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With the majority of this year's CLO deals being refis and resets, investors have had to run to stay invested

Much attention has been drawn to the quantity of CLOs issued this year. Hundreds of billions of 'new' paper has 'flooded' the market. This surely is signalling a bubble, right? How can spreads remain tight to beginning-of-year levels, particularly with some of the largest Japanese buyers of CLO triple As on the sidelines?

The headlines may be misleading. Net, the total outstanding in the US CLO market grew by less than $100 billion this year (about 15%) — a fraction of the headline gross issuance number. Of the $250 billion of issuance, over $150 billion was refinancing and reset paper. As part of every reset or refinancing, existing bonds are repaid (at par, of course). This typically means no net new issuance. Sometimes a CLO might be upsized a bit as part of a reset, but that's not meaningful. At the same time, having some players on the sidelines only creates room for others.

Refinancings often attract a different group of investors, one that is not particularly active in traditional new issue CLOs. While banks and insurance companies often gravitate to offerings with five-year reinvestment periods, many money managers who look after mutual funds seek refinancings. Though refinancings typically offer a bit less spread than a new CLO, they often have one or two years left on their reinvestment period, giving these investors a potentially meaningfully shorter bond. Shorter bonds should, in theory, demonstrate less price volatility. That theory might not have held up well during March 2020 but, in general, it's a sound approach for investors who are sensitive to price volatility.

As a result of numerous refinancings, buyers of longer-dated paper are getting repaid, and their capital is replaced in the market by shorter-duration investors. If you owned a large portfolio of 2019 and 2020 vintage CLO debt at the beginning of 2021 and you just sat still, your portfolio may have shrunk by more than 25%!

Assuming you wanted to grow your portfolio this year, you needed to be active and buying the new CLO issues, as nearly every day you were likely receiving repayment notices. You've had to run hard just to stay in the same place.

Another under-appreciated factor in market dynamics is that a handful of overseas buyers only act in scale. Some triple A buyers will only take the full tranche (and never less) or some no less than two-thirds. This means many domestic investors — those with $25 million or $50 million target bite sizes — often can't get access to investments because the tranches are gobbled up by full-class buyers. These investors who can't access CLO paper end up redeploying their capital in other markets.

With many triple As now sold via an old-fashioned syndication process, we are seeing new CLOs sometimes with 10 or more buyers in the triple A class. That $50 million buyer who was shut out and investing elsewhere is now welcome. It's also great from an issuance perspective to have diversity of investors, as it allows for much more balance in the issuance process.

Calls and amortisation affect market size

Finally, there are two other important drivers of market size that get little attention — calls and amortisation. So far this year, over 72 CLOs were called. This represents over $24 billion of called paper and is pure negative supply.

Other CLOs are amortising, or 'factoring' in bond geek language. Allowing a CLO to amortise de-levers the transaction and increases the weighted average cost of funds. Neither is good for the equity class. In general, there are two reasons why this happens. One is that the junior debt is underwater, so the CLO can't be called. The equity might squeak out a few last payments before the OC test shuts off payments forever.

The other reason is the equity holders are not acting to call or reset. In some cases, the equity holder might also own mezzanine debt in the same CLO with juicy, above-market coupons. They might prefer to keep the debt paper outstanding, which may even have been upgraded. In a few cases, it's investors who simply aren't paying attention to their holdings. Finally, there might even be equity holders who have their positions marked well above liquidation value — and for some reason, don't want to take the markdown.

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