CIO thinks asset-based finance offers fresh opportunities for income and diversification, subject to careful risk management. (UBS)

Should investors look at asset-based finance?

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Asset-based finance has historically been dominated by institutional investors. Private investors may have been put off by perceived complexity and memories of the global financial crisis.

CIO thinks asset-based finance has a role to play in portfolios as a fresh source of income, a potential diversifier, and a beneficiary of enhanced investor protections. Investors should consider the risks of this alternative strategy and its role as part of a financial plan.

Asset-based finance has historically not been on private investors' radars.

- Private asset-based finance (ABF), an estimated USD 5tr market, involves making less liquid loans against the cash flows of various assets.
- ABF can be complex and illiquid, given the wide range of assets used as collateral and the bundling of assets in a process known as securitization.
- Some investors shunned ABF given the role of certain mortgage-backed securities during the global financial crisis.

But we think ABF has a role to play in long-term portfolios.

- ABF can offer appealing risk-adjusted returns, with average annualized fund returns ranging from 6% to more than 15% a year.
- These private loans often have more robust investor protections, like stricter covenants and more collateral, than other forms of credit.

- Private ABF can be a portfolio diversifier, with an average long-term return correlation of 0.48 to US investment grade debt and 0.58 to private direct lending.

We advocate using active risk management to access this asset class.

- We think experienced managers are best placed to understand the opportunities and risks of different underlying assets (from car loans to music royalties).
- Investors should be aware of the risks of private ABF investing, which can include credit, illiquidity, and prepayment risks.

Did you Know ?

- Private ABF has grown as stricter regulation limited banks' willingness and ability to lend to some borrowers.
- The primary driver of private ABF returns is income. Many managers pay out income streams of between 4% and 10% per year. Returns primarily come from the interest and principal payments on the underlying asset classes, such as loans, leases, receivables, or royalties.
- While prime sectors continued to show strength in February 2024, delinquencies in non-prime areas have increased, particularly in the mortgage and auto loan sectors. However, we note that overall pricing and returns for this diverse sector should contain default risks for well-diversified investors.

Investment view

We like asset-based finance as a potential diversifier and source of alternative risk-adjusted returns. It should, however, be noted that managers' performance can differ widely due to differences in expertise, risk management strategies, asset selection, and diversification, underlining the importance of manager selection.

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