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Collaterised Loan Obligations Whitepaper

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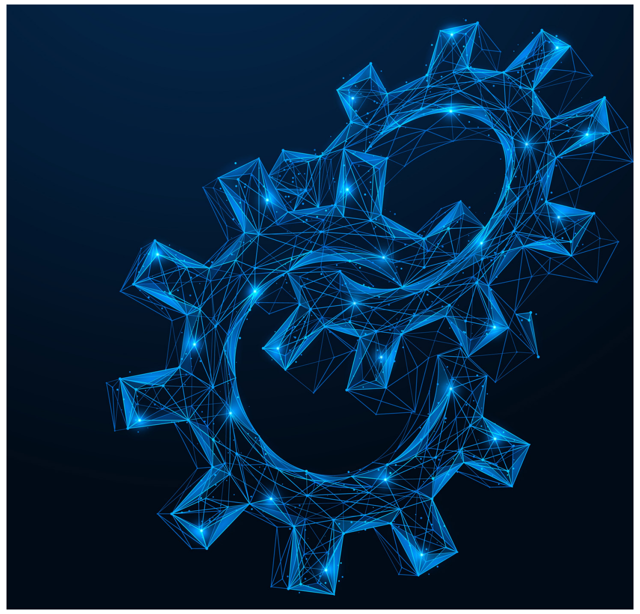

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Welcome to CAMRADATA's CLOs Whitepaper

The return of higher lending rates has pleased asset owners. The simple story for 2024 is that they no longer have to search for 'complexity' premia within the universe of fixed income.

The truth, however, is more subtle. Institutional investors such as pension funds, insurers and charities have developed familiarity with all kinds of sub-sectors of credit over the last fifteen years. It is now too late to dismiss them out of hand.

The genie will not go back in the bottle and nor should it. The ripples of pressure emanating from raised interest rates make all kinds of credit more interesting. Now is not the time for sophisticated investors to ignore where opportunity lies. The question is rather which managers and advisers can steer them to those opportunities.

In the case of Collateralised Loan Obligations (CLOs), they have always suffered from a perception of risk just because they are structured credit with three letters. Champions of CLOs would first point to their historically low risk. The prejudice has never been warranted - before, during or after the Global Financial Crisis [see S&P's comparative rating for HY CLOs versus equivalent HY bonds this century]. CLOs have a distinctive overcollateralisation test that protects buyers.

The second appeal is that the universe is now worth c.$1.2 trillion; deep and broad enough to merit interest. Issuance thus far in 2024 has been surprisingly high.

The third attraction would be the spread available in CLOs over other types of securitised credit, including the likes of CMBS, which carry a lot of risk right now from office property, and ABS.

Nevertheless, investors need to be careful. With more eyes on the CLO market, returns may shrink in line with supply of capital. Top-rated bonds already show tightening more than lower-rated tranches. Asset owners will have to think about whether they want to go down the capital structure here, especially if they have allocated risk to other types of investments, e.g. High Yield or equity, already. Asset owners may also be wary of CLO managers barbelling highly-rated paper with racier B-rated tranches. As ever, it is a matter of communication about where the risks lie in such a mixed portfolio.

CLOs were the best performing sector in fixed income last year. The question is whether that relative success continues in 2024.

Meet the Team

Natasha Silva
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Collateralised Loan Obligations Roundtable

The CAMRADATA Collateralised Loan Obligations Roundtable took place in the late summer of 2024

The CAMRADATA roundtable on Collateralised Loan Obligations (CLOs) began by asking consultants and asset owners where and why they and their clients use CLOs in their portfolio. Emma Coleman, head of credit, manager research at investment consultancy firm, XPS Group, said most of its Defined Benefit (DB) pension scheme clients achieved their CLO exposure within broader securitised mandates. She said this had been an area of growing demand over the last 12-18 months post the gilts crisis in 2022. Coleman clarified that DB funds now don't need to take on more risk and can utilise CLOs as part of their de-risking journey given their liquidity, low duration and credit spread pick-up.

Chetan Ghosh, head of Pensions OCIO at Schroders took a similar line to Coleman. He said that as DB schemes reduced exposure to illiquid investments such as private debt and equity, there was appeal in a dedicated allocation to wider securitised mandates, with a meaningful exposure to CLOs. "That would mostly be in IG but some space for managers to add BB if pricing proves attractive," he said.

Niall Moten, investment manager for Convex, a fast-growing insurer and reinsurer, explained that there were two places for CLOs in the portfolio. Because of the short-term nature of Convex's property and casualty business, a large proportion of its assets are in fixed income, which includes an allocation to investment grade CLO tranches. In the risk-seeking portfolio there is a small exposure to mezzanine and equity tranches.

David Will, fixed income investment lead at Scottish Widows, which manages £220bn on behalf of customers as well as its own balance-sheet assets, said there was very little exposure currently in either book to CLOs. The one current channel is a Multi-Asset Credit strategy (MACs). That will change, however, as Scottish Widows launches a new workplace pension default fund.

> ***Coleman clarified that DB funds now don't need to take on more risk and can utilise CLOs as part of their de-risking journey given their liquidity, low duration and credit spread pick-up."***

Hanna Wan, securitised credit researcher at WTW, a fiduciary and investor consultancy, said that different WTW clients had different exposure to CLOs across the capital structure. She said that clients mostly are in broader securitised mandates where managers can dial up or down relative exposure to various types of securitised credit.

Contrast and Compare

The CAMRADATA panel then compared and contrasted CLOs with traditional credit. Such exercises are complex because CLOs are not one thing. Not only does equity behave very differently to AAA paper but supply of the various options is not uniform. "There is a broad spectrum of risk and reward," said Cathy Bevan, head of structured credit and portfolio manager at BSP-Alcentra. "From my perspective, AA-BBB is a substitute for corporate fixed income but is taking out duration risk. If you look at BB-rated HY bonds versus BBB CLOs, the latter have performed better. But people still typically ask for more from the CLO portfolio, driven partly by industry regulation."

Will admitted that he was one credit fund researcher who did these 'unfair' comparisons. "I would expect a yield pick-up to conventional bonds from CLOs," he said. "It's not AA versus AA. That is because of the nature and specialism of the asset class."

PineBridge Investments has analysed 10-year performance of the various tranches alongside credit, however, and found that in eight out of ten years, a CLO tranche strategy (IG or below IG) proved to be the top performer.

"In a Treasury allocation portfolio, IG is going to win if it's a duration trade," said Laila Kollmorgen, CLO portfolio manager at PineBridge. "But now, when a lot is changing, CLOs will work."

She said that going below IG depends on your risk tolerance, before describing BB as one of the best-ever investments to select.

Bevan agreed. "If I could, I'd have 100% of my pension in BB CLOs," she said. "They are well insulated, but you need a manager with good credit selection."

At the base of the capital stack, Bevan described CLO equity as a difficult beast to compare with anything. She noted that it has a different risk profile to private equity. CLO equity provides a high interest rate cashflow through the life of the investment whereas a typical investment in private equity delivers much more back-ended returns.

"The biggest misconception about CLO equity is that defaults are your biggest risk," warned Bevan. "Income generates most of your return so loan spread compression can hurt as much as defaults on the underlying loans. Personally, I think there is a place for CLO equity in everyone's portfolio."

Kollmorgen stressed that in contrast to private equity or direct lending, CLO equity was something you can get out of. "You can reduce CLO equity exposure at any point. How liquid are those other kinds of investment?" she asked.

Kollmorgen described real estate, private equity and the like as 'vintage' trades. "They are all the same: you have to look at valuations. If you get in the right year, that's great."

But she warned that deals done in, say 2020, were followed by rate hikes and so many of those investments are now 'under water'.

Ghosh had been acting as CIO for a major UK pension fund during the gilts crisis. All its wider securitised mandates, housing the CLO exposures, had been liquidated to meet margin calls in the LDI portfolio. He noted that it had taken longer for managers to exit instruments lower down the capital stack. Schroders' delegated clients would not typically have exposures to CLO equity.

That cautiousness may find its way further into regulation. PineBridge sits on the advisory committee to the U.S. National Association of Insurance Commissioners (NAIC). Kollmorgen said that a greater risk weighting for lower tranches of CLOs is being mooted. Bevan, however, questioned the rationale for greater regulation relative to credit or equity. "I do not know why so much is expected of CLOs," she commented.

Reducing Drama in the Crisis

The truth is that CLO debt remains popular with UK pension funds as a source of liquidity. Coleman explained that as hedging assets in LDI portfolios, the liquidity and low-interest-rate duration of CLOs make them an important tool for Tier One LDI collateral. "[In a crisis] with IG corporates, you are selling down hedging assets to keep your LDI hedge on in a rising rate environment," she observed. "CLOs can be vital because they provide that liquidity to meet LDI capital calls without contributing to a pension scheme's hedge themselves."

Echoing Ghosh, she said that during the gilts crisis, U.S. CLOs were often the main source of the liquidity used by investment managers within a client's wider allocation to securitised credit.

As a very rough guide regarding the headroom in these pension funds' current LDI portfolio, Coleman reckoned 50% of the physical value of clients' hedging assets are held as supporting collateral, and for clients who use it around half of this will be in ABS. "The latter provides greater collateral efficiency - it can be sold down to meet capital calls whilst also providing a return pick-up relative to equivalently rated corporates," she said.

Ghosh gave a similar range of 30-50% in securitised investments currently, expressed as a proportion of total credit assets.

On liquidity, Kollmorgen explained that the market was not reliant on trading desks at investment banks to get deals done. She said that during the gilts crisis, there were auctions with 25 bids being offered: "The main players, banks and insurers, are not dependent on market-makers."

Bevan gave another perspective: "At BSP-Alcentra, we have a book of US$8bn. My team trades almost US$3bn a year. And given we have some AAA buy-and-hold accounts, it is more like half of total assets each year."

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The CAMRADATA panel then discussed how to access CLOs. Kollmorgen said segregated mandates typically started at US$125m. "For large institutions that is the right size. But for smaller insurance companies and pension funds, we have these conversations about how they add CLOs. It starts with ratings and comparisons of volatility. Versus High Yield, CLO BBBs demonstrate much higher volatility. That's because of inherent leverage within the structure."

Wan acknowledged that returns over time have been good. But she warned that you need eyes wide open when trading instruments that are naturally levered, noting that you may need to stomach the volatility during market stress, especially in lower tranches.

Ghosh said that Schroders has not seen many pension funds issue discrete CLO mandates. He suggested that, in part, this was a hangover from the Global Financial Crisis.

"I see a lot of managers with MAC (Multi-Asset Credit) and broad securitised mandates who don't flex the CLO book as much as clients would like," said Bevan.

Will agreed. "Compared to other parts of the credit market, CLOs are underrepresented in UK pension portfolios," he said. Regarding a discrete allocation to CLOs, he said most allocations are typically part of a broader securitised or multi asset credit mandate, but it is important that the manager has the relevant CLO expertise and capabilities.

Within its new workplace pension default arrangement, Scottish Widows may hire a dedicated CLO manager. Will said that as for other specialisms such as regulatory capital or risk-sharing, "we want someone who understands that space."

Bevan claimed asset owners and fund selectors are missing out by going with a generalist manager: "A broad structured credit manager won't know everything whereas I spend all my working hours living and breathing the CLO market," she said. "There is a lot more variation within CLOs of a given rating but from different managers, even at the higher ratings. It is necessary to appreciate these differences to fully understand fair value of one note versus another."

Kollmorgen concurred. She recommended a minimum eight-year relationship if you really wanted to know what's going on in the market. "It behoves asset allocators to go with dedicated CLO specialists," she said.

Regarding quick market access, Moten disclosed that Convex can and does access the market via ETFs to ramp up exposure. As an institutional investor, sweeteners such as no management fee have been offered by new entrants as this is a growing market. As the managers build up primary markets' exposure, the team can unwind an ETF position, as the Convex team would always prefer active security selection in this asset class, rather than more passive exposures.

> *"Wan acknowledged that returns over time have been good. But she warned that you need eyes wide open when trading instruments that are naturally levered, noting that you may need to stomach the volatility during market stress, especially in lower tranches"*

CLOs versus broader securitisation

Wan concurred with the managers on the attractiveness of CLOs' structural protection. Regarding diversification, however, she observed that the underlying exposure of CLOs is still to corporates. "Our underlying clients also want consumer and real estate sources for diversification," she said. She also noted that there is a governance point on how many line items clients are prepared to analyse.

Bevan questioned when ABS has ever been more interesting than CLOs. "The spreads on CLOs have always been wider by a large margin," she claimed. "CLOs are floating-rate credit, not fixed."

"You get credit card ABS; you get autos ABS; you get non-conforming ABS," said Kollmorgen. "It's commoditised. The portfolio is static. There is more art to CLOs. They are actively managed; and the manager can change!"

The art is apparent when it comes to price discovery in the CLO market. Bevan likened this to dealing with estate agents in the UK. "Dealers will give you indicative quotes," she said. "You don't know the exact price but you can estimate based on similar deals, like buying a house in the neighbourhood."

Kollmorgen further noted that other portfolios don't have the same capacity for adjustments. "There is a lot more opportunity from resetting calls; a lot more triggers within CLOs," she said.

Moten said that the challenge is where managers perceive the right risk and return and that different managers have different skillsets. "It's important to lean on those managers that have the team depth and experience in this sector."

Moten said that his team at Convex are very engaged with the external managers in order to take an active approach rather than just track a fixed 'benchmark' allocation. The team itself is looking at valuations. "We will move CLO allocations up and down," said Moten, "so more spread volatility can provide opportunities."

Market tightening

On the current state of markets, Kollmorgen said there were a lot of tight spreads and compression as well as technicalities within CLOs. While recent outperformance has caught investors' attention, she noted that there has not been enough Leveraged Loans – the lifeblood of CLOs - created to meet demand: "The market may be shrinking a bit."

PineBridge is doing short spread duration and moving higher up the stack, although Kollmorgen noted that you still want enough risk in the portfolio. "Our concern is where we are in the credit cycle." She saw a mix of positive and negative economic news flowing through.

Bevan said that at the top of the capital stack, BSP-Alcentra was medium-term bullish on spreads. Regarding supply, she said investors should never underestimate banks' desire to generate fees. For her, the question was how this supply was being absorbed. She warned that many older deals will be amortized and called, potentially generating demand, but some will be reset.

"We think that there is potential for spread widening across the cap stack due to higher CCCs and defaults combined with strong new issue and reset supply weighing on the market going into year end," said Bevan.

Regarding drawdown scenarios, Kollmorgen noted the need for robust portfolio construction, including the use of cash. This is most relevant for the burgeoning CLO ETF market, where PineBridge sub-advises the Van Eck CLO vehicle. She said that having dry powder to hand enabled a manager to manage any drawdown and readily find value buys, as prices fell.

"There is going to be a watershed moment," concluded Kollmorgen. "CLOs' performance will come down to all these things we have discussed."

> *Moten said that his team at Convex are very engaged with the external managers in order to take an active approach rather than just track a fixed 'benchmark' allocation. The team itself is looking at valuations. "We will move CLO allocations up and down," said Moten, "so more spread volatility can provide opportunities."*

Roundtable Participants

Cathy Bevan

Head of Structured Credit, Portfolio Manager

Personal Profile

Cathy Bevan is Head of Structured Credit and a Portfolio Manager for BSP-Alcentra's structured credit funds, overseeing investments in structured products, with a particular focus on CLOs. She has expertise investing across EU and US senior, mezzanine, equity CLO tranches as well as CLO warehouses.

Cathy joined BSP-Alcentra's structured credit team in July 2012. Before joining Alcentra she worked at Citigroup as a member of the structured credit team, responsible for originating and structuring CLO transactions. Prior to this she performed a similar role at CIBC World Markets as part of the CLO/CDO structuring desk.

Cathy graduated with a First Class Honours degree from the University of Warwick in Mathematics and Statistics.

Company Profile

Founded in 2002, Alcentra is an international expert in credit management, private credit, and structured credit strategies and one of the largest and longest-standing European credit and private debt managers. Across all its investment strategies the firm employs a disciplined, value-orientated approach to evaluating individual investments and constructing portfolios.

In 2022, Alcentra was acquired by Franklin Templeton and integrated with Benefit Street Partners ("BSP"). Together, the BSP-Alcentra platform is one of the largest alternative credit managers globally, with a multi-strategy approach targeting attractive opportunities in the global credit markets. The combined platform manages $76 billion in assets under management (AUM) and has expertise in Senior Secured Loans, Private Credit, Structured Credit, Special Situations, High Yield Bonds, Multi-Strategy Credit, and Commercial Real Estate. We have a highly experienced global team of 443, with 168 investment professionals, who work across asset classes, business sectors and geographies, bringing significant expertise and a deep understanding of corporate debt to the firm's strategies. BSP-Alcentra is a wholly owned subsidiary of Franklin Resources, Inc. (Franklin Templeton) which is one of the world's largest independent investment managers with $1.6 trillion in total assets under management *

*Franklin Templeton AUM as of April 30, 2024.

BENEFIT STREET PARTNERS Alcentra

Laila Kollmorgen, CFA

CLO Portfolio Manager, PineBridge Investments, Houston

Personal Profile

Ms. Kollmorgen is responsible for managing the investments in Collateralized Loan Obligation ("CLO") tranches issued by third-party managers. She joined the firm in 2015, having previously worked in originating, structuring, sourcing, investing, and trading US and European products for Bank of America Merrill Lynch in New York, HSH Nordbank in Hamburg, and BNP Paribas in London.

Ms. Kollmorgen holds an MBA from the Wharton School, a Master of Arts from the Lauder Institute at the University of Pennsylvania, and a Bachelor of Arts, cum laude, from Wellesley College. She is a CFA charterholder and holds series 7 and 63 licenses. She speaks German, Spanish, and Brazilian Portuguese.

Company Profile

PineBridge Investments is a private, global asset manager focused on active, high-conviction investing. We draw on the collective power of our experts in each discipline, market, and region of the world through an open culture of collaboration designed to identify the best ideas. Our mission is to exceed clients' expectations on every level, every day. As of 31 March 2024, the firm managed US$168.2 billion across global asset classes for sophisticated investors around the world.

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Roundtable Participants

Niall Moten

Senior Investment Professional

Personal Profile

Niall Moten is a Senior Investment Professional at Convex, an international speciality insurance and reinsurance business with operations in Bermuda, London, Europe and the US.

Niall is primarily focused on investment strategy, asset allocation and manager selection and has a background managing fixed income portfolios for insurance asset owners.

Niall has a Master's degree in Mechanical Engineering from the University of Bristol and is a CFA Charterholder.

Chetan Ghosh

Head of Pensions OCIO

Personal Profile

Chetan has been the Chief Investment Officer for Centrica's pension scheme arrangements within a Common Investment Fund for the last 15 years, now doing that role within Schroders Solutions through an OCIO arrangement. He is responsible for providing support to the Directors of the Investment Committee. His role covers investment strategy considerations, asset class and manager research, and the liaison with the investment advisers.

He has 29 years industry experience, primarily from the consultancy side, where he spent 5 years as a pensions actuary and 10 years on the investment side, a large part of which was at Aon. Immediately prior to joining Centrica, he developed the Fiduciary Management offering at an asset manager where he was able to gain valuable experience on improving investment decision making governance structures.

David Will

Senior Manager Fund Manager Assessment

Personal Profile

David is a Senior Manager in the Investment Office at Scottish Widows. His responsibilities include investment governance, fund manager oversight, search and selection as well as acting as the fixed income investment lead.

Prior to joining Lloyds Banking Group, he worked as an investment consultant where he had responsibility for advising clients on asset allocation, manager selection, liability hedging, strategy implementation and investment governance.

David has over 30 years' industry experience and extensive knowledge of fund manager research across a variety of asset classes. One of his previous roles was that of Head of Manager Research at JLT, now part of Mercer. In addition to his role at Scottish Widows, David is a regular speaker at industry events.

Emma Coleman

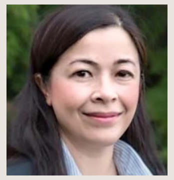
Investment Consultant

Personal Profile

Emma is an Investment Consultant based in the XPS Manchester team. She has five years' experience in the industry and is a CFA Charterholder.

As well as spending her time advising clients, Emma is Head of Credit Research at XPS and is an active member of the XPS ESG team and Investment Diversity & Inclusion Committee.

Roundtable Participants



Hanna Wan

Director, Investments

Personal Profile

Hanna is a member of the Credit Manager Research team at WTW. She leads the Securitised Credit research within the team, and also covers illiquid credit strategies.

Hanna was previously a credit analyst at a boutique investment manager. Prior to this, she was at Altria Group within the corporate audit division, and before that at Ernst & Young in their assurance and advisory services.

Hanna studied Cognitive Psychology at Cambridge University, and holds an MSc in Analysis, Design & Management Information Systems from the London School of Economics and a BEng in Electronics & Communication Engineering from the University of Bath.

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Moderator

Brendan Maton

Freelance Journalist

Personal Profile

A highly experienced financial journalist with an expansive network of contacts in the UK and across Europe. Brendan has written about pension schemes and national welfare systems from Finland to Greece for 18 years and understands the retirement savings industry in each European country.

Brendan has interviewed EU commissioners and national ministers; central bankers; pension scheme heads; insurance chief executives; chief investment officers; actuaries; union officials; professional and lay trustees.He worked at Financial Times Business for eight years, finally as editor-in-chief of all international pensions titles.

Brendan has spent the last ten years as a freelancer for a number of publications, including Finan-cial Times, Responsible Investor, Nordic region pensions news and IPE. He is also Chief webcast host for IPE.

Brendan has acted as conference chair for Financial News, the UK National Association of Pension Funds, Dutch Investment Professionals Association (VBA), sCorestone, Insight Investment, Marcus Evans, Robeco Asset Management, Sustainable Asset Management (SAM), Towers Watson.


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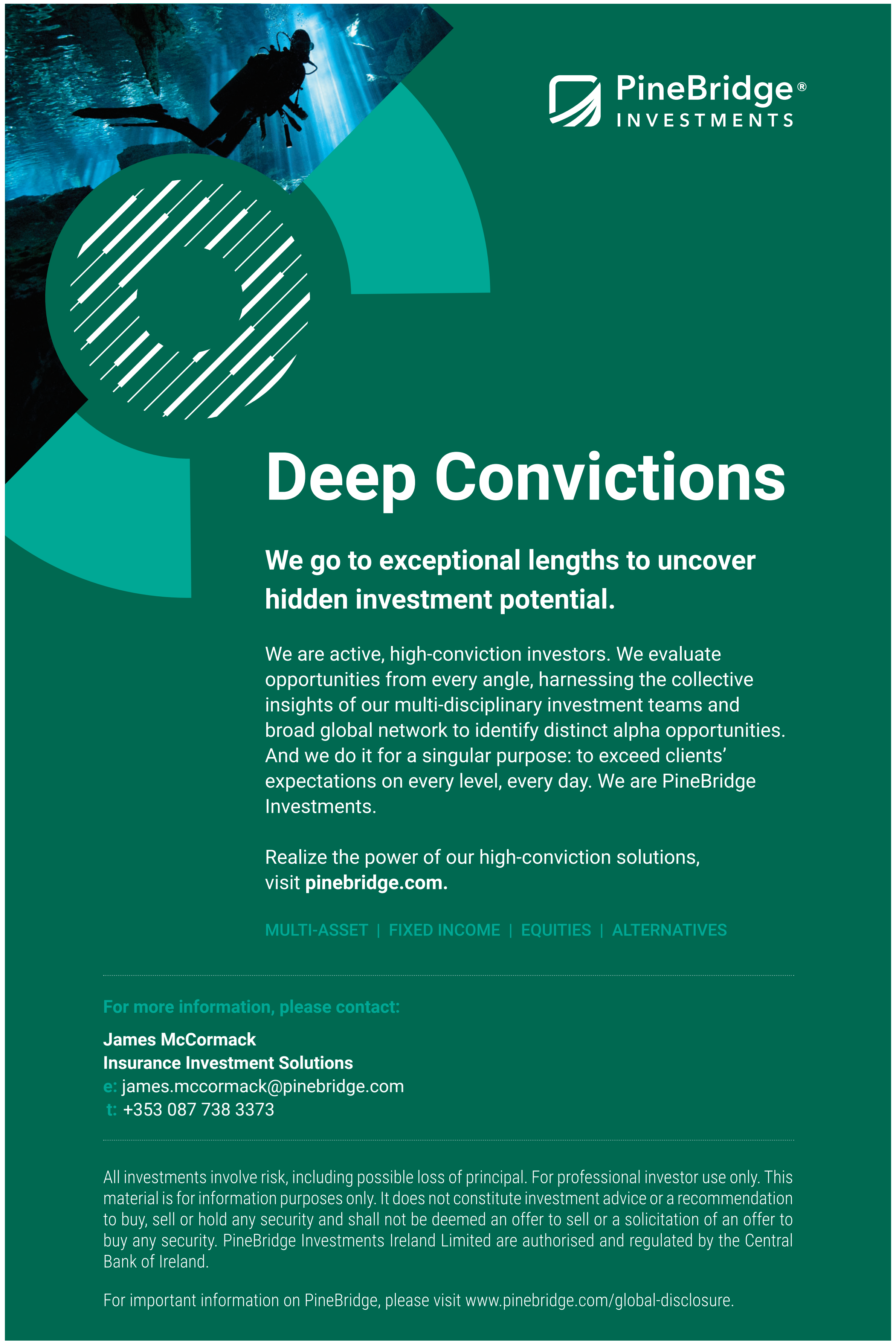
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