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CLOs: A Bias Toward Quality

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CLOs continued their rebound in the third quarter, but the potential for volatility going forward is high. In this environment, there may be benefits to moving up in quality.

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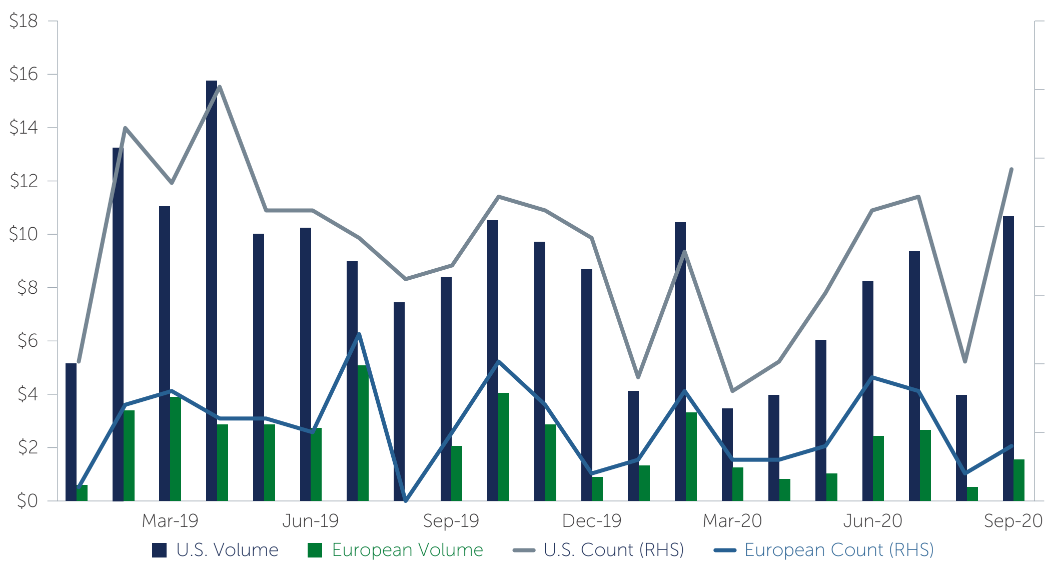
Collateralized loan obligation (CLO) performance was strong through most of the third quarter, supported by better-than-expected economic data and strong technical support. While volatility resurfaced toward quarter-end, the asset class ended the quarter in positive territory, with AAA, AA and single-A finishing up 1.51%, 3.34% and 2.47%, respectively. BBB, BB and single-B tranches also delivered positive performance, at 3.25%, 5.14% and 10.86%.[1]

From a technical perspective, supply and demand dynamics remained largely supportive. Following limited new issuance in July, supply all but dried up in August, causing spreads across the capital structure to tighten meaningfully. Issuance then returned with gusto in September as managers sought to take advantage of the more favorable cost of capital.

The strong supply was relatively well-absorbed by the market and met with decent demand. Senior AAA tranches, in particular, continued to experience strong demand, primarily from insurance companies and other large institutional buyers looking for yield in today's lower-for-longer rate environment. On the mezzanine side, demand remains bifurcated, with a continued preference for clean, new issue deals (versus seasoned secondary deals) with limited exposure to COVID-impacted sectors. That said, a number of opportunistic CLO buyers entered the secondary market in September—in the form of new funds aimed at capitalizing on market dislocations—although that waned somewhat as volatility increased later in the month.

FIGURE 1: Monthly New CLO Issuance Volume



SOURCE: J.P. Morgan. As of September 30, 2020.

From a fundamental standpoint, the pace of downgrades to underlying loans has slowed substantially, and only a small percentage of the market remains on watch by the ratings agencies. The default outlook for the leveraged loan market for next 12 months remains stable—at around 4–6% for seasoned deals, and even lower for newer vintages—and still well-below projections from the height of the crisis, which were closer to 10%.

1. Source: J.P. Morgan CLOIE Index. As of September 30, 2020.

While the default picture appears to be contained, the CLO recovery picture has garnered increased attention in recent weeks. Although CLOs are the largest investors in the leveraged loan market, they can be limited, relative to other buyers, in their ability to invest in higher-risk restructured loans. With a greater portion of the leveraged loan market potentially moving into distressed territory on the back of COVID, questions have been raised around whether these limitations will lead to lower overall recoveries. In response, many CLO managers have been advocating for more flexible documentation, in both recent and existing deals, that would allow them to participate in workouts or distressed exchanges to try and improve ultimate recoveries.

From Volatility to Opportunity

Amid fears of a second wave of COVID and the run-up to a contentious U.S. presidential election, the potential for volatility going forward is high. Against this backdrop, we believe there are merits to moving up in quality—and specifically to taking advantage of pockets of strength to rotate into higher-quality deals that may be better positioned to weather the storm.

Risk-remote AAA and AA tranches, for instance, continue to look attractive given their position at the top of the capital structure. Within AAA tranches specifically, there can be a significant spread differential by manager type. In recent weeks, new issues from strong, tier 2 managers have, in our view, offered an attractive spread pick-up versus deals from tier 1 managers—while still offering good liquidity in the secondary market.

Further down the capital structure, we continue to look for opportunities that emerge on the back of volatility. Generally speaking, we favor mezzanine tranches of new issue CLOs where the portfolios are ramped with full knowledge and consideration of the industries and credits most effected by the pandemic, as well as high quality secondary tranches that offer more discount yet have limited exposure to risky credits. New issue BBBs began to look more compelling toward quarter-end as spreads widened amid a more turbulent market, and we prefer new issue BBs that offer a discount.

It is also worth noting that periods of volatility can, and often have, led to price dislocations, during which even higher-quality portions of the capital structure are marked down, in some cases to prices well below what fundamentals would suggest. Given CLOs' inherently strong structural protections and low historical default rates, these periods of stress can often also lead to compelling investment opportunities. However, manager selection is critical, and we are keenly focused on how CLO managers behaved during the recent period of stress, and on assessing how such behavior may translate into future performance.

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