BARINGS VIEWPOINTS

This article originally appeared in the March 12 issue of Citywire for Professional Buyers.

March 2018

CLOs: ACCESSING THE OPPORTUNITY

Investors in today's high yield market have a multitude of choices for how to access the attractive yields available, while tailoring the risk profile of their investment. Long gone are the days when U.S. high yield bonds were the only option for investors. Today, loans—or more accurately, senior secured bank loans—are a large and very important part of the high yield universe, offering credit investors a more secure way to earn potentially attractive returns by investing as a senior lender in businesses rated below investment grade. Additionally, investors can adjust their duration exposure and diversify globally.

While adding senior secured loans to a portfolio is one way for investors to diversify and customize their high yield allocation, there are additional ways to customize a portfolio's risk and return profile by gaining loan exposure through collateralized loan obligations (CLOs). Slightly more than half[1] of the loans issued in the high yield market are purchased by CLO managers and function as the collateral in newly issued CLO deals—but in investment terms, a CLO is more than just a 'loan clone.' CLOs allow investors to buy securities backed directly by professionally managed portfolios of senior secured loans.

The securities issued by each CLO include high quality (AAA, AA, A and BBB-rated) tranches that, due to their seniority in the capital structure, tend to be insulated significantly from potential losses, as well as more junior (BB, B-rated and equity) securities that provide a leveraged return typically yielding more than the underlying bank loans. The CLO market has helped to expand the global high yield market by providing customized risk and return profiles that appeal to a wide investor base.

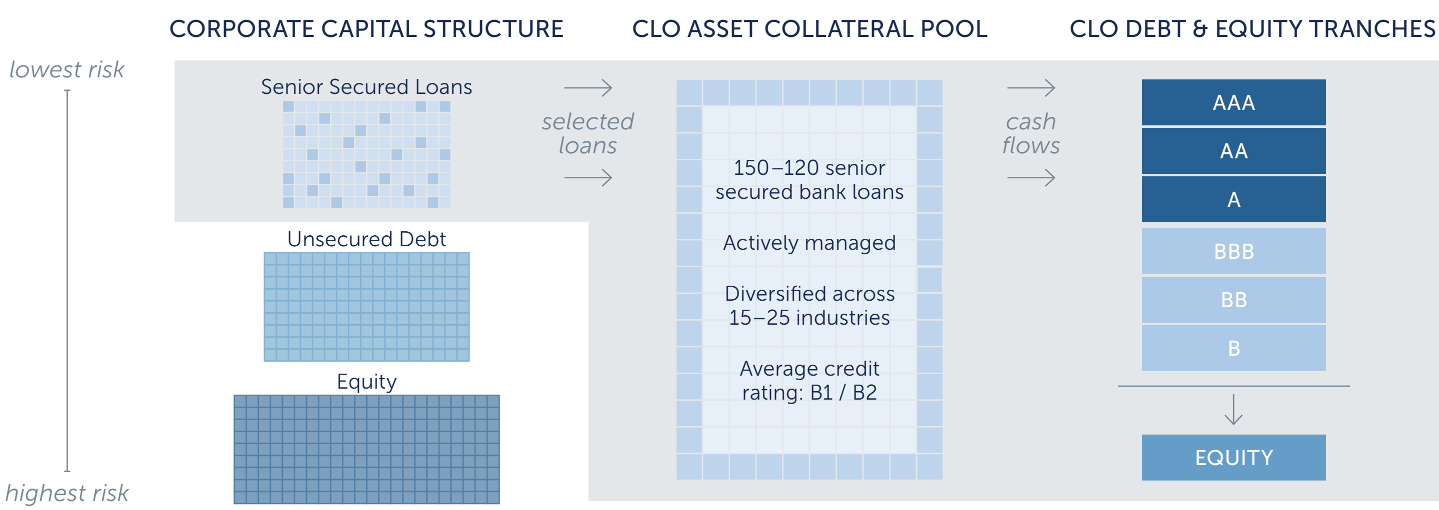
Understanding the basics

CLOs are backed by a diverse pool of senior secured, broadly syndicated bank loans—typically 150 to 200 loans, spanning 15 to 25 industries. The majority of loans in a CLO are first-lien bank loans, which means the loans are secured by the borrower's assets and rank first in line for repayment in the event of the borrower's bankruptcy.

CLO tranching—illustrated below—enables different risk/return options for investors. The desired tranche ratings are achieved through diversification, leverage and by employing a cash flow waterfall designed to protect debt holders. Cash flows are paid sequentially from the top of the capital structure, starting with the most senior CLO tranches. For example, the highest-rated debt tranche—AAA—gets paid first. The cash then rolls down to pay subsequent tranches in order of their ranking—AA comes next, followed by A, and so on down the capital structure.

Because the AAA tranche gets first claim on all cash flow from the underlying loan pool, it offers the lowest coupon of the tranches but also carries the lowest risk of loss. Lower-rated debt tranches pay higher coupons, but at increased risk. CLO equity represents an ownership stake and a first loss position and as such is at the bottom of the structure, carrying the most risk but greatest potential upside. This tranche has no set coupon, but is entitled to all excess cash flows once the CLO has paid what is due to each debt tranche.

CLOs OFFER INVESTORS A RANGE OF RISK/RETURN PROFILES



For illustrative purposes only

1. Source: J.P. Morgan, Credit Suisse Leveraged Loan Index. As of January 31, 2018.

What are the main benefits?

1. RETURN POTENTIONAL

CLO mezzanine and junior tranches can offer investors a higher yield than they might earn on many core fixed income securities with similar risk profiles. This potential yield premium comes from leveraging the credit expertise of professional bank loan collateral managers. The CLOs' term-financed structure enables the collateral manager to focus on credit risk over the life of the CLOs, insulating them from daily market volatility and allowing them to focus on credit risk. CLOs have provided what we view as attractive returns to income-seeking investors over the last decade, especially as interest rates reached and maintained historical lows for an extended period. Even as rates start to rise, the yield premium of CLOs remains an important factor, given that spreads between BB loans and BB CLOs are currently around 270 bps.[2]

As a seasoned high yield manager, we understand the critical role that avoiding or limiting losses can play in potentially achieving attractive risk-adjusted returns for our investors. Against that backdrop, it is important to note that during the CLO market's more than two-decade history, the asset class, in addition to offering a potential yield and return advantage, has defaulted far less frequently than similarly rated corporate credit.

This track record is a testament to the resilience of senior secured loans. Even during the global financial crisis, as some investors worried CLOs could suffer the same fate as similar-sounding but fundamentally different forms of structured investments, CLOs emerged intact, and in many cases, went on to provide attractive returns for investors who focused on the underlying credit fundamentals and rode out the storm.

The performance of the asset class is also a result of the structural protections built into CLOs and the benefits an actively managed portfolio of loans can provide. Managers of actively managed CLO portfolios have the flexibility to buy and sell individual bank loans, to enhance gains or mitigate risk, as the credit quality of a loan within its collateral pool waxes and wanes.

2. A BUFFER AGAINST RISING INTEREST RATES

When interest rates rise—as they are starting to in the U.S.—investors holding fixed coupon bonds may see the value of those bonds fall. The spread premium CLO investors are currently able to earn versus comparable assets such as investment grade corporates, asset-backed securities (ABS), and commercial mortgage-backed securities (CMBS) is further enhanced by the fact that CLO debt tranches have floating rate coupons that reset quarterly, which can serve as a good hedge against rising interest rates.

3. DIVERSIFICATION

CLOs can offer diversification in three important ways:

- ***When added to a portfolio of traditional high yield bonds,*** CLOs can offer the additional benefits of a floating-rate coupon, a lower default history and structural protection from potential defaults in the underlying bank loan portfolio.
- ***Investing in a portfolio of CLOs is ultimately investing in an ultra-diversified portfolio of broadly syndicated loans.*** Within a CLO itself, diversification comes in the form of a portfolio with 150-200 loans spread across 15-25 industries. By actively managing the underlying loan pool of collateral during the reinvestment period, managers help ensure portfolio diversity is maintained over time. Investing in individual bank loans typically does not offer an investor the same diversification or risk/return profile.
- ***Geographically,*** the continued growth of the European CLO market has aided in the expansion of the global CLO market.

How to access the opportunity

Until fairly recently, it has been difficult for private investors and their advisors to access opportunities in CLOs, but that situation is slowly changing. In particular, with the advent of high yield multi credit strategies, investors have a means of accessing the broader opportunities within the high yield universe, including the potential benefits offered by CLOs.

At Barings, our high yield multi credit strategy comprises allocations to bonds and loans in the U.S. and Europe, with the ability to make opportunistic allocations to CLOs and stressed and distressed credits. We believe this approach can be particularly beneficial, as it gives managers the flexibility to pivot to those regions or sub asset classes that offer the most attractive opportunities at any given point in time.

RISK PROFILE

While we see many benefits to investing in CLOs, it is also important to consider the potential risks. Like other below investment grade investments, CLOs are subject to credit, liquidity and interest rate risk. Investors may also be exposed to price fluctuations and/or losses, which can result from changes in overall market conditions or issuer-specific fundamentals. At Barings, our primary goal is to deliver attractive risk-adjusted returns for our clients. To best manage risk, we conduct rigorous, bottom-up credit analysis in our initial underwriting process and regularly track key credit metrics to ensure the investment thesis for each credit that we invest in remains intact.

2. Source: J.P. Morgan, Credit Suisse Leveraged Loan Index. As of January 31, 2018.

Barings is a $304+ billion global financial services firm dedicated to meeting the evolving investment and capital needs of our clients. We build lasting partnerships that leverage our distinctive expertise across traditional and alternative asset classes to deliver innovative solutions and exceptional service. Part of MassMutual, Barings maintains a strong global presence with over 1,800 professionals and offices in 16 countries.*

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. Past performance is no indication of current or future performance. 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 for the details and specific risk factors of any Fund discussed in this document.

*As of December 31, 2017

LEARN MORE AT BARINGS.COM