robust credit protection, even in a scenario of sharp increases in corporate default rates. The floating-rate nature of CLOs also allows investors to benefit from higher short-term rates whilst avoiding significant rate duration in a portfolio. Actively managing a CLO tranche portfolio is key as credit spreads move in line with the corporate cycle. Rotating up and down the capital structure, and between geographies, means investors can benefit from an evolving opportunity set.

We believe that CLO tranches offer attractive relative value to other corporate credit sectors whilst benefiting from structural credit protection against an increase in defaults. The sector has experienced muted default rates through multiple periods of stress, with only 0.33% cumulative defaults globally between 1996 and 2022 (across 22,210 Standard & Poor's-rated CLO tranches).[1]

As Figure 2 below illustrates, European CLO spreads offer attractive relative value versus corporate credit (High Yield).

Figure 2: European CLO Relative Value Versus High Yield Corporate Credit



Source: CQS, Bloomberg and CitiVelocity as at 30 April 2024. For illustrative purposes only. Past performance is not indicative of future results.

"Natural housing demand will continue to provide support for home prices, and therefore encourage strong credit performance."

US Residential Mortgage-Backed Securities (RMBS)

Credit risk transfer (CRT) investments have been a key part of our ABS portfolios since the asset class's inception in 2013. The US government-sponsored entities (GSEs), Fannie Mae and Freddie Mac, issue CRT deals to the market. They buy fully funded credit protection against the performance of 30-year fixed-rate, fully amortizing residential mortgages to prime quality borrowers underwritten to the strict standards of these GSEs. This ~US$50bn market, backed by several trillion dollars of mortgage balances, is the most efficient way to gain exposure to standardized US mortgage credit across a range of risk and return expectations.

1 S&P Default, Transition, and Recovery: 2022 Annual Global Leveraged Loan CLO Default And Rating Transition Study as at 26 May 2023.

The value of US residential housing stock has surpassed US$40 trillion[1] while the quantity of mortgage debt in the US sits at around US$13 trillion[2], only US$3 trillion higher than the same in 2007, while the stock value has more than doubled over that time. Loan-to-value ratios of collateral backing these deals can range from as low as 30% to up to 80% on new production, offering investors a variety of risk exposures.

We believe that natural housing demand driven by the Millennial generation (the largest generation in the US) will continue to provide support for home prices and therefore encourage strong credit performance. Like CLOs, the CRT sector offers investors a unique opportunity to place a core credit view while consistently tailoring the portfolio to the market's perception of risk thereby offering the potential for outsized returns.

US$13 trillion

US Mortgage Debt

US$40 trillion

US Residential Housing Stock

"In CRE, we see attractive opportunities in seasoned, delivered CMBS bonds originated from 2010-2014."

US Commercial Real Estate (CRE)

CRE debt markets have produced attractive total return opportunities on both the long and short side in recent years, given significant changes in fundamentals for the underlying assets. The impact of online shopping and Covid shutdowns on mall revenues, 'Work from Home" drivers on office tenant demand and the negative impact of the higher rate environment on cap rates (and therefore valuations) have all created significant distress and uncertainty in the CRE and CMBS markets.

Currently we see attractive opportunities in seasoned, delevered CMBS bonds originated from 2010-2014 – targeting tranches currently most senior in the structure by taking advantage of some market participants having to reduce their CRE exposure. Here we can re-underwrite and apply high stress scenarios to the small number of remaining loans, ensuring significant cushion on return of our principal whilst benefitting from price convexity on an earlier workout.

Conclusion

We believe the ABS market offers the potential for high, stable income and capital protection to generate attractive, risk-adjusted returns. This is especially relevant in uncertain and volatile markets, like the one in which we find ourselves. Introducing ABS to portfolio construction may provide returns and stability not just for this year but also over a longer-term horizon. Introducing ABS into your portfolio can help provide downside risk mitigation, dampen volatility and lower market beta. Given the breadth and scale of the ABS market and opportunity set, we believe attractive risk-adjusted returns are available through market cycles.

1 Source: https://www.corelogic.com/intelligence/why-the-uss-largest-asset-class-residential-real-estate-does-not-substantially-contribute-to-the-economic-output/ as at 16 June 2023. **2** Source: https://www.federalreserve.gov/releases/z1/dataviz/z1/balance_sheet/table/ as at 31 December 2023.

Manulife | CQS Investment Management

Our Approach to ABS Investing

Fundamental credit analysis to protect capital

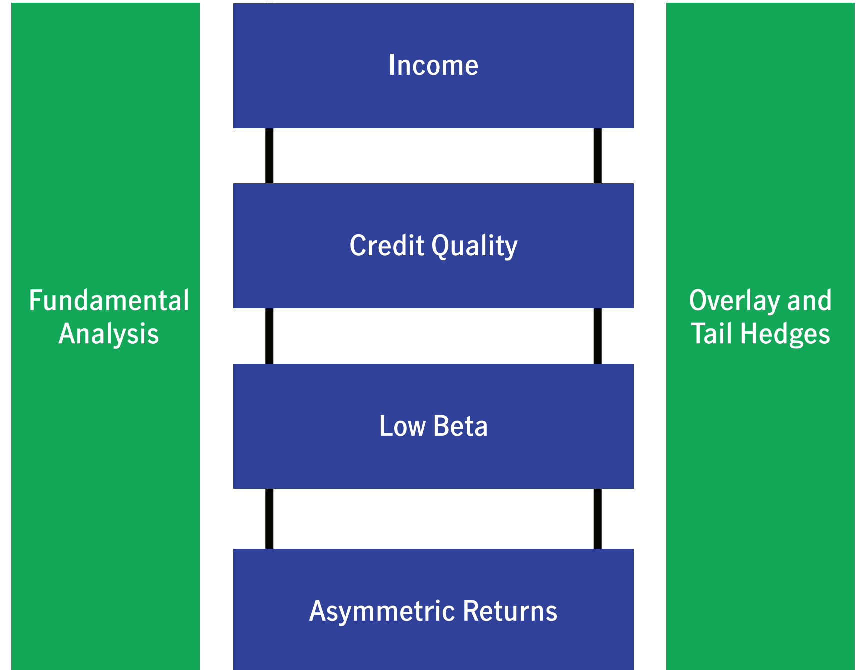
In 18 years of investing in ABS we have developed sophisticated knowledge and data across global ABS sectors, with an established European expertise.

1 Detailed credit analysis
Thorough research and bespoke modelling for each ABS sub-sector to identify the best opportunities globally

2 Relative and intrinsic value
Persistently seeking opportunities with more upside potential versus downside

3 Capital protection
- Bedrock of stable income
- Low correlation strategies
- Overlay hedges
- Dampen volatility

Steps of all-weather portfolio construction



Jason Walker
Co-Chief
Investment Officer

Jason is Co-Chief Investment Officer and manages Manulife | CQS Investment Managements' global asset backed securities strategies across dedicated alternative credit funds and longer-lock mandates. He leads the dedicated ABS team of portfolio managers and analysts. Jason is a Senior Partner and is a member of the Asset Advisory Committee for Multi Asset Credit.

Prior to joining CQS in 2010, Jason held a number of ABS Portfolio Management positions. Before CQS he was with Henderson Global Investors where he was a member of the team managing the Henderson European ABS Opportunities Fund. Before this, he held ABS Portfolio Management roles at Bank of Scotland Treasury, TD Securities and Abbey National Treasury Services, where he began his career as a graduate trainee in 1995. Jason holds an MSc in Finance from the University of Strathclyde and a BA (Hons) Accountancy from Glasgow Caledonian University.

Manulife | CQS
Investment Management

Important Considerations

General Risks

Investing in the investment strategy include several risks and limitations, including but not limited to the risk of loss. Any characteristics, guidelines, constraints, or other information provided for this material was selected by the firm as representative of the investment strategy and is provided for illustrative purpose only, may change at any time, and may differ for a specific account. Each client account is individually managed; actual holdings will vary for each client and there is no guarantee that a particular client's account will have the same characteristics as described herein. Any information about the holdings, asset allocation, or sector diversification is historical and is not an indication of future performance or any future portfolio composition, which will vary. Portfolio holdings are representative of the strategy, are subject to change at any time, are not a recommendation to buy or sell a security, and do not represent all of the securities purchased, sold or recommended for the portfolio. It should not be assumed that an investment in these securities was or will be profitable.

No investment strategy or risk management technique can guarantee returns or eliminate risk in any market environment. Diversification or asset allocation does not guarantee a profit or protect against the risk of a loss in any market. The indices referenced herein are broad-based securities market indices and used for illustrative purposes only. The indices cited are widely accepted benchmarks for investment performance within their relevant regions, sectors or asset classes, and represent non-managed investment portfolios.

If derivatives are employed, note that investing in derivative instruments involves risks different from, or possibly greater than, the risks associated with investing directly in securities and other traditional investments and, in a down market, could become harder to value or sell at a fair price.

ESG Integration and Engagement

Please note, the approach taken in relation to sustainable investing and ESG may differ from the approach taken at Manulife and Manulife Investment Management.

Important Information

This document has been issued by Manulife | CQS Investment Management which is a trading name of CQS (UK) LLP, authorised and regulated by the UK Financial Conduct Authority, and/or CQS (US), LLC which is a registered investment adviser with the US Securities and Exchange Commission and a member of the National Futures Association. The term "CQS" or "Manulife | CQS Investment Management" as used herein may include one or both of CQS (UK) LLP and CQS (US), LLC.

The information is intended solely for sophisticated investors who are (a) professional investors as defined in Article 4 of the European Directive 2011/61/EU or (b) accredited investors (within the meaning given to such term in Regulation D under the U.S. Securities Act of 1933, as amended) and qualified purchasers (within the meaning given to such term in Section 2(a)(51) of the U.S Investment Company Act 1940, as amended). This document is not intended for distribution to, or use by, the public or any person or entity in any jurisdiction where such use is prohibited by law or regulation.

Manulife | CQS Investment Management is a subsidiary of Manulife Investment Management (Europe) Limited.

About Manulife Investment Management

Manulife Investment Management is the brand for the global wealth and asset management segment of Manulife Financial Corporation. Our mission is to make decisions easier and lives better by empowering investors for a better tomorrow. Serving more than 17 million individuals, institutions, and retirement plan members, we believe our global reach, complementary businesses, and the strength of our parent company position us to help investors capitalize on today's emerging global trends. We provide our clients access to public and private investment solutions across equities, fixed income, multi-asset, alternative, and sustainability-linked strategies, such as natural capital, to help them make more informed financial decisions and achieve their investment objectives. Not all offerings are available in all jurisdictions. For additional information, please visit manulifeim.com/institutional.

This material has not been reviewed by, is not registered with any securities or other regulatory authority, and may also, where appropriate, be distributed by the following Manulife entities in their respective jurisdictions:

Australia: Manulife Investment Management (Hong Kong) Limited. **Canada:** Manulife Investment Management Limited. **European Economic Area:** Manulife Investment Management (Ireland) Ltd. which is authorised and regulated by the Central Bank of Ireland. **Hong Kong:** Manulife Investment Management (Hong Kong) Limited. **Japan:** Manulife Investment Management (Japan) Limited. **Singapore:** Manulife Investment Management (Singapore) Pte. Ltd. (Company Registration No. 200709952G). **South Korea:** Manulife Investment Management (Hong Kong) Limited. **Switzerland:** Manulife IM (Switzerland) LLC. **Taiwan:** Manulife Investment Management (Taiwan) Co. Ltd. **United Kingdom:** Manulife Investment Management (Europe) Ltd. which is authorised and regulated by the Financial Conduct Authority. **United States:** John Hancock Investment Management Distributors LLC Member FINRA, SIPC, listed MSRB.

No representations are made that the contents of this presentation are appropriate for use in all locations, or that the transactions, securities, products, instruments or services discussed in this presentation are available or appropriate for sale or use in all jurisdictions or countries, or by all investors or counterparties. All recipients of this presentation are responsible for compliance with applicable laws and regulations.

This material is intended for the exclusive use of recipients in jurisdictions who are allowed to receive the material under their applicable law. The opinions expressed are those of the author(s) and are subject to change without notice. Our investment teams may hold different views and make different investment decisions. These opinions may not necessarily reflect the views of Manulife Investment Management or its affiliates. There can be no assurance that actual outcomes will match the assumptions or that actual returns will match any expected returns. The information and/or analysis contained in this material has been compiled or arrived at from sources believed to be reliable, but Manulife Investment Management or its affiliates does not make any representation as to their accuracy, correctness, usefulness or completeness and does not accept liability for any loss arising from the use of the information and/or analysis contained here. Neither Manulife Investment Management or its affiliates, nor any of their directors, officers or employees shall assume any liability or responsibility for any direct or indirect loss or damage or any other consequence of any person acting or not acting in reliance on the information contained here.

The information in this material may contain projections or other forward-looking statements regarding future events, targets, management discipline or other expectations, and is only current as of the date indicated. The information in this material including statements concerning financial market trends, are based on current market conditions, which will fluctuate and may be superseded by subsequent market events or for other reasons. This material was prepared solely for informational purposes and does not constitute, and is not intended to constitute, a recommendation, professional advice, an offer, solicitation or an invitation by or on behalf of Manulife Investment Management or its affiliates to any person to buy or sell any security or to adopt any investment strategy, and shall not form the basis of, nor may it accompany nor form part of, any right or contract to buy or sell any security or to adopt any investment strategy. Nothing in this material constitutes investment, legal, accounting, tax or other advice, or a representation that any investment or strategy is suitable or appropriate to your individual circumstances, or otherwise constitutes a personal recommendation to you. Neither Manulife Investment Management nor its affiliates provide legal or tax advice, and you are encouraged to consult your own lawyer, accountant, or other advisor before making any financial decision. Prospective investors should take appropriate professional advice before making any investment decision. In all cases where historical performance is presented, note that past performance does not guarantee future results and you should not rely on it as the basis for making an investment decision.

The distribution of the information contained in this presentation may be restricted by law and persons who access it are required to comply with any such restrictions. The contents of this presentation are not intended for distribution to, or use by, any person or entity in any jurisdiction or country in which such distribution or use would be contrary to any applicable laws or regulations. By accepting this material, you confirm that you are aware of the laws in your own jurisdiction relating to the provision and sale of the funds, portfolios or other investments discussed in this presentation and you warrant and represent that you will not pass on or use the information contained in this presentation in a manner that could constitute a breach of such laws by any Manulife entity or any other person.

Unless otherwise stated to the contrary herein, CQS owns all intellectual property rights in this document. CQS is a founder of the Standards Board for Alternative Investments ("SBAI") which was formed to act as custodian of the alternative investment managers' industry best practice standards (the "Standards"). By applying the Standards, managers commit to adopt the "comply or explain" approach described in the Standards. CQS is a signatory of the UN Principles for Responsible Investment and a supporter and participant of certain other responsible investment related industry associations.

Australia: Manulife Investment Management (Hong Kong) Limited ("Manulife IM (HK)") is exempt from the requirement to hold an Australian financial services license under the Corporations Act in respect of the financial services being offered in this material. Manulife IM (HK) is regulated by the Securities and Futures Commission of Hong Kong ("SFC") under Hong Kong laws, which differ from Australian laws. This presentation is directed at wholesale investors only.

Mainland China: This material is prepared solely for informational purposes and does not constitute an offer to sell or the solicitation of an offer to buy any securities in Mainland China to any person to whom it is unlawful to make the offer or solicitation in Mainland China. The securities may not be offered, sold or delivered, or offered or sold or delivered to any person for reoffering or resale or redelivery, in any such case directly or indirectly, in Mainland China in contravention of any applicable laws.

The issuer does not represent that this material may be lawfully distributed, or that any securities may be lawfully offered, in compliance with any applicable registration or other requirements in Mainland China, or pursuant to an exemption available thereunder, or assume any responsibility for facilitating any such distribution or offering. In particular, no action has been taken by the issuer which would permit a public offering of any securities or distribution of this material in Mainland China. Accordingly, the securities are not being offered or sold within Mainland China by means of this material or any other document. Neither this material nor any advertisement or other offering material may be distributed or published in Mainland China, except under circumstances that will result in compliance with any applicable laws and regulations.

Further, neither this material nor any funds/strategies mentioned in this material (if any) has been submitted to or approved by the China Securities Regulatory Commission or other relevant Chinese government authorities (which, for the purposes of this paragraph, does not include the authorities in Hong Kong SAR, Macau SAR or Taiwan Region), unless otherwise expressly indicated. Securities denominated in foreign exchange or with the underlying investments in the offshore markets may only be offered or sold to investors of Mainland China that are authorized and qualified to buy and sell such securities. Prospective investors resident in Mainland China are responsible for obtaining all relevant and necessary approvals from the Chinese government authorities, including but not limited to the State Administration of Foreign Exchange (if needed), before investing.

European Economic Area: The data and information presented is directed solely at persons who are Professional Investors in accordance with the Markets in Financial Instruments Directive (2004/39/EC) as transposed into the relevant jurisdiction. Further, the information and data presented does not constitute, and is not intended to constitute, "marketing" as defined in the Alternative Investment Fund Managers Directive.

Hong Kong: This material is provided to Professional Investors, as defined in the Hong Kong Securities and Futures Ordinance and the Securities and Futures (Professional Investor) Rules, in Hong Kong only. It is not intended for and should not be distributed to, or relied upon, by members of the public or retail investors. This material has not been reviewed by the Securities and Futures Commission (SFC).

Malaysia: This material was prepared solely for informational purposes and is not an offer or solicitation by anyone in any jurisdictions or to any person to whom it is unlawful to make such an offer or solicitation.

Singapore: This material is intended for Accredited Investors and Institutional Investors as defined in the Securities and Futures Act.

South Korea: This material is intended for Qualified Professional Investors under the Financial Investment Services and Capital Market Act ("FSCMA"). Manulife Investment Management does not make any representation with respect to the eligibility of any recipient of these materials to acquire any interest in any security under the laws of Korea, including, without limitation, the Foreign Exchange Transaction Act and Regulations thereunder. An interest may not be offered, sold or delivered directly or indirectly, or offered, sold or delivered to any person for re-offering or resale, directly or indirectly, in Korea or to any resident of Korea, except in compliance with the FSCMA and any other applicable laws and regulations. The term "resident of Korea" means any natural person having his place of domicile or residence in Korea, or any corporation or other entity organized under the laws of Korea or having its main office in Korea.

Switzerland: This material is intended for Professional Clients, including Institutional Clients, as defined in the Federal Financial Services Act ("FinSA") and its implementing ordinance, at the exclusion of Professional Clients with an opting-out pursuant to Art. 5 (1) FinSA ("Opting-Out Clients"), and/or Qualified Investors pursuant to the Federal Collective Investment Schemes Act ("CISA") and its implementing ordinances, at the exclusion of Opting-Out Clients and Managed/Advisory Retail Clients pursuant to Art. 10 (3ter) CISA where relevant. The information provided in this material is for information purpose only and does not constitute an offer, a solicitation or a recommendation to contract a financial instrument or a financial service as defined under FinSA. This material does not constitute an implicit or explicit investment advice. The information provided herein is general in nature and does not constitute an advertisement of financial products in Switzerland pursuant to FinSA and its implementing ordinance.

United Kingdom: This communication is directed only at investment professionals and any investment or investment activity to which it relates is available only to such persons.

CQS (UK) LLP
4th Floor, One Strand,
London WC2N 5HR, United Kingdom
T: +44 (0) 20 7201 6900

CQS (US), LLC
152 West 57th Street, 40th Floor, New York, NY
10019, US
T: +1 212 259 2900

CQSClientService@cqsm.com
cqs.com