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The current vintage of CLOs could be the best ever if the volatility in Q4, when retail funds dumped loans, repeats itself

We have advocated in the past that CLOs in their reinvestment periods are well positioned to weather nearly any loan default rate, as long as there is a commensurate amount of price volatility in loans. The best empirical evidence of this is the strong performance of the 2006 and 2007 CLO vintages. These vintages delivered median realised IRRs that were hundreds of basis points in excess of their commonly marketed base cases.

In our view, the outperformance was not primarily a function of avoiding loan defaults. Rather, we believe it was principally due to the ability to reinvest principal paydowns and recoveries into discounted loans. This was augmented by skilled CLO collateral managers making relative value trades within their portfolios. Looking forward, when the inevitable next credit cycle begins, we believe that formula will again serve CLO debt and equity investors well over the long-run.

Perhaps a better scenario would be a period in which loan prices demonstrate volatility but few loans actually default. This is exactly what happened during Q4 2018, which was close to nirvana for CLO investors. During the quarter, daily liquidity loan mutual funds and ETFs experienced over $20 billion of redemptions. This was a reversal from the $3.4 billion of inflows they had seen in the prior quarter. The average price of the Credit Suisse Leveraged Loan Index (CSLLI) dropped 4.43 points during the quarter, in large part due to this technical factor. At the same time, only six out of the over 1,300 loans in the index were new defaults.

> Q4 2018, which had loan price volatility without defaults, was close to nirvana for CLO investors

Mutuals sometimes sell their best loans

When loan mutual funds need to sell (in a hurry, to meet redemptions), the focus is often on selling the largest, highest quality and most liquid names first. As a result, the vast majority of the drop of the CSLLI was attributable to decreases in the prices of high-quality loans, not due to a meaningful increase in the number of loans trading at distressed prices.

As the loan index fell, many CLO investors lamented the resulting drop in equity NAVs and lower market value OCs on CLO double Bs, and the consequent drop in the market price of those securities. Fewer focused on the principal cause of the decline, which was a technical, liquidity-driven drop in the price of the highest quality loans rather than a fundamental issue in the market as a whole.

In our view, while market scenarios like this typically do bring lower CLO security prices in the short term (as the risk-off sentiment takes hold in the market), far more importantly, they plant the seeds for medium and longer term value creation in CLOs. Markets like we experienced in the fourth quarter are ideal for skilled CLO collateral managers to either build par, increase spread and/or trim risks around the edges on a par-neutral basis. If a CLO didn't show an increase in trading and portfolio turnover in the fourth quarter, one might ask that CLO's collateral manager why they didn't see opportunity to take advantage of the volatility to pursue these objectives.

Sadly, the magnitude of the opportunity decreased in early January when market participants appeared to more fully appreciate that the loan market was oversold. This pushed the price of the loan index up by a couple points, reducing (but not necessarily eliminating) the opportunity. Another increase in mutual fund and ETF outflows, however, could bring it back.

Looking more long term, to recreate the success of the 2006 and 2007 vintages, we believe loan price volatility is an essential ingredient. To frame what occurred in the fourth quarter, the $20 billion of retail loan fund outflows represents only approximately 1.8% of the aggregate loan market. This small outflow caused drop of over four-points in loan prices – with only six companies defaulting.

Imagine what will happen when some borrowers whose loans were "priced to perfection" miss their numbers or when, eventually, there is an increase in default rates? How much will loan prices drop then? If we see even greater volatility in that situation, this could make the current vintages of CLOs, if properly managed by their collateral managers, perhaps among the highest performing in the market's history.

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