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The importance of CLO manager selection: a lesson from my youth

CLO managers who maintain consistent equity payments outperform more aggressive managers in the long term, according to CIFC managing director Jason Ziegler

Jason Ziegler September 30, 2020, 10:34 am

Since the severe dislocation earlier this year, the CLO market has experienced significant spread tightening, resulting in the reopening of the CLO primary market.

Although we are not out of the woods yet, it appears the CLO asset class can add "pandemic proof" to its resume. Given the unprecedented shutdown of the US economy, loan downgrades and watch actions taken by rating agencies were not surprising. However, with no liquidations of cashflow CLOs during the Covid-19 pandemic, the CLO structure has performed as designed, and once again has successfully proven it can withstand a period of higher CCC loan downgrades and defaults.

Nevertheless, there has been a dramatic variation in performance amongst CLO managers. Such performance dispersion has forced investors to re-evaluate the amount of risk they are willing to accept from managers that have typically run higher octane loan portfolios, ultimately resulting in a notable re-tiering of certain CLO managers. This notion of evaluating risk reminds me of a lesson from my youth that I believe is applicable to the CLO market today, specifically, the importance of CLO manager selection.

When I turned 16, I had saved enough money to purchase a car to replace the 1979 Buick Regal my mother so graciously gifted me one year prior. Since my knowledge of cars was limited to judging how nice they looked on the outside and how good the music sounded on the inside, I enlisted my grandfather, a car enthusiast, to offer up some advice. Almost immediately I fell for a blue sports car with a twin-turbo engine, which I knew would be noticed by my friends: my ROI calculation at 16. My grandfather warned, however, that a turbo engine would be more trouble than it was worth and expensive repairs would follow. He also reminded me that a car loses its appeal when it is overheated on the side of the road. Given my balance sheet constraints at the time, I took my grandfather's advice and purchased a different style car with a motor that would be easier to maintain. Ultimately, I upgraded to a much better vehicle, but not one which I would one day regret purchasing if conditions became more challenging.

The lesson I learned as a 16-year-old first-time car buyer should resonate with CLO investors faced with the challenging decision of how to invest their capital. The main question being: How can an investor measure the risks being taken amongst different CLO managers?

In the years following the 2008 financial crisis, certain CLO managers have maintained higher weighted average spread portfolios, which have generated above-average CLO equity returns, albeit, with a higher level of risk – think blue sports car with a twin-turbo engine. Investors in these CLOs likely celebrated their outperformance initially when default rates remained benign. However, as the 2020 market dislocation set in, suddenly these riskier portfolios began to see significantly higher CCC downgrades and defaults. In certain cases, these CLOs failed their senior overcollateralisation (OC) tests, resulting in a shut off of distributions to the subordinate debt and equity – think turbo engine overheating and needing repair.

To put some more context around this performance, out of 900 CLOs with July 2020 payment dates, 25% of those CLOs were failing at least one Interest Diversion/Jr OC test, according to Bank of America.[1] Furthermore, following the July payment dates, a total of 16% of CLOs were still failing an OC test, keeping these CLOs from paying distributions to equity holders.[2] While active management of reinvesting CLOs allows managers to improve their OC tests by purchasing assets at discounted prices, it takes substantially longer for equity investors to once again receive distributions from CLOs that are failing OC tests higher up in the capital structure. Worse still, CLOs failing multiple OC tests must make CLO debt investors whole for any unpaid interest payments as well as pay accrued subordinate CLO management fees before equity distributions may resume.

As for CLO investors who took a more long-term, cautious approach to CLO manager selection pre-pandemic, those investors are today reaping the benefits with continued, uninterrupted distributions. This performance further underscores that during more challenging times a lower octane, less risky approach is more sustainable.

In closing, while the CLO structure by design offers protection to CLO investors, it is important that investors remember that not all CLO managers are the same, with some taking significantly more portfolio risk than others. Therefore, prior to making an investment in a CLO, it is critical for CLO investors to look beyond the CLO structure. Investors should conduct due diligence to properly distinguish the risks between different managers' CLO portfolios and determine which portfolios can withstand, and even thrive amidst, periods of heightened stress.

As my grandfather advised all those years ago, choose wisely, and you will be rewarded.

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[1] Source: Bank of America Research, "CLO Weekly" as of 08/07/20.

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