

BARINGS

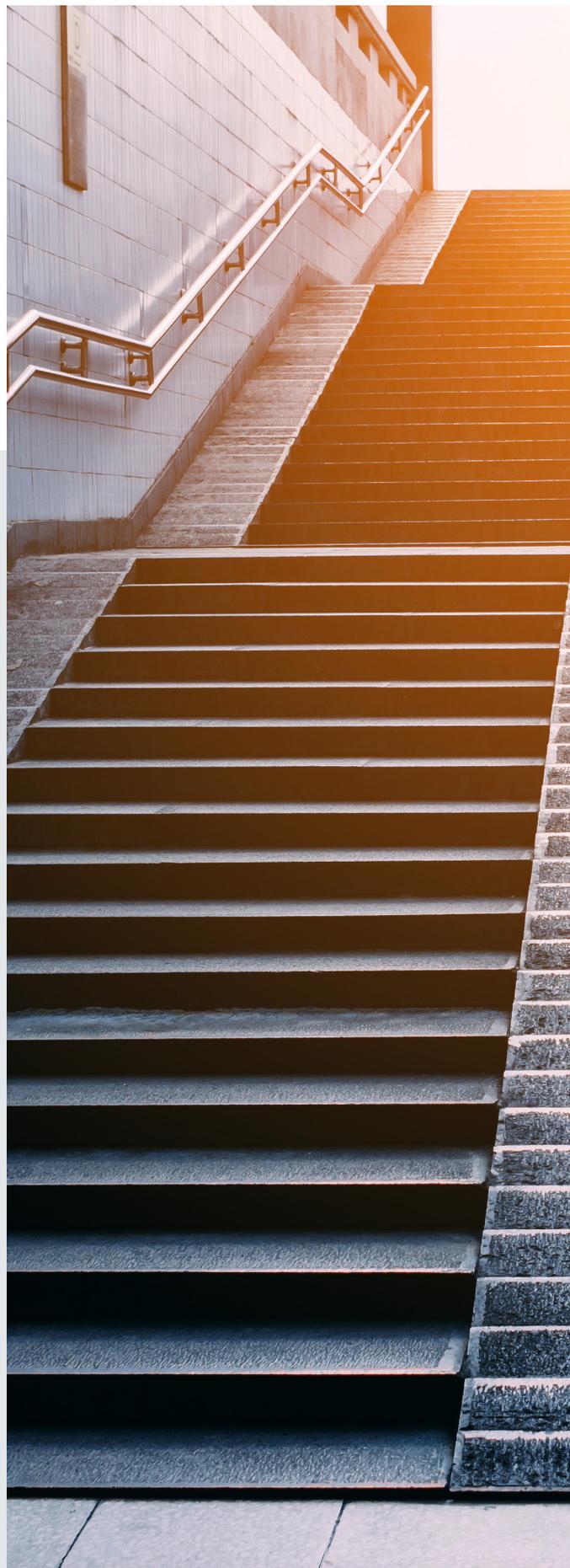
FIXED INCOME

CLOs: The Proof is in the Process

BARINGS CONVERSATIONS



In this Q&A, Adrienne Butler discusses Barings' longstanding presence in the CLO market and shares her views on what it takes to navigate the often-misunderstood asset class.

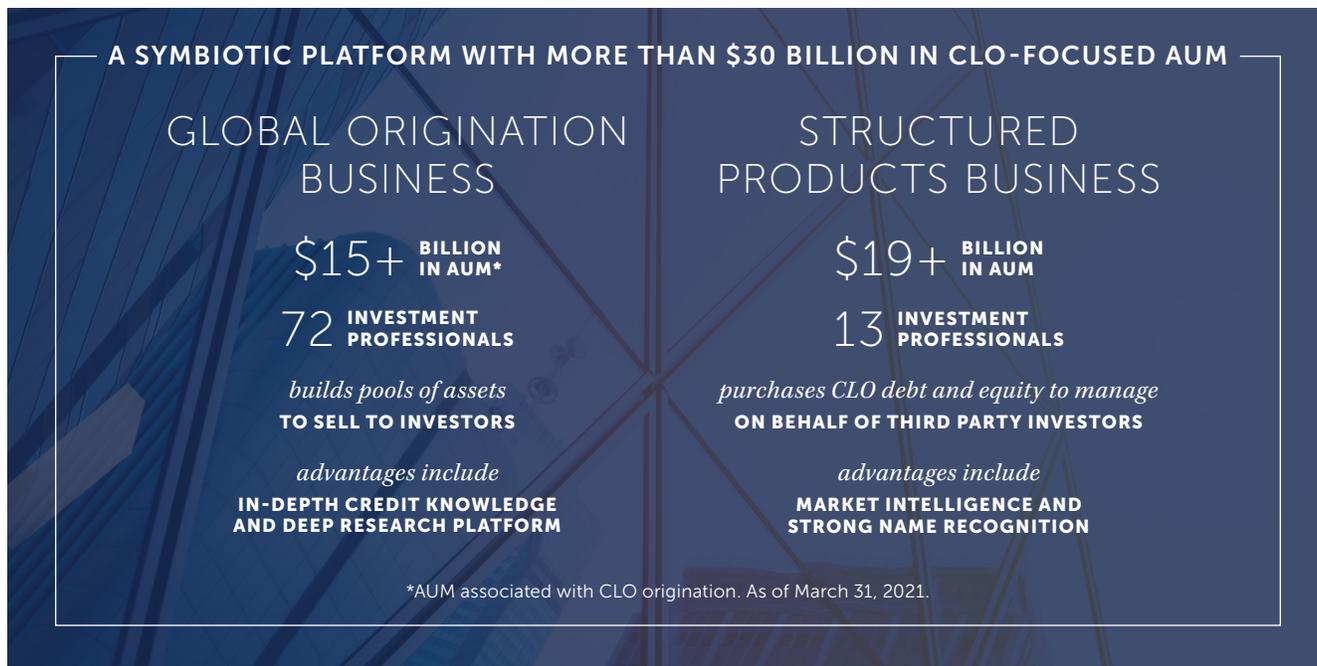


Can you tell us about Barings' capabilities in the CLO market and the firm's history in this space?

If you look back to our roots, Barings was an early adopter of collateralized loan obligations (CLOs). Our CLO business got its start in 1998 as a division of First Union and was marketed under the name First Union Institutional Debt Management, or IDM. As an early CLO manager, we spent a great deal of time educating both investors and bankers on the merits of CLOs and unique needs and opportunities that the structure embodies. In 2001, the IDM CLO platform was acquired by David L. Babson, a wholly owned subsidiary of MassMutual. This acquisition was transformative as it not only doubled the size of the U.S. CLO platform but also was the springboard for Barings' current high yield franchise. Needless to say, the CLO business is an integral part of our firm's history. Given how long we've been active in this space, we have a long track record of managing through downturns and periods of volatility. From the telecom bubble in 2001/2002, to the great financial crisis in 2008/2009, to COVID-19, we have managed through multiple ups and downs, which speaks not only to our experience in the space, but also to the depth of our research team, our fundamental, bottom-up approach to credit analysis, and our history with the below investment grade market.

How does your business differ from the structured products side of the business?

Our CLO business has been divided into two entities almost since inception—the origination side, where I sit as a portfolio manager, and the structured products side. On the origination side, we issue new CLOs and manage them by selecting a diversified pool of underlying assets (senior secured loans) that we think will perform well over the long term. Our investors, typically insurance companies, banks, hedge funds and large institutional investors, will then buy into these vehicles up and down the CLO capital structure based on their specific risk/return thresholds. The structured products side, on the other hand, purchases the debt or equity tranches of vehicles that other managers have issued and manage. The benefit of having both sides of the business is that we can collaborate and learn from each other. The structured products business, for instance, has access to our credit knowledge and deep research platform. On the origination side, we benefit not only from our colleagues' market intelligence that helps us better understand what investors are looking for, but also from the strong name recognition that comes from being in the market regularly as both a seller of, and investor in, CLOs. It's a symbiotic relationship that has been in place for more than two decades.



What are the main attractions of CLOs, and what types of investors do you see allocating to the asset class today?

Historically, CLOs have been misunderstood by the market, drawing a fair share of negative headlines. This has begun to change in recent years, however, with more investors gravitating toward the asset class for its potential to offer consistent cash-on-cash returns and positive IRRs over time. Historically, CLOs have also priced wide relative to similarly rated corporate credit—a notable potential benefit in a yield-hungry world and for investors that may be ratings constrained. At the AAA level, for instance, spreads are currently in the 110–120 basis points (bps) range, versus 40–50 bps for AAA investment grade corporates.¹ It’s a similar story as you look further down the capital structure to the mezzanine and equity tranches.

While institutional investors, foreign banks and domestic banks still account for a large portion of CLO demand—particularly at the AAA level—the buyer base has expanded in recent years to include asset managers, pensions, foundations, risk retention funds and other institutional investors looking for spread and return in a low-rate environment. In recent years, more investors have gotten comfortable investing in the equity tranches of CLOs, which, while riskier given that they sit at the bottom of the capital structure, have provided attractive returns historically for those investors seeking consistent cash flows and strong IRRs.

As CLOs have become more mainstream and the buyer base has continued to expand, issuance has grown notably and is expected to reach roughly \$100 billion this year after declining slightly last year due to uncertainty around COVID. In fact, CLOs make up about 60% of the leveraged loan buyer base today, underscoring their significant presence in the market. As the CLO universe has grown, CLOs have evolved from more of a pure buy-and-hold strategy—today, managers actively trade their portfolio of loans searching for the best relative value while preserving credit quality.

1. Source: Bloomberg Barclays; J.P. Morgan; Barings. As of June 17. AAA investment grade corporate spreads have traded between 43 bps and 86 bps over the last year.

How has the asset class performed over time—especially through periods of volatility?

As mentioned earlier, CLO performance has been fairly consistent over time. This is partly due to the fact that CLOs are backed by a diverse pool of senior secured loans, which are senior to other outstanding debt in an issuing company's capital structure. This seniority means that the loans' interest and principal payments must be paid before other creditors receive payment. The loans are also secured, usually by assets or stock of the company, which can provide investors with additional credit risk protection and increased recovery in the event of a default. When it comes to repayment of CLO debt tranches, there is a cushion beneath each tranche. The AAA tranche has the largest cushion and highest priority in terms of repayment. The BB tranche has less cushion and lower priority of repayment, and equity is at the bottom.

However, when it comes to CLO equity in particular, volatility—somewhat counterintuitively—can actually be quite beneficial, as it can help generate excess return for CLO equity investors. CLO equity returns come from the excess spread of CLO assets over liabilities. When the market goes through periods of volatility, the yields on the assets (loans) can increase as a result of price drops and potential spread widening. On the other hand, the liability spreads are locked during these volatile periods which, in combination with an experienced manager, can lead to excess equity returns. Alternatively, of course, if spreads in the market are tight, the arbitrage starts to get squeezed. In that case, equity investors typically have the right to refinance or reset parts or all of the liabilities in order to align with the market and regain the arbitrage.

How are ESG factors being integrated into the process of analyzing CLOs?

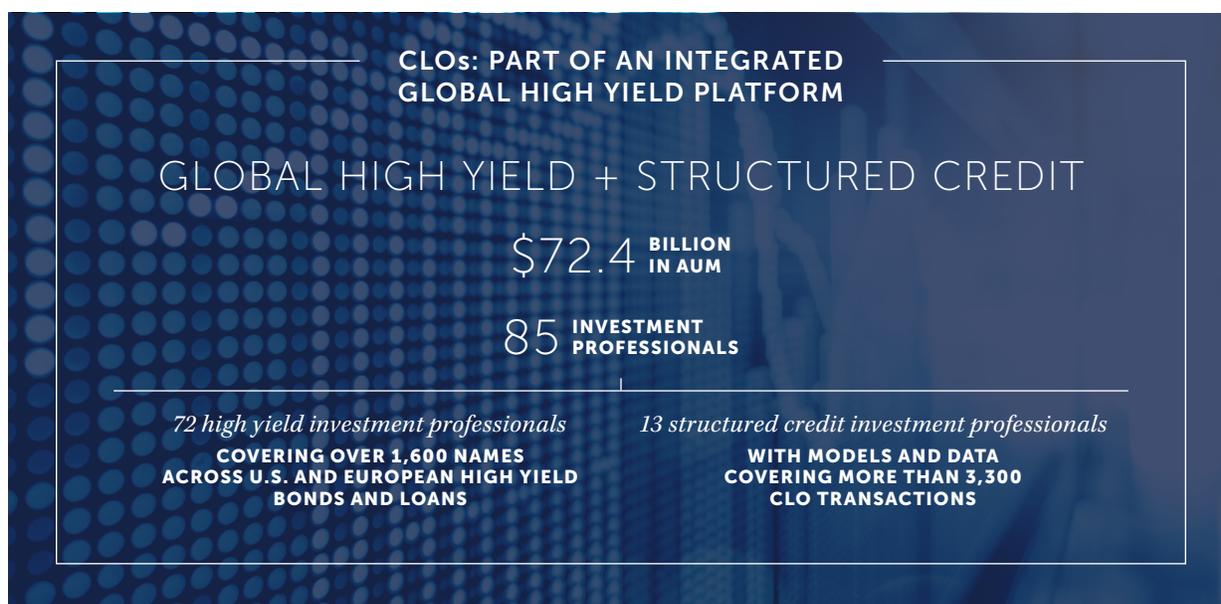
ESG is clearly playing an increasingly important role in investment decisions, but its adoption and integration has not necessarily been uniform. At Barings, the way we integrate ESG is consistent with our overall investment philosophy and an extension of the way we factor in any type of risk when analyzing high yield investments. Specifically, our high yield analysts perform rigorous, bottom-up ESG analysis on each investment we consider, and also monitor ESG developments across our existing portfolio companies. As part of the process, we score environmental, social and governance factors on a scale of one to five, assigning higher numbers to companies with weaker ESG profiles. We also carefully consider an issuer's ESG outlook, which gives us a way to gauge whether an issuer's profile is deteriorating, stable or improving. Ultimately, we believe this approach helps us analyze both risks and opportunities, and can influence our relative value recommendations. As CLOs are rapidly adopting ESG criteria in their asset selection process, we expect to see increased levels of engagement, active monitoring and potentially even an ESG-focused CLO in the near future.

How would you describe Barings’ style as a CLO manager?

We are first and foremost a credit-focused manager, which means we conduct rigorous bottom-up analysis on each loan we consider and are very selective in the way we structure CLOs. While some managers certainly have more or less aggressive styles, our approach has served us well for a long time and through multiple credit cycles. As evidence of this, we have a long track record of strong performance—over 20 years. Ultimately, our longstanding experience in the market has helped us build strong relationships with debt investors, particularly at the AAA level. This is an important point, as managers who have demonstrated consistency in performance over long periods of time may be more likely to garner consistently tighter pricing in the market, which can be beneficial when it comes to delivering returns to CLO equity investors.

We are also in the fortunate position of having a strong and stable parent company in MassMutual, which has been a long-term investor in CLOs. Additionally, as a part of a much broader high yield platform, we have the ability to be flexible and deliberate when issuing CLOs, and to pick the most opportune timing based on market conditions—rather than being forced to issue in less favorable environments.

While the CLO market is complex, it’s a market that can also offer significant benefits, particularly in today’s low-yielding environment. However, experience and breadth of platform, along with longstanding relationships, are crucial to navigating the ups and downs of economic cycles and delivering the best outcomes to investors over time.



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