Assessing leveraged loan CLO managers demands a multi-faceted analytical approach

Assessing asset managers in the context of leveraged loan CLO transactions requires a multi-faceted approach. Past performance, corporate structure, and investment team are three aspects that stand out among the many factors that help determine how skilled managers are at avoiding portfolio losses and performing their role on transactions.

Analysing the historical performance of a CLO manager against the backdrop of the the-then prevailing market conditions is crucial to identifying sources of over or under-performance. Ratios of collateral balance (expressed at par and market values) to debt principal amounts, collateral quality metrics, and generated excess spread over time help to assess how the manager achieved its performance and critically, how sustainable it could be.

Corporate structure and governance influence the CLO manager's operational capacity and ultimate performance. Evaluating the potential backing by a parent company is a key factor, as it may critically impact the managers' resources, market access and capital availability.

Another key point is assessing the structure of the investment team and decision-making processes. The experience and stability of the management team, exposure to different jurisdictions and restructuring processes are determining factors. Gaining insight into the manager's selection criteria, its approach to mitigating credit losses as they arise and its attitude towards market volatility and dislocation is important in assessing the manager's ability to avoid portfolio losses.

For CLO managers entering a new market, in-depth analysis of other leveraged loan strategies under management will be required to compensate for the lack of historical performance. The track records and management style of the main decision-makers should also be examined and compared with the proposed investment strategy to assess compatibility and adequateness with the means at disposal.

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CLO performance is well documented and shows high dispersion

Monthly reports show the manager's activity

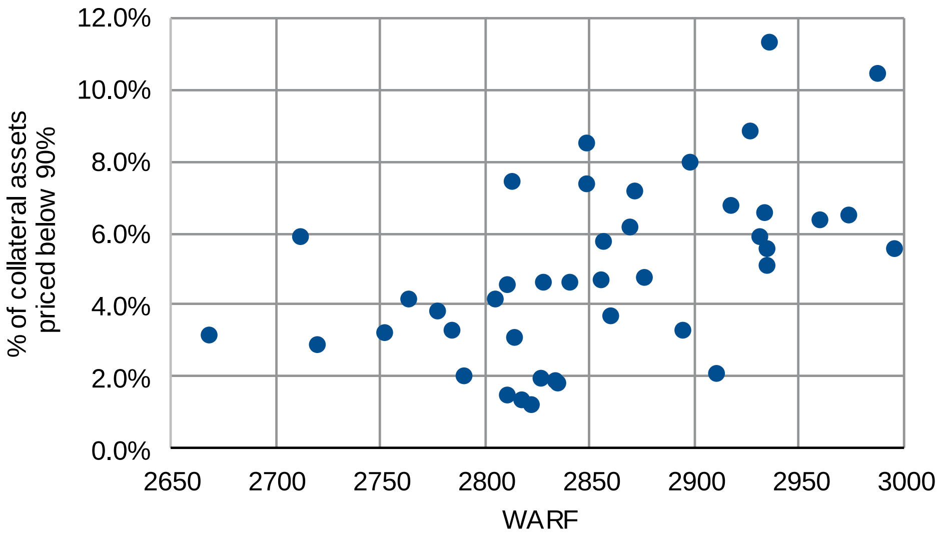
CLO transactions report on a monthly basis. Reports are prepared by the collateral administrator, and are a resourceful platform to assess collateral pools and the historical and current performances of CLO notes. The transparency and frequency of publications enable market participants to monitor managers' trading activity, transaction cash flows, portfolio composition, along with losses and compliance with tests and quality covenants.

Historical performance shows significant dispersion and calls for an in-depth analysis

Not all CLO managers can consistently outperform the leveraged loan index benchmarks given their large number[1] and the fact that CLO vehicles own an estimated 45% of the global leveraged loan market[2]. In fact, there is significant dispersion in CLO collateral pool performance and CLO equity returns, even in benign default environments and for transactions of similar vintage.

Figure 1 illustrates the current state of aggregated CLO portfolios for a large subset of European CLO managers using the weighted average rating factor (WARF)[3] and the proportion of asset portfolios trading below 90%.

Figure 1: European CLO portfolios show different risk profiles



Source: J.P. Morgan, Intex

The wide range of management styles and performance is likely to increase given the relatively high concentration of covenant-lite and CCC-rated obligations in current CLO portfolios. Hence, analysing the track record of a CLO manager is crucial and helps identify the main sources of over or under-performance, such as avoiding portfolio losses, taking greater credit risk, or relying on relative-value trades, among others. This analysis should be performed in light of a manager's strategy, taking into consideration market conditions and transaction features.

[1] as of July 2019, there are over 130 CLO managers active globally
[2] Bank of England, January 2019
[3] As per Moody's WARF metric

Making sense of the signals

Positive par building protects noteholders

For a given transaction, the evolution of the collateral pool's principal balance shows how the CLO manager has been able to build the asset base. The latter grows with trading gains and shrinks with defaults and subsequent losses. It is important to consider both factors individually, as trading gains will predominantly arise during the re-investment period, while portfolio losses can happen at any time.

The principal balance, valued with excess CCC rated and defaulted assets carried at market or recovery price, offers a metric adjusted for the credit quality of the portfolio. This metric is also used to compute par coverage tests. The proximity to the limit for par coverage tests indicates if a diversion of cashflows to senior tranches is likely. Such diversion is detrimental to equity returns but can also undermine the performance of the most junior debt.

A large difference between collateral balance and NAV indicates adverse credit migration

The ratio of a collateral pool's market value to the par value of rated notes indicates where par coverage ratios would converge, if more assets were downgraded to CCC or below. It is an unbiased metric with regard to defaults i.e. the asset fair-value is used whether or not the manager has declared the asset defaulted as per the transaction's definition.

Deteriorating collateral quality metrics are often a sign of increased risk-taking

The manager has an incentive to comply with the transaction's collateral quality tests, as any violation would restrict its ability to trade. However, these quality metrics evolve and the distance of test values to their respective thresholds can shrink. Significant degradations in observed cushions can be tactical, but are often linked to adverse portfolio migration that may lead to portfolio losses at a later stage.

Test restrictiveness influences the CLO manager's behaviour

Thin test cushions are not detrimental to noteholders when the thresholds have been set in a restrictive manner at the transaction's inception. Academic research shows that CLO transactions with a restrictive set of tests are less likely to make early principal repayments and suffer rating downgrades of junior notes. It also shows that restrictive tests give CLO managers an incentive to actively trade in order to avoid breaching tests, ultimately costing equity holders and benefiting noteholders (Loumioti & Vasvari, 2019).

CLO equity returns are positively correlated with the performance of junior notes

Large equity returns mean that the CLO manager has been able to generate considerable excess spread through active portfolio trading. Academic research highlights that CLO equity returns are persistent on a transaction and manager basis, and that transactions with high cash-on-cash returns also show higher par coverage ratios and better portfolio quality on average (Liebscher & Mählmann, 2016).

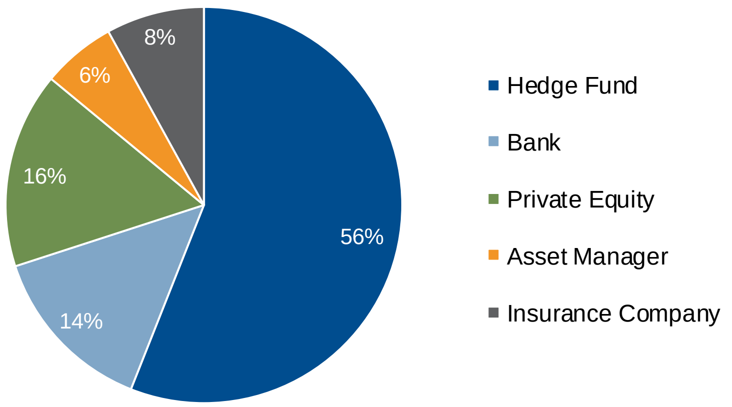
Both factors are beneficial to debt noteholders. However, If the excess spread is generated via tactical increased risk-taking misaligned with the original strategy, short-term high equity returns may hide adverse portfolio migration that can later trigger losses to the most junior-rated classes of notes.

CLO managers have financial backing of different nature

European CLO managers are mostly backed by hedge funds

CLO managers have parent companies of very different nature and size. Figure 2 breaks down the various types of parent company backing active European CLO managers. It shows that there is no unique way to establish oneself as a CLO manager. Key is the alignment between investment, growth strategies and the means at disposal.

Figure 2: Types of parent company for European CLO managers



Strong financial backing helps the CLO manager focus on long-term horizon

The financial power of the parent company influences the capacity of the manager to issue new transactions. Being flexible in deploying capital to fund warehousing facilities, retention requirements or the equity of new transactions significantly helps the efficiency and timing of the origination process. Strong financial backing allows the CLO manager to make long-term investments in operational and information systems, but also attract and retain portfolio managers, credit analysts and traders with excellent track records.

Access to information and liquidity is critical

The nature and size of the parent company also influences ties that CLO managers have with issuers, private equity firms, investment banks and investors. Close ties provide access to information and liquidity in primary and secondary markets, which greatly impact the ability of the manager to form credit views, implement its trading strategy, and ultimately its performance.

Larger structures are usually more complex

A CLO manager with a large parent company can also potentially leverage its in-house systems, resources and policies. It can help establish best practices for information sharing and compliance oversight, but also often has the drawback of added complexity.

Investment team and decision making processes

Industry and product experience matters

Analysing who is part of the investment team and how decisions are made is a critical dimension of any manager assessment. Do the portfolio managers, credit analysts and traders forming the team have extensive experience in dealing with CLO structures, leveraged loan markets in different jurisdictions and at different stages of the business cycle? Breadth of industry coverage, number of credits assigned per analyst, stability of the investment team's composition over time are among the determining factors.

Is the decision-making process compatible with the investment strategy?

CLO managers will generally describe their strategy using a subset of concepts such as i) buy-and-hold, ii) relative value, iii) fundamental bottom-up analysis, iv) top-down approach to portfolio diversification, v) capital preservation, and vi) minimisation of downside risk. It is crucial to confront the strategies presented with available past performance data, and to make sense of the credit selection process in light of the overall strategy.

How do credit analysts assess different obligors and assets? What is the scoring system (if any) and how is performance monitored? Once a credit has been pre-selected, what is the voting process to decide on the investment? Managers with a relative-value, opportunistic strategy will require a quick decision-making process usually driven by portfolio managers, while managers with a more conservative buy-and-hold approach will generally favour consensus-driven decisions. A useful indicator is the turn-down rate (pre and post investment committee). Typical turndown rates for conservative managers are over 70%.

For deteriorating and defaulted credits, what are the measures taken to limit downside risk?

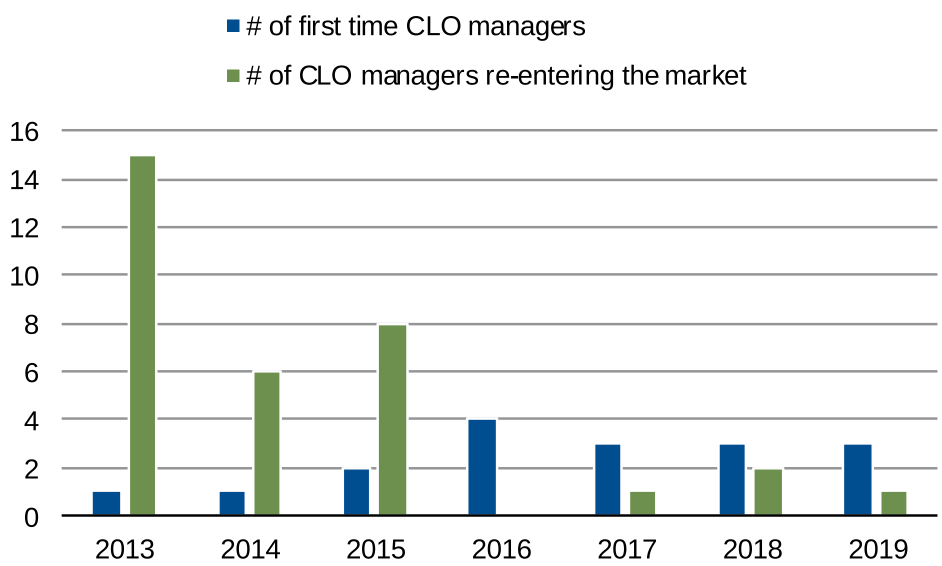
CLO portfolios under management will usually have suffered defaults or will have contained debt of obligors with deteriorating credit quality. Analysing such cases and the related circumstances shed light on how the downside risk has been minimised. Was selling before the default a better outcome in terms of par value loss than going through the default process? How does the achieved recovery rate compare to the market mean recovery rate? It is also important to understand the tendencies of the manager e.g. sell early or late, participate in restructuring processes, involvement in steering committees.

New entrants in the CLO management space

More new managers are entering the European CLO space

The European CLO market currently comprises over 50 managers. The last three years have seen the emergence of managers who had previously not been active in this space (including pre-global financial crisis). Figure 3 illustrates how many CLO managers have re-entered the European CLO market per year since 2013 and the number of new entrants. Market participants expect more new managers to emerge in 2019.

Figure 3: European CLO managers (re)-entering the market



Performance of non-CLO leveraged loan strategies can be benchmarked

The absence of past historical performance for CLO transactions makes the quantitative analysis of a new manager more difficult. However, the manager will most probably have a track record for CLOs in another geographical location, or in managing leveraged loans under a different format. The performance of the CLO management unit in the other geography gives an important insight, but it is important to consider whether its strongest attributes can be replicated in the context of the new geography.

Operational and organisational strengths usually translate well. In the absence of a CLO track record, the manager will oversee strategies in leveraged loans in the target geography under open or private funds format. Comparing such funds' returns and compositions to the ones of established leveraged loan benchmark indices[4] is one way to assess performance.

The drawback of such comparisons is the focus on mark-to-market metrics and the differences in management rules between such funds and CLO transactions. CLO portfolio management rules are usually more stringent, which might restrict managers in taking views and force them to shift investment strategies.

In-depth focus on investment personnel is necessary

As past performance might not be a good indicator, the analysis of the corporate structure and of the investment team, as introduced in the previous two sections, requires substantial effort and attention. The track records and management style of the main decision makers should be examined and compared with the new proposed investment strategy to assess compatibility and alignment with the means at disposal.

References

Liebscher, R. and T. Mählmann. 2016. Are professional investment managers skilled? Evidence from syndicated loan portfolios. Management Science 63 (6): 1892–1918.

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[4] Benchmark indices include: J.P. Morgan Leveraged Loan Index (US), S&P/LSTA Leveraged Loan Index (US), Credit Suisse Leveraged Loan Index (Europe)

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