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Insights

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# *Structured Credit Primer*

## *Structured Credit as an alternative to traditional fixed income*

***Key Takeaways***

1) The structured credit market is a sizable market (just under $13 trillion) containing a diverse set of underlying asset classes, including commercial real estate, residential real estate, consumer debt, and corporate loans.
2) Structured credit products pool underlying assets (i.e. – loans) into a securitization structure that provides cash flows to investors in the bonds issued from the structure.
3) The structured credit markets have helped transform illiquid assets (like single commercial real estate assets) into more liquid assets, to which a broader investor base may now have access.
4) Especially in more volatile market environments, the collateralized nature of structured credit may provide enhanced risk-adjusted returns versus traditional high yield corporate credit alternatives and equities.
5) The hard assets providing the collateral underlying some securitizations (like the multifamily collateral underlying Freddie's SBL structures) may also be more resilient during inflationary periods.

## *Overview*

Structured finance originally dates to the 1970s when home mortgages were first pooled, bundled and sold off by U.S. government-affiliated agencies. Since then, the structured finance market has grown significantly. Today, the market includes a plethora of collateral types, like commercial mortgages, aircraft leases, consumer receivables, and even franchise fees; it now totals almost $13 trillion, which is 25% of the $52 trillion US credit market. The original agency-guaranteed mortgage-backed debt portion has grown, too, and it accounts for just over $8 trillion. The remainder of the market, where the bulk of opportunity exists, comprises the balance. ***Figure 1*** shows a breakdown of the structured finance market.

In general, structured product securitizations 'pool' debt obligations and issue bonds secured by the cash flows from these pooled obligations. The securitization process may pool a variety of financial assets like mortgages or loans. By issuing bonds in tranches, parties securitizing assets can tailor risk-offerings and benefit from investors with demand for different risk-reward profiles. Said differently, investors in structured credit products can potentially diversify their portfolios and tailor credit risk exposures to best serve their investment goals.

Repayment to investors is often supported by hard underlying assets as well as the borrowers' contractual obligation to pay. For example, if an owner of multifamily housing borrows from a bank, this obligation can become part of a securitization pool of like borrowers. The cash flows from the performance of these pooled loans replace traditional fixed-income payment features such as interest coupons. These loans may vary greatly in their characteristics from corporate loans in CLOs (collateralized loan obligations) to loans on multifamily commercial real estate in CMBS (commercial mortgage-backed securities).

## *The Securitization Process*

### Origination and Pooling

1. Obtain homogeneous assets, such as home mortgages, auto loans, credit card receivables, or other cash flowing assets. If the assets are loans, they may have been originated by a bank, a finance company, or other non-bank entity.

2. Create a Special purpose vehicle (SPV) also known as the trust. The trust is a bankruptcy remote, legal entity created to serve as the vehicle for pooling underlying assets and issuing tradeable securities secured by those assets. The trust's legal structure assures that investors in the bonds it issues are not exposed to the potential bankruptcy risk of any one pool borrower - thus removing idiosyncratic credit exposure.

3. Place (pool) the assets in the trust and establish a servicing relationship.

4. Structure the securitization tranches that issue the bonds sold to investors. The structure establishes payment priority of the cash flows received from the pool of assets (i.e. – loans) to the individual securities holders (bondholders) issued by the trust and generates an excess spread. ***Figure 2*** shows a hypothetical example of the process.

***Figure 1. Summary of the Global Structured Products Market;*** *Source: SIFMA and Axonic data as of 12/31/2021*

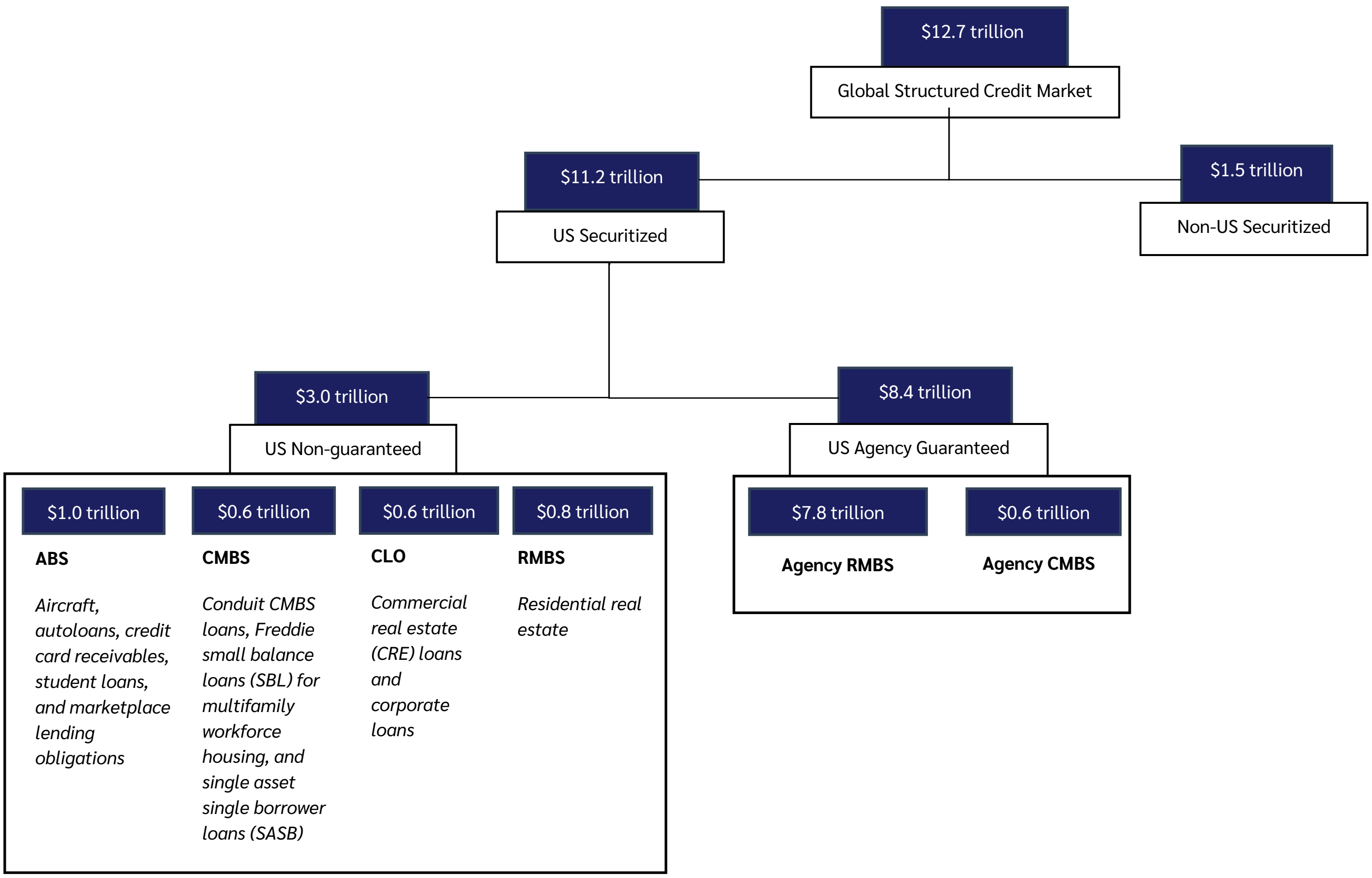
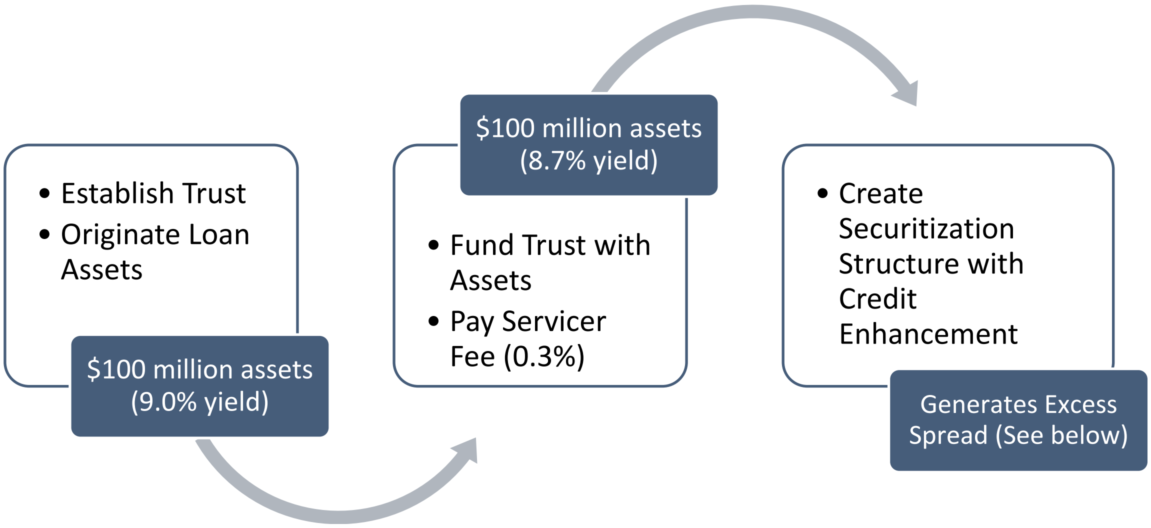



*Figure 1 Key (for a full glossary of terms see Appendix)*

- *ABS – Asset backed securities collateral types include aircraft, auto loans, credit card receivables, student loans, and marketplace lending obligations.*
- *CMBS – Commercial mortgage-backed securities collateral types include conduit CMBS loans, Freddie small balance loans (SBL) for multifamily workforce housing, and single asset single borrower loans (SASB).*
- *CLO – Collateralized loan obligations collateral types may include commercial real estate (CRE) loans and corporate loans.*
- *RMBS – Non-agency and agency mortgage-backed securities collateral type is residential real estate.*

***Figure 2. Example of the Securitization Process; Source: Axonic***




*This hypothetical example is for illustrative purposes only and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. See important disclosures on page 7.*

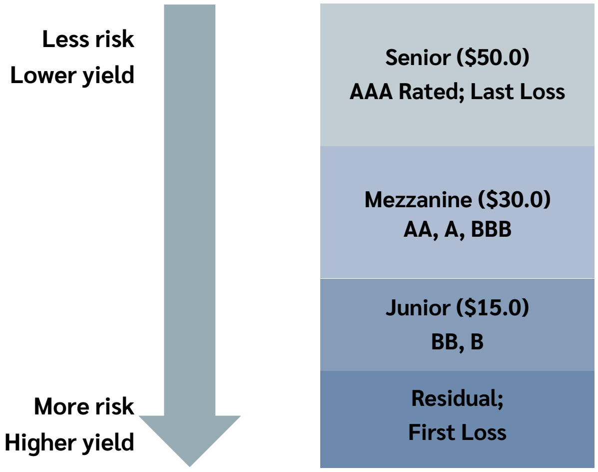
## Structuring: Credit Enhancement

Credit enhancement is designed to mitigate the risk of loss to the structure's bondholders. It is accomplished in three basic ways. The first is subordination, which is the contractual basis for payment priority. The next is overcollateralization, which attempts to assure that there is always sufficient collateral in the overall structure to cover the securitization's obligation to bondholders. It exists when the par value of the underlying loans or other assets is greater than the par value of the securities issued by the trust. Lastly, excess interest, which comes from the spread between what the trust's loans yield and what is paid to bondholders, on a triggering event, may be diverted away from the residual (equity) owner and towards holders in more senior tranches.

Subordination using tranches is foundational to securitization. Cash flows from the underlying assets flow as a 'waterfall' down the securitization's tranched structure with subordinated tranches providing 'cushion' to the tranches above them. After the first senior tranche, remaining cash flow is then paid to subordinate tranches in order of priority. Correspondingly, the bottom-most tranche (often called the residual tranche) will be the first to realize any losses. Losses flow up the structure based on subordination. Each security or tranche has a different risk-adjusted return profile.

***Figure 3*** shows how the securitization structure created in Figure 2 might operate. The example shows how a $100 million loan pool is broken into three tranches, each of which has a different return profile. The three tranches are the senior tranche, the mezzanine, and the junior tranche. Below those sits the equity, which the Sponsor will provide. Depending on the kind of securitization, risk retention rules may require the Sponsor retain/own a 5% slice of the securitization either horizontally or vertically.

*Figure 3. Example of A Structured Product Securitization; Source: Axonic*




| Security | Amount (millions) | Yield |
|---|---|---|
| Loan Pool | $100.0 | 9.00% |
| less: Servicing Fee | | 0.30% |
| Net Yield | | 8.70% |
| **Securitization Bonds** | | |
| Senior | $50.0 | 6.00% |
| Mezzanine | $30.0 | 8.00% |
| Junior Mezzanine | $15.0 | 11.00% |
| **Total** | **$95.0** | **7.42%** |
| Residual (Equity) | $5.0 | |
| Excess Spread | | 1.28% |

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In the example shown, there is 5% horizontal retention. Said differently, $95 million of bonds are supported by a $100 million collateral (loan) pool. The overcollateralization removes $5 million of first loss risk from bondholders. For that risk, the residual holder (equity holder) may receive some or all of the excess spread from the 'overcollateralization' it provided. The excess spread in the example is 1.28%. However, should loans in the pool default, upon the breach of certain 'triggers,' this excess spread could divert to more senior bondholder classes – hence deleveraging the structure.

***Structured Products as an Alternative***

We continue to expect the opportunity in structured products to be one of the richest in memory.

- **Complexity.** Structured products often carry a complexity premium, and this premium is likely to expand alongside volatility. This will create significant opportunity, but it may also lend to illiquidity during times of stress. As we've stated in previous months, Axonic remains positioned to take advantage of potentially favorable investment opportunities across the structured credit universe when unnatural sellers emerge. This has been a consistent theme for us in an environment where being long beta in equities and high yield corporate credit may not provide favorable risk-adjusted returns relative to the idiosyncratic return catalysts (some related to structure) that may drive returns in structured credit
- **Inflation.** In an inflationary environment, certain kinds of structured products have underlying collateral that might be resilient to or perhaps even benefit from inflation. For example, given the relative stability in multi-family cap rates alongside rising rents, we continue to favor multi-family-related structured

credit bonds. Rising rents and a lack of affordability in the single-family housing market – in part a result of inflation – have provided a tailwind to rents.

- **Duration.** In contrast to high yield bonds, which have the closest absolute return profile, structured credit bonds have varied duration. High yield bonds tend to be about four to five years while structured credit investors can manage exposures in and out of the curve. Moreover, a good part of underlying assets in the structured credit market are floating rate, which can be useful in a rising rate environment. All of this is important in a volatile interest rate regime.
- **Diversification.** The structured products universe provides a variety of underlying collateral types. Moving into and out of different collateral types will be of particular importance in the current economic cycle. For example, Axonic has avoided consumer credit-based collateral, but as the cycle turns, we expect significant opportunity to emerge in corporate CLOs, auto and consumer credit card ABS – just not quite yet.
- **Low Correlation.** Over 10 years, the Bloomberg total return CMBS index had a .15 correlation with the S&P while high yield had a .60 correlation. The caveat to this observation is that when severe stress emerges, correlations tend to increase. If and when that happens, we believe it will be an opportunity to acquire structured credit securities that will have superior risk adjusted returns to almost every other asset class.
- **Embedded Deleveraging.** Unlike in corporate bonds, many underlying securities in structured credit securitizations are self-amortizing. For example, mortgage payments often consist of not only interest payments but also repayment of principal as part of their cash flow. Some ABS structures also have this property. This is quite different from most fixed income debt which typically have a ‘bullet’ maturity. That is, only interest is repaid until the maturity date when principal is repaid, hopefully, in full. This amortization feature deleverages the structured credit structures over time and provides enhanced cushion should credit quality of the securitized loans deteriorate.

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## Appendix – Risk Disclosures & Glossary of terms

### Risk Disclosures

***An investor should consider the investment objectives, risks, charges, and expenses of the Fund carefully before investing. To obtain a prospectus containing this and other information, please call (212) 259-0430 or download the file from www.AxonicFunds.com. Please read the prospectus carefully before you invest.***

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**Credit risks and default risks** The risk of loss due to adverse developments in the underlying collateral. Credit risk is the risk that an issuer of, or obligor under, a credit investment, may be unable or unwilling to make dividend, interest and principal payments when due and the related risk that the value of a credit investment may decline because of concerns about the issuer's or obligor's ability or willingness to make such payments. This risk may be especially heightened for certain credit investments, such as below-investment-grade securities, and may include the possibility of dividend or interest deferral, default or bankruptcy. The market values for below investment grade securities or credit investments of comparable credit quality tend to be very volatile, and these instruments are generally less liquid than investment grade securities

**High Yield Securities Risk** High yield may be volatile with higher default risk among underlying issuers. In times of economic stress, defaults may spike

**Illiquidity Risk** Structured credit investments may have limited or no liquidity. Liquidity risk exists when particular investments may be difficult to purchase or sell, potentially preventing sale of such illiquid investments at an advantageous time or price. Structured credit investments are complex securities that may trade infrequently and, therefore, may be difficult to price and to liquidate.

**Interest Rate Risk** Structured credit investments may decline in value because of changes in market interest rates. Interest rate risk is the risk that fixed rate instruments will decline in value because of changes in market interest rates. When market interest rates rise, the market value of such instruments generally will fall. Longer-term fixed rate instruments are generally more sensitive to interest rate changes. An increase in interest rates could negatively affect financial markets generally, increase market volatility and reduce the value and liquidity of credit investments in which we may invest. Because the values of lower-rated and comparable unrated fixed rate instruments are more affected both by credit risk and interest rate risk, the price movements of such lower grade instruments in response to changes in interest rates typically have not been highly correlated to the fluctuations of the prices of investment grade quality instruments in response to changes in market interest rates. Default rates of credit investments may increase due to factors such as prevailing interest rates, the rate of unemployment, the level of consumer confidence, real estate values, the value of the U.S. dollar, energy prices, changes in consumer spending, the number of bankruptcies, disruptions in the credit markets and other factors

**Market Risk** Risk that may affect a single issuer, sector, industry or the market as a whole

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## Definitions

**AAA** the highest possible rating that may be assigned to a bond by any of the major credit rating agencies

**Absolute Return** is the percent amount that an asset rises or declines in value in a given period

**Agency Guaranteed** the majority of MBS and many CMBS are issued or guaranteed by an agency of the U.S. government such as Ginnie Mae, or by GSEs, including Fannie Mae and Freddie Mac

**Asset-Backed Securities (ABS)** instruments secured by financial, physical, and/or intangible assets and investments in any assets/instruments underlying the foregoing structured/secured obligations

**Beta** is the measure of the volatility, or systematic risk, of a security or portfolio compared to the market as a whole

**Bloomberg Total Return CMBS Index** is the Bloomberg Agg eligible non-Agency CMBS total return index

**Call Option** financial contracts that give the option buyer the right, but not the obligation, to buy a stock, bond, commodity or other asset or instrument at a specified price within a specific period

**Cash-Flow Generating Assets** typically return either a principal and/or interest component on a regular, consistent basis

**Class A, B, C Tranches** 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

**Correlation** a statistical term describing the degree to which two variables move in coordinating with one another

**Credit Quality Ratings** a bond rating is a measure of the credit quality of a bond. Bond ratings are determined by private independent bond rating agencies, such as Standard & Poor's, Moody's, Fitch, among others

**CRE CLO** a type of CLO collateralized by a pool of commercial real estate loans

**Collateralized Loan Obligations (CLO)** collateral types may include commercial real estate (CRE) loans and corporate loans

**Commercial Mortgage-Backed Securities (CMBS)** secured by mortgages on commercial properties rather than on residential real estate

**Deleveraging** the process or practice of reducing the level of debt or financial leverage by raising capital or selling off assets and/or making cuts where necessary

**Duration** a measure of the sensitivity of the price of a bond or other debt instrument to a change in interest rates

**First Loss/Last Loss** first lost position refers to a security/tranche within a securitization which will be first to bear any principal losses if the credit quality of the securitized exposures deteriorates. Last loss positions refer to a security/tranche within a securitization which will be last to bear any principal loss from a deterioration in the credit quality of the underlying securitized exposures

**Floating Rate Securities** fixed income instruments which have a coupon that is calculated from a floating-rate index such as LIBOR

**Freddie SBL Structure** Freddie Max Multifamily Small Balance Loan (SBL) program that is designed for loan amounts between $1 million and $7.5 million for apartment buildings with 5 to 50 units. They offer 5,7-, and 10-year fixed rate and hybrid adjustable-rate mortgage options. These loans are non-recourse and can go up to 80% loan-to-value (LTV) in certain markets

**High Yield** is defined as giving a high return

**High Yield Corporate Credit Alternatives** instruments that offer a higher rate of interest due to its higher risk

**Illiquid Assets** are assets that cannot be quickly or easily converted into cash for their fair market value

**Investment Grade (IG)** a rating that signifies a municipal or corporate bond presents a relatively low risk of default

**Junior Tranche** is unsecured debt that ranks lower in repayment priority than other debts in the event of default

**Libor-based** securities have a coupon based on the London Inter-bank Offered Rate (LIBOR)

**Liquid Assets** is an asset that can easily be converted into cash in a short amount of time

**Loan-to-Value (LTV)** refers to the ratio of the loan amount relative to the value of the underlying property

**Mezzanine Tranche** the tranche within a securitization that lies in the middle of the capital structure, below the senior tranche and above the junior tranche (typically an unrated equity tranche)

**Mortgage-backed securities (MBS)** bonds which are secured by real estate loans. They are created when a number of these loans, usually with similar characteristics, are pooled together and redistributed into tranches

**Multifamily Collateral** are commercial term loans for multifamily housing buildings with 5 or more units

**Net Asset Value (NAV)** represents the net value of an entity and is calculated as the total value of the entity's assets minus the total value of its liabilities

**Non-Correlated Assets** perform irrespective to changes in another market (i.e. the S&P500); the price movement in one asset has no effect on the price movement in another

**Par** the value at which a bond will be redeemed at maturity

**Public Offering Price (POP**) the price at which new issues of stock are offered to the public by an underwriter

**Residential Mortgage-Backed Securities (RMBS)** a form of debt-based securities which are backed by the principal and interest payments on loans for residences

**Residual Tranche** collects any cash flow remaining from the collateral after the obligations to the other tranches have been met

**Risk-Adjusted Returns** a measure that puts returns into context based on the amount of risk involved in an investment

**S&P** is the S&P 500 Index or Standard & Poor's 500 Index, is a market-capitalization weighted index of 500 leading publicly traded companies in the U.S.

**Securitization** is the conversion of an asset into marketable securities typically for the purpose of raising cash by selling them to other investors

**Senior Tranche** typically contain assets with higher credit ratings than junior tranches. The senior tranche has first lien on the assets – they are in line to be repaid first in case of default

**Structured Credit** applies broadly to the asset class associated with pooling debt obligations into channels which can then be distributed to different risk appetites

**Tranche** Tranches refer to the segmentation of a pool of securities/loans into individual securities with varying degrees of risks and returns

**30-Day SEC Yield:** The SEC yield is an annualized yield based on the most recent 30-day period. Subsidized yields reflect fee waivers in effect. Without such waivers in effect, yields would be reduced. Unsubsidized yields do not reflect fee waivers in effect

## Important Considerations and Assumptions

The Axonic Strategic Income Fund is classified as "non-diversified" under the 1940 Act. A non-diversified fund is not limited by the 1940 Act with regard to the percentage of its assets that may be invested in the securities of a single issuer. Consequently, the securities of a particular issuer or a small number of issuers may constitute a significant portion of the Axonic Strategic Income Fund's investment portfolio. This may adversely affect the The Axonic Strategic Income Fund's performance or subject The Axonic Strategic Income Fund's NAV to greater volatility than that experienced by more diversified investment companies.

As full compensation for the investment advisory services provided to The Axonic Strategic Income Fund, the Adviser receives monthly compensation from the Axonic Strategic Income Fund computed at the annual rate of 0.85% of the Axonic Strategic Income Fund's average daily net assets (the "Management Fee"). The Adviser has entered into an Expense Limitation Agreement with the Axonic Strategic Income Fund, under which the Adviser has contractually agreed to waive or reduce its fees and to assume other expenses of the Axonic Strategic Income Fund, if necessary, in an amount that limits annual operating expenses (exclusive of any front-end sales loads, interest expense on any borrowings, taxes, brokerage commissions, extraordinary expenses, Acquired Fund Fees and Expenses, payments, if any, under a Rule 12b-1 Distribution Plan and/or Shareholder Services Plan and certain other Fund expenses such as dividend and interest expense and broker charges on short sales) to not more than 1.10% of average daily net assets of each class of shares. Management Fee reductions and expense reimbursements by the Adviser are subject to repayment by the Axonic Strategic Income Fund for a period of three years after the date on which such fees and expenses were incurred, provided that the repayments do not cause Total Annual Fund Operating Expenses (exclusive of such reductions and reimbursements) to exceed (i) the expense limitation then in effect, if any, and (ii) the expense limitation in effect at the time the expenses to be repaid were incurred. Prior to December 31, 2022, this agreement may not be modified or terminated without the approval of the Board. After December 31, 2022, the Expense Limitation Agreement may continue from year-to-year provided such continuance is approved by the Board. The Expense Limitation Agreement may be terminated by the Adviser or the Board, without approval by the other party, not less than 60 days' notice to the other party as set forth in the Expense Limitation Agreement. The Expense Limitation Agreement will terminate automatically if the Axonic Strategic Income Fund's Advisory Agreement with the Adviser is terminated.

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It is important to note that differences exist between the Axonic Alternative Income Fund's daily internal accounting records, the Axonic Alternative Income Fund's financial statements prepared in accordance with U.S. GAAP, and recordkeeping practices under income tax regulations. It is possible that the Axonic Alternative Income Fund may not issue a Section 19 Notice in situations where the Axonic Alternative Income Fund's financial statements prepared later and in accordance with U.S. GAAP or the final tax character of those distributions might later report that the sources of those distributions included capital gains and/or a return of capital.

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