Fixed income: How to get exposure to the fast-growing Australian residential home-loans market

By Perpetual Asset Management

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Residential mortgage-backed securities are offering attractive returns and strong cashflow. Perpetual portfolio manager Thomas Choi explains how to get exposure.

- Opportunities in Aussie residential mortgage-backed securities
- Overlooked opportunity for attractive cash returns
- Find out about Perpetual's Credit and Fixed Income capabilities

The value of new Australian housing loans grew 18 per cent to $27.6 billion in the year to March.

Can Australian investors get exposure to this asset class in their portfolios?

The answer is yes, via something called residential mortgage-backed securities (or RMBS for short).

RMBS are a sometimes-overlooked opportunity to access the enormous Australian mortgage market without taking on excessive credit risk, says Perpetual senior portfolio manager Thomas Choi.

By pooling together thousands of home loans, RMBS offer a way to capture returns from Australians' love of housing without lending directly to individual borrowers.

“There's a bit of a stigma around securitised assets ever since the GFC, but today's bank lending standards are tight, the mortgages are good quality, and the economic backdrop is benign,” says Choi, who works in Perpetual's respected Credit & Fixed Income Team.

“RMBS offer attractive spreads over other credits and the collateral performance is sound.”

RMBS investments form part of the Perpetual Credit Income Trust (ASX:PCI) and other Perpetual credit and fixed-income funds.

Attractive cash returns

Choi says a unique feature of RMBS investments is the potential for attractive cash returns, since investors receive back principal as well as interest on their investments.

This is a feature of how mortgages are repaid. As borrowers repay their mortgages, a portion of the loan principal is paid back each month alongside interest payments.

“It is a natural de-risking property of RMBS. If you hold corporate or government bonds, you are either waiting for that principal to come back or you have to sell.

“But with RMBS, you sit there and get interest for your money and some of your principal back so you can redeploy into other opportunities.”

The principal repayments can be a significant part of the investment's cashflow, says Choi.

One recent RMBS note returned 29 per cent of its original principal alongside a 5.46 per cent income yield over its first 11 months, he says.

Benign economic outlook

RMBS come with inherent risks linked to the quality of the underlying collateral and overall economic conditions, but Choi says the current outlook remains relatively positive for investors.

“The mortgages getting written are of good quality. While the backdrop is probably not as strong as it was 24 months ago, it's still benign,” he says.

“Households are able to service their mortgages. It doesn't look like we're going to see too many more rate hikes. Arrears are at relatively benign levels. The latest jobs numbers don’t indicate we're going to see a material deterioration.”

Pricing opportunities

Active management of RMBS in a portfolio is important since the market is global and there’s a wide range of participants with differing motivations.

For example, in 2022 UK pension funds were forced to sell down their Australian RMBS holdings after a steep increase in interest rates led to margin calls.

This created an opportunity for local investors to pick up high-quality assets at attractive prices, says Choi.

“They had to post collateral – so they just started selling off Aussie RMBS.

“There was nothing wrong with the issuers, there was nothing wrong with the market, they just needed to raise cash.

“We were able to acquire really attractive assets at attractive pricing.”

The global nature of the RMBS market means blocks of assets can regularly become available out of Asia and Europe as local conditions change.

“There is a diverse pool of investors acting on different motivations which creates opportunities to invest.”

Local expertise

When investing in the Australian RMBS market, local expertise is key.

The global RMBS market benefits from a high level of transparency, with global reporting standards ensuring that investors worldwide can access detailed performance data.

However, domestic investors can offer unique insights that enhance decision-making.

"Being on the ground and having relationships with banks, non-banks, mortgage brokers and real estate agents means we're always having conversations.

"You can see the sorts of things that might only show up in an arrears report further down the track."

Warehouse opportunities

Warehouse lending – essentially providing lines of credit that allow non-bank lenders to originate mortgages – is another attractive part of RMBS investing.

"Non-bank lenders need to borrow money so that they can then lend to home buyers," says Choi.

"With warehouse lending, we sit on both sides of the supply chain.

"We provide the cash to manufacture mortgages, and then we provide the storage of those mortgages until they are ready to go to the public market.

"Facilitating that supply chain means we're usually able to negotiate superior terms and more robust structures.

"Warehouses tend to be shorter as well - usually just 12 months which gives you flexibility in managing your risk."

About Thomas Choi and Perpetual's Credit and Fixed Income team

Thomas is a senior portfolio manager with Perpetual's respected Credit & Fixed Income team.

He focuses on the management of the treasury portfolios.

Thomas has more than 20 years of investing experience and has worked with us since 2010. He has a Bachelor of Economics from Sydney University and is a Chartered Financial Analyst.

Perpetual offers a range of cash, credit and fixed-income solutions. We are specialists in investing in quality debt.

We take a highly active approach to buying and selling credit and fixed income securities and invest extensively across industries, maturities and the capital structure.

Find out more about Perpetual's Credit and Fixed Income capabilities

Want to find out more? Contact a Perpetual account manager

Thomas Choi

Senior Portfolio Manager
BEc, CFA

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