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PRIME TIME FOR CLOs

For institutional investors looking for diversification strategies, collateralized loan obligations can be a stable option that provides downside protection in an uncertain macro environment. A market that tops $1 trillion, CLOs are floating-rate instruments that sit within the larger structured credit market. They have different tranches, each with its own risk-reward profile, cash flow structure and credit rating. As such, CLOs can fit into different allocation sleeves within an institutional portfolio. CLO managers **Barings, Polen Capital** and **Sycamore Tree Capital Partners** dig into current market dynamics and the potential impact of lower rates on the asset class. They unpack what increased CLO issuance means for investors and highlight manager characteristics needed to successfully navigate this market.

P&I: Is it 'prime time' for CLOs today?

"It definitely is prime time for CLOs," said Adrienne Butler, head of global CLOs at Barings. "We have seen stars align across the industry, both on the issuance side and on the investing side, which makes it a potentially beneficial time to be invested in CLOs." The firm has seen strong demand for floating-rate products up and down the capital stack, from triple-A rated to equity tranches, she said.

The macro environment, with uncertainty around economic growth and interest rates, is supportive. "Having a diverse pool of assets in a time like this is really important because you don't have complete visibility on where rates are going to go or on any kind of exogenous shocks or geopolitical events," Butler said. "Having a highly diverse pool that you can invest in provides you a degree of confidence in what might be a more volatile market."



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CLOs have gained popularity among institutional investors as they have evolved from a niche product to a broadly used fixed-income alternative, according to Jack Yang, co-founder and president of Sycamore Tree Capital Partners. In addition, the user base of the asset class has expanded beyond banks and insurance companies to include, notably, public pension plans, endowments and asset managers.

"We see CLOs gaining utilization in portfolios, similar to how high-yield bonds and bank loans have done previously. This is now a thoroughly researched, $1 trillion market that offers potential return, diversification and hedging benefits versus traditional fixed income," Yang said. "With asset managers, pension funds and even mutual funds increasingly investing in CLOs, you could over time see the size of the CLO market grow dramatically, even double from where it is today."

Jim Stehli, co-lead of the CLO platform at Polen Capital, pointed out that CLOs have become the largest securitized asset class, another contributor to its use and popularity. "Its size and scale provide investors with a large enough investible universe, across the whole rating spectrum, to consider as part of either a fixed-income allocation or an alternative investment allocation," he said. "The market size is important, and from a product features perspective, structure is one of the key components of CLOs. The product has been performing well for over 25 years — it's been tested through various cycles."

P&I: What's driving strong CLO deal volume in recent years, and do you expect that to persist?

Lower rates driven by the Federal Reserve's easy-money policy after the Great Recession and then following the pandemic helped increase interest in CLOs, and refinancing was a major component that benefitted borrowers. But in the subsequent higher-rate environment, the question is whether the factors that drew borrowers and lenders to the CLO market will remain.

Stehli said that he expects that two components that have emerged relatively recently — tighter credit spreads and relatively calm markets — will keep interest high in CLOs. Through midyear, volumes on broadly syndicated loan CLOs as well as new issue middle market and private credit CLOs are up 80% over last year, he noted. "On top of that, you've got a huge refinance and reset cycle happening," he said. "In both cases, these outcomes are largely driven by tighter credit spreads overall and relatively lower volatility, allowing investors to participate in these deals."

"With record CLO issuance expected in 2024, we anticipate continued growth in CLO volume due to attractive conditions for both assets and liabilities," Yang said. Sycamore Tree Capital Partners is seeing investor demand for CLO debt and equity grow as well, with both existing and new investors increasing capital allocations.

The combination of institutional investors' positive return experience over the last 14 to 15 months and the level of CLOs being called and refinanced is likely to keep volume humming, Butler said. "Even with possible rate cuts on the horizon, there is still demand for floating-rate products right now" with new issue and refinancing activity garnering demand from investors who are receiving repayments of existing exposure to CLOs, she said. "CLOs, in general, offer attractive relative value compared to other fixed-income or floating-rate products, and the market remains an attractive place to invest."

P&I: What's your outlook on the current rate cycle, where we may be at the peak on interest rates, and its impact on CLO assets as well as underlying loans by borrowers?

"While we expect the inverted yield curve to normalize, we see rates reverting to levels consistent with long-term historical averages, not the near-zero rates

created by global government interventions since the great financial crisis," Yang said, adding that Sycamore Tree expects to see base rates of 3% to 4% over the next few years. "We see CLOs having ongoing attractive relative value compared to other corporate and structured credit."

With the Fed poised to embark on its interest rate cutting cycle, Butler said, lower rates could bode well for the CLO market. "That's a positive that would lead to lower cost of capital and increased cash flows for the underlying loan issuers in the portfolio," she said. In addition, "lower rates may very well trigger an upsurge in M&A activity, which could increase loan volume and ultimately help to create additional diversity and growth within the CLO market." Once base rates are cut to some degree, she noted, that could boost consumer-related sectors, such as retail services.

Even when rates come down, CLOs will likely remain attractive relative to other credit vehicles, such as investment grade and high yield, Stehli said. "Most economists seem to be forecasting a target fed funds rate of 3.5% to 4% by late 2025 into 2026," he said. "That's still a far cry from where we were at 0% post-COVID into early 2022. Despite CLOs being floating-rate instruments, there remains an implied risk-free base rate of 3.5% to 4%. Triple-A rated CLOs are still pretty attractive, yielding at 5%-plus, while the entire CLO stack is going to be closer to 6.5% to 7%-plus. We think that's going to represent an attractive potential return compared with investment grade and high yield overall."

P&I: Looking ahead, are you concerned about rising corporate defaults and their impact on the CLO market?

For CLO managers, keeping a close eye on defaults is a critical function that's related to the economic backdrop. "We follow very closely what's going on in the fundamental economy of the United States," Yang said. "The bank loan market is a relevant microcosm of the overall economy, so a lot of our call on what happens with defaults is a function of our outlook on the economy."

He added, "Over the next six to 12 months, we're constructive. We've seen defaults moderate and even come down some from the peaks of '22 and '23, post COVID, post the Ukraine invasion. However, I would also say there's been an uptick in out-of-court restructurings to right-size capital structures." In any scenario, he said, a CLO manager's goal should be to avoid defaults and minimize risk as much as possible. "It's impossible for any manager to outright avoid all ratings downgrades and defaults, but the better we are at identifying and designing process and risk management, the better manager we become."

"CLO managers are paid to be concerned about defaults," Stehli said. "Historically, managers have focused on creating upper-tier performance compared with a broader leveraged loan index and, ultimately, managing against the downside of that broader loan market. Defaults are a concern, and that's what managers are paid to be focused on."

However, lower rates should bode well for defaults, as they could ease the burden on companies that might be feeling the strain of higher rates. "If we're at a point where you've got many companies that are performing relatively well even in today's higher rate environment, one would expect that if rates fall from here, that outcome should result in a more constructive backdrop for CLO managers," Stehli said.

While Barings' team is seeing default rates leveling off, that doesn't mean they are any less focused on them. "We're not overly concerned about a spike in default rates, but it's important to be cautious and committed, and also to be involved in liability-management exercise activity. Having a deep research team with experience in the market, understanding those LME activities and having the market relationships are going to be really important," Butler said.

P&I: Where do CLOs best fit within an institutional portfolio?

The wide range of institutions active in the CLO market, from insurance companies and pension funds to hedge funds, is a proof point of the asset class's versatility.

"CLOs can fit into a variety of different portfolios," Butler said. "How you categorize the asset class depends on where in the capital stack you're investing. This versatility also speaks to why we're seeing this as a compelling time for CLOs. Up and down the capital structure, everybody seems to be finding something to meet their needs."



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— JIM STEHLI, POLEN CAPITAL

It depends on the institutional allocator's portfolio goals, said Stehli.

Since CLO bonds offer a floating rate with a defined reinvestment period and a maturity date along with quarterly coupon payments, "it's logical to consider including CLO debt in a fixed-income portfolio," Stehli said. "Meanwhile, CLO equity, in particular, tends to be less liquid, and with a target return of, say, mid-teens, coupled with a more illiquid nature, Polen Capital believes that it's also desirable to include an allocation to CLO equity as part of an alternative investments portfolio."

"CLOs have the potential to improve the risk-adjusted returns of portfolios, given low correlation to many asset classes," Yang said. "Fit varies based on the part of the CLO where the allocator is investing. Floating rate, triple-A through single-A CLO bonds add attractive yield and diversification to core-plus portfolios focused on income and capital preservation. CLO mezzanine debt and equity are being included in return-seeking portfolios, such as opportunistic credit, and in private-market allocations as a complement to direct lending and private equity."

P&I: Which tranches or ratings should investors focus on to meet their portfolio objectives for yield and diversification?

"Throughout the CLO stack, investors can add spread, even as they're adding protection to the downside through the CLO structure and diversification through the collateral," Stehli said.

"By definition, CLOs offer diversification on an underlying pool of leveraged loans. Regardless of which tranche you're looking at — triple A, double B, equity — investors are receiving the benefit of diversification and, therefore, that element of downside protection," he explained.

"CLOs also offer a pickup in spread to investment grade and high yield," with 6% to 7% yields on single-A to triple-A rated CLOs attracting U.S. institutional investors, as well as Japanese banks, while the CLO exchange-traded fund market is also drawing the interest of retail investors, he said.

"It depends on what your investment objectives are," Butler said. "What we're seeing is that tranches from both top-tier and second-tier managers, as well as across the capital stack, are trading close to par today," she said. "And the spread basis between the various profiles of deals and tranches have compressed, meaning that differences between managers, between styles, between subordination levels are starting to compress because of the demand. So as

an investor, you want to be very picky with and lean toward high quality investing and liquidity."

Yang added that one of the key benefits of CLOs for institutional investors is that they can offer a wide range of options from the standpoint of risk, return and liquidity. "Depending upon their objectives, investors can choose how they gain exposure to an actively managed, diversified portfolio of senior secured, floating-rate loans with the benefit of stable, long-term, non-mark-to-market leverage," he said. For example, triple-A rated CLO bonds can be a good complement to core fixed income while CLO mezzanine debt and equity can be used to deliver income and total return.

P&I: What is your outlook on CLO spreads/yield against public fixed income and private credit for this year and next?

"We remain constructive on 2024 for spreads, as rates remain high and credit spreads, in general, are tight but not necessarily at all-time tight levels," Stehli said. "We are constructive on CLO triple-A's, given the large demand for a performing floating-rate bond from U.S. and global banks. Our view is that an investment in triple-A rated CLOs provides a fair return with significant downside protection."



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Yang pointed to the return potential. "CLO bonds generally provide higher returns than comparably rated corporate bonds due to complexity premiums, despite their attractive performance and protections," he explained. "The relative value of CLO bonds is likely to continue to be attractive versus conventional fixed income in the year ahead, given they're priced off of the short end of the yield curve with floating-rate spreads."

Whether spreads tighten or widen, CLOs look attractive with redeeming qualities in either situation, Butler said. "We're in a pretty good spot right now in terms of liability pricing relative to prior years," she said. "We've got decent visibility into the asset class with a stronger forward pipeline over the next several weeks. Defaults have stabilized. We expect to see more new-issue loan activity, and that creates a more diverse pool of assets to draw from. So, ultimately, we think CLOs should be a solid investment over the next few years."

P&I: What are some characteristics of a CLO asset manager that are key to delivering consistent long-term performance?

Track record is critical. "Research shows that top-quartile managers have historically delivered significant relative outperformance," Yang said. "Our battle-tested experience across credit and market cycles has taught us that disciplined focus on capital preservation supports consistent, long-term performance."

In addition to a manager's performance track record, institutional investors should know whether a manager has successfully navigated different market cycles. "A rising tide lifts all boats," Yang said, "but it's market volatility that really tests a manager's skill and also creates opportunity — the most opportunity, in fact, for the managers to differentiate themselves and create value for their investors."

"We think that the most important litmus test of evaluating a manager is their performance, particularly during volatile markets," Yang said.

"The No. 1 takeaway is making sure you have a focus on quality research," Butler said. "Having a deep and experienced research team is key. There's no amount of spread that can make up for a high level of defaults. You want to make sure that you're buying the right credits and minimizing defaults." Beyond that, she added, a CLO manager must have specialized teams that are experienced in structuring and legal review.

"As a manager, we tend to be more conservative in our approach to managing assets and credit quality," Butler said. "We're never going to stretch for spread. We're always going to make sure that our credit quality is top of mind." It comes down to process, said Stehli, which can translate into performance. "We believe in protecting against the downside and not overreaching," he said. "CLO portfolios that are thoughtfully constructed on day one and are underwritten throughout the CLO lifecycle tend to perform better. We prefer a balanced portfolio construction process that provides for a healthy level of diversification."

P&I: What's an underappreciated fact about recent — or historical — performance of CLOs that's interesting?

While CLOs have been around for decades, their qualities of diversification, return generation and resilience are still sometimes a positive revelation to even experienced institutional investors. "The long-term, stable leverage of CLOs creates stability and optionality for investors, yet some allocators are surprised that the highest-returning CLOs, ever, were issued in 2007, right before the global financial crisis," Yang pointed out.

In addition, investors may not know that in more than 14,000 rated classes of CLOs, just about 20 have defaulted, Stehli said. "All those defaults were in the 2020 era, and all were double-B or single-B rated, so nothing at the triple-A, double-A, single-A or triple-B level."

Butler added, "Not only have there been no defaults in the triple-A part of the stack, but as of June 2024, S&P reported that no triple-A tranches were even downgraded over nine straight years — which further emphasizes the investment's stability." ■

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