Enhancing the credit premium: Securitised Credit a compelling alternative to Investment Grade Corporate Credit

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Key takeaways

- With IG corporate credit spreads at historically low levels, compensation for taking credit risk is now asymmetrically poor, with limited upside potential versus large downside risk in adverse scenarios.
- Securitised credit allows for spread pick-up for comparable rating, along with shorter credit duration than typical corporate credit profiles, providing access to investments with defensive characteristics.
- Matching securitised credit opportunities with the right capital and careful portfolio construction has been demonstrated to be a robust, high yielding and defensive addition to portfolios over time.

The role of IG Corporate Credit and Securitised Credit in a portfolio

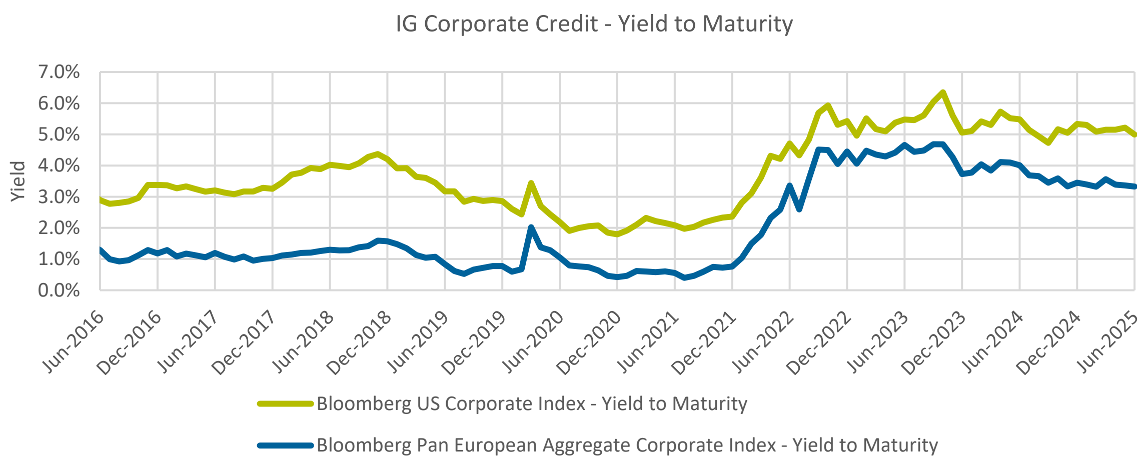
IG corporate credit traditionally plays a core role in investors' portfolios, allowing exposure to both the interest rate component, in return for bearing interest rate risk, and the credit risk component, representing compensation for bearing default, repayment timing, spread volatility and liquidity risks.

In recent years and in the current market environment, insurance investors are increasingly looking at alternatives to help enhance this allocation. For example, Moody's analysis of US Life Insurers in 2024 highlighted that they now have holdings of 16% of their portfolios in securitised assets.

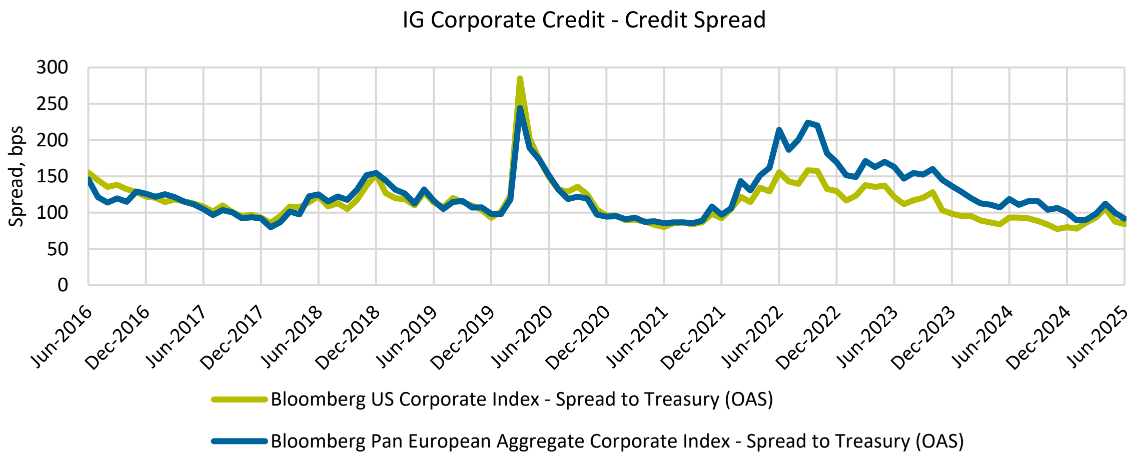
We look at why that is the case and how securitised assets can enhance portfolio return and volatility profiles.

IG corporate bond yields appear attractive, but compensation for IG corporate bond credit risk is low

As interest rates remain elevated, IG corporate bond yields remain attractive, especially compared to pre-pandemic levels.



However, separating this into interest rate and credit premium paints a story of relatively elevated interest rate return component while the compensation for bearing credit risk – as measured by credit spreads – has dropped to historically low levels.



In this environment, it is prudent to consider if a significant allocation to corporate credit continues to offer a strong return profile, or how to enhance the credit spread component. Even if investors are positive on credit fundamentals, the risk versus return trade-off is now asymmetrically poor, offering limited upside from potential further spread compression versus the risk of large downside in adverse scenarios. As the graph above illustrates, the path from the credit spread wides of 2022 to the credit spread tights of 2025 has been marked by periods of volatility.

Enhancing the credit premium utilising securitised investments

One way we believe that the credit risk component can be enhanced is through an allocation to securitised markets.

We observe a persistent pick up in credit spread in securitised markets when compared to corporate credit of similar ratings. In addition, securitised new issuance tends typically to have a shorter expected credit duration of 3-5yrs, compared to 5-8yrs for IG corporate credit. Securitised credit markets in Europe & Australia and across CLOs are also typically floating rate investments, offering reduced price volatility compared to fixed rate investments in volatile interest rate environments. These yield enhancing and defensive characteristics combine to produce what can be an attractive risk-return profile.

The market response to the 1 April Tariff announcements gives us a recent example of the impact of interest rate volatility and spread widening on portfolios in the current environment. Analysis of how securitised credit demonstrated lower volatility compared to corporate credit during that period is highlighted here: [Lessons from Liberation Day: Is now the right time to consider diversifying into securitised credit? - Challenger Investment Management]

Comparison of returns and volatility of corporate vs floating rate securitised

We compare and contrast the credit premium characteristics and returns quantitatively between Investment Grade Corporate Credit and European ABS by considering the following indices:

- Bloomberg US Treasury Index & Bloomberg US Treasury: Long Index
    - Indices composed of US Treasuries with varying interest rate duration but no credit spread duration
- Bloomberg Corporate Credit Index
    - Index composed of Investment Grade US Corporate Credit with varying interest rate duration and credit

- Blomberg Pan European Floating ABS Bond Index
  - Index composed of European Securitised Credit with varying credit risk, low interest rate duration given underlying assets are floating rate bonds

The key features of the indices are shown below:

Characteristic	Index			
	Bloomberg US Treasury Index	Bloomberg US Treasury: Long Index	Bloomberg US Corporate Bond Index	Bloomberg Pan European Floating ABS Bond Index
Currency	USD	USD	USD	EUR
Yield (%)	4.0	4.8	5.0	3.1
Credit spread (bps)	0	0	84	64
Interest rate duration	5.8	14.7	6.8	0.1
Credit spread duration	0	0	6.8	2.2
Average rating (S&P equiv.)	AA+	AA+	A-/BBB+	AA+

Source: Bloomberg, 30 June 2025

Current profile:

Taking these indices as an example, the European Floating ABS Bond Index displays defensive characteristics, such as higher relative credit ratings and lower sensitivity to interest rate and spread moves:

- an investment in the Bloomberg US Corporate Credit Index is generating a spread of 84bps over government and exposing investors to both interest rate duration and credit spread duration of 6.8.
  - i.e. if credit spreads were to widen by 30bps to averages over the past 10yrs, the investment would suffer a mark-to-market loss of 2.1%.
  - if interest rates increase by100bps, the investment would suffer a mark-to-market loss of 6.8%.

- an investment in the Bloomberg Pan European Floating ABS Bond Index is generating a spread of 64bps, exposing investors to credit spread duration of 2.2 but minimal interest rate duration.
  - i.e. if credit spreads were to also widen by 30bps, the investment would suffer a mark-to-market loss of 0.7%.
  - if interest rates increase by 100bps, there is minimal exposure to mark to market loss given the low interest rate duration of 0.1.

On a forward looking basis, investors are more exposed to both interest rate duration and credit spread duration in the asset mix underlying the Bloomberg US Corporate Credit Index vs the European Floating ABS Bond Index, and pick up a credit spread of only 20bps for taking on this risk given the current low corporate bond spread environment.

Historical analysis:

To demonstrate how these defensive characteristics hold up over historical periods, we compare an investment in the Bloomberg US Corporate Credit Index against an alternative investment in a combination of US Treasury Indices, for the interest rate component, and the Bloomberg Pan European Floating ABS Bond Index, for the credit component.

To create the return series we need to remove the interest rate component from the Bloomberg Pan European Floating ABS Bond Index. As such, we consider only the excess returns (the credit risk component) of this index return series by deducting the returns of a cash (Euro Short Term Rate[1]) benchmark.

We then generate a Simulated Index by adding these excess returns to a blend of US Treasury Indices

[1] Euro Short Term Rate Index commenced on 1 October 2019. Prior to this Euribor 1mth used.

which gives the same interest rate duration as the Bloomberg US Corporate Bond Index so that the interest rate exposure is similar and the impact of the credit spread component on the returns can be compared.

We should note that the analysis is based on theoretical index construction using monthly gross return index data so there are some shortcomings, but the results and approach is useful to compare and contrast the credit premium with corporate credit returns.

Creating this Simulated Index gives the below characteristics compared to the Bloomberg US Corporate Bond Index, noting that these are indicative of the current characteristics of the and may change over time:

Characteristic	Blended Index: Blended Bloomberg US Treasury Indices	Simulated Index: Blended Bloomberg US Treasury Indices plus gross excess returns from Bloomberg European Floating ABS Bond Index	IG Corporate Credit Index: Bloomberg US Corporate Bond Index
Currency	USD	USD	USD
Yield (%)	4.1	4.8	5.0
Credit spread (bps)	0	64	84
Interest rate duration	6.8	6.8	6.8
Credit spread duration	6.8	2.2	6.8
Average rating (S&P equiv.)	AA+	AA+	A-/BBB+

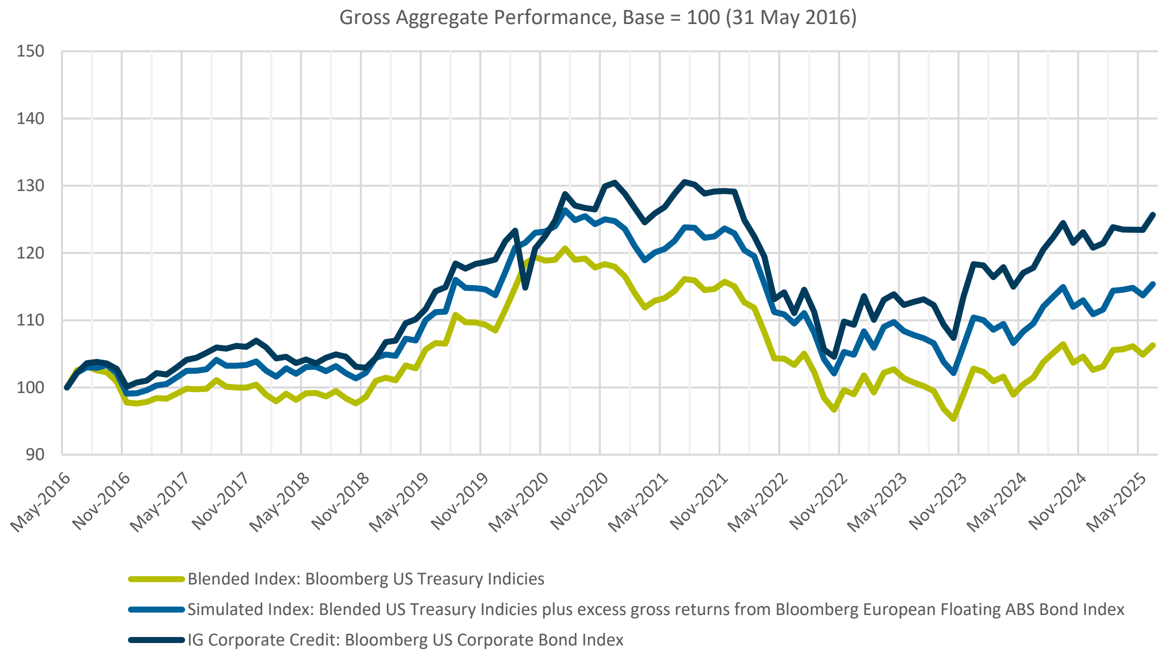
Source: Bloomberg, Challenger IM, 30 June 2025

- Compared to the Bloomberg US Corporate Bond Index, we note an investment in the Simulated Index has the same defensive characteristics as discussed previously of lower credit spread duration and higher rated asset mix, but with the same interest rate duration as the Bloomberg US Corporate Bond Index and a reduced yield/spread of 0.2%.

The defensive nature of this return series over this time period is shown in the table below, highlighting volatility is actually lower to investing in US Treasuries alone with increased yield. When compared to corporates, volatility and drawdowns are reduced. Returns are lower over the period by 1% annualised, reflective of the higher quality AA+ rating of the Bloomberg European Floating ABS Bond Index compared to the A-/BBB+ rating of the Bloomberg US Corporate Bond Index.

Characteristic	Blended Index: Blended Bloomberg US Treasury Indices	Simulated Index: Blended Bloomberg US Treasury Indices plus excess gross returns from Bloomberg European Floating ABS Bond Index	IG Corporate Credit Index: Bloomberg US Corporate Bond Index
Annualised return	0.67%	1.59%	2.55%
Annualised volatility	5.69%	5.66%	6.12%
Max drawdown	-10.7%	-11.4%	-12.5%

Source: Bloomberg, Challenger IM calculations, period 31 May 2016 to 30 June 2025



We further adjust the analysis to consider ABS excess returns of equivalent credit quality to the blended A-/BBB+ equivalent of the Bloomberg Corporate Credit Index.

Instead of using the gross excess returns from the Bloomberg Pan European Floating ABS Bond Index, we use internal realised return data since 2016 to create a modelled return profile for a blend of floating rate, predominantly investment grade, mezzanine securitised credit investments. This gives an indicative gross return profile for securitised credit of average A-/BBB+ rating. As previously, we consider only the gross excess returns (the credit risk component) of this gross return series by deducting the returns of a cash (Euro Short Term Rate[2]) benchmark.

Adding these gross excess returns to the blended US Treasury Index creates a Simulated Index 2 with the below characteristics to compare to the Bloomberg US Corporate Bond Index, noting that these are indicative of the current characteristics of the and may change over time.

Characteristic	Blended Index: Blended Bloomberg US Treasury Indices	Simulated Index 2: Blended Bloomberg US Treasury Indices plus excess gross returns from modelled Floating Rate Mezzanine Securitised Credit	IG Corporate Credit Index: Bloomberg US Corporate Bond Index
Currency	USD	USD	USD
Yield (%)	4.1	6.2	5.0
Credit spread (bps)	0	206	84
Interest rate duration	6.8	6.8	6.8
Credit spread duration	6.8	2.6	6.8
Average rating (S&P equiv.)	AA+	A-/BBB+	A-/BBB+

Source: Bloomberg, Challenger IM, 30 June 2025

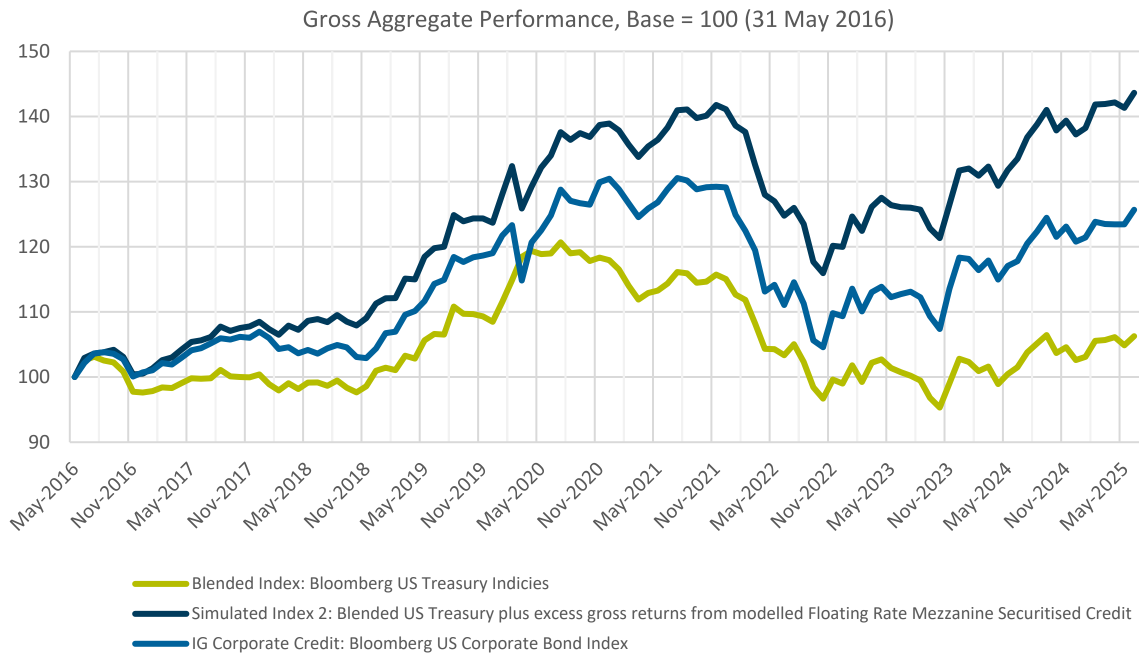
- In this case, we note the increase in credit spread of the Simulated Index 2 (+120bps over Corporates), given the more comparable ratings; securitised credit typically has a higher spread compared to similarly rated corporates.

The defensive nature of this return series over this time period is again shown in the table below, although this time annualised returns are 1.5% higher than the Bloomberg US Corporate Bond Index while volatility and drawdowns remain comparable.

[2] Euro Short Term Rate Index commenced on 1 October 2019. Prior to this Euribor 1mth used.

Characteristic	Blended Index: Blended Bloomberg US Treasury Indices	Simulated Index: Blended Bloomberg US Treasury Indices plus excess gross returns from modelled Floating Rate Mezzanine Securitised Credit	IG Corporate Credit Index: Bloomberg US Corporate Bond Index
Annualised return	0.67%	4.07%	2.55%
Annualised volatility	5.69%	6.12%	6.12%
Max drawdown	-10.7%	-12.0%	-12.5%

Source: Bloomberg, Challenger IM calculations, period 31 May 2016 to 30 June 2025



At a practical level, similar portfolio constructions to capture the interest rate component through investments in government bonds and the credit spread component through securitised credit could be contemplated through use of repo financing or derivatives, for example:

- Buying Government Bonds, raising financing through repurchase agreements and using the proceeds to buy securitised assets
- Buying floating rate securitised assets and adding a fixed/floating swap

In each case, these strategies would require collateral management to manage MTM movements in the financed collateral or derivatives as potential drags to the returns.

Capital impact for insurers

The capital treatment for securitised positions can vary significantly depending on the regulatory environment for the insurer. European regulations under Solvency II post Global Financial Crisis have tended to treat securitisation exposures punitively, while US and Australian regulations are more favourable. That can be seen in life insurer holdings where Moody's analysis in 2024 shows that in the US they hold 16% of assets in securitised assets, compared to just 2% in Europe.

For insurers considering adding securitisation assets as part of their portfolio, given the various regulatory capital frameworks, specific analysis and modelling is needed. This will assist in determining the optimal securitised credit portfolio to generate the capital adjusted risk-return benefit over corporate credit.

Summary

In summary, on both a forward looking and historical basis, adding investment grade credit premium through securitised assets instead of corporate credit can significantly decrease the volatility of returns given the shorter credit duration of the asset class, while similarly rated securitised products continue to offer a yield pick up over corporate credit.

Experienced managers of securitised products can assist clients to identify the appropriate securitised credit asset mix for their portfolio, liabilities and capital framework. Experience and expertise is required both to underwrite these assets and to manage portfolios for clients under their unique risk, return and liability management or capital frameworks.

About Us

Challenger Investment Management (Challenger IM) are specialists in public and private credit markets, creating value for our clients by providing more diversified sources of income compared to more traditional fixed income managers.

Challenger IM is part of the ASX-listed Challenger Group, a leading provider of annuities and retirement solutions. Since 2005, Challenger IM has invested for its own balance sheet alongside clients across a range of strategies focused on generating consistent income whilst minimising capital volatility.

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Important Information