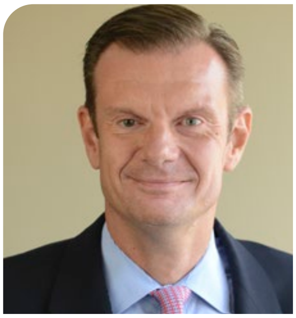

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CLOs can trade cheaply and directly, which helps keep volumes steady even in a crisis

Amid all the volatility since March, through the first seven months of 2020, secondary CLO trading volumes on Trace surpassed all of 2019's volumes. Indeed, through July, total reported secondary CLO trading volume exceeded $110 billion. This is just under 20% of the $600 billion total US CLO market (and if we factor in the $100 billion of CLO securities held by investors that rarely sell, then perhaps we can say that more than 20% of the actual tradeable CLO universe changed hands in seven months). So much for CLOs being an illiquid asset class!

Is trading CLOs as hard as some pretend?

Frequently we hear of CLO market participants lamenting the bid-ask spread in the market (this is heard in most markets in times like these). Embedded in that statement is an implication that widening makes trading nearly impossible.

Something that is different about the CLO market, compared to many other markets, is that much of the secondary trading activity is effectively done on a customer-to-customer basis. While there are dealers involved with nearly all trades, they often act as a riskless principal once the buyer and seller have agreed, not putting their own capital on the line buying a security in the hope of finding a buyer later.

In other markets, dealers send out runs — often multiple times in a day — covering dozens of securities indicating where they themselves are likely to buy or sell. 'Likely' is an important word in the previous sentence: when you call to trade off a run sheet, the level may have miraculously become 'stale'. Worse, in times of volatility, the spread between the proposed buy and sell prices widens, sometimes significantly.

In the CLO market, dealer runs are typically sparsely populated with just a few securities listed. In choppier times like recent months, they're often more accurately called offer sheets, with bid prices not indicated at all. This isn't to say dealers don't have inventory, but most secondary CLO trading volume takes place away from these offer sheets.

Of this year's robust secondary activity, roughly 25% was via an auction process called a b-wic, or bids wanted in competition. In addition to b-wics, a significant amount of CLO paper traded out of competition, whereby a holder of a security shows it to one dealer, or a small number, and asks them to quietly market the securities to potential buyers.

What's great about these processes is that the transaction costs, measured in dollars paid as transactional fees, are often quite nominal when compared to high yield and loan markets. When an investor buys through either process, they often pay on top, so they pay a small fee, effectively a commission, to the dealer for arranging the trade. These fees typically range from a few basis points to up to a quarter of a point, depending on the type of security involved. Put more simply, the functional bid-ask spread in the CLO market, for trades actually consummated, is really quite low.

Regionals have helped boost volumes

This brokering process (versus a dealing process) also allows for firms without deep balance sheet support, often called regionals, to be relevant in the market. They don't need to hold inventory, they just need a few seasoned salespeople with good relationships. This increased competition helps spur volume with active low-overhead participants.

These low costs don't paint the full picture, however. To any CLO trader seeking to buy securities, perhaps the worst three letters you can see are DNT, or 'did not trade'. In b-wic auctions and out of competition offerings, there is no assurance that the seller will actually sell at a reasonable price.

Often, prospective buyers spend significant amounts of time analysing CLO structures, portfolios and stress cases — only to find the seller won't accept a market bid. As a result, as a prospective buyer, you might end up sitting uninvested longer than you want. If your account is otherwise sitting in cash, you're foregoing return against your benchmark while you keep up the hunt for a realistic seller. In such a situation, your best hope is that prices fall overnight.

> Around 20% of the US CLO market has traded this year — not bad for an asset class that is seen as illiquid