Commentary | 2Q23

Voya Securitized Credit Fund

Tap into Voya's Flexible "Through-the-Cycle" Approach

Strategy overview

Invests in fixed income sectors collateralized by distinct asset types: commercial real estate (CMBS), residential housing (RMBS) and non-mortgage assets such as asset-backed securities (ABS).

Key takeaways

- Monetary policy continued to produce market volatility in the second quarter of 2023.
- The Fund outperformed its benchmark, the Bloomberg U.S. Securitized Index (the Index) on a net asset value (NAV) basis. Security selection, sector allocation, duration and yield curve positioning all contributed to relative performance.
- We expect growth to continue to slow, and the threat of recession to remain elevated and our strategy remains broadly defensive, with a preference for high quality spread opportunities.

Portfolio review

For the quarter ended June 30, 2023, the Fund outperformed the Index on NAV basis. Security selection, sector allocation, duration and yield curve positioning all contributed to relative performance.

Monetary policy continued to produce market volatility in the second quarter of 2023. Despite the failure of a fourth U.S. Regional Bank just two days prior, the U.S. Federal Reserve delivered another 25 basis points (bp) hike at their meeting in May. That said, with inflation trending in the right direction, and lending from banks expected to tighten, it was widely believed that this hike might be the last. Inflation data over the next couple of months was relatively well behaved. While the numbers remained elevated, they avoided moving higher. Meanwhile, the labor market remained strong. Monthly job gains surpassed already elevated expectations, with each monthly gain exceeding the previous one. While the Fed did not deliver a hike at their meeting in June, these upside surprises in the labor market all but eliminated hope of a "pause", with market participants instead viewing the Fed's inaction as a "skip".

In corporate credit markets, spreads moved to the tightest levels of the year after setting recent wides post bank failures in March. While First Republic became another casualty, remaining regional banks found sufficient support in the Fed's bank term lending facility and deposit outflows were not as bad as feared. On the earnings side, 1Q23 figures came in much better than expected (albeit negative) which was also supportive of credit spreads.

The fallout from the bank failures also had implications for other sectors of the bond market, particularly agency mortgage-backed securities (MBS) given the Federal Deposit Insurance Corporation (FDIC) needed to liquidate roughly $90 billion. To the surprise of many, MBS overcame this challenge, and posted decent excess returns for the quarter as money manager demand for high quality assets was high.

Across other securitized markets, performance was also positive. While the challenges in commercial real estate (CRE) are ongoing, commercial mortgage-backed securities (CMBS) took a break from recent spread widening and managed to post modest excess returns. Collateralized loan obligations (CLOs) were supported by the performance of their bank loan collateral and asset-backed securities (ABS) continued to be supported by mostly strong consumer balance sheets. The economy and financial markets in 2Q23 could best be described as "resilient". And this may be best illustrated by activity in the housing market. As mortgage rates moved from multi-decade lows to multi-decade highs in relatively short order, many expected a quick and substantial drop in home prices. Not only has that yet to occur, but home prices have been moving slightly higher over the last couple of months, supporting the non-agency residential mortgage-backed securities (RMBS) and credit risk transfer (CRT) segments.

Security selection, sector allocation, duration and yield curve positioning all contributed to relative performance. A positive risk sentiment tone meant that our overweight to credit sectors broadly contributed. Non-agency RMBS was the top contributor to excess returns, adding 99 bp to the portfolio total. Jumbo 2.0 was the main contributor followed by CRT. CMBS outperformed treasuries with 31 bp of excess return contribution. Agency resecuritization of real-estate mortgage investment conduits (ReREMICs) were the leading contributor. CLOs were the best performing sector on a per-dollar basis and added 27 bp to the portfolio total. BBB rated issuers tranches were the top contributor followed by BB rated issuers. Asset-backed securities contributed 12 bp to aggregate excess in 2Q23. Whole business and student loan were the top contributing subsectors. Finally, duration and curve positioning positively impacted performance on both an absolute (24 bp) and active (158 bp) basis. From a relative standpoint, our lower duration profile was beneficial in a quarter where rates moved higher, while absolute returns were driven by tactical changes and curve positioning. Following a strong quarter of outperformance, we took the opportunity to reduce risk and increase dry power. Areas we reduced exposure include BBB rated CLOs (–4.5%) and Jumbo 2.0 RMBS (–1.9%).

Current strategy and outlook

We expect growth to continue to slow, and the threat of recession to remain elevated. With corporate earnings in decline, leverage ratios are beginning to move higher. And while most corporate borrowers termed out their debt at very low fixed rates, this is not the case for senior bank loan issuers (collateral for CLOs), where leverage is higher. Meanwhile, CRE financing markets remain challenging, which could become problematic as many loans are approaching their maturity date. And finally, while consumer spending is supported by the strength in the labor market, this strength is also keeping inflation elevated, in turn motivating the Fed to keep rates higher for longer.

Portfolio strategy remains broadly defensive, with a preference for high quality spread opportunities. Having improved credit quality over the last few quarters, we continue to look for the right opportunities to redeploy capital but would need to see markets more appropriately discount the risks mentioned above.

The **Bloomberg Barclays U.S. Securitized MBS/ABS/CMBS and Covered Index** includes the MBS, ABS, and CMBS sectors. Indexes do not reflect fees, brokerage commissions, taxes or other expenses of investing, and investors cannot directly invest in an index.

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