Marquette Associates

A Portfolio Needs Structure: An Overview of the Securitized Credit Asset Class

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CONTENTS

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INTRODUCTION

Fixed income is the largest global financial market and often one of the largest allocations within institutional investors' portfolios. A typical fixed income allocation implements an investment grade anchor with a few "satellite" mandates — most commonly high yield bonds, leveraged loans, and emerging market debt — that carry more credit risk but provide higher levels of yield. Fixed income portfolios are often over-exposed to corporate borrowers through both anchor and satellite allocations. Additionally, these satellite allocations usually increase corporate credit risk while reducing equity diversification that fixed income is supposed to provide. Securitized credit provides higher yields and more compelling diversification benefits.

Securitized credit is a large asset class that has been largely ignored by institutional investors due to under-representation in fixed income indices, perceived complexities, and a stigma from its role in the Great Financial Crisis. While factors responsible for under-allocation to securitized credit have merits, these have caused investors to overlook the benefits of the asset class. Securitized credit provides a spread and yield premium relative to similarly rated corporate credit, diversified risk exposure to various credit and market cycles, and lower correlation to both traditional fixed income and equities. Overall, securitized credit's attributes can help to further optimize portfolio structures.

OVERVIEW OF SECURITIZED DEBT

History of Securitized Debt

Securitized debt started in the 1960s when the Government Sponsored Entities (GSEs) — Fannie Mae, Ginnie Mae, and Freddie Mac — created the first agency mortgage-backed security (Agency MBS). Agency MBS pools residential mortgages to create a publicly traded security with principal and interest guaranteed, either explicitly or implicitly, by the U.S. government. Agency MBS has grown into an $11.8 trillion[1] market.

As the agency market grew and popularity increased, other areas of the securitized debt market emerged. Banks and financial institutions in the 1980s began securitizing the credit risk associated with their assets. This marked the bifurcation of the securitized debt market into two distinct asset classes: Agency MBS and securitized credit.

What is Securitization?

Securitized assets have a reputation as complex and opaque, which is true to an extent. The additional complexity, as well as a plethora of acronyms, are a primary reason securitized assets have largely been ignored or swept into broad based strategies. Learning the underlying mechanics of the securitization process helps one understand the complexity and benefits of securitization. Consider the following section explaining securitizations as Marquette's version of Margot Robbie in "The Big Short" explaining sub-prime mortgages in layman's terms.

Securitization is the process of pooling similar assets and packaging them into a bond backed by the cash flows of the collateral pool. The cashflows are principal and interest paid from the underlying assets that include mortgages, auto loans, credit card receivables, student loans, corporate loans, lease payments, as well as other forms of debt. In theory, anything that has a contractual and recurring cash flow can and will be securitized.

The pools are then divided into separate tranches and assigned a credit rating from AAA (the most senior tranche) down to an equity tranche. Each tranche varies in size and the amount of interest paid is based on the credit risk of the underlying collateral and seniority in the securitization. AAA tranches pay the lowest interest of the tranches, but have the most protection, shortest maturities, and lowest volatility. Lower-rated tranches provide higher yields and return potential but also have the most credit risk. The cashflows are paid in descending order, with the senior tranche having priority of payments. Once the senior tranche has been paid, the next most senior tranche then receives priority, and so on. Losses are the opposite and move in ascending order. The lowest rated tranche absorbs any default loss until it is wiped out. Further losses are then absorbed sequentially by the next

[1] Bloomberg as of December 31, 2025

tranches until all of the losses are realized. This ascending/descending priority of payments and losses is referred to as the cashflow waterfall.

Tranching creates structural protections — or credit enhancements — that protect debtholders by reducing the nonpayment risk of the underlying collateral. Securitized credit assets are also self-amortizing, which means there is not a balloon payment due at the end like most fixed income securities. Maturities vary based on the asset, but the credit enhancements from the structuring process and the priority of payments waterfall allows the respective securitizations to deleverage over time. As the underlying loans in the respective pools get repaid and the senior tranches are repaid, protections within the subordinate tranches increase and credit risk decreases over time as there are fewer senior securities and a higher percentage of subordinated securities.

Exhibit 1: Sample structure of a securitization

Credit Quality	% of Deal
AAA	60%
AA	10%
A	7%
BBB	5%
BB	5%
B	3%
Equity	10%

Portfolio Cash Flows · Portfolio Losses

Securitized Credit Opportunity Set

Securitized credit is a large and heterogenous asset class that provides investors with a broad range of risk-return profiles and diverse business cycles. There are four primary sectors within the asset class:

- **Asset Backed Securities (ABS):** Pools of secured and unsecured consumer loans and other cash-flowing assets such as whole business securitizations and music royalties
- **Commercial Mortgage-Backed Securities (CMBS):** Loans backed by properties including office, industrial, hospitality, retail, and multi-family
- **Collateralized Loan Obligations (CLOs):** Diversified pool of actively managed public or private corporate loans
- **Non-Agency Residential Mortgage-Backed Securities (RMBS):** Backed by single family residential mortgage loans or other privately issued mortgage-related assets

Of these sectors, CLOs are the largest within the opportunity set, while ABS is the most diverse. Each of the four main sectors is driven by different fundamentals and exhibit unique credit cycles. These four sectors can be further broken down into a myriad of subsectors that target a wide variety of borrower types and are backed by assorted forms of collateral.

It is important to note that Agency MBS — the largest securitized market — is not considered credit. There is no credit risk associated with these assets as the principal and interest of agency securities are either guaranteed, or carry an implied guarantee, from the U.S. government. They are an interest rate volatility product whose primary risks is prepayments driven by U.S. interest rates.

Exhibit 2: Securitized credit risk factors vary based on sector

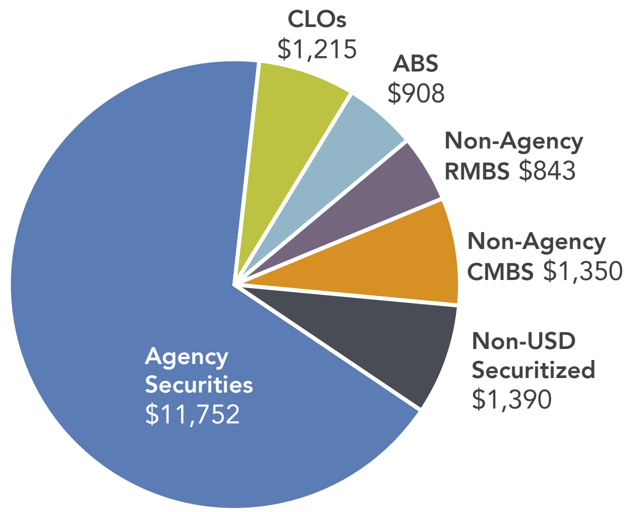
	ABS	CMBS	CLOs	Non-Agency RMBS
Cycle	Consumer/Varies	Commercial Real Estate	Corporate Credit	Housing Market
Rating	AAA to Below-IG	AAA to Below-IG	AAA to Below-IG	AAA to Below-IG
Coupon	Mainly Fixed	Fixed & Floating	Floating	Mainly Fixed

Market Size

The securitized debt market is mostly comprised of agency securities. Of the approximately $17.5 trillion in outstanding securitized assets globally, $11.8 trillion is agency securities. Although dwarfed by the agency market, securitized credit markets are robust, presenting a $5.7 trillion global opportunity set that has continued to expand. Compared to the combined size of the high yield and leveraged loan markets, which is currently $2.9 trillion,[2] securitized credit is a larger opportunity than other common satellite allocations.

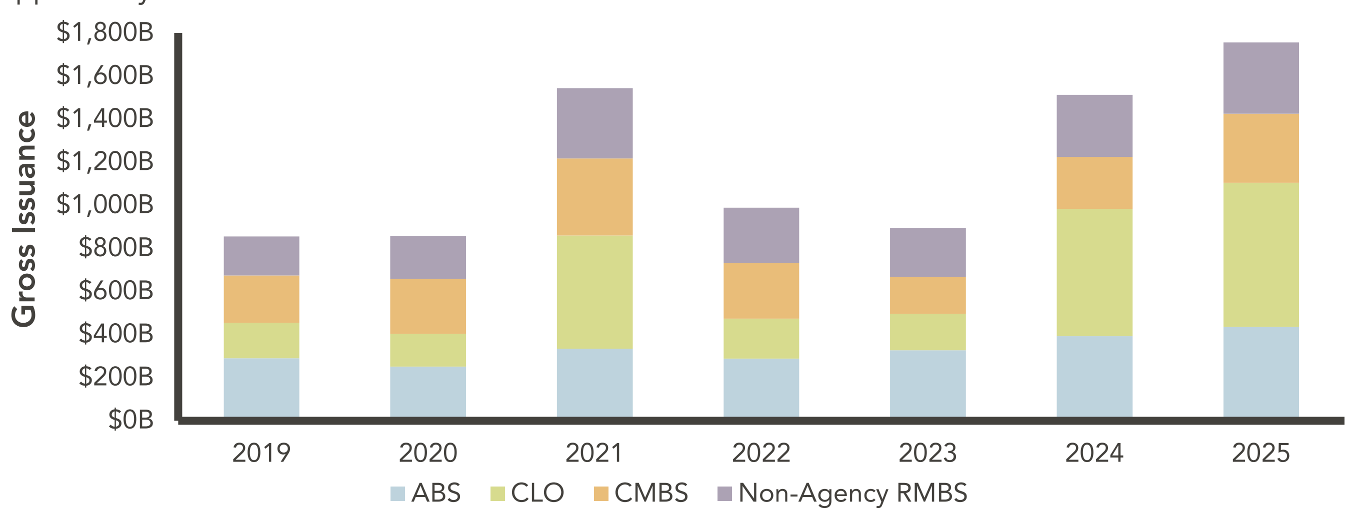
Despite its size, securitized credit is underrepresented in investor portfolios. A primary reason for this under-allocation, outside of complexity and perceived risks, is the lack of a broad securitized credit index. For example, Agency MBS make up ~25% of the bellwether Bloomberg U.S. Aggregate Index, the most utilized index within fixed income. Securitized credit is only ~2% of the index[3] and is quite limited in scope (only IG, fixed rate auto and credit card ABS and conduit CMBS). There is also no standard, widely tracked securitized credit index like other satellite asset classes such as high yield and leveraged loans. As a result, investors structurally end up with minimal allocations to securitized credit.

Exhibit 3: Securitized debt market is dominated by agencies, but the credit market is robust



Source: BofA, Intex, PGIM as of December 31, 2025

Exhibit 4: Issuance in securitized credit markets is consistent and growing, supporting a continued opportunity set



Source: Intex, PGIM as of December 31, 2025

SCARS OF 2008: IS IT REALLY DIFFERENT THIS TIME?

The unspoken difficulty regarding securitized credit is the role it played in the Global Financial Crisis (GFC). Securitizations filled with risky sub-prime residential mortgages caused a systemic crisis when an unexpected

[2] BofA as of December 31, 2025, for agency market size; J.P. Morgan as of December 31, 2025, for high yield and loan market size
[3] Bloomberg as of December 31, 2025

number of borrowers began defaulting on the underlying mortgages that made up the respective collateral pools. While investors should be skeptical, it actually may be different this time.

The fallout of the GFC led to significant regulations to mitigate the risks in securitizations to prevent a future crisis. This began with the Dodd-Frank Act in 2010, installing greater regulation and oversight of the banking system. Additional regulations were also implemented, such as Qualified Mortgage Rules, Regulation RR, Regulation AB II, and Basel III. These regulations increased the stability of the banking system, introduced more stringent lending practices, set limits on risky loan features, reduced banks' capacity to make subprime loans, required retention of credit risk of the underlying collateral on lender balance sheets, and increased disclosure rules and transparency of securitized securities. These regulations directly led to a significant increase in the credit enhancements and subordinations embedded into the structures of the securitizations that exist today. These improvements provide debtholders with more protection across the entire structure to prevent a repeat of what happened in the GFC.

Exhibit 5: Post-crisis structures have significantly stronger embedded credit enhancements and protections across the entire securitization

PRE-CRISIS CAPITAL STRUCTURE

Credit Quality	% of Deal	% Enhancement
AAA	77.0%	23.0%
AA	3.5%	19.5%
A	6.5%	13.0%
BBB	3.5%	9.5%
BB	3.0%	6.5%
Equity	6.5%	

POST-CRISIS CAPITAL STRUCTURE

Credit Quality	% of Deal	% Enhancement
AAA	62%	38%
AA	13%	23%
A	7%	18%
BBB	5%	13%
BB	5%	8%
Equity	8%	

To help contextualize the above graphic, it's helpful to explain the embedded credit enhancements in post-crisis structures using a generic CLO deal. The AAA tranche above has 38% credit enhancement. Using an apocalyptic scenario, let's assume every single one of the loans held across all tranches in the deal default. Given the historical average recovery rate on defaulted leveraged loans is ~70%, a AAA CLO tranche would need a minimum of 30% enhancement to ever take an impairment. Based on historical data, the likelihood of AAA-rated CLO tranches defaulting is essentially non-existent. Even assuming a more modest — but still extremely unlikely — 20% default rate, an A-rated CLO tranche in theory would still not take a loss.

Defaults and impairments will vary based on sector, asset types, and the individual deals held within them. Credit risk is still present, and tranches can and do default. Additionally, not all securitized deals have the exact structures as shown above but are generally structured similarly. However, this simple example shows the extreme protections that are embedded within senior tranches and how the larger tranche sizes and increased credit enhancements present in post-crisis structures create added protections across the securitization structure.

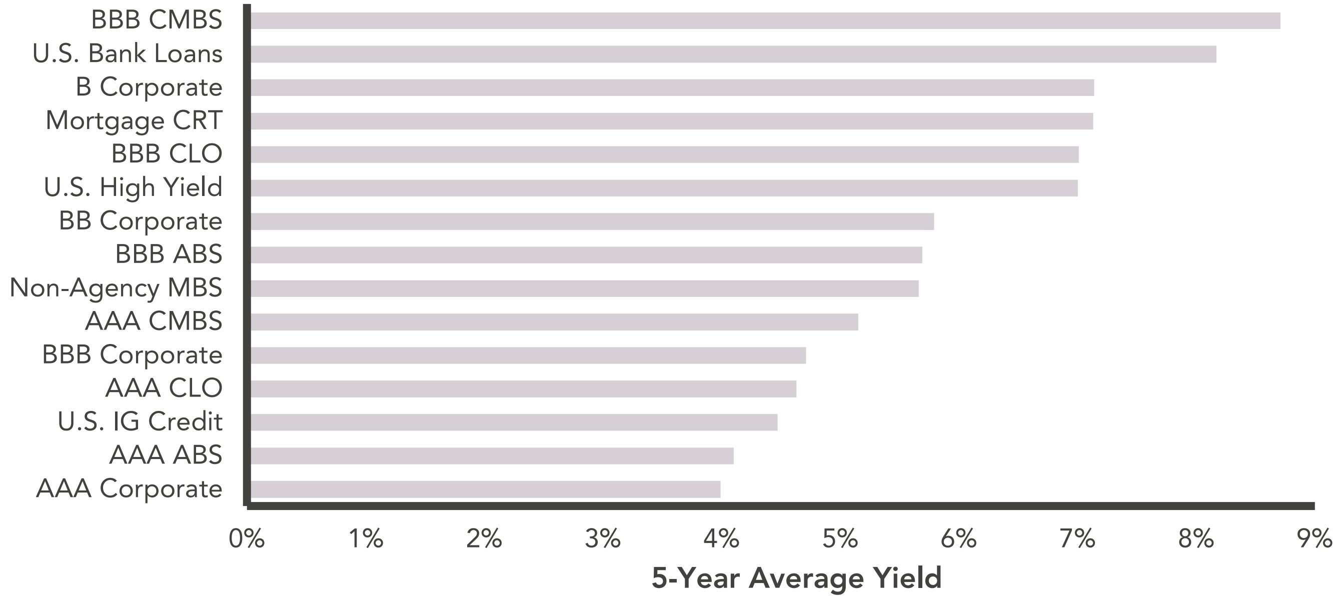
INVESTMENT CASE FOR SECURITIZED CREDIT

Benefits of Securitized Credit

Utilizing securitized credit as an additional satellite allocation provides multiple benefits. The two primary benefits it offers are yield premium and diversification.

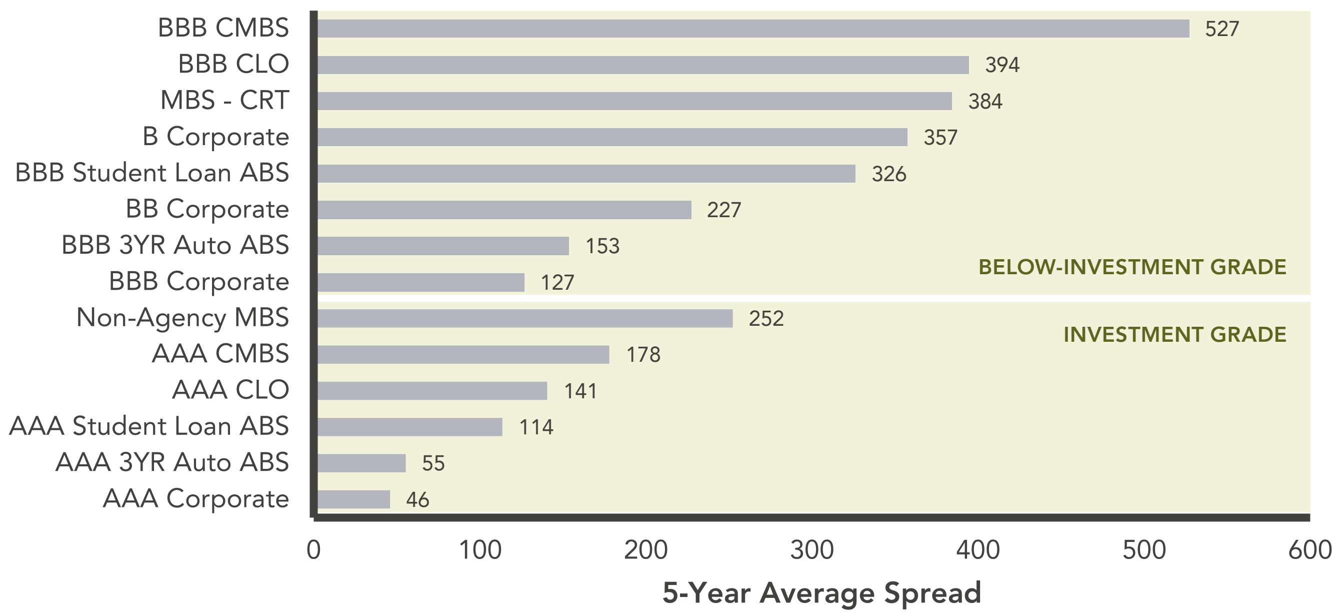
The securitization process creates embedded credit enhancements that allow for a higher credit rating, which creates a structural yield premium relative to similarly rated corporate bonds. This income premium holds across assets of the same rating. Often times, higher rated securitized assets have a yield premium versus corporate bonds multiple rating notches lower. For example, the yield on AAA CMBS was ~4.9% while A-rated U.S. Corporates offered a yield of 4.7%.[4] Lower-rated securitized tranches offer even greater yield premiums for those willing to take on increased credit risk. Yields will vary based on ratings and types of collateral, but securitized credit consistently provides an enhanced level of income for the same level of credit rating. This dynamic also applies to securitized credit spreads, where there is also an embedded premium relative to corporate bonds.

Exhibit 6: Securitized credit offers a yield premium over similarly rated corporate credit



Source: Bloomberg, J.P. Morgan as of December 31, 2025; AAA & BBB CMBS yields are an average of 50% Conduit CMBS and 50% SASB Fixed-Rate, SASB Floating-Rate, and CRE CLO CMBS yields.

Exhibit 7: Securitized credit spreads also have a structural premium relative to corporates



Bloomberg, J.P. Morgan as of December 31, 2025; AAA & BBB CMBS spreads are an average of 50% Conduit CMBS and 50% SASB Fixed-Rate, SASB Floating-Rate, and CRE CLO CMBS yields. While BBB is definitionally an investment-grade rating, BBB securitized assets are commonly viewed as below-investment grade by many market participants due to the higher yield and historical volatility.

[4] Bloomberg, J.P. Morgan as of December 31, 2025

Fixed income anchor portfolios typically have a heavy skew towards corporate bonds. This is due to the makeup of traditional indices, particularly the Aggregate Index. Roughly 25% of this index is corporate bonds.[5] Active mandates benchmarked to this index often hold significantly higher allocations to corporate debt relative to the benchmark as there is a higher yield on corporate bonds versus the other Aggregate sectors. Common satellite asset classes of high yield and leveraged loans also consist entirely of corporate borrowers. Taking these factors into account, it is easy to see how portfolios end up with elevated exposure to corporate credit risk. Corporate credit risk has a high correlation to equity risk since the issuing entity is the same.

Adding securitized credit can ease this dynamic. Most of the underlying credit pools are not loans made to corporate borrowers, but instead loans made primarily to consumers and real estate sectors of the economy; thereby, reducing corporate exposure. Additionally, corporate credit, particularly below-IG credit, exhibits higher correlation to equities since it behaves more similarly to risk assets. While securitized credit still has credit risk, it is a distinctive form of credit risk with different cycles and macro drivers than traditional allocations.

Exhibit 8: Many assets within securitized credit have lower correlations with traditional asset classes

	AAA CLO	BBB CLO	AAA ABS	BBB ABS	NON-AGENCY MBS	MBS - CRT	CMBS 2.0 AAA	CMBS 2.0 BBB
U.S. Aggregate	21.1%	16.5%	60.8%	56.6%	59.9%	11.4%	89.7%	26.9%
U.S. IG Credit	49.5%	45.7%	75.0%	73.1%	73.9%	41.6%	89.9%	43.5%
U.S. High Yield	72.5%	71.5%	63.3%	64.5%	68.8%	60.4%	57.7%	54.9%
U.S. Bank Loans	92.6%	92.4%	63.6%	66.4%	62.7%	83.1%	36.3%	56.7%
Russell 3000	55.8%	54.0%	40.5%	39.4%	50.1%	43.5%	36.2%	31.8%
S&P 500	53.7%	51.5%	39.4%	38.0%	48.6%	41.2%	35.8%	29.7%

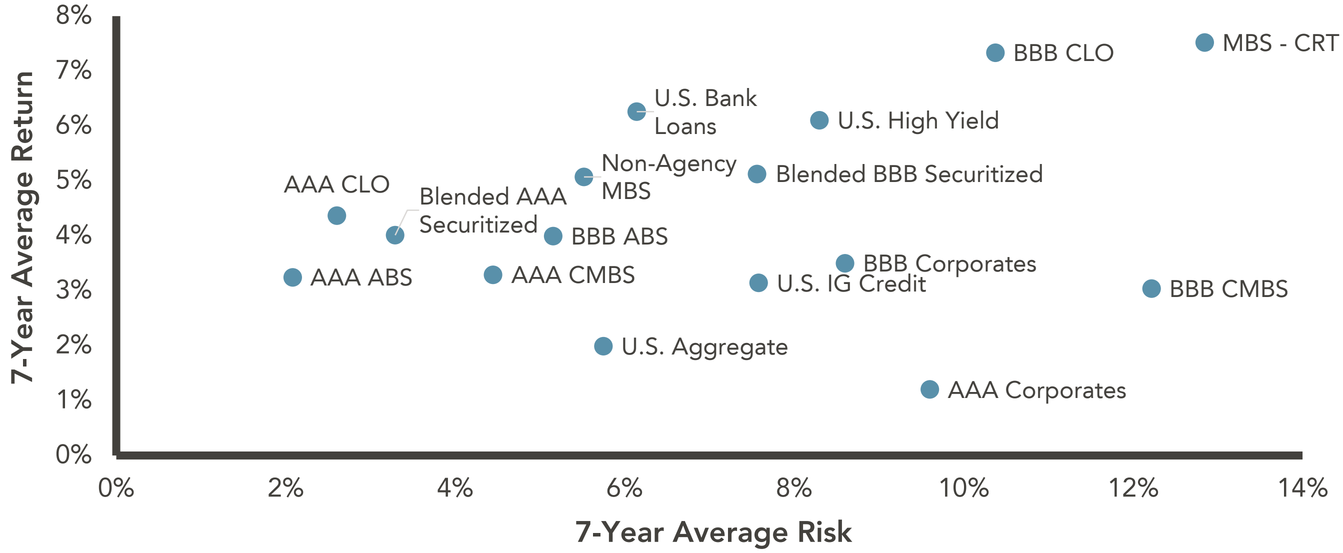
Source: Bloomberg, J.P. Morgan as of December 31, 2025; Correlations shown are 10-year correlations utilizing monthly returns.

The amount of diversification will differ based on collateral and credit rating, amongst other factors. Additionally, CLOs are tied to the risks of corporate credit cycles as the underlying collateral is leveraged loans to below-IG corporate borrowers.

Securitized credit cannot diversify away all a portfolio's corporate credit risk, but it does diversify another common risk in fixed income portfolios: Interest rate risk. Many securitized assets are floating rate. CLOs are the largest market within securitized credit and are floating-rate. Large parts of the CMBS market as well as portions of ABS and RMBS markets are also floating-rate. The interest rate paid with a floating-rate coupon resets to match current market rates. This means there is minimal interest rate risk associated with these assets. Additionally, securitized credit structures are self-amortizing and de-leverage over time, creating shorter maturities for most of these assets. The number of floating-rate securities and amortizing fixed rate securities lowers duration of the portfolio, thereby reducing interest rate risk. This leads to lower volatility and reduced correlations relative to other fixed income assets. It is important to note that since there is less interest rate risk, credit risk becomes the dominant risk associated with this subset of assets. With a broad opportunity set that features embedded yield premiums, diverse risk factors, and lower interest rate sensitivity, securitized credit offers investors attractive risk-return profiles that can benefit a broader portfolio.

[5] Bloomberg as of December 31, 2025

Exhibit 9: Securitized credit offers a variety of risk and return profiles that often provide better risk-adjusted returns than other fixed income asset classes

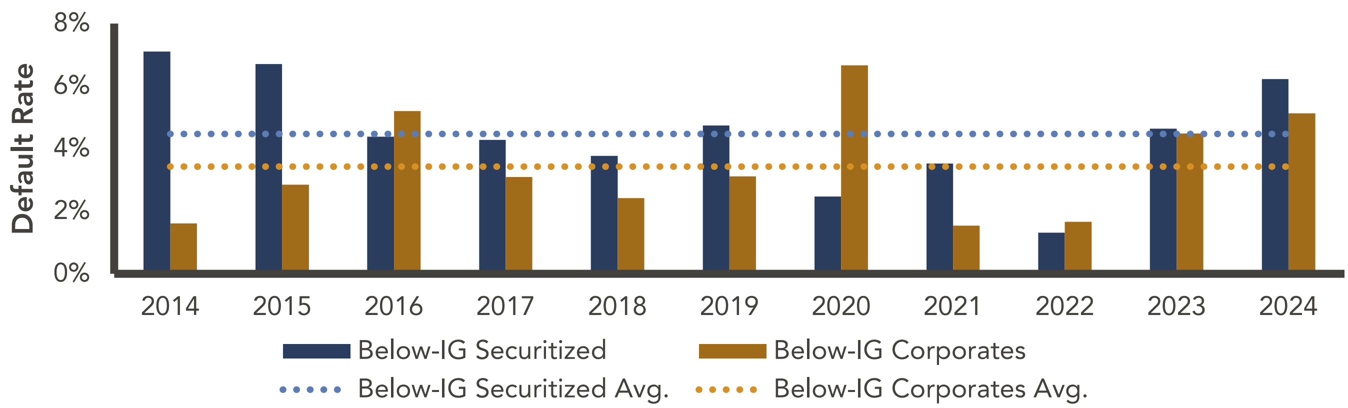


Source: Bloomberg, J.P. Morgan as of December 31, 2025; Blended AAA Securitized is the risk and return for an equal-weighting consisting of the Bloomberg CMBS 2.0 AAA Index and the J.P. Morgan AAA ABS, CLOIE, and Non-Agency MBS indices; Blended BBB Securitized is the risk and return for an equal-weighting consisting of the Bloomberg CMBS 2.0 Baa Index, the J.P. Morgan BBB ABS and CLOIE indices, and 20% J.P. Morgan Non-Agency MBS and 5% MBS – CRT indices.

Risks in Securitized Credit

Securitized credit provides many attractive risk mitigation features, but there are still multiple risk factors to consider. The first risk is obviously credit risk. There is always the risk that the underlying loans within the collateral pools default. The structure and mechanics of these assets help protect investors, but defaults can and do happen. Defaults are practically non-existent in both IG securitized and corporate credit. The credit risk is greater in below-IG, which is where defaults come with the territory. Non-investment grade securitized credit has shown slightly more default risk than below-IG corporates over time. The average default rate is ~1% higher over a 10-year period. However, this average is skewed higher by defaults that occurred in securities that were issued pre-GFC. Defaults over a more recent 5-year period are at nearly identical levels. While securitized credit has shown slightly higher credit risk than below-IG corporates, the structures and diversity of collateral pools mitigate idiosyncratic risks and help keep overall defaults low.

Exhibit 10: Below-IG securitized credit has slightly higher credit risk, but defaults are concentrated in lowest-rated tranches



Source: S&P Global Ratings, Voya as of December 31, 2024; Average is based on most recent availability of data which is 10 years from 2014–2024.

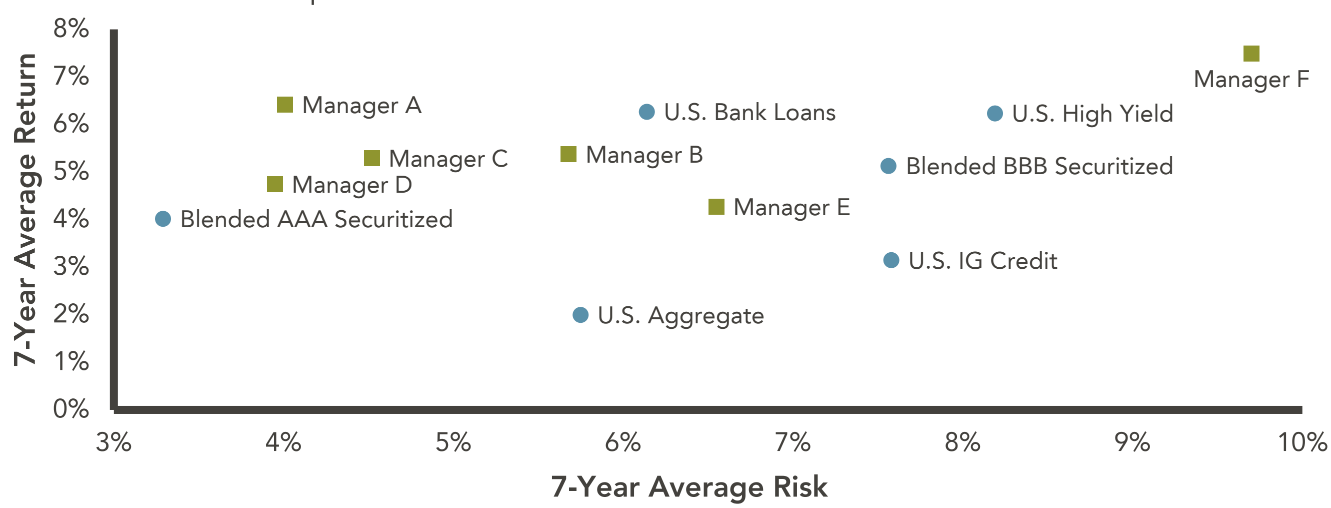
The next risk is the complexity risk. Securitized credit assets have intricate structures, with underlying pools consisting of thousands of loans. This creates opacity that can hide unique credit risks and complicate the risk assessment and valuation of the individual loans in the collateral pools. Complexity risk leads to the next risk, liquidity risk. Since valuation of tranches can be more difficult, there is often higher mark-to-market price volatility within securitized credit due to the relative illiquidity. This price volatility is particularly acute in times of significant market stress and lower-rated tranches. Investors are rewarded with a liquidity premium, but it can also introduce higher volatility into a portfolio in times of market stress. The final risk is prepayment risk. This is the risk that as interest rates fall, borrowers refinance and repay loans earlier than anticipated. This causes investors to lose out on higher yields and forces reinvestment at lower levels of yield.

HOW TO BRING STRUCTURE TO YOUR PORTFOLIO

Incorporating a dedicated securitized credit allocation into a portfolio provides increased income and diversification benefits but also adds new risks. Decisions around implementation can have a lasting impact on the long-term benefits of the asset class.

The optimal method by which to implement securitized credit is through an active mandate that diversifies allocations across all four of the primary securitized credit sectors. Allocations to single-sector securitized mandates are more a trade than a strategy due to the concentrated beta of a single-sector. Utilizing a broad active mandate without constraints on sectors or ratings allows a skilled manager to allocate to the best relative value and risk-return opportunities. This approach brings an allocation that offers diversified risks with embedded premiums into a broader portfolio. Active mandates within securitized credit provide a diversity of risk-return profiles and can enhance overall portfolio outcomes.

Exhibit 11: Active management within securitized credit provides diversity of risks with a variety of attractive risk-return profiles



Source: Bloomberg, eVestment as of December 31, 2025

CONCLUSION

Whether due to difficulty understanding the complexity, scars from the GFC, or simply not knowing how to implement the asset class, standalone securitized credit continues to be largely ignored within fixed income allocations. Securitized credit is a robust opportunity set that has undergone material improvements in structure and safety. Embedded yield premiums, diversification, and attractive risk-return profiles show the merits of this asset class. By implementing an active and diversified securitized credit mandate into a broader portfolio, investors can gain exposure to a new opportunity set and potentially improve the outcomes of portfolios.

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