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CLO volumes outstanding have passed \$1 trillion, but index omission and private placements are holding us back

The size of the global CLO market just crossed \$1,000,000,000,000. If that doesn't signal a bubble, what does, right?

All numbers, of course, are relative. The global CLO market has grown at about 10% annually over the past eight years. While not slow, this represents a reasonable rate for a market that has consistently delivered for its investors, despite being battle-tested many times.

The first CLOs were issued in the early 1990s. Since then the market has experienced: the Russian crisis (1998), tech/telecom/terrorism (2000-02), the financial crisis (2008-10), taper tantrum (2013), energy and China growth fears (2015-16), and, lastly, covid (2020).

Through all these events the number of CLO triple As or double As that have taken an impairment remains unchanged — zero. Looking further down the capital structure, even the vast majority of US CLO equity tranches have delivered positive IRRs to their holders.

Today, CLOs hold the significant majority of broadly syndicated loans to US companies. They are a steady hand for ownership of corporate loans because they eschew margin triggers and forced sales. Perhaps even more powerfully, through their reinvestment mechanics, CLOs can be a valuable provider of liquidity when credit markets are distressed.

Yet CLO securities remain an outcast in the broader credit market. Certain aspects of the

late-1990s, a development that helped broaden demand significantly, as many investors cannot invest in private placements.

Libor replacement drags on

At time of going to press, 12-year CLOs are still being issued referencing three-month Libor. It's been over four years since the cessation of Libor was announced, yet both the CLO and loan markets are still issuing paper using a soon-to-be-extinct rate while we ponder replacements. Let's just pick a rate and get on with it.

Few holders of any given security

Billions of dollars of CLO securities change hands in the secondary market each week. While a specific CLO may be held by dozens of investors, owing to the number of classes in any given CLO, there are often CLO securities held by fewer than five. In some cases, there might be only one holder of an entire class. Compared to traditional corporate bonds and loans, which often have well over 100 holders of a specific security, having so few holders hinders secondary liquidity.

B-wic inefficiency

A meaningful portion of secondary CLO trading, particularly debt tranches, happens via inefficient, opaque b-wics. While 'wics' exist in many markets, their prevalence in CLOs is much greater. Compared to the number of bonds that trade, the

In some ways, CLOs resemble a quirky, cottage industry more than a trillion-dollar market

CLO market still resemble a quirky, cottage industry, rather than a trillion dollar market.

Omission from indices

CLOs are not in the Barclays Agg. CLOs' exclusion from the Agg keeps many fixed income investors on the sidelines. Considering the trillions of dollars of capital invested seeking to mimic the returns of the Barclays Agg, this might be the single biggest factor holding back demand for CLOs.

Private placement status

Whereas many ABS securities and IG-rated CMBS securities are issued via public offerings, CLOs remain exclusively private placements. CMBS came into the public markets in the

amount of time and effort spent by dealers and prospective buyers on b-wics is grossly out of sync. There are efforts to streamline this process, but there is as yet no accepted alternative.

None of these considerations make CLOs a bad investment. Their long-term performance is clear. But investors face many roadblocks that help keep CLOs a cottage industry — albeit a trillion-dollar cottage industry. Thankfully, these roadblocks also help create a return opportunity that, in our view, far outweighs the risk of loss.