CLOs Distinguishing facts from fiction

Expert commentary by **Stan Sokolowski**, senior portfolio manager and deputy chief investment officer, CIFC

CLO: the acronym that will surely be the root of financial Armageddon, right? Wrong. Much has been written about collateralised loan obligations, and while it has possessed a certain amount of truth, most of it has been uninformed. Countless articles on the subject have contained inadequate perspective, flawed assumptions and employed selective facts, or have been written by people with limited life or financial markets experience. Many have included massive numbers designed to elicit a reaction.

Yet one shouldn't blame the pundits or 'experts'. It is human nature to seek the tributes and treasure associated with identifying catastrophe. It is also unfashionable these days to be anything other than bearish. Readers beware: emotion and misinformation are ubiquitous, while facts and analysis are scarce.

CIFC manages and invests in CLOs and felt it only equitable to provide our firm's perspective on the product based not only upon our years of experience across cycles, but more importantly, on the facts.

Like a bank, a CLO is an actively managed entity that issues debt and equity securities and deploys that capital into a pool of senior secured loans. From a commercial standpoint, a CLO, like a bank, borrows money, lends it, generates income and incurs credit costs. It then takes the 'net' income, pays its creditors and employees, and distributes the remainder to equity investors. A CLO can be viewed as a bank that does not accept deposits and has a defined start and end date. Not so scary after all.

However, there is an important distinction between banks and CLOs: a bank lends long and borrows short, whereas a CLO lends long and borrows long. The CLO business model, unlike that of a bank, is not exposed to liquidity or refinancing risk. A CLO is match funded with the maturity of its capital structure. Less scary still.

Raison d'être

A core reason CLOs exist is because regulators do not want banks using depositor capital to make loans deemed to be risky. Yet capital and lending, being the lifeblood of any economy, need to flow to create jobs and economic growth. Regulators realise this, so banks remain large originators of loans but are the minority of the end investor base today by design. Enter CLOs.

Let's be clear: CLOs, which invest in loans to companies through rigorous underwriting methods, are not the cousins of collateralised debt obligations, which were primarily invested in subprime mortgages. Just like a bank, a CLO is designed to complete a thorough credit underwriting process with every investment made. Each borrower is identifiable and analysed with financial transparency. CLO portfolios are independently constructed, actively risk managed and subject to forced diversification. A CDO, on the other hand, generally amalgamates debt, for which little is known about the individual entity.

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As it happens, banks have evolved to become large investors in the highest-rated CLO securities. This makes sense given their 'lend long, borrow short' model, their need for rate-insensitive income and their familiarity with lending operations. Additionally, those AAA-rated CLO securities are structured to insulate investors from severe defaults. Of the 6,000-plus AAA and AA CLO tranches tracked by Moody's since 1993, not one has ever defaulted.

There are many other facts to discuss, including the multi-decade evolution of the loan market, CLO indentures, the role of rating agencies and regulators, and the motivations of CLO investors, but we'll save those for another day.

We'll leave you to consider this: although the familiar structure of CLOs offers significant inherent protection to investors, not all CLO managers are the same. As with any asset class, managers are of varying quality, and times of crisis differentiate the winners from the losers. Ultimately, the superior credit pickers will leverage the tested structure of CLOs to generate the best risk/reward outcomes. It's up to investors to filter through the noise and select the right manager with which to invest their capital. ■