Abo **Collateralized Loan Obligations**

CLO - the spurned yield pearls

Bundled and securitized corporate loans are endowed with many advantageous features. However, Swiss pension funds rarely have the financial instruments in their portfolios.

Sylvia Walter
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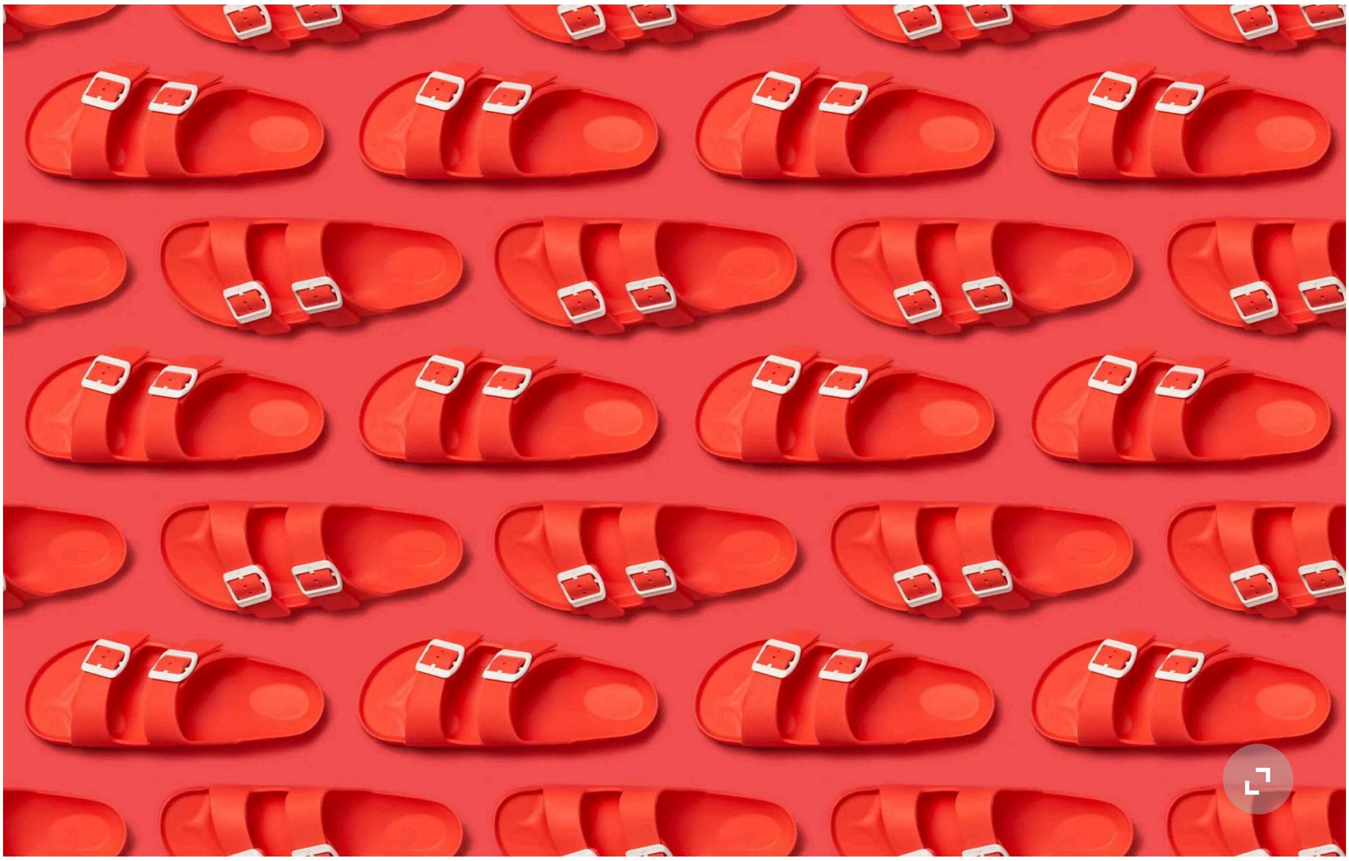

The majority of borrowers are well-known companies, such as the shoe manufacturer Birkenstock, which have to finance a major acquisition.
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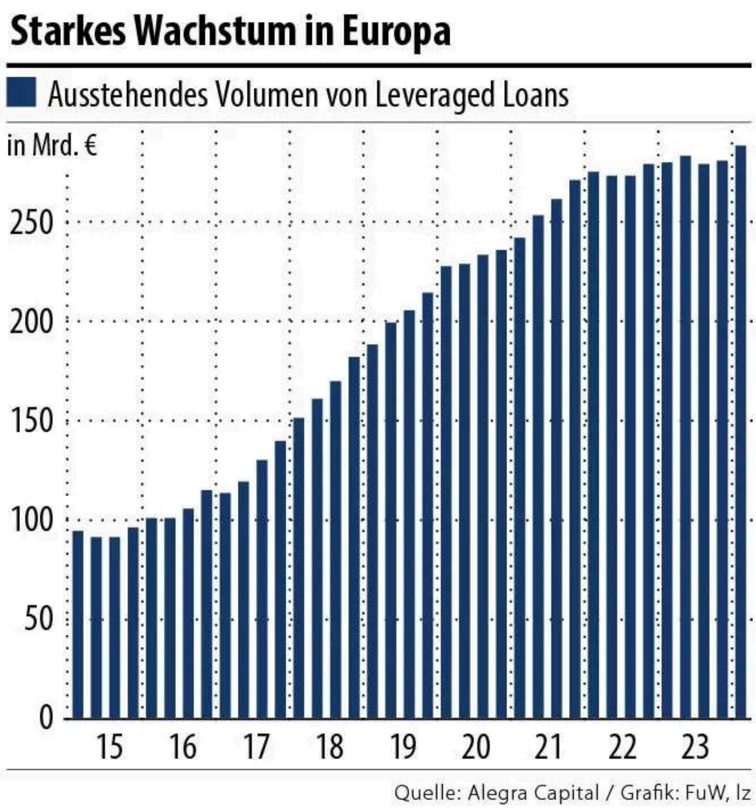
Securitized, non-transparent, devil's work – this is the image that securitized and bundled corporate loans (Collateralized Loan Obligations, CLOs) have been struggling with since the great financial crisis at the latest. The stigma is not least due to the black sheep among asset-backed securities, subprime mortgages, and their bundling beyond recognition. The term subprime – mortgages of inferior quality that were then packed up and sold off as securities on the market – has become etched in the painful memory of many investors.

Since then, financial instruments whose names begin with collateralized and bundle certain claims into a package have been triggering alarm signals among investors. For example, collateralized debt obligations (CDO) and collateralized loan obligations (CLO) should not be placed on the same level in terms of their inherent risks.

In fact, CDOs can include and mix a wide range of debt securities, such as corporate bonds, mortgages, credit card receivables, or student loans. These instruments therefore tend to be less transparent, the risk is much higher and the performance profile is therefore also very different from that of the CLO.

Global player as debtor

CLOs, on the other hand, are actively managed securitizations of senior secured corporate loans, known as senior secured loans or leveraged loans. This market is growing at impressive rates in Europe (see chart).

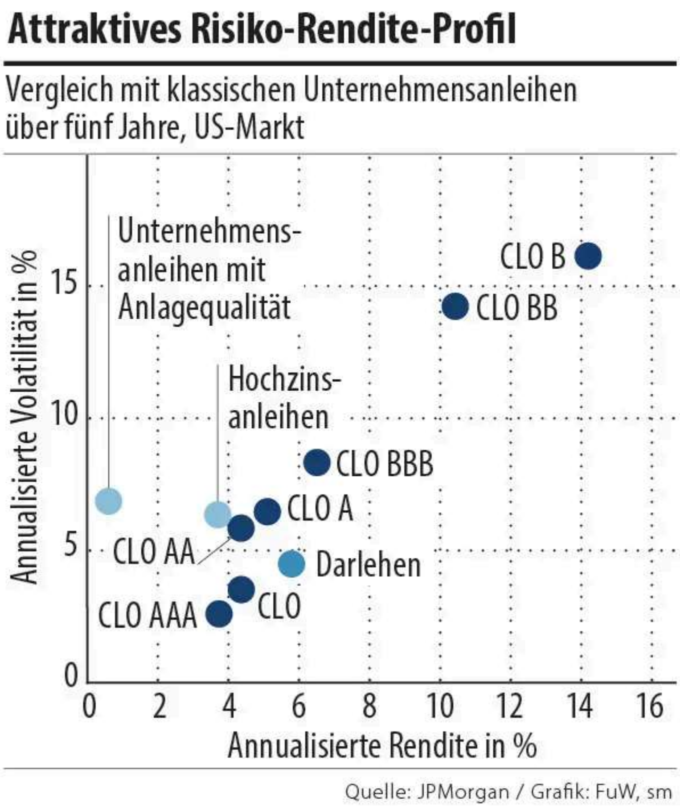


The underlying exposure consists of senior secured loans to large companies with a BB+ credit rating and worse. "The creditors of CLO investors include many companies with well-known names, such as the watch manufacturer Breitling, the shoe manufacturer Birkenstock or the chemical company Ineos," explains Daniel Riediker, partner and CEO of Alegra Capital, a CLO manager with a long-standing track record in Europe.

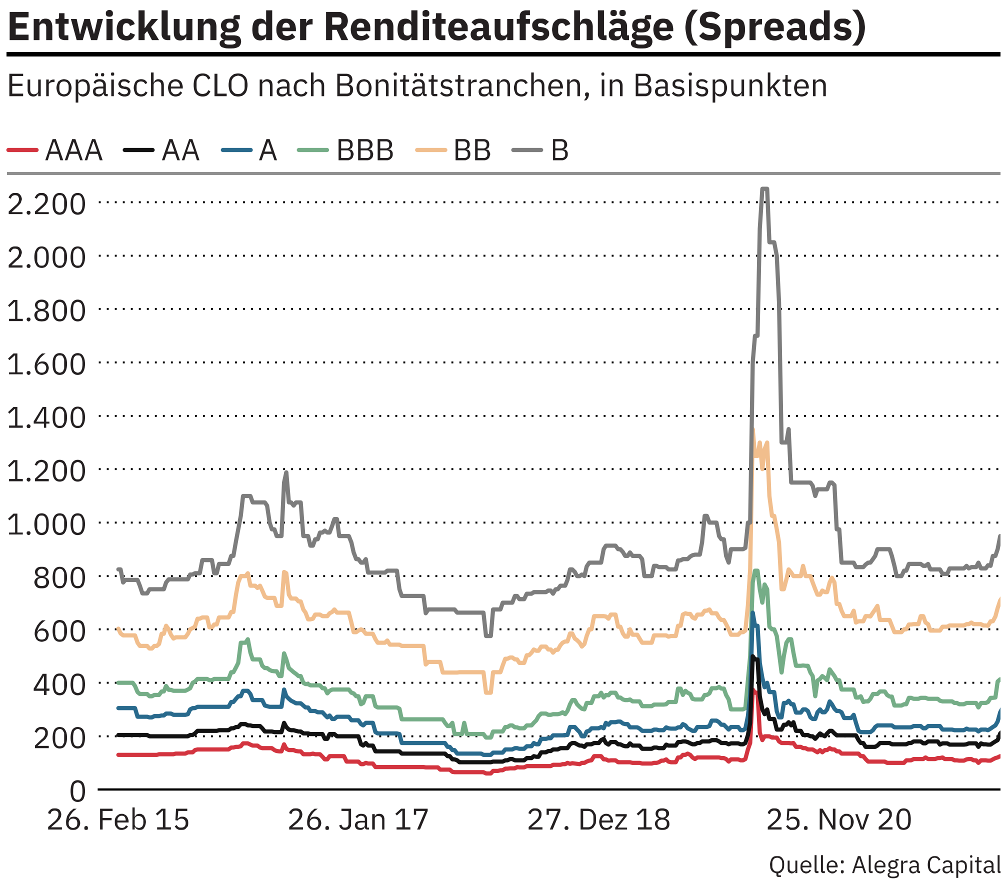
Most of the debtor companies that use leveraged loans have more than a billion in revenue. They are either an industry leader or a global player. "The smallest loan is probably around 400 million euros and the largest go up to 15 billion euros," Riediker specifies. Investor receivables are at the top of a company's capital structure and take precedence over other liabilities and other liabilities and the interests of shareholders when it comes to repayments. Rating agencies also take a close look at securitisations and rate them – based on the experience gained during the great financial crisis, the requirements are set extremely high.
Leveraged loans are rated below investment grade by the major rating agencies, making them a significant segment of the high yield asset class. This is often due to the fact that the issuing companies have a high debt ratio in relative terms. This can happen if the loan is granted to finance an acquisition, for example – these are typically large sums.

Built-in inflation protection

From an investor's point of view, leveraged loans offer a highly attractive risk-return profile that is superior to that of conventional corporate bonds. This also applies to the CLO, the product bundled from it (see graphic).



The loans are equipped with variable coupons, consisting of a yield premium on a variable reference interest rate. Due to the variable interest rate, the loans and thus also the CLO are particularly interesting for investors in times of interest rate increases, because they reduce duration risk and offer built-in inflation protection. In Europe, the Euribor serves as the variable reference interest rate, while the Libor is increasingly being replaced by the SOFR (Secured Overnight Financing Rate). If a recession is imminent, yield spreads rise because the creditworthiness of companies suffers.



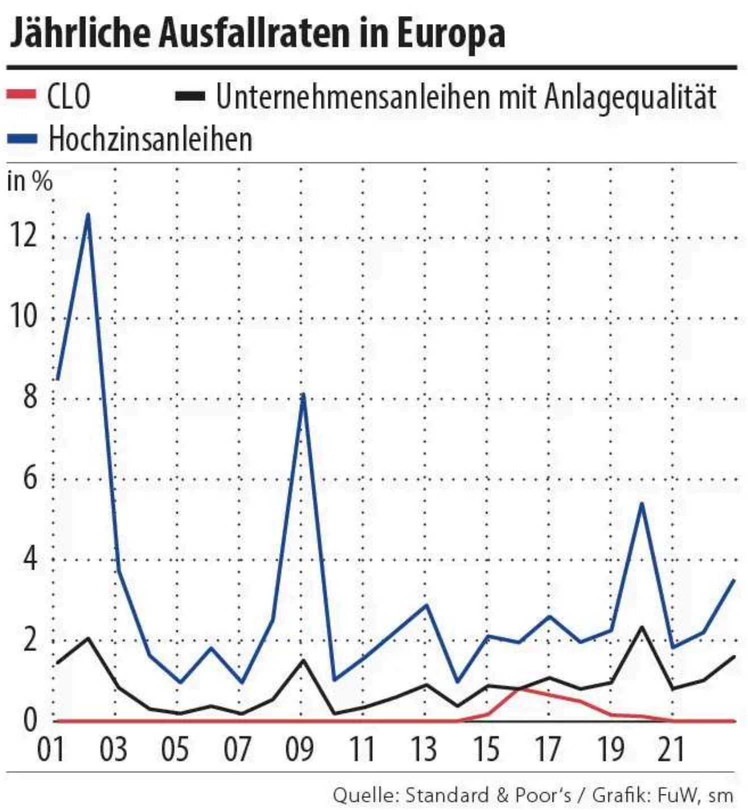
A typical European CLO usually bundles about a hundred of these loans, with a single one accounting for no more than two to three percent. "With a Euribor of currently around 3.6% and a yield premium of currently 100 to about 1000 basis points (10 percentage points) – depending on the CLO's credit rating tranche – the investor can achieve a handsome return," Riediker emphasises (see chart and text box on the structure).

Actively managed CLOs have been issued in the USA since the early 1990s, and in Europe the first transactions were carried out at the beginning of the 2000s. They are particularly popular with institutional investors such as asset managers and pension funds. In the Anglo-Saxon world and in Japan, they are in particularly high demand. Investment volumes are growing worldwide. According to JPMorgan, the American CLO market was worth $794 billion at the end of June 2024, while the volume in Europe was over €200 billion. The loan terms are usually between five and eight years.

Hardly any loan defaults

A CLO portfolio is usually managed by a team of proven experts. The task of these credit specialists is to track and analyze the development of various companies in each industry. The diversification and fine granularity of the portfolio, consisting of secured loans in different industries and countries, leads to a lower correlation of loans with other markets – a big plus from an investor's point of view. Since 2006, Alegra Capital has also been offering a CLO fund in Switzerland that is accessible to private investors – the PvB Alegra CLO Fund, with a stronger focus on US-CLO. From a sum of 3000 to 4000 francs, you are in.

Due to the intensive and active management of the underlying loans, CLOs shine with low default rates – the loan securitizations have not been exposed to any fundamental stress over the past twenty years.



According to statistics from financial services group S&P Global, global default rates were 0.09% last year, up from 0.05% in 2022. In the European CLO market, there has not been a single loan default for three years in a row, so the default rate is 0% (see chart). By comparison, the default rates of conventional, global high yield bonds were almost 4% last year.

Unnecessary renunciation of returns

If a loan within the CLO nevertheless defaults, then the risk for most investors is low. Not only because their financial interests are taken into account first in the insolvency proceedings and the loan may still be repaid. The structure also protects, which is particularly beneficial for investors in the higher-rated tranches.

In Switzerland, however, the interest of pension funds leaves much to be desired, despite attractive returns and manageable risks of the CLO. They shy away from the alleged lack of transparency of financial instruments and their complexity. The relevant consulting firms that support the Swiss pension funds in their investment strategy prefer to rely on traditional asset classes such as equities, bonds, real estate and infrastructure investments. Regulatory regulations can also have a deterrent effect in this country.

However, for many Swiss people, the accumulated capital in the pension funds is by far the largest asset block of all. In view of the advantageous properties of CLO described above, it would be desirable for local pension funds to take a closer look at the asset class. The use would help diversification in the overall portfolio and the return prospects.

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Abo **Interview with Mariusz Platek**

"Our CLO portfolio returned 28% last year"

The head of investment at the Pension Fund of the City of Winterthur appreciates the advantageous risk-return profile of securitized corporate loans.

Sylvia Walter
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"The drawdown of the CLO in March 2020 was comparable to the correction of the stock markets, but two or three months later we were already back at break-even."
Image: ZVG

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The Pension Fund of the City of Winterthur had already ventured into CLO before the great financial crisis. Head of Investment Mariusz Platek answers questions.

Mr. Platek, what is CLO's share in the portfolio of the Pension Fund of the City of Winterthur?

When I joined the pension fund in 2015, about 9% of the assets were strategically invested in senior secured loans, also known as leveraged loans. In other words, in individual securitized loans to companies, unbundled. Only a few percent of that was invested in CLO at the time. The problem with senior secured loans is that U.S. loans make up about 70% of the market. In local currency, the performance of European and US loans was comparable, but as a pension fund, we naturally hedge currency risk. After hedging costs, we were left with a yield of only plus or minus 1% on US loans. That was not enough for us. In 2017, we exited senior secured loans altogether and are now invested in European CLOs, which in principle have a higher expected return. Their weight in the overall portfolio is currently around 1.5%.

And the commitment to the CLO is exclusively in Europe?

Yes, we have been invested in Euro-CLO since 2008, which consists of loans to companies with lower credit ratings.

What performance has been generated over these years?

The average annual performance of our CLO portfolio since the beginning is 10.3% and thus higher than equities world, classic high yield bonds or senior secured loans.

So you were also invested in CLO during the financial crisis?

Yes, but you have to be aware that the maximum drawdown, i.e. the percentage difference between the high price and the low price of a CLO, can sometimes be painful. The price loss can usually be higher than with conventional high-yield bonds. However, it is also quite clear that the expiry of these instruments only results in a negative return if you have high defaults on the basis of the underlying debtors for several years. Several major crises would therefore have to follow one after the other in order to make losses over a cycle.

"If you exclude the times of crisis, the volatility of the CLO is lower than that of equities."

What was the CLO's performance during the pandemic and the hyperinflation?

When we slid into the corona crisis, we had great fears, but the loan defaults were extremely low – not least thanks to government aid and liquidity from the central banks. The drawdown of the CLO in March 2020 was comparable to the correction of the stock markets, but two or three months later we were already back at break-even. In 2022, we also briefly recorded a negative return because market participants feared loan defaults by companies due to the rise in interest rates. However, the market has calmed down quickly.

What was the overall performance of the Euro-CLO last year?

Our portfolio returned 28% last year, and we are already back at 12% this year.

Do the instruments also generate an attractive current return?

Absolutely, the instruments have a double-digit cash flow yield. This year, this is around 18% in our portfolio. CLO also contribute to diversification, which we greatly appreciate.

High returns usually also mean high risk. That sounds almost too good to be true?

As I said, a price correction can be severe, but we have been investing in CLO for a long time, and sitting it out has always been worth it. Excluding times of crisis, the volatility of the

CLO is lower than that of equities. In addition, the CLO manager regularly conducts stress tests of the included loans, the results of which we then receive.

Can you understand why many pension funds shy away from using CLO because of the supposed lack of transparency?

No, we have the list of all debtors, over 400 in number, that are bundled in our CLO portfolio and receive details at any time if desired. Of course, we cannot analyse these debtors ourselves. This makes it all the more important to choose an experienced, active manager who knows the individual positions inside out.

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