

Macro Markets Podcast Episode 87: The Complexity Premium in Structured Credit: Fundamentals and Absolute/Relative Value (Part 1)

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Jay Diamond: Here we are in June 2026, and investors are navigating a set of complex macroeconomic, geopolitical and market forces. We have a new Fed chair, a mid-term election in a few months, at least two wars going on in the world, and oil flirting with \$100 a barrel. Whether it is this set of conditions, or others that are just as challenging or more benign, we here at Guggenheim Investments lean into structured credit as an important allocation in most of our fixed income strategies. Why has structured credit become such an important differentiator in how we approach active fixed-income investing, and the allocations and return profile of our portfolios? It's a big topic, and we have a two-part episode to address it. I'm Jay Diamond, head of thought leadership for Guggenheim Investments, and I will be in conversation with Karthik Narayanan, head of our structured credit team. Now, part one of our two-part episode addresses the fundamentals of structured credit investing and why we believe this sector is attractive on an absolute and relative basis. Part two will explore the opportunity set and risks in current market conditions. So with that, let's get started with part one. Hi Karthik, welcome back to the podcast and thanks for taking the time to chat with us today.

Karthik Narayanan: Thanks, Jay. Happy to be back.

Jay Diamond: All right. Now I know we always start with this question when we have you on Karthik, but it is worth asking again for our first time listeners. In plain terms, what is structured credit or asset-backed finance—another name by which it's called—and what types of assets sit behind structured credit?

Karthik Narayanan: It's true that in structured credit or asset-backed finance there's a lot of ambiguous terminology. So it's a good thing to start with sort of level setting on what an acronym

is with principles and basic ideas to help our listeners cut through the noise and some of that jargon. So the broadest term is asset-backed finance or ABF. So that is basically secured lending in any form on contractual cash flows and assets. There's no hard and fast published numbers or estimates, they are something like a \$25 trillion market. A lot of that is government guaranteed. Some of that is real estate related. If we take away the \$10 or \$11 trillion that is government guaranteed and look at the remaining credit market, and take away loan form investments and only focus on securities, like tradable bonds, we're talking about something like 3 to 3.5 trillion of what we typically called structured credit. So structured credit, you know, if you want to think about it very simply, is the tradable bond part of the broader asset-backed finance market. Now, what are all these financing instruments? They are really any kind of debt that's secured by contractual cash flows as well as a pledge of assets. The other thing that's common within structured finance or the structured credit tradable bond part of the market that we tend to focus on, is that in addition to that pledge of assets there are a number of bondholder protections that reduce the likelihood of a loss if something goes wrong.

Jay Diamond: And what types of assets or underlying contractual cash flows are we talking about here?

Karthik Narayanan: It's a very wide spectrum. So you take the four major food groups of structured credit which are asset-backed securities, collateralized loan obligations, residential mortgage-backed securities or commercial mortgage-backed securities. Those are backed by either mortgages on residential properties, mortgages on commercial properties, in the case of CLOs, they're backed by a diverse pool of senior secured loans to non-investment grade companies. And in the case of ABS, they're backed by a diverse range of contractual cash flows, such as aircraft leases, leases on maritime shipping containers, auto leases, royalty streams, and the list goes on and on. So it's a very diverse technology as opposed to a narrow asset class.

Jay Diamond: Karthik, as I said at the top, structured credit or securitized income or asset-backed finance, it's a common feature of how we manage total return portfolios. So what is it about structured credit that has made it such an important sector for us and our clients?

Karthik Narayanan: It's true that structured credit has played an important role in our portfolios, and it's really because at a high level, we have viewed and continue to view it as offering better risk and return trade off than the more liquid fixed-income sectors such as investment-grade corporate credit. Now, that's a fairly generic statement. But I want to elaborate on that. We think there's a persistent sector level structural type advantage within structured credit. And the magnitude of that advantage will ebb and flow and the riskiness will ebb and flow. But what we're saying is in the long term, we view the sector as having incremental yield per unit of risk. Now there's a couple of reasons why this sector has been so favorable for us and why that relative value view has emerged. First is on the risk side. Historically, structured credit has experienced lower default rates than

more liquid debt markets, such as corporate credit, for a given rating category. So especially when you look at the investment-grade level, the historical probability of default and probability of losing your money through default in structured credit for a given rating category is lower than in corporate bonds. Now this matters because unlike equities, which could go up or down, bonds generally can only go up a little bit and they can go down a lot. So really, as a portfolio manager, what you want to get paid for is grinding out better returns over time and not giving it away very quickly on a few bad positions. Now, second, because there are contractual cash flows, structured credit instruments tend to be intermediate duration. They don't tend to be as long as the types of debt instruments you see in the corporate bond market or in infrastructure or other sort of very long, you know, type of obligations. They tend to be in the 3 to 7 year maturity range. Part of the reason for that shorter maturity is because there is amortization, which is bondholder friendly. It's taking out your risk or passively over time, which de-risk the position. And the second thing is as a shorter maturity debt instrument, there's lower spread duration or prospective mark to market volatility of return. So from a portfolio construction standpoint, you have A) instruments with a lower likelihood of default and then B) you're able to, invest in that part of the market without having to extend duration far out the curve and pile on either interest rate duration or spread duration risk to get there. The third factor is a complexity premium. So this is shifting more from the risk side to the return side. The complexity premium is what I would call an efficient amount of inefficiency, where investors are getting paid to do more work to analyze complex documents, payment priorities, cash flow, waterfalls, bondholder rights, and pledges of assets. You require more work to understand investment, you certainly want to get paid more. So I think that's a basic premise there. So you put all that together, you have lower default rates, historically intermediate durations, and potentially lower mark to market volatility and higher yields for a given level of credit risk. That's really what our, favoring of structured credit has revolved around. Now, all this sounds great how you actually access and monetize this excess yield per unit of risk is very important. The execution is is a very important. And it's something we've spent a lot of time here building a platform process. You know, guardrails around as well as opening the funnel to see the broadest potential range of opportunities over time so that we can fish in the biggest ponds.

Jay Diamond: You mentioned the complexity premium and how you monetize it, if you will. Does it take any particular expertise or experience to be good at taking advantage in this way?

Karthik Narayanan: You know, I think being involved in structured credit has been the hallmark of what we've done as fixed income investors for 20 plus years. There's, you know, obviously deep knowledge of structures and robust analytical toolkits. And this is a big commitment. It's a commitment the firm has made and kept over a long period of time. And it restricts the ability of tourists in the market to earn returns without elevated volatility over time. You may not see a month to month, but you will see those differences in the long term. And so credit first is kind of the way we're approaching things. Now there's a couple of differentiators which you asked about. I think one that's maybe a little bit underappreciated is you have to have access to a broad array of deals. I think a fundamental premise in investing is you want to see a lot of deals. You can say no to a lot of things, and say, you know, if you say yes to ten things out of 100, those ten things are going to look better if you're rejecting 90 than if you're saying yes to ten things out of 20 things and rejecting ten.

So, you know, how do you gain access to a broad array of deals? There's sort of a broad range of models that that can exist there. One is sort of the classic, you know, bond trader archetype where you're sitting by the phone waiting for Wall Street dealers to call you with the next syndicated deal. A lot of business gets done that way. There's nothing wrong with that. It's an efficient way to access the market, but it's limited. You only see deals after they're fully baked, when it's a proven concept, when the sponsor and the arranging dealer already know that there are anchor investors involved ready to commit capital. And it's a good way to sort of rinse and repeat unproven concepts, but it doesn't allow you to have a differentiated funnel. I think where that comes from is having a proven expertise, presence in the market, commitment of capital, commitment of organizational support, industry contacts and all of that, to give sponsors and counterparties confidence that the less well formulated deals can get done. And so a lot of that comes in moving upstream from the classic syndication process and being a part of either structuring or guiding others to structure investments that serve a particular financial purpose for the sponsor, but also create optimal return and bondholder guardrails for investors. So it's sort of that level of intermediation that's different than passively seeing a stream of deals is one of the key ways that incumbent investors that have been involved in this market can widen the funnel and become aware of a broader range of situations, whether or not they actually come to fruition. So I think a broad array of deals, first point. I think the second point is having a more holistic understanding of the types of financings that are rising in structured credit. People can be very good at analyzing documents, the four corners of what's in a long bond indenture, you know, building a waterfall or computing bond cash flows and bond analytics very efficiently. A lot of bells and whistles, but I don't think that's a differentiator. Those are table stakes. Those are already challenging tasks, but they're table stakes. What is the differentiator? A level of commercial awareness about the parties involved, their motivations and incentives, and why a transaction exists in the first place. And that's not something that you get from reading a document. That's something you get from experience in the industry, commercial context, and just a general awareness of the various forms of financing technology that are in play in the market, one of which is structured credit. So that helps identify key linkages between entities. The potential for adverse selection. It assists in determining what's the right price for a level of risk. And none of those things are going to show up in a deal pitch book or cash flow model. You know, those things are necessary, but not sufficient, I think, for really having an edge on alpha generation of this market.

Jay Diamond: Now let's get practical. How do investors make money in structured credit and how do they lose it?

Karthik Narayanan: First, just grounding principles. There are four ways to make money. One is duration risk. And that, you know it comes from fact that yield curves are generally upward sloping. So you get paid more yield for taking on more duration. And with that comes higher marked market volatility as well as reinvestment risk. Way number two you make money in active fixed income in general is in credit risk. So this is the risk that you don't get paid back in full. Now that's particularly complicated in structure finance just given the density of information that one needs to understand to actually do a good job here. And when selecting the right bonds, the benefit of the strategy is obvious. You earn an excess return premium. And when you don't sort correctly, back to

the old adage, you violate that principle of the best way to make money is not to lose it. We tend to take a grind it out approach, preferring to accumulate many small and medium size wins over time through our credit selection process. The third is convexity risk or call risk. Bonds may be callable. This is speaking about fixed income generally. And that means the borrower can refinance or pay off the debt instrument whenever they feel like it. And that's going to happen generally when they can borrow the money at a lower rate than what's already in place with you as the lender. So just think of, you know, the classic example is US mortgages. One borrows money to buy a house, but reserves the right, but not the obligation to refinance it. If they look around and think they can get a better deal in the future, that's the lender's problem, right? So that's one way to get paid or to make or lose money is through convexity or call risk. The final fourth one in the sort of classic framework and rubric for active fixed-income investing is liquidity risk. All portfolios have liquidity needs. You have investor redemptions, external liquidity needs. They have sector rotation, internal liquidity needs. Anyone who follows the financial press is aware of some of those pressures that are arising in other parts of the market where investor liquidity demand is sort of out of balance with what governing documents allowed and certain types of fund structures, etc. But all portfolios have some liquidity needs and some parts of the market are less tradable than others, and that requires a premium. So those four points: duration risk, credit risk, convexity risk, and liquidity risk are very generic to all active fixed income. I'll add two more points specific to structured credit. The first is recognizing the commercial context for when these instruments get created. There's credit demand from a sponsor or the underlying business, and there's a financing technology that has to get married with that, that allows them to raise capital. What you can do as a creative investor is to move further upstream and help facilitate that financing technology part of that, and that really bridges the gap between commercially viable financing terms and the structural safeguards that investors need. And so that gets you out of the sit by the phone model that I mentioned earlier, and being more of an active participant in ideation and in deal formation. The second thing is a really immutable commitment to the credit process. Now, one of the four ways in fixed income I mentioned is credit risk. But I think with the complexity and density of terms that are needed to be understood in structured finance, it kind of goes through the point you asked about Jay, about legal documents of waterfalls. Very, very important and a lot of investors may not be fully able to not only analyze what is contained in the document, but also think from a historical, backward looking perspective or a creative, forward looking perspective. You know, in maybe a speculative, creative way to think about how the deals may work and incentives may align or not align under existing conditions.

Jay Diamond: You mentioned that one of the reasons this is an attractive and compelling sector is that it has superior risk return tradeoffs. So let's explore for a minute how investors should think about structured credit relative to these risk return tradeoffs that you will get from more traditional, let's say, non-governmental parts of the, fixed-income market, you know, corporate credit or private credit. So let's just start with the return profile of structured credit versus other opportunities in a fixed income market.

Karthik Narayanan: You know. So the good news is, and as an active fixed income portfolio manager, if you have a holding period of more than, you know, 3 to 5 years, you pretty much know what your return is going to be. It's going to be the yield of the instruments you own, less default

costs. So that's what we call loss adjusted yield. Now, in the short term that may not be true, but over a longer period of time that is. So it helps to start out by thinking about loss adjusted yields across broad investable asset classes and comparing those to what's available in structured credit. So if we just think about the intermediate duration part of the fixed income world, you know, there are not many indices out there that are published that track asset-backed securities or RMBS or CMBS. There are a few, but if we just take ABS at the generic index level, there's one that tracks down to triple B rated asset-backed securities. This one has a maturity of about three and a half years, and a yield about 5.75 percent. Now, if we compare that to, U.S. Treasuries, first off, they don't have any credit risk. That's 1.7 percent above what you would earn there. So pretty significant difference. Now if we compare that to the corporate bond index, which has some credit risk, but is obviously a bigger, more of a benchmark type sector. ABS, even just at the pure index level, which is still fairly generic, is yielding about 0.6 percent above the benchmark. So it's nearly double the credit spread of the intermediate duration corporate benchmark. So, you know, on, you know, if we compare these two, we have one with about a four point, 7 percent yield on the corporate benchmark in about a 5.7 percent yield on the ABS benchmark. So a pretty significant difference there on two investment grade related indices. Now, if we want to take a little more risk and we look at the highest quality part of the high yield corporate bond market, that's double B rated corporates to just bookend our comparison, we find the double B corporates have roughly the same yield as single A ABS. So this is the part of the ABS index that's single AA rated and comprised mostly of first priority senior commercial ABS tranches. So you know, here we have on the one hand a double B rated corporate bond index and on the other hand a subset of ABS, which is single AA rated senior and first priority, they have roughly the same yield. So I think that's pretty compelling relative value comparison, especially given that we have not even attempted to adjust double B corporate bonds through a cycle of defaults and losses, which will be non-zero. So, I think just off the bat there's a pretty favorable comparison of structured credit to corporate credit right now.

Jay Diamond: So that was return profile, relatively speaking. And we've already touched on structure and complexity, which probably helps account for some of that difference in the return profiles of the different parts of the fixed income market. Is there anything you'd want to add there about the relative structure complexity between structured credit and let's say, corporate credit?

Karthik Narayanan: Yeah, it's sort of a gradient. And I agree with you. That is a big portion of what you do get paid for. If you start off in the unsecured corporate market, which is most of the investment grade market and some of the high yield bond market, the real focus of credit work is going to be on the borrower's debt capacity, and that's going to be a corporate obligor. In the industry that operates in, in the business prospects, debt, capacity, there's some but a finite amount of variation in the structure of these lending terms. Now, if you move into secured corporate lending, which is in some smaller parts of the high yield loan market, as well as almost the entirety of the corporate loan market, in addition to the obligor and industry dynamics, you're looking at, you know, assets and protective covenants as well. And then you move up the gradient into structured credit, you have all of those things. Maybe a little bit of a less of an emphasis on the industry in the company because you have assets instead. But now you need to do work to

understand payment priorities and how cash gets distributed across the various classes. So in CLOs, you may have a dozen different interest coverage and over collateralization tests in a typical deal and several dozen collateral eligibility and reinvestment tests, you know, is there a lot of overlap with the corporate work? Yes, there is, but the emphasis, I think, is different and the specialized knowledge and tools are different. And honestly, that's a lot of what investors are getting paid for is doing additional work to separate favorable investments of deselecting less favorable investments in this market.

Jay Diamond: Talk about the comparative investor benefits, if there are any, between structured credit and, say, corporate credit.

Karthik Narayanan: What we see in structured credit, you know, in terms of investor benefits, the closest parallel to structured credit is probably in the secured lending world in corporate credit. There are some differences, but I think that's really jumping off point. And some of the benefits of structured credit is similar. And there are some differences. So where the similar benefits with secured lending in corporate credit? We have a pledge of assets and contractual cash flows that's similar. You know and that creates some degree of incentive alignment. We have a floor on recoveries if things go wrong. And really a lot of the credit work we do is similar, which is what are the assets? What are they worth through a cycle? What is the appropriate amount and quantum of debt that is, appropriate for that asset value and volatility around that value? And then what are bondholder protections along the way that prevent bad behavior or, protect bondholders in the case of, bad market conditions or business conditions? Now, where they differ in terms of investor benefits is, there are quite a few tests and triggers that will exist in structured credit that will accelerate the debt if things start to go poorly a little bit earlier. So we think that's maybe a differentiating factor. Now one thing I want to mention is structured credit does not always have these benefits relative to what you'd see in secured lending on the corporate side. Sometimes what we find in structured credit and ABS, their bondholder protections are, you know, could be weaker on a given deal than what you'd see in the secured lending world. And this is something that comes about from, you know, a lot of collaboration with, our colleagues on the corporate debt side in terms of thinking about what an appropriate capital structure should look like for a given proposed, you know, a collateral package and borrower profile. So in most cases, we find that there are good bondholder benefits, the pledge of contractual cash flows and assets. But that's not something you can take for granted and this is a big part of what the security analysis and security selection comes into play.

Jay Diamond: And, the last kind of metric then is compare the risks of corporate credit versus structured credit.

Karthik Narayanan: We talked about the higher yield for a given level of credit risk. I think on the risk side what we've seen is lower default rates historically. So especially at the investment grade

level, part of that is coming from the fact that there's some differences in rating agency methodology. There's difference in the effects of bondholder features like amortization, credit enhancement, over collateralization, some of those things kicking into to lower losses on structured credit in bad conditions. And the other thing is, frankly, credit diversity. There's a lot of different assets that are represented in this market. What that diversity allows you to do is take risk across a very wide spectrum of asset types. And so that's not going to help you on any given one deal but at a portfolio level should allow for better returns on a risk adjusted basis. The other thing that's fair to mention is liquidity. If you look at, let's say investment grade corporate bonds, that market trades, you know, 50 to 60 percent turnover a year. So you know, the outstanding amount of bonds is X, something like 0.6 X will actually change hands in trade every year. If you look at structured credit the number is something like 10 to 15 percent annual turnover. So less trading volume. So certainly the ability to move you know enormous size is different. But what we've seen over time is with the increasing number of participants in structured finance and primarily through real money participants like insurance companies and those with sort of sticky capital, the amount of trading has sort of stabilized and the depth of the market is improved. So even though the total headline number doesn't trade that much, it's kind of reflective of the fact that you have a lot of hold to maturity type investors in this market that historically have been comfortable to step in and support the market through a bid side that may be lower than where it was yesterday or the day or the week before, but you don't get these giant air pockets because there is a depth of real money investors in the market. So clearly there is a liquidity difference. You want to get paid for that. But the real density of that underlying bid has probably improved over time.

Jay Diamond: Thanks, Karthik, for walking us through the fundamentals of investing in structured credit and how we approach it. And thanks to all of you who have joined us for episode one of our discussion. I'm Jay Diamond and I encourage everyone to listen to episode two with Karthik Narayanan to learn more about where we are seeing value and risk in the current market for structured credit. In the meantime, visit GuggenheimInvestments.com/perspectives for more of our thought leadership. So long.

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