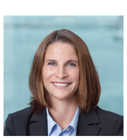
FIXED INCOME

CLOs: When Technicals Create Opportunity

BARINGS CONVERSATIONS

This piece was adapted from an interview with Taryn Leonard and Melissa Ricco. The full audio podcast can be found ***here.****

Investors are on heightened alert amid a multitude of macroeconomic risks and negative headlines in the press. Taryn Leonard and Melissa Ricco, Co-Heads of Barings' Structured Credit investment team, discuss where they're seeing opportunities and risks today—and why technical factors are creating inefficiencies, and hence opportunities, in today's market.



Taryn Leonard
Co-Head of Structured Credit Investment Team

Melissa Ricco
Co-Head of Structured Credit Investment Team

*Full podcast URL: https://www.barings.com/viewpoints/clos-triple-cs-and-market-unease.

There is somewhat of a dichotomy occurring in the market at the moment. On one hand, the economy is still in pretty good shape, with low unemployment and slow-but-steady growth. On the other hand, we've seen some stress in parts of credit markets. Can you discuss what you're seeing in the credit markets overall, and in the loan markets more specifically?

Melissa: There is definitely more of a risk-off sentiment in the market today. It's safe to say that investors are concerned over the state of the economy—whether that's due to slowing global growth, trade tensions or simply that many believe we're late-cycle. On the loan side of the equation, idiosyncratic risks are starting to appear more frequently in the market. We're starting to see large price movements, and concern over downgrades in the low single-B rated part of the market. As a result, there's been notable bifurcation between low quality and high quality credits, with a bias toward the latter.

Taryn: Loans do appear to be largely out of favor. Investors were very interested in the loan market in 2018, when rising rates were a concern. But once the U.S. Federal Reserve (Fed) pivoted to a dovish tone in the first quarter of 2019, we started to see an exodus out of retail funds—in fact, we've seen 13 straight months of outflows. This sell-off created a technical opportunity in the market—and as a result, in some of our broader multi-credit strategies, we've started to pivot and add to our exposure in loans. We think they offer a number of potential benefits in the current environment—not only on a yield basis relative to bonds, but also because they are secured assets. Over time, we think loans are well positioned to outperform—and CLOs can be a great way to access the loan market with the added benefits of diversification and structural protection.

That's a good segue to CLOs. With respect to those structures, can you discuss what you're currently seeing from a supply and demand perspective?

Melissa: The CLO market has seen impressive supply over the course of 2019—standing at about $100 billion in the U.S. through the third quarter. And the prior two years were even stronger. Taken as a whole, this speaks to the fact that investors across the globe are looking at the asset class as being particularly attractive in a low-rate environment. More recently, we've seen supply slow quite a bit. The main reason is that CLO spreads are wide relative to collateral loan spreads, making this a less attractive time to form CLOs from an equity perspective.

From the demand side of the picture, there has been a slight slowdown as well—as investors grow increasingly concerned with credit fundamentals and negative headlines, and shift their focus to the highest-quality portfolios.

Drilling down to the bottom portion of the capital structure, can you discuss some of the opportunities and risks that you're seeing in the mezzanine tranches of CLOs today?

Taryn: Similar to the bifurcation that we've seen in the loan markets in general, there has been a bifurcation within the mezzanine CLO space. In one respect, we've seen increased tail risk in the more seasoned deals—as they tend to have more exposure to some of the recently storied credits that have traded off a fair amount—and the market value coverage for all BB tranches has decreased, which many investors see as a sign of increased risk. But on the flip side—as a result of the whole market trading off, combined with negative headlines—new issue deals are coming to market that are backed by clean portfolios of loans with arguably lower credit risk, and they've widened to levels that are extremely attractive.

"This loan sell-off by retail funds created a technical opportunity in the market—and as a result, we've started to pivot and add to our exposure in loans. We think they offer a number of potential benefits in the current environment—not only on a yield basis relative to bonds, but also because they are secured assets."

This volatility poses a significant investment opportunity in newly issued CLOs, particularly in lower-rated tranches like BBs and BBBs. Within most underlying portfolios of CLOs, the loans have weighted average spreads somewhere in the range of LIBOR plus 350–355 basis points (bps). And if you look at BBs with clean underlying portfolios, right now we're able to source those in the new issue market at close to LIBOR plus 800 bps—which means BB buyers are currently earning about 2.25 times the loan spread, whereas for much of 2018, that was about 1.6 times. So, from a historical perspective, the mezzanine tranches of CLOs are an attractive place to be invested.

All of that said, we still want to acknowledge that there are increased risks. While AAA CLOs are very risk remote, BB tranches are leveraged exposure to leveraged loans. On top of that, there could be further outflows from retail funds, or other factors that could result in pressure on loan prices.

Should investors be concerned about the headlines surrounding CCC rated loan exposure in CLOs and loans trading below $80?

Taryn: CLO portfolios today are positioned with a much larger exposure to low single-B rated credits than they were in the last cycle. So, as we look out at rating agency forecasts, investors fear that there could be a large spate of downgrades of low single-B to CCC—which could result in cash diversion within the CLO structure. Most CLO structures have a 7.5% threshold for CCC rated collateral. Once you get above that percentage, haircuts are applied—which could lead to the triggering of a mechanism that cuts off cash flows to equity, and instead diverts those cash flows to buy more collateral or pay down AAAs. Not surprisingly, this creates concern for investors. But this is also one of the reasons that these structures have held up so well over time. From a default perspective and ultimate repayment perspective, AAA rated and AA rated tranches have never lost a dollar of principal or interest. They're remarkably robust.

Additionally, investors are increasingly focused on the exposure to credits in underlying portfolios that are trading below $80 (based on $100 par value). However, many of the loans trading below $80 do not pose near-term default risks, and some are conviction credits for managers. Price doesn't always tell the full story. There are loans trading in the neighborhood of $70–80 that are essentially orphaned because there is no natural buyer. They are not yet trading at levels that are wide enough to garner interest from distressed buyers—and CLO managers don't want to buy them either, because they cannot buy loans trading below $80 without haircutting them. The good news is that there is an opportunity for investors who have the ability to drill down into the actual risks in the underlying portfolios instead of just focusing on headline numbers.

If we step back and consider the bookends of the capital stack—meaning AAAs and equity—are you seeing value in either today? How do investment grade (IG) rated CLOs stack up against other corporate credits?

Melissa: IG-rated CLO tranches look attractive in most comparisons to other asset classes. Not only do they provide incremental yield for the rating, but they can be viewed as more defensive given their capital structural support and cash diversion trigger mechanisms. For example, AAA rated tranches pay at least 30 bps more spread than the IG index, on average. That tranche can withstand the entire portfolio defaulting with a 70% recovery, on average. Looking further down the stack, a BBB rated tranche trades at a spread equivalent to a single-B rated loan portfolio, and can withstand approximately 15% collateral loss.

Taryn: On the other end of the spectrum, we think there's value to be found in CLO equity—but not much in the new issue market today. New issue CLO formation tends to be more of an AUM growth game for managers right now—and in most cases, those managers are buying all of the equity in their own deals, since third parties aren't raising their hands.

This reticence is not so much a function of being late-cycle as it is a function of where CLO liabilities are currently pricing.

That said, we think there's an interesting opportunity in the secondary market right now. With the recent loan sell-off, valuations of CLO equity have gone down quite a bit. For the most part, CLO equity tends to be owned by fairly sophisticated investors, and they're not necessarily looking to sell into the current environment. But to the extent that we see opportunities pop up, we believe it's a compelling time to buy secondary equity.

Finally, we've been flooded with headlines of a potential economic slowdown or the end of the credit cycle, and the default picture is also top-of-mind for investors. As you think about managing through this period, what does your playbook look like? Do you have any final advice for investors?

Melissa: First and foremost, I would say—we've been here before and in a much more extreme situation. The key is patience, understanding the risks and knowing how to identify them proactively, and selecting the right managers. We've seen a lot of dispersion in manager performance over time—and it's critical to invest with CLO managers that have been through a cycle before, and have a proven track-record with a deep bench. We think there are significant opportunities in the market, but it's imperative to drill down into the underlying portfolios and understand how the managers will behave in volatile markets.

Investors with a longer-term view and an eye toward risk management, in particular, should be well positioned to enter the asset class. No good manager designs a CLO without the expectation that they will eventually go through a credit cycle or experience defaults. These structures are built to withstand the bumps that will inevitably come—and right now is testament to that. Though we are seeing some volatility, it isn't anything outside of what we would expect to see over the course of a cycle.

"In our view, the best approach is to look for opportunities that arise from the volatility, and buy deals and tranches from high quality managers—with structures that are strong and portfolios that have contained credit risks."

Taryn: We certainly prefer to be buyers versus sellers in the current environment. In our view, the best approach is to look for opportunities that arise from the volatility, and buy deals and tranches from high quality managers—with structures that are strong and portfolios that have contained credit risks. There will undoubtedly be some turbulence ahead—but this is an asset class that has weathered quite a bit of battering effectively.

Barings is a $335+ billion global financial services firm dedicated to meeting the evolving investment and capital needs of our clients and customers. Through active asset management and direct origination, we provide innovative solutions and access to differentiated opportunities across public and private capital markets. A subsidiary of MassMutual, Barings maintains a strong global presence with business and investment professionals located across North America, Europe and Asia Pacific.*

IMPORTANT INFORMATION

Any forecasts in this document are based upon Barings opinion of the market at the date of preparation and are subject to change without notice, dependent upon many factors. Any prediction, projection or forecast is not necessarily indicative of the future or likely performance. Investment involves risk. The value of any investments and any income generated may go down as well as up and is not guaranteed by Barings or any other person. PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS. Any investment results, portfolio compositions and or examples set forth in this document are provided for illustrative purposes only and are not indicative of any future investment results, future portfolio composition or investments. The composition, size of, and risks associated with an investment may differ substantially from any examples set forth in this document. No representation is made that an investment will be profitable or will not incur losses. Where appropriate, changes in the currency exchange rates may affect the value of investments. Prospective investors should read the offering documents, if applicable, for the details and specific risk factors of any Fund/Strategy discussed in this document.

Barings is the brand name for the worldwide asset management and associated businesses of Barings LLC and its global affiliates. Barings Securities LLC, Barings (U.K.) Limited, Barings Global Advisers Limited, Barings Australia Pty Ltd, Barings Japan Limited, Barings Real Estate Advisers Europe Finance LLP, Baring Asset Management Limited, Baring International Investment Limited, Baring Fund Managers Limited, Baring International Fund Managers (Ireland) Limited, Baring Asset Management (Asia) Limited, Baring SICE (Taiwan) Limited, Baring Asset Management Switzerland Sarl, and Baring Asset Management Korea Limited each are affiliated financial service companies owned by Barings LLC (each, individually, an "Affiliate").

NO OFFER: The document is for informational purposes only and is not an offer or solicitation for the purchase or sale of any financial instrument or service in any jurisdiction. The material herein was prepared without any consideration of the investment objectives, financial situation or particular needs of anyone who may receive it. This document is not, and must not be treated as, investment advice, an investment recommendation, investment research, or a recommendation about the suitability or appropriateness of any security, commodity, investment, or particular investment strategy, and must not be construed as a projection or prediction.

Unless otherwise mentioned, the views contained in this document are those of Barings. These views are made in good faith in relation to the facts known at the time of preparation and are subject to change without notice. Individual portfolio management teams may hold different views than the views expressed herein and may make different investment decisions for different clients. Parts of this document may be based on information received from sources we believe to be reliable. Although every effort is taken to ensure that the information contained in this document is accurate, Barings makes no representation or warranty, express or implied, regarding the accuracy, completeness or adequacy of the information.

Any service, security, investment or product outlined in this document may not be suitable for a prospective investor or available in their jurisdiction.

LEARN MORE AT BARINGS.COM

*As of September 30, 2019

19-1013991