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Last year's CLOs could become the benchmark for manager performance

For the past decade, essentially all newcomers to the CLO market started their assessment of the market with an incorrect preconceived notion — didn't all CLOs blow up during the financial crisis?

For those whose study of the market made it beyond the 'C-blank-O' moniker, they found data that I suspect surprised them. Of the more than 500 cash-flow CLOs issued between 2002 and 2011, over 90% had a positive return to the equity class. The instance of default on CLO double Bs was a small fraction of comparably rated high yield corporates and, notably, the best vintage for CLO equity was in 2007 deals, which were issued on the eve of the financial crisis.

Indeed, according to our research, the median CLO from 2007 delivered an ultimate equity IRR in the high teens, well in excess of the low-to-mid-teens yield commonly shown as the base case in marketing books back in the day.

Despite the tumult of 2008 and 2009, which was mired by low loan prices, numerous corporate defaults and a copious amount of tripe C-rated assets, nearly half of all CLOs did not miss a payment to the equity. Of those that did miss a payment, many missed just one. Put simply, for most CLOs, despite the ups and downs in the world, the cash kept flowing.

Since those turbulent times over a decade ago, we've had a few hiccups during the recently ended decade-long expansion. I suspect few even recall the sell-off in late 2014, which many at the time called the beginning of the end. More recent sell-offs include the energy-driven draw down in 2015 and 2016, and then another in late 2018, driven by a surge in retail outflows.

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A sharp turnaround in outlook

What has transpired in the markets globally over the past few weeks reflects perhaps the sharpest change in economic trajectory in my career — and I suspect in yours. Whereas in February we were looking at equity markets at record highs and lamenting a new loan repricing surge, today we are looking at many major cities in America (and the world) under some form of lockdown. International travel has been largely halted.

Equities are down nearly a third from their highs and, as of this writing, the loan market is down over 17% this year.

For everyone's sake, we hope the virus outbreak is contained as quickly as possible, and life as we recently knew it can resume. Regrettably, no one knows exactly when that will be and, until then, investment professionals need to prepare for continued volatility.

A notable attribute of the sell-off that we are experiencing today is that it is market-wide. It is largely agnostic to loan rating and no industry has been spared. This is rather different to the energy rout in 2015, when most other sectors traded near par. In 2018, it was a double B-driven sell-off, exacerbated by retail outflows occurring at year end. During those sell-offs, many CLO collateral managers said they couldn't fully offset energy losses (because quality names weren't down) or they couldn't capitalise on the draw down in the market due to limited trading volume (because it was the holiday season).

Huge change in mindset

Now is the time for loan managers to outperform. Whereas a month ago we expect no one underwrote credits under a 'complete economic shutdown for X months' scenario, every loan in a CLO portfolio now needs to be revisited with that mindset. Knowing what we now know, some companies will be losers, while others survive and some may even thrive. Bid/ask spreads in the loan market are wide today, but secondary loan volume has increased materially. There is an active and robust secondary loan market, so managers can express views.

Earlier this week, I could have written that 90 is the new par. Today, 90 feels like a premium. The opportunities to build par and spread within a CLO haven't been this plentiful since 2009. Many CLO collateral managers deservedly take pride in their track record from 2008 and 2009. Going forward, the success of collateral managers' 2019 vintage CLOs may become the new benchmark.

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