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Double B-rated CLOs price at a premium over corporate credit and yet default rates are much lower

Until recently, double B-rated CLO debt securities were principally the domain of hedge fund-type investors seeking to express a view on credit with a shorter-term investment horizon. Today, we believe significant demand comes from longer-term, yield-oriented and sophisticated institutional investors, such as asset managers, insurance companies and pension funds.

These long-term investors have been attracted to double B CLOs for three reasons: (1) a low historical default rate (over the past 20-plus years, double B-rated CLO debt has experienced a default rate of less than 10 basis points per annum based on rating agency data, compared to approximately 300bp or more per annum for high yield bonds and leveraged loans); (2) in today's markets, the asset class offers a cash yield and return profile hundreds of basis points in excess of high yield bonds and leveraged loans; and (3) the floating rate nature of the asset class provides protection against rising interest rates. Taking these three factors into account, double B CLO debt is an asset class that has simply become hard for sophisticated long-term yield-oriented investors and their investment consultants to ignore.

The Credit Suisse Leveraged Loan Index has had positive returns in 25 of the past 27 years. The consistent performance of the CLO market's underlying assets helps provide a strong foundation for CLO double B performance.

In addition, multiple structural protections within CLOs (self-correcting mechanisms) are designed to protect creditors. Also, structural features and covenants provide key credit enhancement to double B-rated CLO buyers, including:

Overcollateralisation: at a CLO's inception, the par or principal value of the loan collateral exceeds the principal amount of the CLO debt outstanding (ie, the CLO debt is 'overcollateralised' by the loan collateral). This provides a cushion against potential future credit losses.

Excess spread: since the weighted average spread on a CLO's loan collateral typically exceeds the weighted average spread on the CLO debt, this excess spread (which is the source of the excess interest-related cash flow for CLO equity investors) serves as a source of credit enhancement for CLO debt investors. Specifically, if a CLO breaches an interest diversion test, an overcollateralisation test or an interest coverage test, all or a portion of equity cash flow is diverted away to the benefit of CLO debt tranches, and is either used to acquire additional loan collateral or to prepay CLO debt in order of seniority, both of which are credit positive for CLO debt.

Non-static, revolving structure: The structure of CLOs enables a skilled CLO collateral manager to capitalise on periods of market stress and loan price volatility without concern for any triggers based on market value by reinvesting principal proceeds from loan repayments and sales into other loans, typically with lower prices and wider spreads. Even in times of market distress, the loan prepayment rate is usually higher than many understand. These par dollars come back into a CLO during periods of distress, allowing the most capable CLO collateral managers to mitigate credit losses, build par cushions and improve loan portfolios for the benefit of all CLO investors.

CLOs have a built in safety margin

In our view, these self-correcting features of the CLO offer a margin of safety for double B investors and have contributed substantially to this lower historical default rate.

Double B-rated CLO tranches have, over the past few years, offered a return profile that is approximately 250-350bp in excess of that for similarly rated high yield bonds and leveraged loans (based on the indices for those asset classes). We are aware that a free lunch is very hard to find and believe this excess spread includes (appropriately) compensation for lower liquidity and the potential for greater price volatility. However, few would consider high yield bonds to be assets immune from volatility.

In fact, we believe that 250-350bp is excessive compensation for these incremental risks and that long-term investors are well suited to capture this premium. Sophisticated institutional investors may be doing themselves a disservice by not evaluating how CLO double Bs could fit within their strategic asset allocation.

> The extra 250-350bp is excessive compensation for the incremental risks run by long-term CLO investors

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