Looking Under the Hood at CLOs

Collateralized loan obligations can offer relative value.

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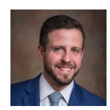

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KEY INSIGHTS

- Collateralized loan obligations (CLOs) are a type of securitized debt that can offer value compared with other types of bonds with similar credit quality, including investment-grade corporates.
- Detailed analysis of a CLO's structure, the collateral manager, and the credit quality of the underlying loans is essential to managing risk in the segment.
- We have exposure to select high-quality CLOs that currently provide meaningful yield above corporates and other securitized debt with similar quality and volatility.

Collateralized loan obligations (CLOs) are a type of securitized debt that can offer value compared with other types of bonds with similar credit quality, including investment-grade corporate debt. However, detailed analysis of a CLO's structure, the collateral manager, and the credit quality of the underlying bank loans is essential to managing risk in the segment. In our diversified bond strategies, we have exposure to select high-quality CLOs that currently provide meaningful yield above corporates and other securitized debt with similar quality and volatility.[1]

Actively Managed Portfolios of Loans

CLOs are portfolios of bank loans, which have high yield credit ratings, that are structured into slices, or tranches. A third-party collateral manager actively manages the CLO portfolio, which sets the CLO structure apart from most types of securitizations, which are backed by discrete pools of assets. Most of the debt tranches have credit ratings that range from AAA to BB, depending on the amount of credit enhancement—support from the cash flow structure of the CLO. In addition to debt tranches, CLOs also have an equity tranche. The equity tranche has no credit enhancement and does not pay a coupon, instead receiving all remaining cash after debtholders have received their expected principal and interest payments. The CLO manager receives extra fees if the equity investors reach return targets.

For a period of time after selling the CLO tranches to investors to fund the deal, the CLO portfolio manager reinvests the principal payments on the bank loans

[1] Exposure, yields and credit quality of underlying issuers are subject to change.

At T. Rowe Price, analyzing CLOs... involves close collaboration between securitized debt analysts and global high yield credit analysts.

owned by the CLO in new collateral. This reinvestment period, which can be as long as five years, assumes that the current holdings pass a variety of coverage tests that examine whether the portfolio meets certain quality guidelines and can generate enough cash to make interest payments. These compliance tests include limits on loans that have been downgraded to CCC or defaulted.

After the reinvestment period, or if the CLO fails the coverage test, the highest-rated tranches have priority to receive the cash flows from principal and interest payments on the underlying bank loans. These higher-rated pieces offer the lowest yields of the various tranches because of their seniority in the capital structure. The equity tranche has the lowest priority on cash flows but the highest potential yield if all debt obligations are met.

Solid CLO Structures

Unlike some other types of securitized debt, such as non-agency mortgage-backed securities, CLOs did not experience major defaults during the financial crisis of 2007–2009. The limited CLO defaults that did occur only affected lower-rated tranches. From an investor's point of view, CLOs issued after the financial crisis have better structures that incorporate higher levels of credit enhancement, which reinforces our confidence that CLOs could endure another sustained period of broad stress in markets. CLOs also now pay meaningfully higher spreads above LIBOR[2] than they did before the financial crisis.

Deteriorating Quality of Underlying Loans

The quality of the bank loans underlying CLOs has deteriorated in recent years as the size of the CLO market has vastly expanded. "Covenant-lite"[3] loans now account for the vast majority of CLO collateral. Bank loan borrowers—particularly those that issue only loans, not bonds—now often have higher overall leverage from a corporate point of view. This can potentially make it more difficult for them to meet their debt obligations, particularly in an economic downturn. CLOs also have a meaningfully larger allocation to B rated loans than was common before the financial crisis.

This trend makes rigorous fundamental analysis key to selecting CLOs as portfolio holdings. At T. Rowe Price, analyzing CLOs for potential purchase—or monitoring current CLO exposures—involves close collaboration between securitized debt analysts and global high yield credit analysts. Securitized debt analysts specialize in examining CLO deal structure as well as CLO portfolio managers in terms of track record, experience, and style. CLO debt investors can negotiate the terms of the deal with the collateral manager in seeking to ensure that adequate structural protections are in place, adding another layer of complexity for specialized analysis.

Our global high yield credit analysts are very familiar with the fundamental credit quality of the individual bank loan issuers that make up a particular CLO's collateral pool as well as the overall credit trends in the loan market.

Relatively Liquid Secondary Market

Unlike individual bank loans, which may have longer trade settlement times, the secondary market for CLOs is relatively active and liquid. Most trading tends to occur in tranches rated AAA and BB (the highest rungs of the investment-grade and noninvestment-grade ratings categories). The investor base for

[2] The London interbank offered rate. Credit spreads measure the additional yield that investors demand for holding a bond with credit risk over a similar-maturity, high-quality government security.

[3] Covenants provide legal protection for debtholders against a deterioration in the borrower's fundamental credit metrics. "Covenant-lite" debt places fewer restrictions on the borrower and thereby provides less control for debtholders.

CLOs has broadened since the global financial crisis with increased participation from asset managers, supporting liquidity in the market.

Exposure to Highest-Rated CLOs

The allocation to CLOs in our diversified fixed income strategies is primarily AAA and AA rated tranches. These currently provide meaningful additional yield over A rated corporate bonds, which have a similar volatility profile. We view this as attractive relative value. In light of the liquidity and credit risk in lower-rated investment-grade CLOs, we favor the highest-rated tranches. However, we may consider tactical purchases of lower-rated CLOs to try to take advantage of price dislocations.

WHAT WE'RE WATCHING NEXT

Japanese banks are major investors in CLOs, particularly AAA rated tranches. A prolonged pullback by these banks would likely put downward pressure on CLO prices. The exchange rate between the Japanese yen and the U.S. dollar affects the hedged yield for certain Japanese investors, so we closely monitor the currency market for signs of change.

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