Structured Credit Market Outlook: Opportunity in Volatility

April 2023

INTRODUCTION

Recent market turmoil has created a compelling opportunity to invest in CLO tranches; with the asset class offering high cash yields, embedded default protection and no interest rate/duration risk in a rising rate environment.

Headwinds caused by inflation, rising rates, and geopolitical uncertainty have put pressure on risk assets globally, but have also created a historic opportunity to purchase CLO tranches at depressed prices. When compared to other areas of credit, CLOs offer particularly attractive relative value as a result of their structural protection and asset subordination, which largely insulate them from defaults.

In this paper, we explore the current CLO market opportunity and why investors should consider exposure to this asset class today to take advantage of meaningful potential upside.

KEY TAKEAWAYS

- Historic dislocation in CLO tranches offers a compelling double-digit total return opportunity
- Attractive risk-reward offered in mezzanine BB and B CLO tranches
  - Insulated from default risk by asset subordination and structural protections
  - High current income of 12-17%
  - No rate duration risk
  - Price upside/convexity given dislocated prices
- European CLO tranches are most compelling, with the added benefit of enhanced asset subordination
- CLO asset class is cycle-tested, insulated from rising rates and has proven resilient to higher sustained defaults rates due to unique embedded structural protections
- An active manager with a fundamental credit focus and ability to look across the capital stack and geographies to find attractive relative value is best equipped to navigate the current environment

AN ASSET CLASS WITH BUILT-IN RESILIENCE

While broader macro weakness over the past year has led to concerns about an extended default cycle, CLOs have embedded structural protections and 'self-curing' features to ensure capital preservation during periods of market volatility (see "What is CLO?" on page 3).

CLO tranches have demonstrated remarkable default resilience across market cycles compared to similarly rated corporate loans. As seen below, CLO BB and B tranches have significantly lower cumulative default rates when compared to leveraged loans over the past five years, a particularly impressive achievement.

US CLOs (1996-2021)[1]				Leveraged Loans (5-Year)
Original Rating	Total Tranches[2]	Defaulted Tranches	Cumulative Default Rate[3]	Cumulative Default Rate[5]
AAA	4,869	0	0.0%	
AA	3,281	1	0.0%	
A	3,010	5	0.2%	
BBB	2,787	9	0.3%	
BB	2,217	24	1.1%	9.5%
B	401	6	1.5%	
Total	16,565	45	0.3%	

European CLOs (2001-2021)[1]				Leveraged Loans (5-Year)
Original Rating	Total Tranches[4]	Defaulted Tranches	Cumulative Default Rate[3]	Cumulative Default Rate[5]
AAA	1,134	0	0.0%	
AA	921	0	0.0%	
A	702	0	0.0%	
BBB	715	4	0.6%	
BB	604	17	2.8%	5.6%
B	356	1	0.3%	
Total	4,432	22	0.5%	

[1]Standard and Poor's Ratings Services, Ratings Direct, 2021 Annual Global Leveraged Loan CLO Default Study and Rating Transitions as of Oct 2022. [2]Includes all US cash flow CLO tranches rated from 1996-2021. [3]Default rate = number of ratings that had ratings lowered to D/total number of ratings. [4]Includes all EU cash flow CLO tranches ever rated from 2001-2021. [5]S&P Global Market Intelligence, 5-year cumulative US and EU leveraged loan index default rates based on average monthly LTM default rates on principal amount as of Dec 2021. **Past performance is no guarantee of future results. No investment strategy or risk management technique can guarantee returns or eliminate risk in any market environment.**

Though recession fears have dampened since last year, we do anticipate more volatility in 2023 and for corporate defaults to rise to 2-3.5% annually from current historic lows. We believe CLO debt tranches can easily withstand increased defaults, and based on our internal stress tests, can even withstand a default spike of 10% annually for two years with no loss of principal or interest.

Another important characteristic of CLOs is they are insulated from rate risk due to their floating rate coupons, at the CLO and underlying collateral level, expressed as a spread over LIBOR, EURIBOR, and SOFR. In the current environment, CLO investors pick up an additional 4-5% yield from the rise in base rates alone. Combined with historically wide discount margins and price discounts, CLOs are generating some of the most attractive returns we've seen in over a decade.

CLOs: A HISTORIC DISLOCATION

There was significant downward pressure on US and European CLO prices in 2022 driven by market technicals (rising rates, geopolitical fears, recession fears, supply and demand imbalance). Despite the market rally year to date in 2023, CLO prices are still historically cheap offering attractive entry points for investment.

In the current market we find mezzanine tranches, in particular CLO BB and Bs, to be most attractive, conservatively offering current yields of 12-17% without even accounting for appreciation in price. CLO BB and Bs are 10-20 points cheaper than they were at the end of 2021 as depicted below, providing ample opportunity to source high-yielding, discounted paper. When convexity from price appreciation is factored in, total return potential exceeds 20% globally and 30% in Europe.

USD SUMMARY

	Secondary ***DM***			Secondary ***Price***		
	Apr-23	**Dec-21**	**Delta**	**Apr-23**	**Dec-21**	**Delta**
AAA	173	115	+59	97.99	99.83	-1.84
AA	248	182	+66	95.87	99.84	-3.97
A	314	226	+87	95.43	99.63	-4.20
BBB	475	353	+123	92.27	98.74	-6.47
BB	869	722	+147	90.54	97.36	-6.82

[1]JPMorgan secondary spread data as of April 20, 2023.

EUR SUMMARY

	Secondary ***DM***			Secondary ***Price***		
	Apr-23	**Dec-21**	**Delta**	**Apr-23**	**Dec-21**	**Delta**
AAA	208	110	+98	97.07	99.83	-2.76
AA	281	182	+99	95.09	99.75	-4.66
A	369	229	+140	93.48	99.40	-5.92
BBB	564	365	+200	90.31	99.60	-9.29
BB	929	637	+292	85.37	96.27	-10.90
B	1337	863	+474	80.88	96.29	-15.41

THE SWEET SPOT IN EUROPE

Though it is important to note that market dynamics are constantly changing, Europe is currently where we see the best relative value in CLOs. Having an active presence across both geographies is imperative when assessing which region offers better relative value at any given time. Despite historically strong credit fundamentals, European CLOs sold off more compared to the US in 2022 in tandem with leveraged loans. Leveraged loan prices, the main technical driver of CLOs, were driven down in Europe during 2022 by volatility from the Ukraine war and a continental energy crisis in addition to globally high inflation, rising rates, and recession fears. However, CLO debt tranches in Europe have more asset subordination – or excess collateral – and better credit quality historically than their US counterparts. While US CLOs have a more diversified issuer base, they tend to have a greater proportion of assets trading at stressed levels, higher CCC concentrations and greater exposure to historically volatile sectors such as commodities. These factors made European CLOs more attractive on a relative value basis during 2022, and although they have rallied more in 2023, they still trade at comparable or wider levels than US CLOs. European CLO mezzanine tranches are a particularly attractive pull-to-par play. Even in a higher corporate default environment, we believe 95% or more of these CLO tranches are money good.

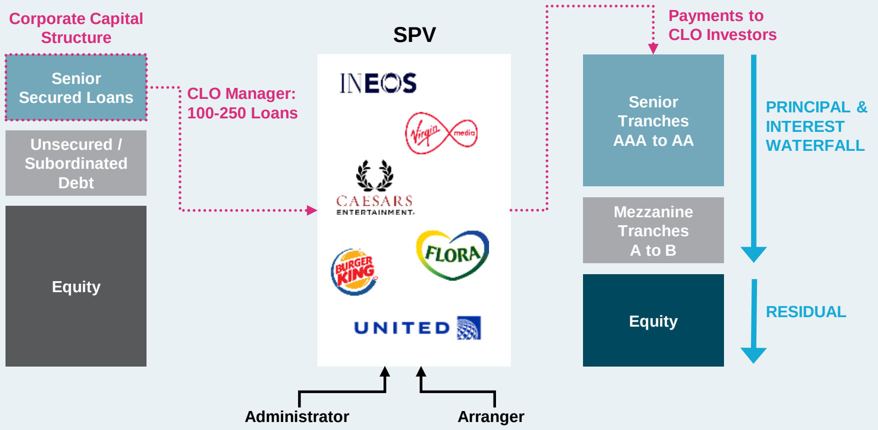
CONCLUSION

Against the current backdrop of elevated inflation, hawkish monetary policy, and the ongoing war in Ukraine, we believe global credit markets will continue to offer attractive entry points. CLOs should be a consideration for a global and diversified credit portfolio, offering high current cash yields, price convexity, and default protection in the form of structural protections and healthy fundamentals.

While European assets are particularly attractive today, winds can shift quickly. In a rapidly evolving market environment, investors are best suited to leverage a large global manager, with cross-border and cross-capital structure expertise. Even with higher rates of sustained defaults ahead in corporate credit, we see CLO investments as a valuable addition to a credit portfolio.

WHAT IS A CLO?

A CLO is a special purpose vehicle that holds highly diversified pools of senior secured corporate loans. Its liabilities are instruments issued to investors as tranches rated from AAA down to BB or B with an unrated "equity" tranche at the bottom. Tranche ranking determines priority of claim to interest and principal generated by the asset pool. CLOs are not synthetic credit derivatives, instead the CLO is a lender of record for the loans it owns.



A DIVERSIFIED STRUCTURE

- Underlying loans primarily rated BB+ to B-
- The median number of companies that US CLOs have exposure to is 285, in Europe this number is 157*
- No single obligor is typically greater than 3%
- Significant diversification across industries

*Intex February 9, 2023

BUILT-IN PROTECTIONS: THE PAYMENTS "WATERFALL"

Cashflows received from the underlying loans are distributed down the CLO capital structure quarterly, with the equity tranche receiving whatever is left at the bottom of the waterfall (typically 13-20%). The AAA tranche is paid first in the "payments waterfall", and because its size is typically 60-65% of the portfolio notional, it is significantly overcollateralized and benefits from substantial asset subordination. Each tranche above the equity benefits from overcollateralization (asset subordination).

		USD	EUR
Average Subordinated for 2.0 CLOs*	AAA	38.4%	39.3%
	AA	25.8%	28.5%
	A	19.5%	21.9%
	BBB	13.4%	15.6%
	BB	8.5%	10.1%
	B	-	7.3%

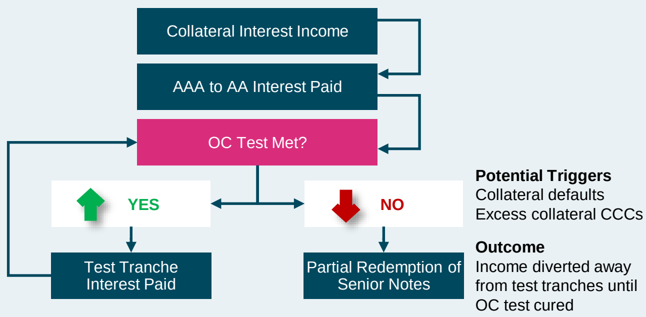
*Intex, par attachment points as of March 10, 2023.

BUILT-IN PROTECTIONS: OC TESTS

$$OC = \frac{\text{"adjusted asset balance"}}{\text{Par balance of liabilities at or above the level of the tranche being tested}}$$

CLOs have embedded structural protections in the form of overcollateralization ("OC"). OC tests measure excess asset coverage compared to the CLO liabilities at or above the tranche being tested in the waterfall.

If the OC test falls below a pre-set level (tests may fail due to deterioration in the underlying loan collateral pool), interest is diverted from more junior tranches in the waterfall to repay the most senior tranche until tests are cured. The OC tests effectively act as a safety valve that delever the CLO in times of stress.



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