PUBLIC FIXED INCOME

CLOs: Well-Suited for Difficult Economic Times

CONVERSATIONS

CLOs are a trillion-dollar market that attracts a wide range of investors seeking attractive yields and diversification. In this Q&A, Melissa Ricco, Co-Head of Structured Credit, shares her latest views.

Melissa Ricco
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This year has seen soaring inflation, rising rates, war in Ukraine and growing concern about a recession. How have CLOs weathered past periods of economic stress?

Collateralized loan obligations (CLOs) have not been immune to the volatility in the markets. That said, there is reason to believe the floating-rate nature of the asset class will help stabilize performance going forward, given the rising rate environment. It's also worth noting that the CLO market has come a long way; it's now a $1 trillion market, and one that is not easy for asset allocators to ignore in this environment.[1]

Historically, CLOs have performed relatively well during times of stress. It's important to remember the basics of CLOs—these are pools of loans that have seniority in the capital structure and are ultra-diversified in the sense that they are not overexposed to one issuer or industry. For instance, one issuer typically makes up only about 50 basis points (bps) of the CLO, and any one industry, on average, tends to comprise 10% or less.[2]

In addition, CLOs are not mark-to-market vehicles. As such, while significant price moves occur and can be unnerving, in many cases they prove to be just noise, especially at the top of the capital structure. In fact, when markets are volatile, opportunities often arise for managers to take advantage of that volatility by buying loans potentially at a discount—and that value accrues to the CLO's debt and equity holders. Therefore, the fact that these structures are actively managed is important.

With the potential for a recession top of mind for many investors, it's also worth looking at historical default rates. Of note, no AAA tranches have ever defaulted or experienced a principal impairment **(Figure 1)**. Further down the capital structure, BBs, which are the lowest-rated tranche in a CLO capital structure, historically have had a default rate of less than 2%. S&P Global recently published a statistic that was also fairly compelling: they have rated over 16,000 CLO tranches since the 1990s, and only 50 of those have defaulted. Of those, 40 occurred before the 2008–09 financial crisis.[3] Since then, the structures of CLOs have only gotten stronger; subordination has improved at every tranche level, and the collateral is higher-quality as well.

Figure 1: CLO Tranches Have Defaulted Less Frequently Than Similarly Rated Corporate Credit

S&P U.S. CLO Tranche Default History (1996–YE 2020)				
Rating	Total Tranches	Defaulted Tranches	Default Rate	S&P Avg U.S. Corp 5-Year Cumulative Default Rate
AAA	4,026	0	0.0%	0.3%
AA	2,631	1	0.04%	0.3%
A	2,451	5	0.2%	0.4%
BBB	2,268	9	0.4%	1.5%
BB	1,819	22	1.2%	6.2%
B	354	3	0.8%	16.7%

Source: S&P. As of December 31, 2020.

1. Source: J.P. Morgan. As of 2022.
2. Source: Based on Barings' market observations.
3. Source: S&P Global. As of March 23, 2022.

A lot of credit rating downgrades occurred early in the pandemic, and another period of economic difficulty may soon be in store. How would you assess the current status of credit quality in this asset class?

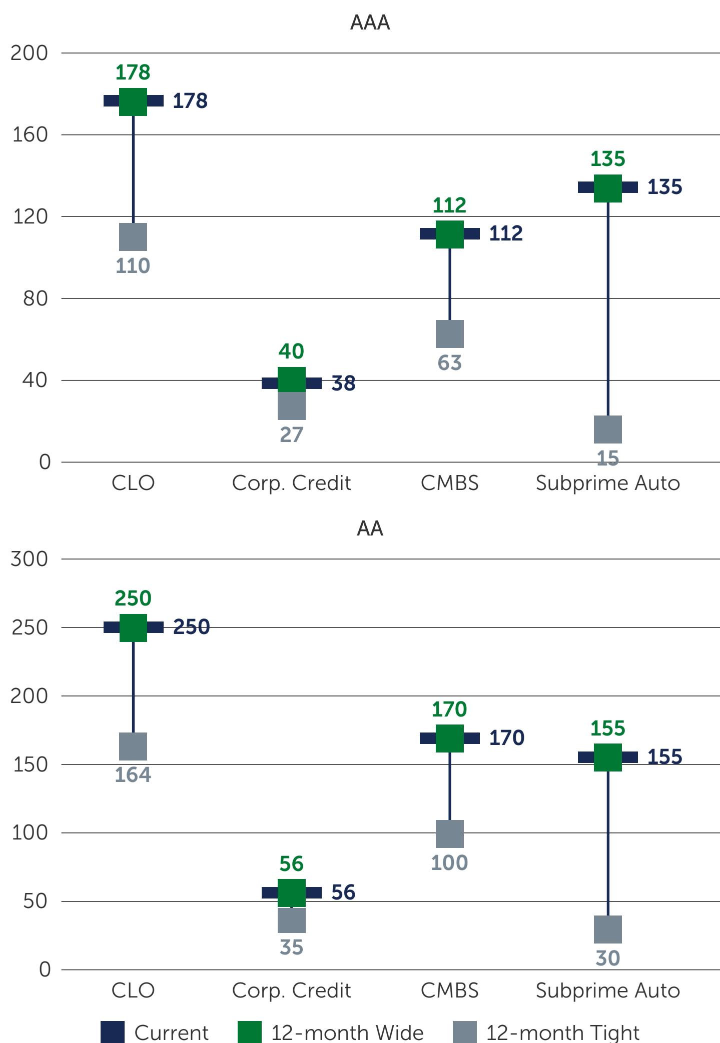
As we look forward, we expect the environment to be much more measured and predictable than when we saw the swathe of downgrades in early 2020. From a fundamental standpoint, loan borrowers have had access to capital markets for quite some time now, and most have strengthened their balance sheets, lowered their leverage and pushed out maturities—suggesting we're starting from a solid fundamental base.

That said, idiosyncratic risk could start to creep in. It may come from inflationary pressures if borrowers are unable to continue passing higher costs on to customers. Of course, certain sectors will be more impacted than others, so active management and individual credit selection will be key.

The CLO asset class has become more mainstream over the last decade. How has it developed over the years, who are the major types of investors, and what is attracting them?

Investors have certainly become more comfortable with the asset class—the CLO market wouldn't have grown to its current size if it were not for a large increase in the investor base. That base consists largely of banks, insurance companies, asset managers, pension funds and hedge funds.

Figure 2: AAA/AA CLO Relative Value to Similar Asset Classes (June 2021–May 2022)



Sources: CLO spreads represent the entire U.S. CLO post-crisis market. CMBS, and Subprime Auto Spread to Swap Source: Bank of America/ Merrill Lynch. As of May 31, 2022. Corporate Credit Spread to Swap Source: Barclays. As of May 31, 2022. U.S. and Europeans Loan Spread Source: Credit Suisse. As of May 31, 2022.

Looking at the capital structure, banks are mostly interested in the AAA tranches. Insurance companies, given their risk-based capital framework, tend to be more focused on the middle of the capital structure, particularly given the potential spread pick-up relative to similarly rated corporate credit. We have even seen CLO structures designed specifically for insurance companies, which are structured to be more efficient from a risk-based capital standpoint. At the mezzanine and equity levels, we typically see more interest from hedge funds, although we have more recently seen an increase in activity from asset managers. In fact, asset managers have raised a significant number of equity funds, many of which are designed for that manager's CLO issuance program.

We also see continued interest from overseas banks, mostly in AAA tranches, with Japanese banks in particular showing increased interest. Even with the higher hedging costs that have to be factored in, CLOs still look attractive, and offer a number of potential advantages, relative to alternatives like investment grade corporate credit.

As you look up and down the capital structure, where are you seeing the best relative value today?

It ultimately comes down to an investor's risk/return profile. At a high level, a case could be made for almost every part of the capital structure given the potential for attractive spreads relative to other investment options.

That said, relative value does tend to move around. Looking at the market today, we are seeing more value in the primary market than we have recently, as the new issue spreads have widened to be more in line with secondary levels and, in some cases, are even wider. That said, we continue to see opportunities in the secondary market as well, where investors can put their money to work more quickly versus waiting for a new issue. There is also the potential to earn a LIBOR coupon, which is currently about 12 bps higher than a SOFR coupon.[4]

Looking at different parts of the capital structure, AAAs and AAs look quite attractive, in our view. While As and BBBs remain well-bid, select managers and deals continue to offer attractive yields relative to public corporate credit. Further down the capital structure, we also see select opportunities in BBs, which are currently offering roughly two times the spread of the leveraged loan market—giving investors a meaningful spread pick-up for owning the same or similar collateral, but in a different form.[5]

While past performance is not indicative of future results, it is also worth noting that historical periods of spread widening have, in several instances, been followed by positive performance, as measured by forward index total returns. For context, spreads across the capital structure today have widened to their 77th to 87th percentiles since 2011 **(Figure 3)**.

Figure 3: CLO Spreads are Wide Relative to History

	May 2022	December 2021	Historical 75th Percentile	Historical 90th Percentile
CLOIE	276	222	268	308
AAA	178	116	154	187
AA	260	172	227	284
A	331	221	309	413
BBB	484	347	454	606
BB	895	704	764	974

Source: J.P. Morgan CLOIE Index 2.0 DM. As of May 19, 2022.

4. As of June 15, 2022.
5. Source: Based on Barings' market observations. As of May 31, 2022.

As for equity tranches, we prefer them in the secondary market versus new issue. Spreads on AAA tranches are quite wide at the moment, and so the arbitrage for equity is a bit challenged for new issues. Also, if you look to the secondary market, there can be more upside from workout equity and distressed loans, for example, which tend to provide additional upside.

Where do you see the market heading, and what factors will you be watching over the coming months?

We're following a number of developments. One is manager consolidation, which we have seen a fair amount of lately and expect to see more of going forward. This is taking place as many private equity and asset managers continue to look for ways to diversify their asset base and increase their exposure to a stable income stream—and CLOs can be a very attractive way to do that.

Second, the transition from LIBOR to SOFR is taking place and going quite smoothly. In the CLO market, we've already seen a handful of deals transition, aside from the new issue market.

Third, we're having ongoing conversations with our managers around environmental, social, and governance (ESG) issues, and we think there will continue to be more data disclosure around this topic.

Lastly, we're watching new issue arbitrage. The supply of AAAs in the secondary market has come down in recent weeks, which should help stabilize spreads going forward. The arbitrage, as a result, looks more attractive relative to a month or two ago—although with the improvement in loan prices more recently, AAA spreads will need to tighten even further going forward for the arbitrage to remain attractive.

Overall, it's going to be an interesting time in credit. We expect to continue to see volatility and potential for increased tail risk. We're still forecasting defaults to stay below historical levels over the near term, but we think it's going to be a crucial time for active management and a strong focus on fundamentals.

This Q&A is based on a recent episode of Streaming Income. Listen to the full podcast conversation here.*

*Full podcast URL: https://www.barings.com/perspectives/viewpoints/clos-finding-value-in-turbulent-markets

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