ELLINGTON
INCOME OPPORTUNITIES FUND

The Cycle Repeats: Post Crisis Opportunities in Structured Credit

December 2021

Key Takeaways:

- While the March 2020 shock affected all financial markets, structured products, which traditionally experience relatively low volatility in benign markets and relatively high volatility in stressed markets, were especially adversely impacted and trailing performance metrics remain depressed. Spreads on liquid credit indices have since recovered to post-financial crisis tights. Nevertheless, in structured products, absolute value persists due to elevated dispersion and relative value persists due to elevated complexity and liquidity premia.
- In contrast to the prior benign market environment where there was little room for differentiation, the COVID crisis created significant bond-level dispersion. Top tier spreads for BB Collateralized Loan Obligations (CLOs) are tighter than early 2019, while bottom tier spreads are wider, driving the bottom/top tier spread difference to 263 basis points (bps), relative to 95bps pre-COVID.
- Elevated bond-level dispersion reflects significant collateral dispersion that caused deal performance to vary widely. The difference between the 75th and 25th percentiles of delinquencies across commercial mortgage-backed securities (CMBS) Conduit 2.0 deals has increased from 1% in 2019 to 10% today, reflecting varying exposure to highly stressed sectors like hotel and retail. As for the recovery in air traffic, global domestic travel is around 20% below 2019 levels while international travel remains 70% below, benefiting Enhanced Equipment Trust Certificates (EETC) and aircraft asset-backed securities (ABS) deals with low concentrations of widebody planes that fly long-haul, international routes.
- Complexity and liquidity premia remain notably elevated relative to historical levels. Underscoring the relative cheapness of structured products versus plain vanilla products, BB CLO spreads are at the 39th percentile of their 1/2016-10/2021 historical range while high-yield corporate bond spreads are at their 4th percentile. Already constrained dealer balance sheets have shrunk even further, with non-agency RMBS primary dealer holdings contracting over 30% since COVID, expanding the liquidity premium.
- The market share of active managers has declined, consistent with permanent credit impairments on COVID-exposed investments and redemptions exacerbated by forced liquidations. Combined hedge fund and private equity market share in US CLO mezzanine debt has declined over 70% relative to 2019. Conversely, bank, mutual fund, and pension fund investors have become a larger percentage of the investor base.
- Altogether, this suggests there is reduced competition among active investors who specialize in sourcing more complex bonds passed over by constrained long-only capital that must deploy at scale, recharging the opportunity set across structured products.

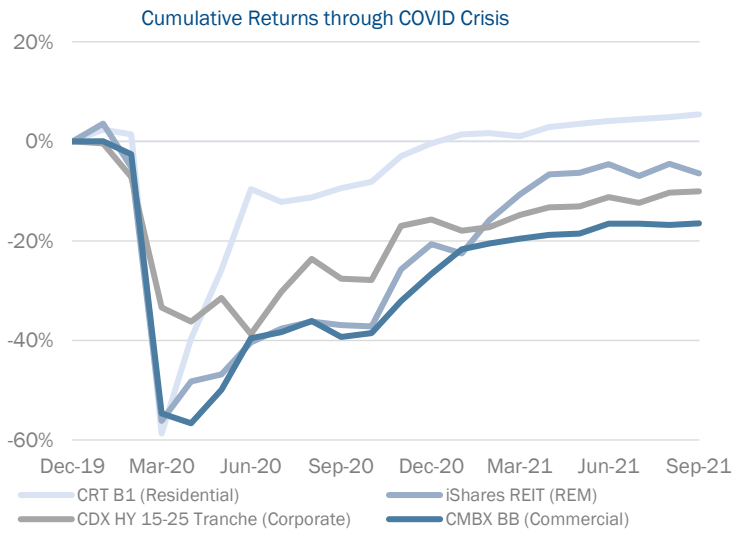
While the credit market selloff at the onset of the pandemic was the most precipitous in recent decades, so too was the recovery following the Fed's emergency liquidity facility announcements and the passage of fiscal stimulus. Spreads on many liquid credit indices and Exchange Traded Funds (ETFs) now stand near post-financial crisis tights as sustained excess liquidity drives a reach for yield. The buy-the-market beta opportunity in liquid credit may have passed, but sectors like structured products continue to offer relative value compared to more vanilla credit markets. Furthermore, across structured credit markets, elevated bond-

level dispersion, resulting from significant differentiation in deal performance through the March 2020 shock, persists, creating asset-picking opportunities particularly well-suited for active managers. Many levered pools of capital suffered significant permanent impairments through the COVID shock. As a result, asset-pickers have lost market share in structured credit markets relative to long-only pension and mutual fund investors, many of whom have constraints around metrics like rating and effectively hold the market given the scale at which they have to deploy. This shift has largely increased premiums on complex or illiquid assets, creating an opening for remaining active managers that target harder-to-source, complex bonds on a smaller scale. There are clear parallels to the financial crisis of 2007-2008. After facing similar impairments, it took years for levered pools of capital to regain market share, enabling active managers that combined years of expertise, alternative data sources, and analytics to earn consistent excess returns by capitalizing on dispersion.

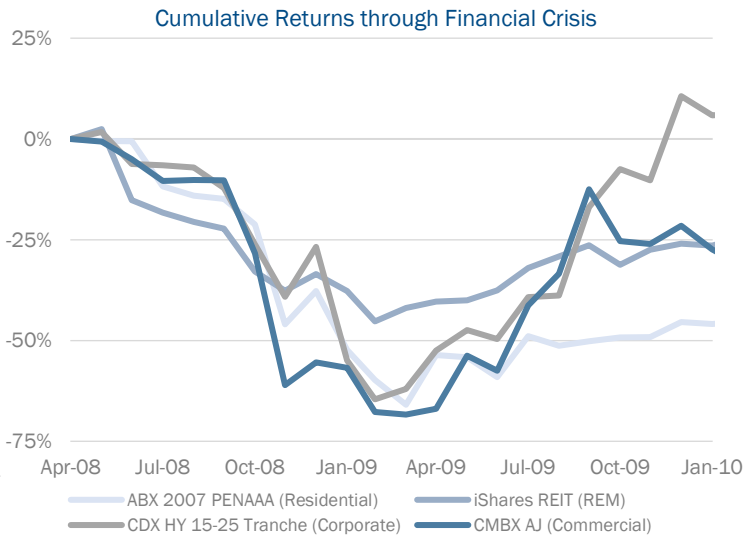
March 2020: History repeats itself

As financial markets came under stress in March 2020, repeated headlines reported yet another structured credit hedge fund or real estate investment trust (REIT) struggling to withstand balance sheet stresses. Liquidity mismatch and high structural and external leverage drove forced selling, compounding mark-to-market price declines. Among the myriad reports of funds coming under stress, a multi-manager fund pointed to its big wager on structured credit hedge funds with ample leverage that were insufficiently hedged, a 40 Act fund contended with liquidity mismatch between its assets and daily liquidity draws from investors, and a hedge fund that sold short-dated protection to investment banks on hundreds of investment-grade and high-yield bonds endured increasing corporate defaults.

Many stories pointed out the obvious parallels to the financial crisis of 2007-2008. Credit cycles had been discussed repeatedly in financial and academic circles post-financial crisis, drawing on prior research, such as John Geanakoplos' seminal study of leverage cycles.[1] Nevertheless, the same narrative was repeating itself once again, most starkly with mortgage REITs. The classic embodiment of balance sheet stresses resulting from liquidity mismatch and excessive leverage in the COVID crisis, REITs faced tremendous liquidity pressures through their funding of mortgage assets with repo, and were ultimately forced to dump mortgage bonds, driving down prices well below fundamental value. Defaults or forbearance on repo became front-page news, and, in the aftermath of the crisis, some REITs moved to financing their loans through securitization rather than repo, effectively shifting the loans' mark-to-market price volatility to debt investors.



Source: Markit, Morgan Stanley, Bloomberg, Citi



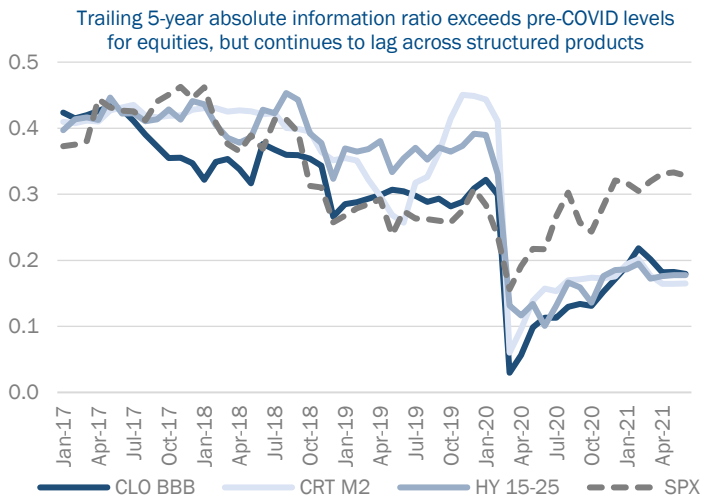
Source: Markit, Morgan Stanley, Bloomberg, Citi

[1] John Geanakoplos is the James Tobin Professor of Economics at Yale University. He is a Founding Partner and Managing Director at Ellington.

Short memories promote cyclicality

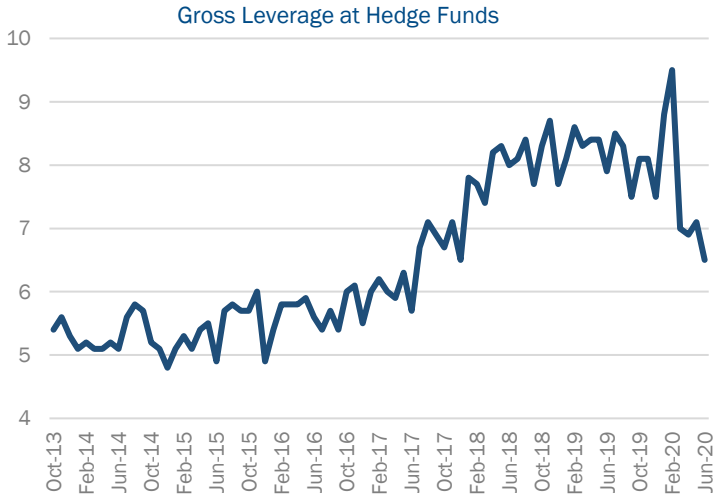
Leverage cycles are repeating phenomena. Before the 2007-2008 financial crisis and the March 2020 COVID shock, the mortgage derivatives crisis of 1994 prompted hedge fund failures and the emerging markets mortgage crisis of 1998 brought down Long-Term Capital Management. The natural question is why so many market participants are caught unprepared to weather a downturn from a liquidity management standpoint when it occurs, despite having seen this cycle play out time and again.

One explanation is that investors understate the likelihood of extreme price moves after an extended benign market environment and overstate the likelihood in the aftermath of a shock, consistent with the availability heuristic well-documented in the field of behavioral finance by Kahneman and Tversky. This phenomenon is particularly relevant for structured products with negatively convex profiles that experience low volatility relative to local moves in broader equity or corporate credit indices and outsized volatility in extreme market moves. As crisis episodes fall out of lookback windows, backward-looking investors that emphasize trailing performance metrics, like Sharpe Ratio or rolling default rate, are often lulled into complacency. Investors reengage in previously avoided markets, crowding out the alpha opportunities a less competitive playing field presents: complexity, bid/offer, and process/event premia compress.



Source: JP Morgan DataQuery, Citi, Markit, Morgan Stanley, Bloomberg

Many funds then increasingly rely on taking on left-tail risk exposure to boost returns. This takes multiple forms: investing in securities with higher structural leverage, increasing external balance sheet leverage on those securities, limiting or foregoing hedging, and amplifying liquidity mismatches by placing illiquid products in liquid funds. Another channel to increase left-tail risk is by increasing exposure to surprise defaults (or "jump-to-default" risk), effectively earning an idiosyncratic left-tail risk premium. This risky behavior is rewarded until a stress episode occurs and those risks become detrimental. Following the shock, many market participants become wary after experiencing losses that exceeded their expectations in the downturn. The result is that allocation to structured credit is routinely low following stress episodes when excess returns can be achieved without taking left-tail risk, while high leading up to stress episodes when they cannot.



Source: Federal Reserve, Financial Stability Report (May 6, 2021)

In the wake of the financial crisis, markets like subprime residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS) ground to a halt. Issuance collapsed as many market participants stepped away from these products. Enterprising investors willing to venture back into these markets were rewarded with excess risk-adjusted returns from 2009-2014. Gradually, as memories of the crisis faded, new highly-levered product types like credit risk transfer (CRT) emerged and gained prominence. Investors became increasingly comfortable with securities that had never experienced extreme price action or fundamental credit stress (e.g. high delinquencies/defaults). Though they were tremendously levered to tail events, especially relative to the vast majority of the structured product universe, those tail events were deemed improbable. Issuance of CMBS and collateralized loan obligations (CLOs) ramped back up around pre-financial crisis levels.

Following the credit cycle narrative, leverage increased and left-tail risk management decreased in the years leading up to the COVID crisis as a more competitive playing field led to increased efficiency and fewer mispricings. Some investors sold left-tail risk by placing securities with abnormally high structural leverage like CRT in funds with daily liquidity or increasing their external leverage. While these securities could fundamentally withstand a stress comparable to the financial crisis, they ultimately sold off 40-50% as holders were forced to sell to raise cash once prices began falling with heightened uncertainty, the drawdown clearly dwarfing the maximum expected return. While post-crisis regulation did mitigate overleverage in the banking system, successfully limiting systemic risk, it did not curb leverage in the financial system as a whole. Financial activity shifted from banks to less regulated nonbanks like REITs.

Out-of-the-money risks require skilled liquidity management

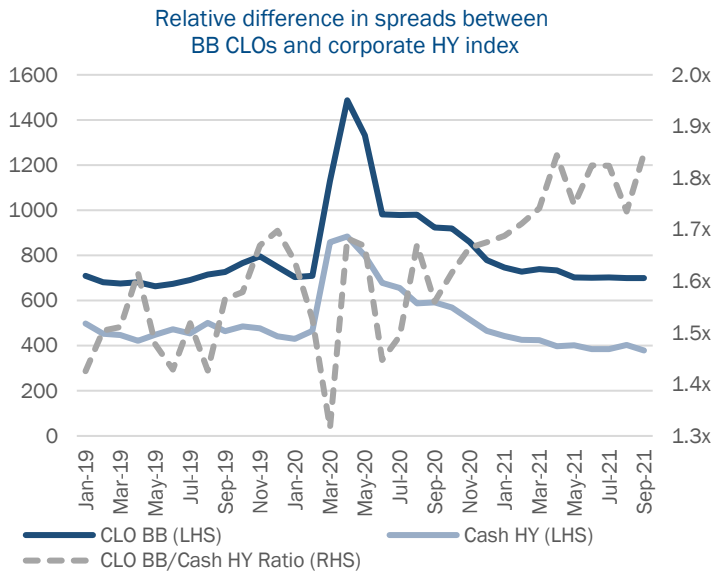
External leverage on securitized products can trigger liquidity spirals where even fundamentally impenetrable assets experience significant mark-to-market price declines, as described in Gorton and Metrick's "Securitized Banking and the Run on Repo". CLO AAAs, for example, traded below $90 at the depths of the March 2020 crisis despite even the most Armageddon of scenarios resulting in no cashflow impairment. With around 40% credit enhancement, 80% of the loans would have to default with stressed recovery levels of 50% for the AAAs to take any losses. Therefore, structured product investors earn a liquidity premium as compensation for the risk that mark-to-market prices plummet below fundamental value when financial markets come under stress.

By and large, structured products are highly resilient fundamentally as breakeven scenarios to impair cashflows are generally well out-of-the-money. That said, there are securities with high embedded structural leverage that are particularly vulnerable to unexpected stresses. For example, CRT M2s were generally assumed to be no-loss bonds prior to the pandemic. Though they were extremely levered, with attach/detach points around 1% to 3%, they could withstand a stress comparable to the financial crisis. Since a more severe housing-related shock seemed highly unlikely, M2s traded around L+200bps. As the world began to shut down in March 2020, however, and unemployment projections soared to Great Depression levels, defaults/losses exceeding the subprime mortgage crisis appeared more possible. Bonds levered 100x are quickly wiped out as collateral loss expectations increase and prices plummeted dramatically as uncertainty increased, reflecting the binary outcome of these profiles. As described in an Ellington Q3 2017 newsletter, "[CRT] securities represent such a levered piece of the capital structure that they introduce increased modeling difficulties. We [have] always believed that the true risk of these securities was an unforeseen event that could significantly impair a small pocket of the nation's housing stock, which would be magnified in such a small slice of the capital structure."

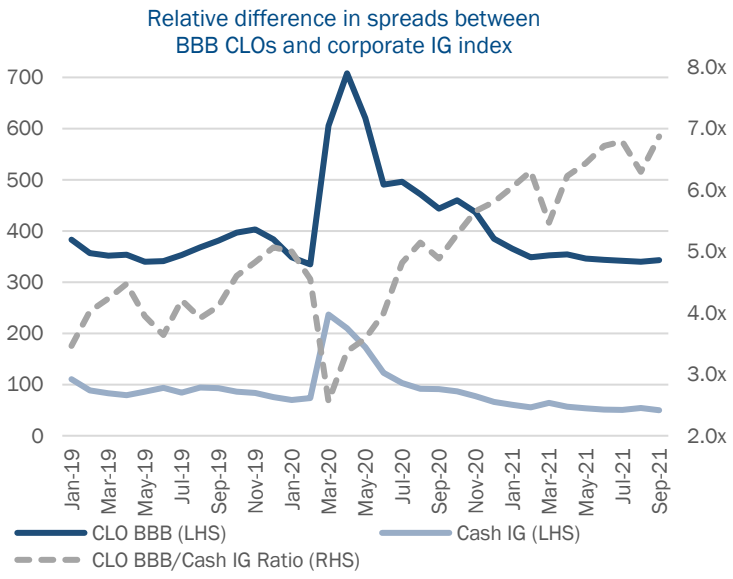
Current opportunities for active managers

Though spreads ultimately snapped back across credit markets following the Fed's announcement of the corporate credit facilities and the passage of fiscal stimulus, the market share of active managers in structured credit markets has nonetheless declined, consistent with permanent credit impairments on COVID-exposed investments and redemptions exacerbated by forced liquidations. Conversely, bank, mutual fund, and pension fund investors have become a larger percentage of the investor base. As a result of this capital shift, there is reduced competition among active investors who specialize in sourcing more complex bonds passed over by constrained long-only capital that must deploy at scale, recharging the opportunity set across structured products.

While structured products regularly trade wider than their vanilla counterparts because of the additional complexity, this "complexity premium" is notably elevated relative to historical levels, meaning structured products offer value relative to other credit markets. As Nomura stated for the secondary CLO market, "At the non-IG level…the spread pickup for CLO BBs versus HY cash remains very high on an absolute basis" and "At the IG level, the spread ratio between CLO BBBs and IG cash is…higher than average over a multi-year period" (Nomura SPW 9/21). Goldman Sachs also noted that "structured products continue to offer value versus plain vanilla products" given persistently high complexity and liquidity premia, especially for CLOs, which they believe "offer the best risk-reward tradeoff for unconstrained investors" (Global Credit Outlook, September 2021). To underscore this relative cheapness, they point to BB CLO spreads "at the 39th percentile of their 1/2016-10/2021 historical range while high-yield corporate bond spreads are at their 4th percentile (where 0th percentile=historic tight, 100th percentile=historic wide)" (GS Structured Credit Trader, 10/15/21).

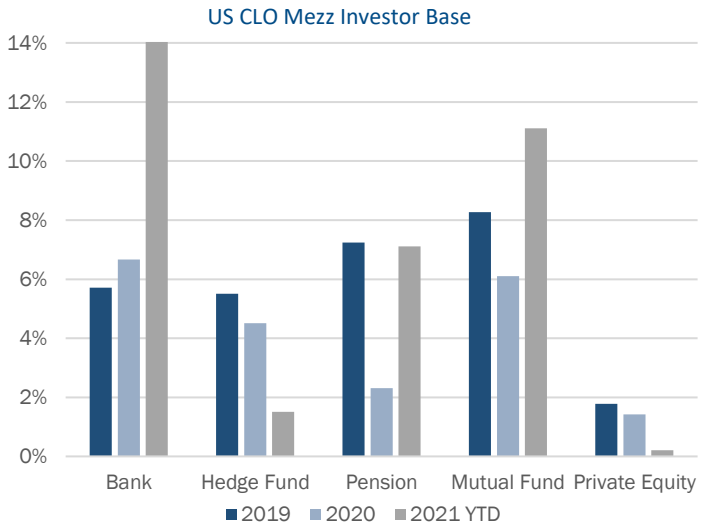


Source: JP Morgan DataQuery, Ellington



Source: JP Morgan DataQuery, Ellington

The sustained relative undervaluation of more complex CLO junior mezzanine debt is consistent with the shift in the product's investor base. While shares for insurance companies and asset managers, the largest holders of CLO mezz, remained largely flat between 2019 and 2021, the remaining investor landscape shifted notably. Bank and mutual fund participation increased from 14% to 25%, contrasting the decline in hedge fund and private equity participation from 7% to under 2%. Hedge funds' shrinking market share in 2020 is particularly stark given the drastic widening in spreads – opportunistic money had the ability to earn incredibly outsized returns and capital was certainly raised to deploy at these distressed levels. The fact that their share nonetheless declined supports the notion that capital in structured credit has shifted away from active managers that dig through bond-by-bond, picking up securities trading below fundamental value based on detailed modeling of collateral cashflows. Bonds that screen wide are typically complex, trade in the secondary market as opposed to the new issue market, and can only be sourced a few million at a time.



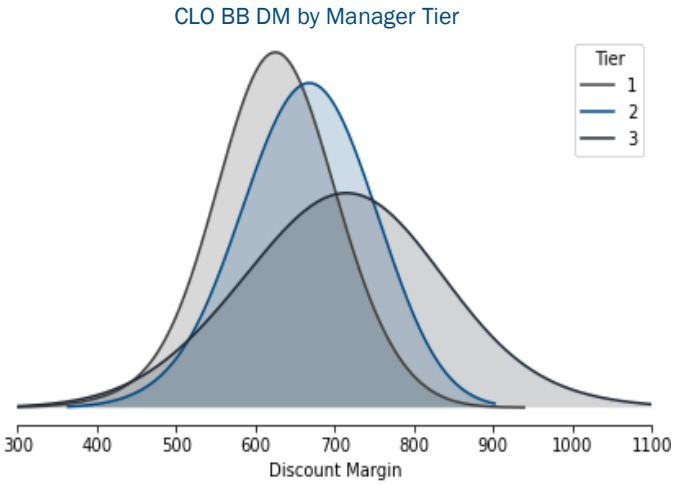
Source: Citi Research

Other, generally long-only, participants that have gained market share are often constrained by bond-level metrics, potentially hindering their ability to capitalize on elevated bond-level dispersion. Moreover, because of the scale at which they have to deploy, long-only investors often limit purchases to securities they can buy in size. Since size is typically more readily available at new issue, there is relatively less focus on sourcing in the secondary market. Many investors are extremely rating-focused because of regulatory capital requirements or explicit rating constraints. As CLO upgrades have ramped up markedly through 2021, however, reaching nearly 9% in September,[2] from both the continued credit recovery and structural protections that delever the structure to increase the debt's overcollateralization, unconstrained investors able to view rating as dynamic rather than static in security selection can yield better returns for comparable risk. While strong tests and triggers that force this

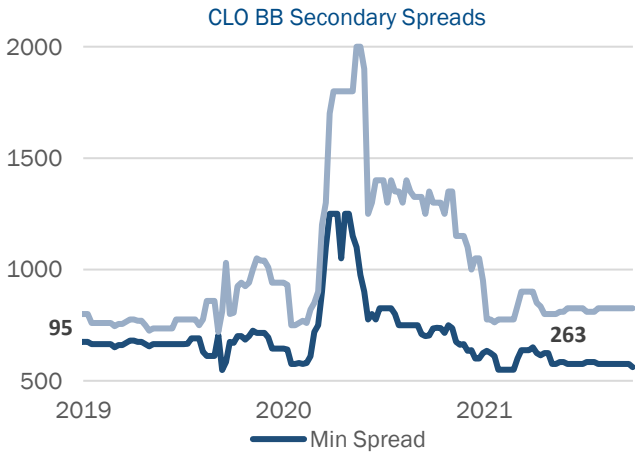
[2] Moody's September 2021 Structured Rating Transitions (Jan 1993-Sep 2021), Global CLOs Trailing 12-month Rating Transition Trends

delevering are highly important, collateral metrics, like low Weighted Average Rating Factor (WARF) and high loan Weighted Average Price (WAP), tend to be prioritized over these structural features. Relatedly, investors without the wherewithal to engage in the complex work of modeling intricate CLO cashflows tend to concentrate on metrics like Market Value Overcollateralization, without projecting out various scenarios for how these metrics may evolve over time.[3]

Additionally, manager tier is weighted very heavily for many investor types – certain types of investors exclude very "off the run" managers from their investable universe. While the recovery for top tier managers has been robust, deals from lower tier managers continue to trade wide relative to pre-COVID levels. In contrast to the prior benign market environment where there was little room for differentiation, the COVID shock created significant bond-level dispersion as deal performance varied widely, particularly for lower tier managers. Certain investors are prone to stay away from more dented deals, even if loss-adjusted returns are attractive. Many of these deals continue to look attractively priced as a result. Reflecting current elevated dispersion, the BB spread range quoted by Deutsche Bank now stands at 263bps, relative to 95bps pre-COVID. Minimum spreads are now tighter than early 2019, while maximum spreads are wider, reflecting an increase in the percentage difference from around 20% to nearly 50%. Active managers with strong analytics willing to look beyond name-brand deals are particularly well-positioned to take advantage of this elevated dispersion, buying CLOs that offer better risk-adjusted returns across the capital stack.



Source: Dealer Color on CLO BWICs, Ellington



Source: Deutsche Bank Securitized Products Market Databank

Moreover, the cashflow projections themselves for CLOs have become more favorable in many cases relative to the historical levels used to calibrate estimated defaults and prepayments. To begin with, corporate defaults have historically been considerably lower than average levels for years following default waves, as the weakest credits fail leaving the stronger credits that were able to survive the shock. The aftermath of the COVID crisis has been no exception. The 2021 default volume is on pace to be the lightest in a calendar year since 2007 and Street forecasts project below average defaults to persist in the coming years. As a result, cashflows are likely to be stronger than historically calibrated models would project in the near-term, implying loss-adjusted spreads remain wider than pre-COVID levels. Another source of material upside for CLOs is reorganization ("reorg") equity, which managers can receive as part of bankruptcy exit packages. Reorg equity has experienced significant price appreciation alongside the rally in loans, occasionally recovering more than par, however, CLOs typically mark such assets at zero. Since widely used cashflow engines do not attribute value to reorg equity when generating cashflows, the market tends to underappreciate the additional coverage on the debt by ignoring this value. Overall, dispersion in the underlying collateral has actually decreased in 2021 as previously distressed credits have outperformed (e.g. basis between CCC and BB loans has compressed), yet the CLOs that hold these loans maintain a high level of dispersion. By meticulously incorporating all of the relevant drivers to fundamental value, active investors can discern which bonds offer excess value relative to price. Looking at tailwinds on the technical side, the CLO and loan markets, both floating rate products, continue to benefit from strong demand as expectations for interest rates steadily increase.

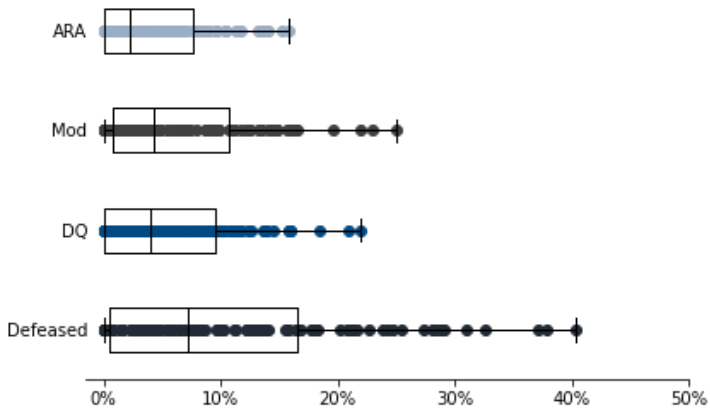
[3] MVOC is defined as (Collateral Balance * WAP + Cash Balance) / (Senior Tranche Balances + Pari Passu Tranche Balance)

Across other asset classes, sectors particularly impacted by the specific nature of the shock, like the housing sector during the financial crisis, lag the broader market recovery and remain inefficient for the most prolonged period given investor reluctance to engage in markets with relatively more fundamental uncertainty. Aviation and commercial real estate are classic COVID distress examples with the crater in travel decimating air traffic and hotel occupancy at the onset of the pandemic. Though many investors generally characterize these markets as unfavorable and to be avoided, there remain fundamentally solid securities trading wide because of the stain associated with the industry and the emphasis on metrics like rating over those valuing the underlying collateral. Credit performance varies widely across CMBS Conduit 2.0 deals – the middle 50% of delinquencies range from zero to ten percent versus zero to one percent pre-COVID. Modifications and appraisal reduction amounts (ARAs), which were effectively zero in early 2020, have also picked up to varying degrees across deals. Moreover, not all delinquencies or modifications should be treated equally, requiring a deep dive on the credit of each distressed loan that considers a wide range of quantitative and qualitative factors.

Turning to the air traffic recovery, domestic travel has far outpaced international travel, benefiting narrowbody planes that fly shorter-haul, domestic routes relative to widebody planes that fly longer-haul, international routes. The uneven recovery has created stark differentiation across aircraft-related securities, like EETCs and aircraft ABS, based on widebody concentration and other factors like airline-specific defaults. Particularly elevated dispersion in these sectors creates similar opportunities for credit pickers willing to actively dig in and discern which securities are undervalued based on fundamentals across a range of plausible forward scenarios.

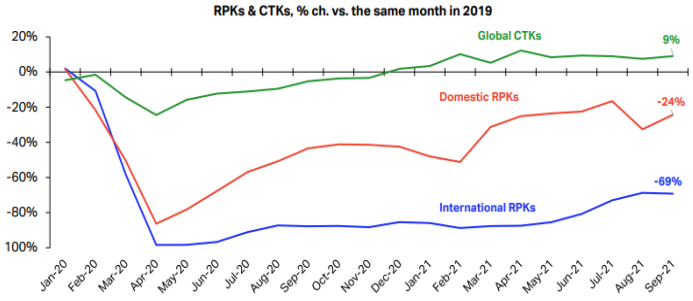
Even sectors that have greatly benefited from the unique nature of the pandemic-induced crisis, and have largely rallied back, continue to offer greater upside than they did prior to the pandemic. For example, in the legacy non-agency sector, the already low number of levered participants has whittled down even further as many prior owners of legacy bonds, like mortgage REITs, are significantly less levered or no longer exist. The resulting reduction in market players has created more market inefficiencies to exploit, particularly in a market where dealer balance sheets were arguably already strained before COVID, rendering dealers less effective market-makers.

Dispersion in CMBS Conduit 2.0 Credit Metrics



Source: Trepp, Ellington

Domestic travel recovery has far outpaced international travel recovery, while cargo traffic has soared above pre-COVID levels



Source: IATA Monthly Statistics

Revenue Passenger Kilometers (RPK): *Number of revenue passengers multiplied by the total distance traveled;* ***Cargo Ton Kilometers (CTK):*** *Number of revenue tons of cargo (freight and mail) carried multiplied by distance flown*

Non-Agency RMBS Primary Dealer Holdings

Source: Deutsche Bank Securitized Products Market Databank

Buy-side participants can then step in as liquidity providers and capitalize on this reduced competition from dealers, earning an enhanced bid/offer premium. In terms of fundamentals, single-family housing has been an overwhelming beneficiary of the pandemic, with home prices roughly 20% higher than last year's levels.

Accordingly, cashflow expectations for these securities have dramatically improved, with severities for legacy loans declining from around 60% to 25% year-over-year, supported by a significant increase in the percentage of liquidations with no losses.[4] Most importantly, recoveries on principal forborne during the global financial crisis have surged 3-4x in recent quarters, and continue to be a source of strong upside for investors, particularly for securities that have previously taken losses and now have the potential to write up.[5] Similar to reorg equity for CLOs, forbearance data is often inconsistent or inaccurate across standard data providers and therefore is often misvalued by the market – it requires diligence from active investors that underwrite on a loan-level basis and leverage alternative data to truly ascertain value less sophisticated participants are missing. Crucially, the lessened playing field has also prevented a "crowding out" of these opportunities.

Opportunities resulting from elevated dispersion likely to persist

The increase in market share for long-only or rules-based investors implies that these market inefficiencies will likely persist for years to come, leading to sustained alpha opportunities and high risk-adjusted returns across pockets of structured credit markets. Premia earned by active managers that have the expertise to properly value and manage complex assets or capture the bid-ask spread by actively trading and providing liquidity are elevated, and may remain so until levered pools of capital gradually reenter these markets, attracted by years of consistent excess returns. Increased participation from active managers should further drive returns on complex, harder-to-source paper by compressing complexity and liquidity premia. The easy money opportunities presented by the COVID crisis may have quickly come and gone, but the ramifications of the shock and the capital shift that emerged will likely endure.

[4] Nomura Securitized Products Weekly, October 29, 2021 p.23
[5] Nomura Securitized Products Weekly, September 10, 2021, p.32

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Glossary
Asset Backed Securities (ABS) are financial securities collateralized by a pool of assets such as loans, leases, credit card debt, royalties, or receivables.

Basis Points (bps) are a unit of measure used to describe the percentage change in the value of financial instruments or the rate change in an index or other benchmark.

Collateralized Loan Obligations (CLOs) are securities backed by a pool of debt, often low-rated corporate loans.

Commercial Mortgage-Backed Securities (CMBS) are a type of mortgage-backed security that is secured by mortgages on commercial properties, instead of residential real estate.

Enhanced Equipment Trust Certificates (EETCs) are corporate debt securities generally issued by airlines. They are structured though special purpose companies created specifically to own the equipment and enhanced elements such as debt tranching, availability of liquidity facilities, and over-collateralization.

Real Estate Investment Trusts (REITs) are companies that own, operate, or finance income-generating real estate by pooling the capital of numerous investors.

Residential Mortgage-Backed Securities (RMBS) are a type of mortgage-backed debt obligation created from residential debt, such as mortgages, and subprime mortgages.

Tranches are segments created from a pool of securities – usually debt instruments such as bonds or mortgages – that are divvied up by risk, time to maturity, or other characteristics in order to be marketable to different investors.