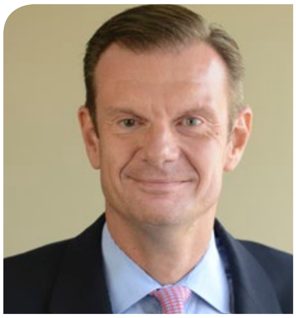

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The IRR differential can be as much as 3.3% for a fully invested CLO versus one that maintains a 5% cash balance

Can you ever have too much cash? If you are a CLO collateral manager, the answer is unambiguously, yes.

While many in the market promote their purportedly low default rates or above average par build, few CLO collateral managers focus their marketing efforts on cash balances. Uninvested principal cash can be a meaningful drag on a CLO's performance — and, in some cases, above average cash balances can be more harmful to the performance of specific CLOs than defaults.

Excess cash balances can arise both initially and throughout the life of a CLO. During the early stages, beyond constructing an actual portfolio that meets or exceeds the marketed target portfolio, the speed at which the CLO collateral manager completes the ramp is also of great importance.

In particular, the difference in the internal rate of return between being (1) fully ramped at close, (2) 75% ramped at close and fully ramped in two months, and (3) 60% ramped at close and fully ramped in four months, is far greater than many CLO collateral managers or investors appreciate.

Effective ramp can boost IRR by 1.5%

Holding all else constant, being 75% ramped at close and fully ramped in two months, versus just 60% ramped at close and fully ramped in four months, boosts the equity IRR by about 1%. Being fully ramped at close could result in a 1.5% increase in IRR versus the alternative.

Later on, even with a successful and timely ramp, maintaining a fully invested portfolio with a zero or even slightly negative cash balance is also a bigger driver of returns than many market participants realise. Modelled returns shown by CLO arrangers to prospective CLO investors typically assume that the proposed CLO is fully invested at all times once the ramp is completed. Investors should consider these models carefully.

CLO investors benefit from diligently monitoring the cash balances in the CLOs in which they are invested. To show the impact of ongoing cash, consider the difference in returns between (1) a CLO that is fully invested during the reinvestment period, (2) the same CLO with a 2.5% cash balance during the reinvestment period and (3) that same CLO with a 5% cash balance during the reinvestment period.

We've observed that, as compared to the fully invested CLO, the same CLO with a 2.5% principal cash balance has an equity IRR that is reduced by about 1.7%. The same CLO running a 5% principal cash balance faces an even greater IRR reduction, of 3.3%. These differences are material — and typically have an IRR impact greater than avoiding 1% or 2% defaults annually during the life of the transaction.

Delaying investment often wrong call

The reality is that some CLO collateral managers are much more diligent in remaining fully invested than others. For CLO investors, it was particularly frustrating when CLO collateral managers allowed meaningful amounts of cash to build in their CLOs during December 2014, December 2015 and December 2018, when loans were available at attractively discounted prices.

In our view, the only valid reason not to be buying loans during those periods was if you had a view that loans would fall further after the turn of the year. Two out of those three times, waiting for a deeper dip to buy was the wrong call, and in the third case (December 2015), the consequence of timing the dip a little early did not end up being materially harmful.

> "Being fully invested can have a greater impact on IRRs than avoiding 2% defaults annually

As long-term market participants, we recognise there is no one right way to manage a CLO. Any number of paths can lead to superior returns. Mindful that market timing is something very few investors can get right on a consistent basis (no collateral manager has a crystal ball), simply minimising cash drag initially and on an ongoing basis is one of the easiest ways for proactive CLO collateral managers to better position themselves to outperform the market.

How much cash is in your CLO?