

Market Concepts



CLOs

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By:

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What it is

Collateralized Loan Obligations, or CLOs, are part of a fixed-income sector called structured credit. The sector also includes asset-backed securities (ABS), residential mortgage-backed securities (RMBS), and commercial mortgage-backed securities (CMBS). A CLO in of itself is a single security backed by a pool of loans issued to corporations with low credit ratings or to financial sponsors in need of financing for a leveraged buyout. Typically, the loans that make up a CLO are rates below investment grade, or high yield. This means they are higher risk but also provide higher returns. In addition, the bulk of the underlying loans are first-lien senior-secured bank loans. Simply put: "first-lien" means the holder of the loan ranks first in priority of payment in case of a bankruptcy event and "senior-secured" means these loans have a legal claim to the company's assets. All of this ensures that the CLO investors are at the top of the capital structure, reducing their overall downside.

How it works

A CLO acts as a vehicle to invest in where there is a CLO manager that actively buys and sells loans to make trading gains or mitigate losses. This is called the "reinvestment period". The CLO manager will use the capital raised by the investment fund sponsoring the CLO to bundle multiple loans - generally 100 to 250 loans. The selling of interest in the CLO is done in tranches - or "slices" of the CLO that dictate who will be paid out first and the underlying loan payments are done. Thus, a riskier tranche would be paid out later increasing the risk of default with the benefit of higher payments.

Benefits

Investors are willing to pay managers a fee for CLOs as they provide some benefits over investing in a single loan. First (1) high-yield bonds and leveraged loans have an average default spread of 1%-6%, (2) during bankruptcies, the recovery rate - how much of the principal is recovered - was of 70% for CLOs compared to 50% for high-yield, and lastly (3) the securitization of the CLO increases the credit profile and reduces overall risk.