



FIXED INCOME

## Are CLOs Unfairly Vilified?

BARINGS INSIGHTS



**Melissa Ricco**

Managing Director, Co-Head of Barings'  
Structured Credit Investment Team



**Taryn Leonard**

Managing Director, Co-Head of Barings'  
Structured Credit Investment Team

The fact that today's collateralized loan obligation (CLO) market has often found itself in the crosshairs of the financial press—purportedly mired in 'hidden risks'—suggests that the asset class tends to be somewhat misunderstood, and the benefits overlooked.

It's important to acknowledge that we are, in fact, deep in the throes of an elongated credit cycle, and market jitters are not only commonplace, but in many cases, substantiated. That said, there is a danger that fear around CLOs—potentially stoked by negative headlines and rooted in a misunderstanding of their mechanics—could result in a missed opportunity for investors to earn potentially strong risk-adjusted returns in what has proven time and time again to be a resilient asset class.

In recent months, we've seen two predominant concerns highlighted in the press: widespread stress in the leveraged loan market, and looser documentation—both within CLOs and the underlying loans by which they are collateralized.

## Concern #1: Underlying Loan Market Stress

Late-cycle credit market fears are nothing new to investors, especially with a current cycle that is now more than 10 years in the making. But fears intensified last year, as evidenced by outflows from the leveraged loan market (likely also heavily driven by lower interest rates), a number of idiosyncratic credits that encountered stress, and the underperformance—though still positive returns—of loans versus high yield bonds.

Within CLOs specifically, the primary concern is that the loan market weakness will lead to a spate of downgrades from single-B rated loans to CCC rated loans in their underlying collateral. This has the potential to rattle CLO investors for two reasons:

- First, if there's a greater percentage of CCCs within the collateral pool, inching nearer and nearer to its typical 7.5% threshold—investors could potentially be exposed to credit losses and/or defaults within the CCC bucket. And if that bucket continues to grow, it could eventually trigger the structure's cash diversion mechanism and cut off cash flows to the junior debt tranches.
- Second, in order to prevent that, CLO managers might decide to sell those newly-downgraded CCC assets into the market at unfavorable prices.

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## The Reality

While these are valid concerns, there is more nuance than may be obvious at the headline level. For the leveraged loan market, despite broader late-cycle concerns, interest coverage ratios and balance sheets are still quite strong. Loans are secured by the assets of the company, and have demonstrated historically strong performance with lower volatility. Maturities have been pushed out—which means we do not face a ‘maturity wall’ over the next few years, in which a substantial portion of the loan market would need immediate financing at the same time. There are also typically solid equity cushions beneath the debt, and defaults are still low, and expected to remain that way for the near to medium term.

Regarding CCC collateral concerns within the CLOs themselves, we think there are two important misconceptions here. First, CLOs are **not mark-to-market vehicles** and **managers are not forced sellers**.<sup>1</sup> In fact, because many CLO managers take a longer-term view on CLO structures, they might reasonably opt to hold those underlying assets through a period of market weakness—assuming they expect the CCC rated names to ultimately rebound at a higher recovery value. That's exactly what happened throughout the Global Financial Crisis, and more recently when BB-rated tranches of CLOs sold off in 2019—both of which proved to be opportunities for nimble managers. Second, in the event that a CCC bucket meets its stated cap and the cash diversion mechanism is triggered, this is meant to be a **short-term diversion for long-term investor gain**. That cash flow to the junior debt or equity tranches is temporarily used to either pay down the structure or buy more collateral—both of which serve the purpose of making the overall structure stronger.

1. The financing of the CLO structure is not marked to market. The cost is locked in and not subject to market moves. Reinvestment periods allow managers to buy and sell collateral in order to maintain or improve the credit quality of the structure.

## Concern #2: Looser Deal Documentation in Both the Underlying Loans and CLO Structures

Concerns around loosening documentation have proliferated across a variety of asset classes—and leveraged loans and CLOs are no exception.

In the loan market, concerns include:

- The trend toward covenant-lite loans as the market standard (approximately 80% of the broadly syndicated loan market is now considered covenant-lite).
- EBITDA adjustments (i.e. earnings before interest, taxes, depreciation and amortization), for the express purpose of improving the company's stated profitability
- Modifications to voting provisions or collateral release that could fundamentally change the economics of the loan

In the CLO market, concerns include:

- Swapping distressed assets for other distressed, but still performing, assets and carrying them at par (known as discount swap)
- Ability for collateral principal to be passed out to equity holders, which can reduce debt holder enhancement
- Transition risk from the LIBOR benchmark replacement that is forthcoming in 2021 (also a potential concern with underlying loans)

### The Reality

**With respect to loan documents**, this is where the **absolutely critical component of manager selection** comes into play. While there are plenty of unfavorable terms out there, a seasoned CLO manager will identify potential issues within each loan document, in an effort to effectively underwrite and price risk. At Barings, we're looking for loan managers with experience managing through multiple cycles, a track record of minimizing credit losses, a deeply resourced team, strong internal research capabilities, and consistency of style. This is essential to navigating a late-cycle credit environment where boundaries may be pushed.

As it relates to covenant-lite loans—or loans lacking financial maintenance covenants—while we prefer more lender protections than less, the reality is that maintenance covenants can be cumbersome and costly for issuers to manage. And while in theory it could be helpful to get an early warning sign in the form of a maintenance covenant breach, in reality, managers with large teams analyzing single credits day-to-day should be well ahead of these potential problems. It's worth noting that the loans are also not "covenant-free." They still contain financial incurrence covenants—or metrics that must be met before an issuer takes an action like issuing debt or making an acquisition. Given the proliferation of covenant-lite documentation, ironically, it is the loans that are most troubled that tend to carry maintenance covenants today.

**With respect to CLO documents**, it's imperative to understand that **deal documents are typically negotiated by the CLO investor** as part of the underwriting process—which again underscores the importance of partnering with a trusted veteran. At Barings, we review all document provisions prior to investing, and pay special attention to those that erode traditional investor protections. That said, we are mindful of allowing collateral managers enough flexibility to manage the portfolio in times of stress, rather than being handcuffed by static provisions. The discount swap is an example of a provision that can be beneficial to debtholders, as the collateral manager is incentivized to swap into what they believe is a better loan. In fact, there are dangers from constraining a manager too much as non-CLO investors (i.e. distressed debt managers) seek to exploit CLO restrictions for their own purposes.

Based on our experience, collateral managers are heavily incentivized to build trust and achieve strong performance for their investors **over the long term**. Short-term financial engineering that benefits the manager at the expense of the investors is the exception rather than the rule—and, in our view, is likely to tarnish the reputations (and likely the future ability to raise capital) of any managers who go down this path. It is also one of the reasons we believe manager selection is so important.

## The Benefits

In our view, the benefits of CLOs far outweigh the arguments made against them.

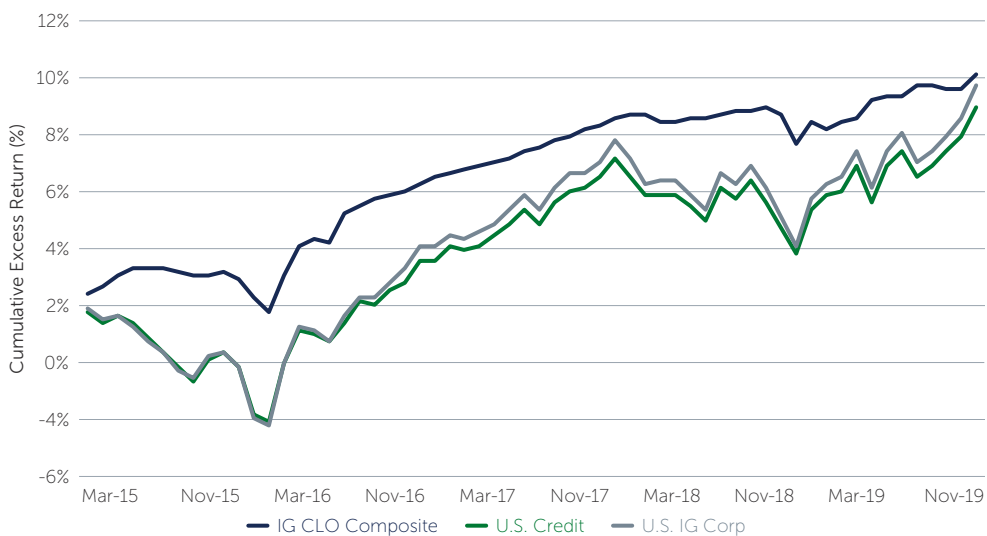
1. CLOs can potentially provide incremental yield—with less volatility and lower interest rate risk for investment grade tranches.

CLOs tend to earn greater yield than investment grade corporate credits, given their historical tendency to trade at a wider spread to a 'risk-free' rate, therefore earning a spread premium for similarly rated assets. Additionally, the diversification offered by CLOs innately offsets idiosyncratic credit risk—or the risk posed by any one individual credit—in investment grade tranches, thereby reducing overall volatility.

The incremental yield aspect is true of the high yield portion of the structure as well. Leveraged loans are the building blocks of CLOs, and the BB tranche of a CLO, based on recent market prices, offers about two times the spread of the leveraged loan market itself. So investors are earning a material spread pick-up by owning the same or similar collateral, but in a different form.

Further, CLOs have floating-rate coupons, making the duration—or interest rate risk—less. So, prices tend to be more stable in a rising-rate environment than those of their fixed-rate counterparts. This contributes to the lower volatility of investment grade CLO tranches versus corporates, as shown in **FIGURE 1**.

**FIGURE 1:** CLOs Have Achieved Comparable Returns With Less Volatility



	Barings IG CLO Composite*	Barclays U.S. Credit Index	Barclays U.S. Corporate Index
Excess Return (Cumulative)	9.91%	8.67%	9.50%
Excess Return (Annualized)	1.91%	1.68%	1.83%
Standard Deviation	1.37%	3.71%	3.89%
Sharpe Ratio	1.39	0.45	0.47

SOURCES: Barings, Bloomberg Barclays. As of December 31, 2019.

\*Barings IG CLO Composite is comprised of approximately 55% AAA rated credits, 35% AA, and 10% single-A and BBB.

**2. CLOs have had historically lower default rates than their corporate and securitized counterparts.**

CLO tranches have defaulted far less frequently than equivalently rated corporate credit and other securitized products, reinforcing the attractiveness of the asset class versus traditional fixed income sectors. In fact, according to S&P, only 0.3% of all CLO tranches have defaulted since 1994—even after the Global Financial Crisis.<sup>2</sup> Within that, AAA tranches have not experienced a single default—meaning the top tier has never lost one dollar of principal or interest—and AA tranches have only experienced one, as shown in **FIGURE 2** and **FIGURE 3** to the right.<sup>3</sup>

**3. CLOs offer several structural protections for investors.**

CLO structures are notably robust, partially because they contain a series of coverage tests that protect investors' capital over the structure's life. An overcollateralization test, for example, diverts cash in the event that collateral dwindles low enough—thereby cutting off cash flow to junior CLO debt tranches, and instead rerouting it to senior debt tranches. An interest diversion test—which is a similar concept—instead reroutes cash to buy more collateral. In either case, this tends to be a short-term diversion, with the goal of long-term betterment for the debt holders. By paying down the structure or enhancing its collateral value, the mechanisms are effectively suppressing the likelihood of default and loss, especially for the more senior tranches.

**4. CLOs documents are typically negotiated.**

Importantly, as mentioned, CLO deals are negotiated in most cases. It is not a 'take it or leave it' scenario where asset managers investing on behalf of their clients are forced to buy a deal with unfavorable terms. Rather, it is a negotiation where asset managers can influence the terms of the deal, ask for additional provisions, or request other features that may benefit the end investor.

This is where experience in the market and knowledge of the CLO collateral manager landscape are absolutely critical. Underwriting the quality of both the collateral, and just as importantly, the manager—and being in a position to influence terms on transactions—can materially benefit the end investor over the long term.

But it's equally important to give trusted managers flexibility, especially when they are properly incentivized, to actively manage the portfolio as they aim to achieve attractive long-term returns.

**FIGURE 2: S&P Default Rates**

S&P Original Rating	Total U.S. CLO Tranches Rated <sup>1</sup>	Total U.S. CLO Defaulted Tranches <sup>1</sup>	Total U.S. CLO Default Rate <sup>1</sup>	S&P Average U.S. Corporate 5-Year Cumulative Default Rate <sup>2</sup>
AAA	2,803	0	0.0%	0.4%
AA	1,629	1	0.1%	0.5%
A	1,625	5	0.3%	0.7%
BBB	1,475	9	0.6%	2.1%
BB	1,182	19	1.6%	8.4%
B	218	3	1.4%	19.6%

1. Source: Barings. For the period from 1996 through the third quarter of 2017, the date of the most recent study by S&P.

2. Source: Barings. For the period from 1981 through 2016.

**FIGURE 3: Moody's Default Rates**

Moody's Original Rating	U.S. CLO Default Rate <sup>3</sup>	European CLO Default Rate <sup>3</sup>	Moody's Average Global Corporate 5-Year Cumulative Default Rate <sup>4</sup>	CMBS Default Rate <sup>5</sup>	ABS Default Rate <sup>5</sup>
Aaa	0.0%	0.0%	0.1%	2.1%	0.7%
Aa	0.0%	0.0%	0.3%	7.8%	3.9%
A	0.1%	0.0%	0.8%	14.2%	2.8%
Baa	0.9%	0.5%	1.5%	17.6%	5.6%
Ba	1.4%	2.5%	8.5%	31.4%	16.3%

3. Source: Barings. For the period from 1993 through 2017, the date of the most recent study by Moody's.

4. Source: Barings. For the period from 1983 through 2017.

5. Source: Barings. For the period from 1993 through 2016.

**The Takeaway**

While we acknowledge that there are some legitimate concerns, in our view they are somewhat overstated—and do little justice to the many benefits that CLOs offer. We would argue that investors should consider an allocation to CLOs as a core component of their credit portfolio for several reasons—primarily incremental yield, enhanced structural protection, and lessened idiosyncratic credit risk via diversification. While CLOs are subject to relative bouts of volatility, as with any asset class, they have also continued to deliver impressive risk-adjusted returns and low defaults over time.

2. As of December 31, 2019.

3. The AA default was not due to loss of principal, but rather a technical issue per the documentation, due to late maturing assets. The tranche was fully paid off.

Investment Grade CLO Strategy Composite  
Reporting Currency: USD  
Schedule of Performance Results

Annual	Composite Annual Return (Gross)	Composite Annual Return (Net)	Composite Asset-Weighted Dispersion	3-Year Annualized Std Dev. (Composite)	Total Composite Assets (USD Millions)	Total Firm Assets (USD Millions)	Percentage of Firm Assets	# of Portfolios at End of Period (# of Entire Period)
12/31/2019 <sup>^</sup>	4.97%	4.55%	1.05%	1.05%	4,096	319,150	1.28%	12 (8)
12/31/2018	1.52%	1.11%	0.93%	1.48%	2,261	286,629	0.79%	9 (8)
12/31/2017	3.59%	3.18%	0.94%	1.42%	1,962	284,798	0.69%	9 (6)
12/31/2016	4.50%	4.08%	0.46%	1.53%	1,248	178,724	0.70%	7 (6)
12/31/2015 <sup>^</sup>	2.13%	1.72%	NM	0.97%	1,072	163,934	0.65%	7 (5)
12/31/2014 <sup>^</sup>	1.15%	0.80%	NM	N/A	1,172	157,257	0.75%	5 (3)
12/31/2013 <sup>^</sup>	1.28%	0.93%	NM	N/A	571	142,832	0.40%	4 (1)
12/31/2012 <sup>**^</sup>	1.34%	1.25%	NM	N/A	51	116,633	0.04%	1 (1)

<sup>^</sup> All information for the periods indicated has not been examined by independent accountants.

NM The asset-weighted dispersion of five or fewer portfolios for the entire year is not meaningful.

\*\* Returns from composite inception date of October 01, 2012 to December 31, 2012.

#### COMPLIANCE STATEMENT

Barings, fka Babson Capital Management LLC, claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Barings has been independently verified for the periods 1993–2018. See firm definition for further information. Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm’s policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. The Investment Grade CLO Strategy composite has been examined for the periods 2016–2018. The verification and performance examination reports are available upon request.

#### DEFINITION OF THE FIRM

Barings, “Firm”, provides investment management and advisory services to both institutional and individual clients. For purposes of compliance with the Global Investment Performance Standards (GIPS®), the Firm defines itself as consisting of the portfolios that it manages directly. In 2017, the previous subsidiaries of Babson Capital Management, “Babson”, including Babson, were consolidated under the Barings name for GIPS purposes. Those entities included Babson Capital Management LLC, Cornerstone Real Estate Advisers LLC, Baring Asset Management Limited, and Wood Creek Capital Management LLC. In 2017, the firm assets represent the consolidated entity. Barings, “Firm”, excludes Barings Shanghai and Baring Asset Management Korea Limited. Baring Asset Management Korea Limited independently claims Compliance with the GIPS standards. A list of the Firm’s composite descriptions is available upon request.

#### POLICIES

The Firm’s policies for valuing portfolios, including performance and preparing compliant presentations are available upon request.

#### COMPOSITE DESCRIPTION

Portfolios included in the Investment Grade CLO Strategy composite seek to invest in US CLO securities that carry original ratings from AAA to BBB. Some portfolios may also invest in European CLO tranches, however all investments are hedged back to US Dollars. The minimum portfolio value requirement for inclusion in the composite is USD \$25,000,000. The name of the composite was changed from Senior CLO Strategy to Investment Grade CLO Strategy in September 2015. The composite was created in September 2012.

#### BENCHMARK

Due to the lack of market availability regarding benchmarks related to this strategy, US CLO priorities tranches, no benchmark will be assigned.

#### FEES

Returns are presented gross of management fees, custodial fees, and withholding taxes but net of all trading expenses. Net of fee performance results are calculated by deducting from the gross monthly return using the highest fee charged for a member portfolio on an annual basis dedicated to this strategy during the periods presented. Applicable Fees for 2012–2014: 35bps, and 2015 forward: 40bps. Actual fees may depend on, among other things, the applicable fee schedule and portfolio size.

#### PERFORMANCE RESULTS

Results are calculated using a time-weighted total-rate-of-return formula. The composite is asset-weighted; individual portfolios are valued daily on a trade-date basis and include accrued income. The composite and benchmark results assume the reinvestment of distributions. Performance results include all portfolios under the Firm’s management that meet the Composite Definition. A portfolio is included in the composite when it is deemed that the investments made by the investment advisor fully reflect the intended investment strategy.

#### PAST PERFORMANCE IS NOT A GUARANTEE OF FUTURE PERFORMANCE.

#### ASSETS, COMPOSITE DISPERSION, EX-POST STANDARD DEVIATION

The asset base used to calculate the composite’s percentage of Firm assets includes both discretionary and non-discretionary portfolios managed by the Firm, and also includes non-fee paying portfolios. The asset-weighted dispersion calculation measures the deviation of individual portfolio returns around the aggregate composite return. Only portfolios that have been managed for a full annual period have been included in the dispersion calculation. No Dispersion is reported for periods with five or fewer portfolios (shown as NM). The three-year annualized ex-post standard deviation of the composite gross return and benchmark are displayed above unless 36 monthly returns are not available (shown as N/A).



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