Harnessing the unique characteristics of CLO Equities for a credit portfolio

The recent performance of collateralised loan obligation (CLO) equity has been impressive. In fact, over the 10 years to the end of 2016, the annualised performance of the asset class surpassed that of private equity, equities and high yield.[1]

While CLO equity tranches sit within the credit universe, their characteristics including their risk and return profile – and the way they behave in a rising spread or crisis environment – differ from other credit instruments.

The distinctive characteristics of CLO equity tranches

The equity tranche of a CLO bears the first loss that could occur at the underlying loan pool level. But in return, CLO equity tranche investors are given significant control over the length of the life of the overall CLO structure and are entitled to receive the excess cash flows after payments to the CLO debt tranches. These potential cash flows typically display a unique, front-loaded pattern which generally makes CLO equity tranches moderate duration instruments, of circa four years, within the credit universe.

Potential robust performance and diversification benefits in a rising spread environment

In the very short term, the valuations of CLO equity tranches tend to react to spread movements similarly to any credit instrument. But they can also benefit over the medium term from a rising spread environment. This feature makes CLO equity tranches unique instruments in the credit universe and enables them to offer some diversification to a credit portfolio.

As with the rest of the credit universe, CLO equity tranches were impacted during the 2008 global financial crisis. However, despite a peak in loan defaults and a temporary shutoff of equity distributions, overall returns for most vintages were remarkably resilient throughout the crisis. Part of the reason for this is the instrument's ability to lock in low-funding costs at inception and high loan spreads during the initial years. But whether or not this factor becomes an advantage, greatly depends on the future path of underlying loan spreads.

Impact of potential losses in the underlying loan collateral

Losses and defaults on the underlying loan collateral do occur, and have the effect of reducing the total interest payment to equity tranches. However, their impact should remain relatively limited should only a few loans default.

In the 20-plus years of CLO issuance, we are not aware of any US or Euro CLO structure issued since 1999 that would have been unwound, with no cash flows left to allocate to the equity tranche holders – although this may not always be the case and is not impossible in the future.[2]

From barbell to bucket

Given these unique characteristics, asset allocators have a range of ways in which they can make use of CLO equity tranches within their portfolios.

For example, they could form part of an investor's credit opportunities bucket. In this case, a decision to buy or sell the asset becomes more of a risk-budgeting decision, than a discrete asset allocation decision. But given the level of expected return, CLO equity exposure could also be positioned in a growth portfolio, with the aim of helping to close funding gaps.

For some institutional investors, a barbell strategy could be of interest. The most frequent example consists of replacing a 100% high-yield portfolio with a barbell approach i.e. 75% investment grade bonds and 25% CLO equity tranches.

Such an allocation would also allow an investor to reallocate assets from investment grade to high-yield securities in the event of an uptick in high-yield spreads. This could possibly further increase the potential return of the portfolio.

Some risk factors to be aware of before investing

The potential benefits of CLO equity investing present a compelling case for investors. As with all investments, however, investing in CLO equity tranches involves risks, all of which need to be carefully considered. These include the subordination of cash flows to CLO debt tranches, the leveraged exposure and the risks associated with the underlying loans, as well as low liquidity, performance issues and undefined maturity.

➤ Low liquidity

CLO equity tranche trading is irregular – some tranches have never traded during their life. However this does not mean that these instruments are always illiquid and broker dealers, due to the very high level of transparency on CLOs, would typically offer a bid/ask spread of close to 1% in normal market conditions and up to 5% during periods of volatility.

➤ Performance risk

Although CLO tranches are traded in non-regulated markets, they are extremely transparent financial instruments in the sense that trustee reports are published every month containing a full list of the CLO's holdings. This enables investors to estimate the fair value of any equity tranche available in the market at any given time. Investors can also rely on independent cash flow forecasts and valuation estimates from industry providers[3] that integrate observable and public measures on the most recent trades of CLO tranches, loans and other credit asset classes.

Valuations can also be quite volatile. For example, in the Autumn of 2008, monthly CLO equity valuations fell by as much as 50% from one month to the next - and rebounded by a similar level in mid-2009[4]. A large part of these drawdowns came as a result of CLO structures which were excessively leveraged at the time. Recent structural changes which have occurred sincemay reduce the risk of such a level of forced selling reoccurring, but investors would need to allow for a potential drawdown of typically 30% to 40% for this asset class.

➤ Undefined maturity

The maturity of the equity tranche and that of the CLO structure usually ranges from six to nine years, though the final maturity is undefined at launch. The termination of the overall CLO structure is usually decided by the CLO equity tranche holders in conjunction with the manager and in accordance with their ability to continue make the underlying loan pool profitable to the CLO equity position.

Not all CLO managers are created equal

CLO managers actively manage and trade the loan collateral to help assure full payment of debt tranches and to enhance equity returns. Performance-linked fees and the risk-retention rules requiring CLO managers to keep 'skin in the game' combine to help encourage CLO managers to maximise the return on equity tranches. However CLO managers can perform very differently in similar market conditions.

Ready to dip a toe in the water?

CLO equity instruments demonstrate a set of characteristics and behaviours unique in the credit universe. High front-loaded cash flows, moderate duration, potential performance resilience in the face of cash-flow interruptions, and a positive mid-term response to a rising credit spread environment, all serve as potential attractions of investing in the asset class. But given the range of returns across CLO equity tranches of a similar vintages, investors need to carefully select CLO managers with the a sufficient level of insight and governance infrastructure if they are to achieve the full potential benefits of the asset class.

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[1] Source: Standard & Poor's (S&P 500 Index – US Equity), Citi Research (Citi US High Yield Bond Index), Wells Fargo (Equity CLOs) and Cambridge Associates (US Private Equity) as of December 2016, AXA IM analysis. CLO Equity 1.0 and 2.0 returns correspond to the average return between US and European samples. Past performance is not a reliable indicator of current or future performance. Historical market trends are not reliable indicators of future market behaviour. Actual results may vary and the variations may be material.
[2] Source. AXA IM analysis of market information and industry research papers. [3] E.g.: JP Morgan Direct, Markit, etc [4] Source: Credit Suisse, The CDO Strategist, February 2012