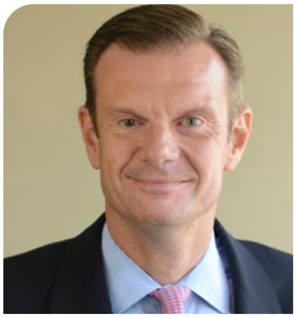
Don’t be tempted by low debt costs — the key driver of performance in static CLOs is market timing



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The development of a term curve in CLO debt does not necessarily make short tenor deals a good bet

In fixed income markets, short dated bonds trade at tighter spreads than long tenor bonds of comparable credit risk. Yet, despite the sophistication of CLO market participants, the concept of a term curve has eluded the CLO industry for much of its existence.

One possible explanation is the uncertain timing of principal repayments to CLO debt securities, even though most would agree that, despite the optionality — and holding all else constant — more seasoned deals will show a higher call propensity than those more recently originated.

Historically, what little tenor curve we have seen was largely concentrated in triple-A CLO debt tranches, and sometimes in the double B class during strong markets.

Full capital structure term curves

Today, we are seeing a more developed tenor curve appear at most points in the CLO debt capital structure. Indeed, at time of writing, a generic triple A tranche with one year left in its reinvestment period might trade to a 100 basis points DM (discount margin). This compares to 126bp for a newly originated triple A tranche issued by a CLO with a five-year reinvestment period and a comparable CLO collateral manager.

Further down the stack, we see similar trends. For triple-B tranches, quality paper with one year left in the CLO’s reinvestment period might trade at 265bp DM. This compares to 315bp DM for newly originated five-year paper of comparable quality.

This is a welcome development for CLO debt and equity investors. For the former, it can allow holdings to appreciate as they naturally move down the term curve. For the latter, it can make refinancing transactions feasible where they might not have been. This is a sign of the CLO market’s growing maturity.

Taken to its extreme, however, the developing CLO term curve can lure equity investors into positions that have more risk than they may realise, particularly in static CLOs.

Occasionally we see periods where a handful of static CLOs are issued. These periods are typically episodic and, in many cases, the transactions are issued by CLO collateral managers where the debt costs for a traditional five-year reinvestment period CLO would be prohibitively high.

When evaluating potential new CLOs, low debt costs (thanks to the term curve) can be enticing. However, imagine you invested in a static pool CLO in 2007. Whereas the median CLO from that vintage (with a standard reinvestment period) delivered an equity return in the high teens, it’s hard to envision a static CLO from the same period ever making more than a handful of payments to the equity before permanently shutting off cash flows (due to its inability to reinvest in what quickly became a deeply discounted loan market). While we are in no way calling 2020 the next 2007, we do believe that keeping a reinvestment option has significant value regardless of market timing. Frankly, if 2007 CLOs were all static, it wouldn’t be a stretch to conclude that there wouldn’t be a CLO market today.

Static deal returns are tough to predict

Looking at the performance of some of the static CLOs from the 2.0 era, we see a wide dispersion. Some ultimately did quite well, while others seem likely to fail to deliver even a full return of capital to the equity. According to our research, one static CLO, issued during the second quarter of 2016, delivered a handsome 22.3% internal rate of return to the equity class. Another static transaction, issued in the second quarter of 2014, paid total distributions to the equity of less than the face amount. There may be other transactions with more extreme outcomes, as well as others between these bookends.

The key driver of performance in static CLOs is simply market timing. Many of the most successful bought loans when they were cheap and capitalised on a rally in loan prices. Many of the static CLOs that ramped during periods of higher loan prices delivered some of the lowest returns.

While market timing is simple to understand, there are few (if any) investment professionals who can repeatedly call tops and bottoms. In exchange for a few extra basis points of debt costs, CLOs with longer reinvestment periods and customary equity optionality minimise the luck factor in their investment thesis.