Asset-based finance is a potential diversifier and alternative source of portfolio income. (Shutterstock)

Is now the time for diversified asset-based finance?

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While it has long been the preserve of professional and institutional investors, we believe asset-based finance (ABF) offers increasing appeal as a potential diversifier and alternative source of portfolio income. Here are three reasons to take a fresh look.

Asset-based finance (ABF) has long been the domain of institutional investors. Private investors have been more sceptical to put money to work in the asset class due to its perceived complexity and challenging memories of performance during the global financial crisis, especially mortgage-backed securities.

But we think it may be time to reconsider the role of ABF in investment portfolios as a potential source of diverse income and portfolio diversification. Here are three reasons why:

ABF can provide an alternate source of income. In a market estimated at USD 5 trillion, ABF presents an opportunity for appealing risk-adjusted returns, in our view. With average annualized fund returns ranging from 6% to over 15%, ABF stands out as a potentially interesting additional source of yield for income-seeking investments. The primary driver of these returns is the income generated from the interest and principal payments on underlying assets, such as loans, leases, receivables, or royalties.

The asset class may provide diversification qualities to a portfolio. ABF can serve as a potential diversifier in long-term portfolios, with an average long-term return correlation of 0.48 to US investment grade debt and 0.58 to private direct lending suggests. This diversification potential stems from the unique characteristics of the assets used as collateral and the varied cash flows they generate.

Privately negotiated loans may offer stricter investor protections. Private loans in ABF often feature stricter covenants and more collateral than other forms of credit, providing a layer of additional security for investors.

As with all private markets, it's essential to approach this asset class with active risk management. Investors should be mindful of the credit, illiquidity, and prepayment risks inherent in private ABF investing. Moreover, the importance of manager selection cannot be overstated, as performance can vary significantly based on expertise, risk management strategies, asset selection, and diversification.

On balance, CIO sees asset-based finance as a potential diversifier and source of alternative risk-adjusted returns. Today may be an opportune time to consider its part in a well-diversified portfolio. Going forward, we think growth in private ABF, driven by stricter regulation and the search for income, should provide an evolving and growing opportunity set that may appeal to long-term investors.

For more details on asset-backed finance, please see *Alternative investments: The case for asset-based finance(5 February 2024).*

With thanks to Antoinette Zuidweg (UBS Chief Investment Office) for her contribution.

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