WELLINGTON MANAGEMENT®

January 2020

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Alyssa is a fixed income portfolio manager on the Financial Reserves Management Team. She is responsible for managing multisector, securitized, and dedicated CLO portfolios for clients with customized risk and return objectives often related to accounting and/or regulatory constraints, such as insurance and bank clients.

Debunking four common myths about CLOs

KEY POINTS

- Collateralized loan obligations (CLOs) have typically not been portrayed in a favorable light by the financial press, leading to several common investor misconceptions about CLOs.
- We continue to have high conviction in CLOs, but given the later stages of the current credit cycle, we are being careful and selective with regard to where we invest.
- We see compelling value in the AAA, AA, and A tranches of CLO debt (but not the BB tranche), while equity tranches look attractive for higher-return-seeking investors.

CLOs ARE PERSISTENTLY IN THE FINANCIAL HEADLINES, and most of the over-the-top articles would have you believe they are the next crisis waiting to happen. While such fearmongering may make for a good news story, we do not believe it presents a fair or accurate assessment of the actual risks that CLO investments pose — or the benefits they may offer many investors. Here we aim to debunk four common CLO-related myths that have been perpetuated by the press.

Myth #1: All CLOs are levered investments.

Facts:

- CLOs do not contain leverage or any type of borrowing. Rather, a CLO issues debt to finance the purchase of a portfolio of broadly syndicated bank loans that is actively managed by a bank loan manager. If US$500 million of debt is raised, for example, US$500 million of bank loans is purchased (less fees).
- CLO equity is a levered investment (~11x) in the underlying broadly syndicated bank loan pool, as is the BB tranche (~8x levered). CLO mezzanine and equity investors buy the most junior tranches of the CLO, thereby structurally subordinating themselves and creating a levered investment in the underlying bank loan pool. There is no borrowing involved; there are no more dollars invested in bank loans than were raised by the issuance of debt to institutional investors.

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Myth #2: A high-yield default cycle would be catastrophic for CLO investors.

Facts:

- CLOs are built to withstand high-yield default cycles. In fact, after the global financial crisis (GFC), CLOs fared extremely well from a default perspective; no AAA, AA, or A rated CLO defaulted. Despite this positive performance, post-crisis CLOs were structured with even greater credit enhancement and cleaner collateral pools than their pre-crisis predecessors (**Figure 1**).
- The AAA tranche of a CLO is built to withstand 4 – 5 x prior high-yield default cycles and with lower recoveries relative to history. Even a BBB tranche is expected to weather a repeat of the 2001 – 2003 high-yield default cycle or the GFC, while still receiving its interest and principal payments in full.
- CLOs are not forced to sell any defaulted or downgraded broadly syndicated bank loans.

Figure 1

Post-crisis CLOs are structured more conservatively

Credit support, based on assets (%)

	CLO 1.0	CLO 2.0
AAA	25.0	36.0
AA	18.6	25.2
A	12.8	17.6
BBB	8.1	12.7
BB	5.6	8.4

Collateral summary

	CLO 1.0	CLO 2.0
Reinvest period (years)	5 – 7	3 – 5
Non-call period (years)	3 – 5	2
CLO bucket (%)	5 – 10	0
High-yield bucket (%)	10	0
EMD bucket (%)	10	0

For illustrative purposes only. PAST RESULTS ARE NOT INDICATIVE OF FUTURE RESULTS. | Sources: S&P, Moody's, Creditflux, Intex, Wells Fargo Securities | Chart data: 2008 – 2019

Myth #3: Now is a terrible time to invest in CLO equity.

Facts:

- On the contrary, a mild default cycle — with defaults in the 4% to 6% range — that results in some spread widening on the underlying loan pool could benefit CLO equity due to the improved arbitrage. (CLO debt costs are fixed, while spreads on the underlying bank loan assets widen.) We are modeling CLO equity internal rates of return in the 10% to 15% range at current valuations, which we view as attractive.
- For many investors, CLO equity may be worth considering as a late-cycle investment. It is not for the risk-averse, however, since prices can be highly volatile; for instance, CLO equity will likely experience price drawdowns during a credit downturn. But for investors with longer investment time horizons, CLO equity offers the potential for high, consistent income (**Figure 2**).

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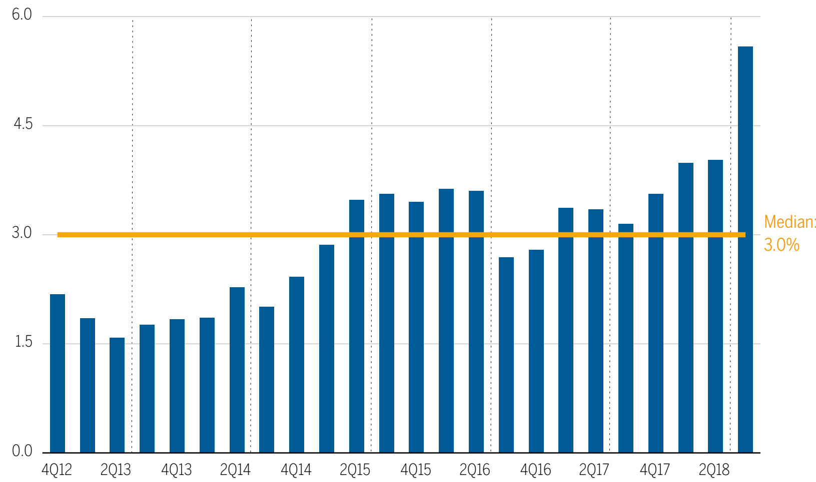
FIGURE 2

CLO equity offers high income potential

Most recent quarterly equity distributions (1Q19, %)



For illustrative purposes only. **PAST RESULTS ARE NOT INDICATIVE OF FUTURE RESULTS.** | Sources: Intex, Wells Fargo Securities | Chart data: 4Q12 – 3Q18

Myth #4: CLOs own the entire bank loan market.

Facts:

- CLOs have historically owned around 50% to 60% of the broadly syndicated bank loan market. This is still the case today.
- CLO managers have vastly different investment styles. Our manager-centric approach to investing in CLO debt and equity incorporates the styles each manager emphasizes in pursuit of low debt defaults, but attractive equity returns.

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Bottom line

We continue to have high conviction in CLOs, although we are being selective about where we invest given the later stage of the credit cycle:

- We have been finding compelling value in the AAA, AA, and A debt tranches for investment-grade fixed income investors, while equity tranches appear attractive for higher-return-seeking investors.
- Spreads at the top of the capital structure look attractive relative to spread opportunities in other investment-grade fixed income sectors.
- While total returns for CLO equity were negative in 2019, its forward-projected returns over longer holding periods (greater than three years) look very attractive — in the 12% to 15% range under our base-case scenario.
- In contrast, BB CLOs look the least compelling, in our view; spreads would need to widen from current levels before we would consider investing in this segment.

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