LAKEMORE PERSPECTIVES: CLO Tranche Investing
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Background

Our entry into the CLO market started in 2000 when we were faced with the fact that our alternatives portfolio had grown to a significant size since 1995 and, at least to us, had more risk than the inception-to-date track record suggested.

We were in search for a strategy with the following key attributes:

1. Delivers a core of stable earnings
2. Acts as an effective diversifier in extreme down markets
3. Gives us full Portfolio Construction & Exposure Management control as the Investment Manager

CLO Tranches - A viable solution

As we looked at various investment options, we found that CLO tranches were the most effective solution to address our quest. Special area of focus for us were CLO Equity, and lower rated debt tranches which provided a strong balance between contractual protection in the debt tranches and effective diversification in CLO equities during extreme down cycles.

CLO Debt Tranches

CLO debt tranches offer steady contractual payments which are Libor linked with a reasonably high risk adjusted spread creating a strong core of stable earnings. In an early to mid-cycle environment debt tranches offer significant spreads above Libor with a high likelihood of getting repaid through refinancing or resets within the CLOs re-investment period.

The typical risks to such tranches of decreasing rates and widening of credit spreads are also limited as the early cycle economic tailwinds drive inflation (hence interest rate increase) and earnings growth (hence credit spread tightening).

The combination of contractual high payments and supporting rate and credit spread environment in early to mid-cycles leads to a supportive environment for CLO debt tranches.

During Late cycles, however, spreads over Libor on CLO debt tranches are typically tight. Further outlook for credit spreads in such environment is tilted towards a widening and interest rates are expected to remain flat or move negative as recessionary pressures impact the portfolio. This environment results in decline in cash yield from interest rate decline and decline in value from credit spread increase and increase in the maturity profile of CLO debt tranches.

CLO Equity Tranches

CLO equity tranches on the other hand offer high, reasonably stable cash flows as well as benefits during times of stress as credit spreads widen.

Ideal market condition for CLO equity is late cycle when cost of the liability of a CLO are at their lows which allows locking in that liability spread for a long term and then waiting for asset spreads within the portfolio to widen as down cycle pressures kick in and re investment within the CLO portfolio takes advantage of increasing credit spreads .

This is because the debt side of a CLO is roughly 12+ years in nature, and the asset side, has an average life of under 4 years and both are floating rate in nature.

So, the loan book must continuously be replenished with new assets as existing loans amortize &/or prepay. Historically the tune of amortizations and prepayments was around 30% annualized. This meant that the loan manager had to consistently buy new loans every year to the tune of around 1/3 of the portfolio. This creates a short credit position that benefits as new loans would be acquired at wider spreads as markets retract.

In other words, if credit spreads were to widen, the CLO Equity would deliver higher returns as the positive carry between the floating rate income from the loan book and the floating rate debt fixed for 12 years widened. This is a natural diversifier as other non-CLO Equity portfolio holding might be suffering.

Alternatively, during bull market runs, the positive carry narrows delivering compressed returns to the investor. Note this would happen at times when the rest of the investor's portfolio should be performing well.

CLO Tranche Investing

The complementary performance profiles of CLO debt tranches, that position attractively in early and mid-cycle, and CLO equity tranches which position attractively in late cycles form an ideal combination within an all cycle portfolio investment strategy. Further the relative value comparison of these tranches factoring in market cycle position offers an efficient tool for portfolio construction that aligns well to our investment philosophy of cycle aligned risk allocation.

Early in a cycle, when issuance of new CLOs is not advisable given the potentially high cost of debt, accessing positions across the capital structure, especially in the BBB & BB tranches, becomes most desirable.

Late in a cycle, when CLO debt can be raised at attractive spreads, say below 230bp, it is more beneficial to put together a CLO and be the control equity.

As an example, in early 2012

1. Libor was at 0.5% and
2. CLO BBB tranche spread was at around 7.5% and
3. CLO BB tranche spread was at around 9.5%.

On a total return basis CLO BBB tranche expected return was around 8% and BB tranche total return expected was around 10% assuming a flat Libor.

2012 market condition was pointing to an economic expansion of an early cycle, where Libor was expected to increase, and credit spreads were expected to tighten.

In such a scenario the comparative return on a CLO equity position going through a spread contracting environment was being modeled by us at around 8%.

As we were evaluating the 2012 market condition it was clear that the CLO BB and BBB tranche had a higher relative value for the risk exposure compared to a CLO equity position.

In 2019 we are faced with a market where we see a late cycle market construct with,

1. Libor at around 2.5% and
2. CLO BBB spreads at around 3.7% and
3. CLO BB spread around 6.8% for high quality managers.

This results in a total yield on a BBB position of around 6.2% and on the BB position of around 9.3%.

Given the late cycle nature of this market our forecasted return in a recessionary scenario on an CLO equity position managed by a high-quality manager is around 14% factoring in a higher default rate and lower recovery rate compared to last recession.

Compare that to a CLO BBB or BB tranche which would face a possible Libor decline as markets go through a recessionary environment. Assuming that the average Libor experience of the tranche was 1% instead of the current level of 2.5% implies a total return expectation on CLO BBB tranche of 4.7% and the CLO BB tranche of 7.8%.

The relative excess return on the CLO equity tranche in the current 2019 environment is around 10% over BBB tranche and around 6% over the BB tranche which is an attractive risk compensation for CLO equity investments in the current market environment.

Key factors driving the performance of a CLO tranche investing portfolio

Performance of tranche investing portfolios focusing on the BBB and below tranches require an experienced team and specialized infrastructure dedicated to this asset class.

Based on our experience the key factors we focus on to drive performance of these portfolios are as follows:

1. **Relative value analysis between tranches based on market conditions:**
   Investment opportunities within the CLO market broadly fall within two types which are either the broadly syndicated loan CLOs or Middle market loan CLOs. Depending on the assessment of returns and risk profile as well as alignment of opportunity set to market cycle position, we make a specific selection of the CLO type and relevant CLO tranche attractiveness.

2. **Portfolio quality of underlying CLO:**
   Detailed analysis of the CLO portfolio is done to identify weakness in credit quality, liquidity issues or constraints in active management execution within the loan book. This analysis becomes especially important while buying CLO equity positions whose performance is to a large extent dependent on the portfolio construction of the CLO loan book. Portfolio analysis is critical in assessing the future cash flows of the tranche. Two CLOs with same manager and same vintage could have a markedly different portfolio quality as a result of underlying positions, defaults and recoveries as well as gains and losses from active management.

3. **Manager selection in line with tranche selection:**
   Collateral Manager selection process is based on manager style, CLO type and tranche preference identified through the relative value analysis. The CLO manager universe consists of more than 140 firms. Our strategy within CLO investing is focused on avoiding speculative risks and we focus on managers who have a large and established infrastructure to manage CLOs effectively and can achieve tight liability pricings. Based on a detailed quantitative and qualitative diligence of CLO managers we identify managers whose styles are most suitable to the specific tranche position. As an example, in a late cycle we prefer CLO equity positions of CLOs managed by highly defensive managers with focus on loss minimization as opposed to managers that focus on attractive risk adjusted return generation.

4. **CLO structure and documentation:**
   We believe documentations and structural analysis is key to assessing a CLO tranche position. Depending on the tranche position we are looking to take a position in we thoroughly review and mitigate potential risks that arise for debt tranches (when we are buying debt tranches) or for equity tranches

when we buy Equity positions. Managing the conflicts of interest that arise between the three key participants in a CLO, Debt holders, CLO equity and CLO manager, are a key to performance risk mitigation.

5. **Market analytics and proprietary models:**
   CLO tranches are a complex asset class with many variables which can impact the performance of a tranche.
   There are various third-party analytical tools that are available which allow an assessment of these positions; however, they also suffer from various limitations including a black box nature of many of these models.
   Proprietary models with the necessary analytical infrastructure are key for a CLO tranche investing practice to accurately assess the implications of various risk factors and market conditions on a CLO position. More-over the necessary analytics allows us to understand regularly the performance and risk potentials in a CLO tranche position.

6. **Ongoing portfolio position management:**
   A key driver towards maintaining a high-quality tranche portfolio is ongoing assessment of the portfolio quality and evolving risks within the portfolio. As managers of CLO tranche portfolios with a focus on CLO equities in the current environment we look to control risks within the CLO portfolios through constant dialogue with CLO managers as well as looking for specific risk adjustment trades on our portfolio positions.

7. **Market access and position management:**
   Having a good market access that includes primary markets and secondary markets is very important from the perspective of acquiring attractive positions as well as ongoing risk management which would require us to resize positions within the portfolio.

Learnings of 2007-09

While the 2008 experience was invaluable in many ways, it proved to us that our CLO investment strategy was sound.

Important learnings however came in the form of:

1. Understanding certain structure and documentation intricacies that could severely impact the performance of CLO debt and equity, and
2. Understanding the importance of having real time detailed proprietary models that can guide our portfolio management behavior and specific actions with the collateral manager, as the control equity.

This drove home the critical role the Investment Managers plays to ensure that returns remain in line with investment risk, and more importantly that investment risk does not migrate into unacceptable territory.

Risk – What goes wrong

Our experience since 2007 has shed a lot of light on what could go wrong, first hand.

Self-Imposed Exit:

The maximum loss is a direct result of a self-inflicted rule that would force an investor to sell at the most inappropriate time.

In 2008 and early 2009, various investors including many banks had rules to exit under certain mark-to-market conditions or certain downgrade events.

In early 2009 most CLO debt tranches were downgraded as mark to market value of loan assets were no longer supporting the leverage level of the CLO and rating agencies were highly sensitive to such events. At the same time mark to market prices of most debt tranches and CLO equities had taken a significant hit and were trading at significant discounts.

Many investors with the above-mentioned rules whether (self-imposed or regulator imposed) sold CLO tranches at well below 50% of par. All these CLOs tranches delivered strong returns with equity tranches delivering enhanced returns, some as high as 30% IRR for those who held them till orderly exit.

Those who had the risk appetite and presence of mind in 2008-09 to acquire CLO tranches at the time made much higher returns.

This self-imposed sell event in our experience is the only event that caused a loss to capital for investors.

Investors in CLO tranches should therefore (a) have the intention and ability to hold the investment for the full term, and (b) never have a self-imposed - “forced sale” – rule that is based on mark to market conditions or rating agency downgrades.

Distribution Shut-Off for CLO Equity Tranches

In lieu of a Mark-to-Market covenant which does not exist in CLOs, the debt providers impose a condition that if the asset quality drops below a certain level, the excess returns are not paid out to Equity investors but retained to buy additional loans or deleverage which works as an internal risk mitigation within a CLO structure.

This is a condition that has affected CLO Equity performance positively on an IRR and MOIC basis, even though the investor suffered temporary shut-off of quarterly income.

For example, in 2008 two similar managers with a different active management style delivered similar IRR for the same early 2007 vintage CLOs. The manager that had no equity distribution shut-off delivered an IRR of 20% and a MOIC of 2.4x. The manager that had a 4-quarters equity distribution shut-off delivered a 21% IRR – similar to the first manager but had a MOIC of 2.9x. A significantly higher wealth creation effect.

Distribution shutoff risk is one that would actually benefit returns. However, investors in CLO equity must come to terms with the possibility of temporary distribution shut-off so it does not become a destabilizing event to the decision-making process of the investor should it occur.

Mark to Market:

As a CLO portfolio is typically 10x leveraged, a drop-in loan prices from 99.5%, where the loans may have been bought, to an average to 94.5% would result in a 50% drop if you were to mark-to-market the NAV of a CLO Equity Tranche.

This drop-in price could happen even when the underlying loan portfolio is performing as planned. The concern is that investors see the price shift in revaluation and assume it means their investment is unlikely to recover. The reality of the matter is that once loans trade again in an orderly fashion around 99.5% or mature at par, the value of the CLO equity tranche recovers.

Most importantly is the decisions made by the Control Equity not to call the CLO at such a time. This is why the length and robustness of the debt is critical to allow investors to hold CLOs through market retractions. Remember it is during these market retractions that the enhanced return potential of CLO Equities plays out.

It is extremely important for CLO tranche portfolio investors to acknowledge that CLO performance is not driven by the mark to market of the loan portfolio. It is driven by the credit default and recovery performance of the loan book. As a result, any decision or hypothesis based on mark to market factors should be avoided.

Documentation issues:

While the last few risks mostly relate to investors psychology which results in wrong decisions, intricacies in CLO documentation is one of the risks that are inherent to the CLO structure.

There are instances where CLO documents allow CLO manager to change certain document terms without the consent of noteholders or equity. This could have an adverse impact on the performance of a CLO. Further the conflicts of interest between CLO debt holders, CLO equity holders and CLO managers at various times lead to weak CLO documents, that result in specific tranches losing attractiveness to a secondary buyer and has an impact on the return profile of the CLO tranche specifically the equity tranche.

Investors in CLO tranches need to focus on mitigating risks arising out of weak documentations within CLO structures which can have significant impact on the position's performance.

Conclusion

Since 2000 our approach is to invest across the capital structure of CLOs, which became known as tranche investing in CLOs.

As the lead investment manager and in most cases control equity in CLOs, we aligned our tranche investing to the prevalent market cycle to ensure we are adequately paid for the maximum downside risk (MDSR) we take. While we prefer being the control equity in a CLO in a late cycle market, there are times when accessing CLO equity via secondary minority positions is more beneficial.

Today our proprietary risk models, that have been built and evolved since our early days of CLO investing in 2000, consider and measure the impact of the smallest markets shifts, as well as structure or documentation intricacies.

Furthermore, our relationships with underlying loan portfolio managers has evolved in a mutually beneficial way to both. We can select the highest quality loan managers with much more clarity than we did in the early 2000s, and act in a timely manner to align portfolio risk to the intended outcomes both at the loan portfolio level as well as the CLO Fund level as we have access to attractive secondary positions from time to time.

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