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Triple-A by design

James Robertson, Jr. writes:

Interest rates will rise, fall or remain the same. The business climate will remain hospitable or turn stormy. The Fed will ease or tighten or do not much at all. Taking one possibility with another, we turn to collateralized loan obligations. A good CLO pays floating-rate interest income in the sub-7% range without reaching too far to get it. In preview, we are bullish on the type.

In particular, we are friendly toward the triple-A portion of those securities. Safety is a CLO design feature rather than a characteristic inherent in the loans themselves. Indeed, individually, the loans are rated, or estimated, as speculative-grade. What protects the senior investors are the junior investors. They bear the first losses.

There's risk, of course, even to the triple-A-rated tranches: credit risk, call risk and interest rate risk, among other kinds. A new bull bond market would deprive floating-rate investors of the capital gains they could have enjoyed if they had only listened to the guy in the office who kept saying that inflation was transitory. A crisis of leveraged finance could tear down the structures that withstood even the Great Recession.

CLO exchange-traded funds, including the Janus Henderson AAA CLO (JAAA) and the BlackRock AAA CLO (CLOA) are also on the editorial agenda. We treat the CLOs stocked with bank loans as well as the kind that hold loans generated by non-banks, i.e., the private credit form of lending about which you have been reading so much.

Not in 12 years has a triple-A tranche CLO been downgraded, and not in 30 has one defaulted, according to S&P Global Ratings, though the prudent investor takes proverbially small comfort from past performance. We live in leveraged times, and CLOs serve the interests of the promoters, facilitators and dealers in debt as well as the needs of the yield-needy creditor. The world's habituation to heavy borrowing and slim margins of debt-service coverage constitutes a risk of its own. The ability of a borrower to meet its obligations, admonished Benjamin Graham and David L. Dodd in the 1940 edition of their masterwork, *Security Analysis*, "should be measured under conditions of depression rather than prosperity." Certainly, a depression would test the mettle of even the triple-A tranche of a modern-day CLO. It's a thought to keep in the back of one's vigilant mind.

Functionally, CLOs are the receptacles of leveraged loans. A leveraged loan is a floating-rate, senior secured, tradable bank loan. It's issued to finance a LBO, for the most part. CLOs held 70% of all leveraged loans at the end of last September, up from 52% in 2018, according to Guggenheim Investments. The size of the CLO market has more than tripled, to nearly $1 trillion, in the past decade, fast approaching the $1.4 trillion high-yield bond market.

CLOs collect leveraged loans in a special-purpose vehicle. Because it takes debt to buy debt, CLO managers issue securities to fund themselves. The debt is structured to accommodate various tolerances for risk, from triple-A down to double- or single-B. Coupon payments and principal repayments flow from the top to the bottom tranches, according to credit rating, while losses accumulate from the bottom to the top. An equity tranche sits underneath all.

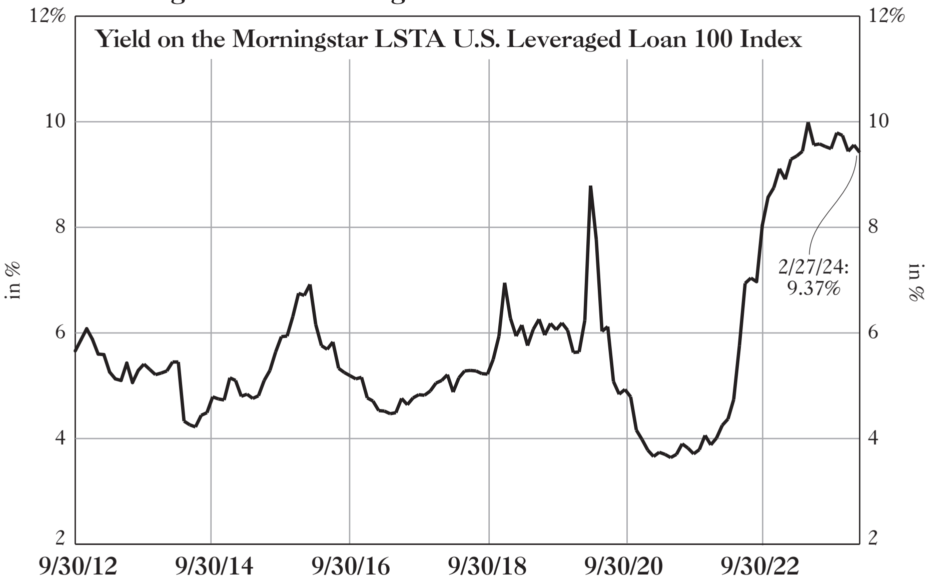
For most of the roughly eight years of a typical CLO's lifespan, a portfolio manager stands ready to trim holdings here or add holdings there. An amortizing period precedes the winding up, in which the assets mature and the investors are paid off. What surplus funds remain go to the equity holders.

Nowadays, new-issue, senior triple-A tranches yield 6.93%, or 158 basis points above SOFR, i.e., the three-month secured overnight financing rate, according to LevFin Insights. Spreads over SOFR have tightened by 42 basis points since last year's regional banking crack-up, but CLOs nonetheless offer a 202 basis-point pickup to the average fixed-coupon yield in the Bloomberg U.S. Aggregate Bond Index.

To earn a profit, a CLO must pay out less than it takes in. Thus, on average, across all tranches, a CLO will take in 9.37% and pay out 8.32%, according to the Palmer Square CLO Debt and Morningstar LSTA Leveraged Loan Indices. The 1.1% net spread—sans taxes, manager and other fees—provides the profit engine.

"There is no learning in financial markets," some say, but the calamity of the subprime mortgages set financial engineers to work to fortify the CLO senior tranches that, though they proved money-good, traded down to 70 or so cents on the dollar in the 2008–09 liquidation. The resulting credit enhancements, including stricter collateral tests and bigger loss-absorbing subordinated tranches, mean that today's CLOs could bear a cumulative

The high cost of leverage



source: The Bloomberg

loss of 38% before triple-A investors face impairment, Morgan Stanley estimates. Before the 2007–09 meltdown, that threshold was on the order of 25%.

The new and improved design features of the "CLO 2.0" was the subject of a December note from Guggenheim Investments. "First," the analysis led off,

> rating agencies now require that CLOs carry substantially more overcollateralization than their pre-crisis counterparts. Second, whereas pre-crisis CLOs were able to make meaningful investments in subordinated bonds and other structured credit instruments, post-crisis CLOs are collateralized almost exclusively by senior secured bank loans. Third, post-crisis CLOs' documentation is much more investor friendly, for example, by shortening the trading period during which the manager is able to actively manage the loan portfolio and limiting extension risk for CLO securities.

Moreover, the CLO's manager must comply with rules pertaining to overcollateralization, credit quality and interest coverage, among other safeguards. Failure of the overcollateralization or interest-coverage test requires the manager to redeploy cash flows to pay down the triple-A tranche until the deficiency is cured. CLO, heal thyself.

There are other rules of the road, including limits on portfolio concentration and on holdings of second-lien and covenant-lite loans. As of last year's third quarter, technology claimed the top share of CLO portfolio exposure (12.2%), followed by healthcare and pharmaceutical (11.4%) and business-services companies (10.0%).

CLOs offer more liquidity than you might suppose. There's a transparent secondary market for the individual loans; a typical CLO turns over 15%–16% of its portfolio a year during the reinvestment phase of its life. Triple-A tranches, too, are marketable; banks, insurance companies, pension funds and asset managers buy and sell them.

"If you go back to the dark days of Covid," John Kerschner, head of U.S. securitized products at Janus Henderson Group plc, tells me, "a lot of markets were completely shut down. You couldn't really trade anything at all. The markets that were open were Treasury, agency mortgages—and triple-A CLOs. So we actually were trading triple-A CLOs on March 24, 2020, the second-worst day to trade any spread product in fixed income since the day before Lehman went bankrupt."

The question of liquidity gains new relevance as private credit moves to issue CLOs of its own. Last Thursday, Blackstone, Inc. priced a $402 million private credit CLO with a triple-A tranche offering a 183 basis-point pickup over SOFR. The fund will hold loans originated by BCRED, Blackstone's in-house private credit fund.

Like private credit itself, private credit CLOs are enjoying a growth spurt. In the first six weeks of this year, $4.2 billion of direct-lending CLOs came into the world, according to Goldman Sachs research, marking a record 23% of total CLO issuance, up from the typical 10%.

The objective of a bank-originated CLO is to earn a spread; the point of a private credit CLO is to clear out portfolio space for more lending. "Private credit CLOs are typically financing trades," Andrew Berlin, vice president and director of policy research at the Loan Syndication and Trading Association, tells me, "which means they are used to transfer or free up capacity on the balance sheet of the originator...giving the originator capacity to extend new loans."

There's no mistaking a bank-originated CLO for the private credit version. The average borrower in a bank CLO is rated single-B or higher; the average borrower in a private credit CLO is "estimated" (not rated) single-b or lower. The lower-case "b" is no typo. It denotes no formal rating (which earns capital letters) but a judgment based on information provided by the party requesting the estimate. More than two-thirds of such private credit obligors received a credit estimate of single-b-minus, according to a September report by Morgan Stanley.

In the third quarter of 2023, S&P saw the highest number of downgrades in credit estimates since 2020. The 91 demotions were more than four times the number of upgrades (19).

There are differences, too, in portfolio size and concentration and—by reason of those variances—in portfolio diversification. If the standard bank-originated CLO holds 300 credits, the standard private credit variant might house only 100. Private credit portfolio managers buy to hold, but the anemic secondary market in private credit claims means that there may not be another option. The loan, or the tranche, they bought is the one they tend to keep.

Mitigating such risks, private credit CLO managers and investors operate with higher equity cushions, yields and covenant-lite limits than bank-originated structures. You see it reflected in the estimated threshold of cumulative losses before the triple-A investors face loss: 44.7% compared with the aforementioned 38% for the bank-originated structures.

Anyway, Mr. Market seems to like what he sees. Triple-A tranches of direct-lending CLOs nowadays earn a spread premium of fewer than 20 basis points over SOFR versus the bank-originated kind, down from 75 basis points in June, Goldman Sachs analysts led by Roger Ashworth reported two weeks ago.

For the individual investor in search of CLO exposure, exchange-traded funds solve a number of problems, including a manageable minimum investment size (compare the $250,000 minimum for the typical CLO) and diversification by borrower, industry type and loan vintage. The funds are actively managed—you can think of a CLO exchange-traded fund as a fund of CLO funds. Some hold solely senior tranches, while others go further afield, to the mezzanine level. Expense ratios range from 0.20% for the BlackRock AAA CLO ETF (CLOA) to 0.50% for the Panagram BBB-B CLO ETF (CLOZ).

Janus Henderson's AAA CLO ETF (JAAA) leads the pack in fundraising, with $6.74 billion under management compared with the distant second, VanEck CLO ETF (CLOI), which has $267.8 million. JAAA yields 6.75%, per the 30-day Securities Exchange Commission standardized yield. In 2023, the fund returned 8.58% versus 8.68% for the J.P. Morgan CLO AAA Index.

According to the prospectus, JAAA must invest 90% of its assets in triple-A tranches with the remainder divided between double-A and single-A. Currently, the segmentation looks like this: 93% triple-A, 6.6% double-A and 1.4% single-A; the private credit market is expressly off-limits. The management fee, for now, stands at 22 basis points.

A newcomer to the CLO AAA fund arena is BlackRock's CLOA, which launched in January 2023 and offers a SEC standardized yield of 6.54% after a 20 basis-point fee. The fund does not currently hold any private credit CLOs.

The BlackRock entrant has returned 8.60% since inception versus 8.40% for the J.P. Morgan Index. At least 80% of its assets are devoted to investments in tranches initially rated triple-A with up to 20% in double-A and single-A. As of Feb. 23, the fund held 80.2% in triple-A, 14% double-A and 2.2% single-A tranches.

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