(HEADLINE) Exploiting inefficiencies
(STANDFIRST) Jay Huang, md and head of structured credit investments at CIFC, answers SCI's questions

Q: How has investor perception changed around CLOs, given the resiliency of the asset class in 2021?
A: Three years ago, when I was visiting investors, I would have to bring up the resiliency of the CLO product. However, I have noticed a trend that when I come into investor meetings now, they are bringing up the resilience of the product more than I am.

A lot of this has to do with the number of distressed cycles that we have been through. Remember, CLOs have only existed for around 25 years. Yet since then, there have been many distressed cycles.

In each one of these periods, the CLO structure has held up its end of the bargain and performed well. The more cycles we endure where the benefits of the CLO structure materialise, the more people will believe in them. It has become a more accepted product than it was just a few years ago, given the attractiveness of the yields and performance of the asset class as a whole.

Q: How do CLOs compare to other structured credit products?
A: Relative to other securitised products, the nature of the CLO product allows the investor to maximise the value of the term matched, non-mark-to-market, non-recourse financing embedded within the structure. CLOs are the only mainstream product in the securitised markets where the underlying loans are actively managed, whereas most other structured products tend to be more static in nature.

With CLOs, there is a reinvestment period where you can reinvest proceeds as loans in the portfolio prepay or mature. This is especially valuable when the market becomes dislocated and assets can be purchased at favourable prices. Specifically, with respect to the equity tranche, a manager may be able to capitalise on dislocations in the market to the benefit of the product – making it more secure and stable.

Q: Where in the CLO capital stack are you finding the most opportunity?
A: Looking at the capital stack, we have recently been most focused on CLO equity. Bigger picture, however, what we find most interesting are opportunities to exploit the inefficiencies that exist in the CLO market.

To be clear, what I mean by that is not that the returns are going to be higher than people think, but rather differences as it relates to market data and models. Take, for example, the upcoming Libor to SOFR transition. What we have observed is that there is generally inconsistency about how the transition will impact CLOs – specifically with respect to loan documentation – which creates market inefficiency and a trading opportunity [SCI 21 September].

Another example relates to market underwriting assumptions. We have found that that commonly used models in the market tend to contain outdated or imperfect data. Sometimes the coupons on underlying loans are even incorrect in the models that the market uses.

At CIFC, we leverage our proprietary data and analytics capabilities to construct in-house models that we find to be more up-to-date and accurate. We also leverage these capabilities to run stress tests on the credits we are buying. Through these tests, we have identified several instances where the market underwriting assumptions tend to be more severe than people have realised, which gives us conviction in our investments even during periods of market stress.

Q: How has record CLO issuance impacted your investments in the asset class and the overall landscape?

A: Record supply of CLOs has been driven by record demand, as more and more new investors enter the asset class. This supply, coupled with record trading volume, has benefitted our investment process, as it has broadened our selection of product and enhanced our ability to more easily find bonds that cater to our risk profile. Record supply has also kept spreads relatively wide to corporate bonds, which may prove to be important to attract the marginal investors who are currently sitting on the sidelines.

Q: What is your outlook for 2022 and do you expect the pace of new CLO issuance to continue?

A: We are very bullish on the continued growth of the CLO market. 2021 set a new CLO issuance record and while we don't expect 2022 to break that record, we don't think it will be very far away. We also expect activity in the secondary market to continue to be as actively traded as that of the record-breaking volumes in 2020-2021.

We are looking out for Q2/Q3 next year – we are expecting supply to potentially drop-off in a significant way because we expect many fewer CLO refinancing and reset transactions to take place. The record-breaking volumes of reset and refinancing transactions in 2021 was amongst the biggest technical contributors of 2021 that kept spreads wide to other spread products and we think that technical will be more muted next year.

Q: Do you expect the opportunity to invest in CLO equity will continue? What about mezzanine debt?

A: Eventually the mezzanine debt opportunity will normalise and spreads will tighten, but we do believe CLO equity will present an attractive investment opportunity for an extended period of time.

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This article was published in Structured Credit Investor