



CLOs: What are they and why now?



Mark Shoet
Senior Analyst
BlueBay Fixed Income Team

Marketing Communication

Published March 2022

With the asset class breaching the USD1 trillion mark in 2021, demand for CLOs continues. Find out more about these floating-rate instruments, what differentiates them from other securitised products and how they are likely to perform in today's volatile market environment.

What is a CLO?

CLO stands for collateralised loan obligation. It is a type of securitisation transaction in which a pool of leveraged loans is aggregated to form the collateral. Cashflows from those loans provide interest and principal payments to investors in the CLO vehicle.

The assets in a CLO are typically broadly syndicated below investment-grade floating rate first lien loans that sit atop a company's capital structure, although some CLOs have flexibility to add second lien loans or fixed rate notes such as bonds.

Investing in a CLO is another way to access the loan market, but the real appeal for investors is that the CLO has a number of different tranches that vary in risk and return profile.

“Investing in a CLO is another way to access the loan market, but the real appeal for investors is that the CLO has a number of different tranches that vary in risk and return profile.”

How do the debt tranches work?

CLOs are structured with a number of debt tranches – typically rated AAA down to single-B, as well as an equity tranche. Interest or principal payments are made first to the most senior bonds and residual interest cash flow, if available, can be passed to the equity tranche. Conversely, losses in the collateral pool of loans are first absorbed by the most junior tranches, meaning the equity tranche would receive first losses.

The AAA-bond is the most senior part of the capital structure and sits at the top of the priority of payments waterfall. The AAA bond offers the lowest coupon, but it is the most liquid and the most remote from default risk.

Most AAA CLOs are structured with 35%-40% credit enhancement, which means that nearly half of the collateral pool would have to default at a 0% recovery rate for a AAA bond to take a principal loss. Due to other structural protections in the deal, the amount of collateral losses would need to be substantially higher than that for a AAA bond to take a loss.

Contrastingly, a BB bond is further down in the capital structure, lower down in the priority of payments and more exposed to default risk. However, investors are compensated for this risk with a much higher spread and total return.

Even at the BB and B level, tranches are structured with 6-10% credit enhancement so they are relatively well insulated from credit risk given their structural protections and deals' diversified collateral pools.

“The AAA bond will offer the lowest coupon, but it is the most liquid and as the lowest risk part of the structure it is most remote from default risk.”

What differentiates a CLO from other securitised products?

The main difference is that CLOs are actively managed by an asset manager versus other securitised products that have an asset pool that is static in nature. CLOs typically have a reinvestment period of five years, during which the asset manager can trade or reinvest principal repayments into new loans. The reinvestment period can be fairly powerful, particularly during a period of market dislocation.

How big is the CLO market and what are the issuance expectations for this year?

The market has matured and grown over the past decade. In 2021, it passed the USD1 trillion mark—with around 80% in the US and 20% in Europe.

Every year the market sees additional participants and new types of investors attracted to what the asset class has to offer, so we expect growth to continue.

We saw record-breaking issuance in 2021, with USD187bn in the US – 2x the issuance seen in 2020 and 1.5x 2019 issuance. Europe saw EUR45bn of issuance in 2021 vs. EUR25bn in 2020 and EUR33bn in 2019. Both regions benefited from elevated asset spreads, low cost of capital and a plethora of deals that were ripe for refinancing or reset opportunities following the pandemic.

“Every year the market sees additional participants and new types of investors attracted to what the asset class has to offer, so we expect growth to continue.”

What's performance been like so far in 2022?

The primary market got off to a slower start to the year given the Libor-SOFR transition in the US and other macro volatility, which has added some uncertainty to spreads.

We're currently seeing elevated geopolitical concerns, but ultimately, we think things will calm down and CLO issuance will be robust in 2022 given that CLO equity investors have found ways to make the arbitrage work and floating-rate assets, both in the loan space and CLO tranche space, are in demand.

We believe this will continue to be the case as the Federal Reserve and European Central Bank have clearly laid out their hawkish intentions.

Investor appetite remains robust for the CLO market; continued demand should lead to further issuance.

In the secondary market, CLO spreads have leaked wider over the last few weeks given broader macro concerns. CLO secondary prices are a few points off the January highs, depending on the part of the capital stack and bond quality, but we believe that these can be good buying opportunities and continue to look cautiously and carefully at deploying capital here.

Why are CLOs attractive in the current market environment?

There are several factors that we believe make CLOs attractive for investors.

The first is that these assets are floating rate and therefore partially offset rising interest rates, in contrast to fixed income instruments.

Second, the relative value between CLOs and similarly rated corporates is attractive. For example, BBB US CLOs currently have a spread in secondary markets of 325-375bps vs. BBB US corporates at 155bps. In our view, this spread premium is more than compensating investors for the credit risk taken in CLO tranches, particularly given some of the aforementioned structural and collateral protections.

We sometimes say that CLO investors are essentially being paid a "name premium" since they are actually more shielded from credit risk than their corporate counterparts are; "CLO" sounds like "CDO" and this scares some people off, but they are absolutely not the same thing.

For senior investment grade-rated CLO bonds, the weighted average life (or spread duration) is typically shorter than that of investment grade-rated corporates. This is important since in periods of market volatility, shorter spread duration assets will have less mark-to-market volatility.

How are the fundamentals?

Fundamentals are also positive for CLOs as loan defaults are forecasted to remain at low levels given companies' relatively healthy cash balances, leverage levels, and limited near-term maturities. The backdrop of low default rates and rising interest rates creates a supportive backdrop for CLOs.

"On the secondary side of things, CLO spreads have leaked wider over the last few weeks given broader macro concerns."

"These assets are floating rate and therefore partially offset rising interest rates, in contrast to fixed income instruments."

"CLO" sounds like "CDO" and this scares some people off, but they are absolutely not the same thing."

What do you see as the biggest risk for the asset class?

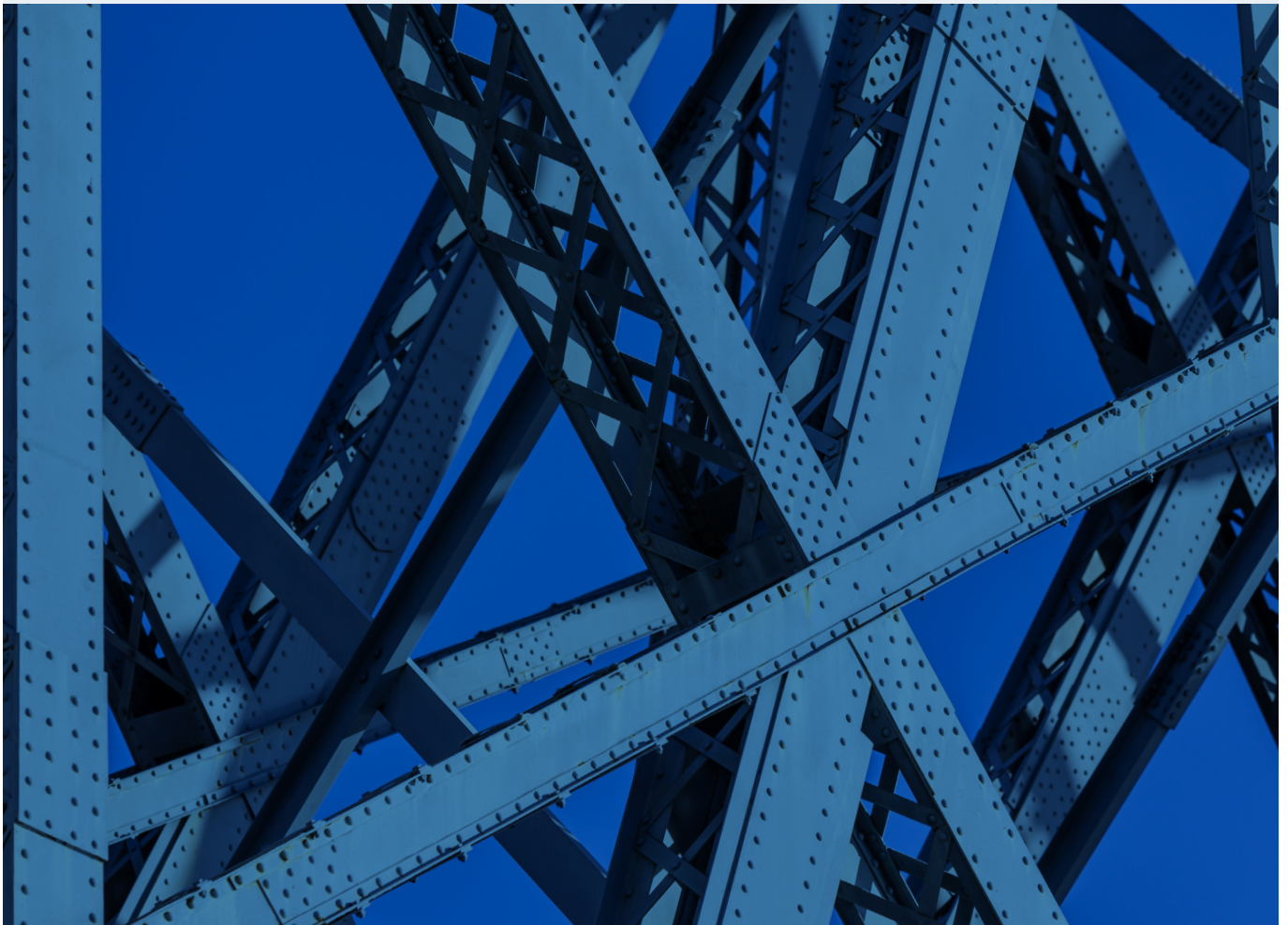
In our view, the biggest risk for the CLO market would be a large risk-off credit event coupled with idiosyncratic credit issues, particularly for secular decliners, perhaps due to a tightening or slowing economy. This would cross interest rate risk with credit risk. Most of the weakness seen in credit in the early part of 2022 was driven by inflation concerns and rising rates. As such, the CLO market was fairly robust; in fact, it held up remarkably well versus almost all other asset classes given the demand for floating-rate paper and record retail loan inflows in the US.

With macroeconomic and geopolitical issues dominating the headlines, CLO structures are now being tested again as they were during the global financial crisis, European sovereign debt crisis and the Covid-19 pandemic. Their successful weathering of these unprecedented events is another reason why we believe we'll continue to see new investors attracted to the asset class.

Fundamentally, we believe CLOs are robust vehicles that have been tried and tested through various cycles – in fact, no US or Euro AAA or AA-rated CLO tranche has ever taken a dollar of impairment and only one US A-rated tranche has ever seen an impairment. But ultimately, CLOs are risk assets and during large disruptions risk assets tend to become more correlated and liquidity becomes more challenging to find, even for “money good” investments.

But overall, we think CLOs can withstand current, and additional, risk-off events and we always look to buy into weakness because of the potential opportunities that CLOs can provide.

“Most of the weakness seen in credit in the early part of 2022 was driven by inflation concerns and rising rates. As such, the CLO market was fairly robust; in fact, it held up remarkably well versus almost all other asset classes.”



This document may be produced and issued by the following entities: in the European Economic Area (EEA), by BlueBay Funds Management Company S.A. (the ManCo), which is regulated by the Commission de Surveillance du Secteur Financier (CSSF). In Germany and Italy, the ManCo is operating under a branch passport pursuant to the Undertakings for Collective Investment in Transferable Securities Directive (2009/65/EC) and the Alternative Investment Fund Managers Directive (2011/61/EU). In the United Kingdom (UK) by BlueBay Asset Management LLP (BBAM LLP), which is authorised and regulated by the UK Financial Conduct Authority (FCA), registered with the US Securities and Exchange Commission (SEC) and is a member of the National Futures Association (NFA) as authorised by the US Commodity Futures Trading Commission (CFTC). In Switzerland, by BlueBay Asset Management AG where the Representative and Paying Agent is BNP Paribas Securities Services, Paris, succursale de Zurich, Selnaustrasse 16, 8002 Zurich, Switzerland. The place of performance is at the registered office of the Representative. The courts of the registered office of the Swiss representative shall have jurisdiction pertaining to claims in connection with the distribution of shares in Switzerland. The Prospectus, the Key Investor Information Documents (KIIDs), where applicable, the Articles of Incorporation and any other applicable documents required, such as the Annual or Semi-Annual Reports, may be obtained free of charge from the Representative in Switzerland. In Japan, by BlueBay Asset Management International Limited which is registered with the Kanto Local Finance Bureau of Ministry of Finance, Japan. In Australia, BlueBay is exempt from the requirement to hold an Australian financial services license under the Corporations Act in respect of financial services as it is regulated by the FCA under the laws of the UK which differ from Australian laws. In Canada, BBAM LLP is not registered under securities laws and is relying on the international dealer exemption under applicable provincial securities legislation, which permits BBAM LLP to carry out certain specified dealer activities for those Canadian residents that qualify as “a Canadian permitted client”, as such term is defined under applicable securities legislation. The BlueBay group entities noted above are collectively referred to as “BlueBay” within this document. The registrations and memberships noted should not be interpreted as an endorsement or approval of BlueBay by the respective licensing or registering authorities. Unless otherwise stated, all data has been sourced by BlueBay. To the best of BlueBay’s knowledge and belief this document is true and accurate at the date hereof. BlueBay makes no express or implied warranties or representations with respect to the information contained in this document and hereby expressly disclaim all warranties of accuracy, completeness or fitness for a particular purpose. Opinions and estimates constitute our judgment and are subject to change without notice. BlueBay does not provide investment or other advice and nothing in this document constitutes any advice, nor should be interpreted as such. This document does not constitute an offer to sell or the solicitation of an offer to purchase any security or investment product in any jurisdiction and is for information purposes only. This document is intended only for “professional clients” and “eligible counterparties” (as defined by the Markets in Financial Instruments Directive (“MiFID”)) or in the US by “accredited investors” (as defined in the Securities Act of 1933) or “qualified purchasers” (as defined in the Investment Company Act of 1940) as applicable and should not be relied upon by any other category of customer. No part of this document may be reproduced, redistributed or passed on, directly or indirectly, to any other person or published, in whole or in part, for any purpose in any manner without the prior written permission of BlueBay. Copyright 2022 © BlueBay, is a wholly-owned subsidiary of RBC and BBAM LLP may be considered to be related and/or connected to RBC and its other affiliates. ® Registered trademark of RBC. RBC GAM is a trademark of RBC. BlueBay Funds Management Company S.A., registered office 4, Boulevard Royal L-2449 Luxembourg, company registered in Luxembourg number B88445. BlueBay Asset Management LLP, registered office 77 Grosvenor Street, London W1K 3JR, partnership registered in England and Wales number OC370085. The term partner refers to a member of the LLP or a BlueBay employee with equivalent standing. Details of members of the BlueBay Group and further important terms which this message is subject to can be obtained at www.bluebay.com. All rights reserved.

Published March 2022



**Global Asset
Management**