E X P E R T Q & A

The CLO market has moved into the mainstream, generating strong returns and appealing to new investors. Himani Trivedi, head of structured credit at Nuveen, reflects on its evolution

The changing face of CLOs

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Q Can you start by giving an overview of the CLO market today and the dynamics driving activity?

The collateralised loan obligation (CLO) market has grown significantly over the last few years. We started with balance sheet CLOs in the late 1990s, before we moved towards more managed transactions syndicated across different tranches during the 2000s. Those sat with a tight group of institutional investors until, post-global financial crisis, we saw CLO 2.0 capture more attention. Post-covid, we have seen more investors, both institutional and retail, and CLOs are now a mainstream product in the credit space.

The asset class includes a range of different types of credit risk, from AAA through to equity, and is a $1 trillion-plus market, absorbing a significant proportion of the syndicated loans issued through leveraged buyouts and public companies.

With the cost of CLO debt falling this year relative to transactions issued in 2022 and 2023, there has been a focus on cost optimisation, with a lot of refinancing and resetting of structures dominating activity. Net issuance on the loan side has been a bit limited given dynamics in the deal market but as we move forward, we expect falling rates to spur more M&A. There is still a large new investor base, particularly on the CLO equity side, looking for long-term excess returns relative to the public credit market, so we expect 2025 to see more activity.

Q How do you invest and what do you look for?

We have two parts to our business: CLO issuance, which we do under the Symphony name, and CLO investing, where we invest in third-party managed tranches up and down the capital structure. CLO issuance allows us to invest in CLO equity that we can create opportunistically, using deep credit expertise that stems from our $42 billion in overall leveraged finance assets across syndicated loans and high yield bonds, of which about $17 billion is in CLOs.

Two things drive total returns in CLO equity: the opportunity on the asset side, and the liability financing levels. The difference between those is CLO arbitrage, which can potentially generate the mid-teens returns we seek.

Over the past few years, we have seen one side or the other dominate but what matters is total returns. In 2022, for example, you had a volatile market where credit was trading off and we could buy loans at deep discounts, but liability costs were high. As the market has tightened, our assets have moved up and our liabilities can now be refinanced at tighter levels as financing costs have come down.

Q What is investor sentiment like for CLOs?

During the GFC, the CLO market shut down, but in 2022, despite fears of recession, there was limited impact on the ability to continue creating CLOs. Now, more CLO investors have managed through cycles and understand the resilience of this asset class, so they come with an opportunistic mindset to capture higher coupons.

Investors like the asset class, and gradually the investor base has expanded. Whereas it used to be just banks and insurance companies, gradually we have seen credit funds looking at the lower parts of the capital structure and pension funds starting to understand the product. Then we saw more captive funds forming and being offered to clients post-covid, and we are seeing the retail investor base increasingly looking up and down the capital structure. ETFs are being established, further driving demand, and we expect that retail opportunity to continue growing.

Q How is the CLO market suited to retail investment?

The retail market wants to achieve excess carry without much excess risk and CLOs offer that at different risk profiles. Virtually no investment grade tranches have seen any impairment over the past 20 years; they are really resilient in a waterfall structure with a lot of subordination and cushion.

Going down the capital structure, A or BBB tranches offer even more carry on a risk-adjusted basis versus other corporate credit investments. With low correlations to core bond allocations and near-zero duration, CLOs can be a nice diversifier in retail portfolios to deliver return diversification and minimal impairment risk. In addition, the market is becoming more liquid as it grows, allowing investors to buy in both the primary and secondaries markets. Managers can deploy money coming in from retail more easily than in the past.

Q How do CLOs best fit into GPs' product suites and LPs' portfolios?

The higher part of the capital structure is more retail friendly because of the benefits it provides from a carry perspective relative to other similarly rated fixed income options. The lower part is interesting for LP/GP portfolios looking for a higher total return target.

CLOs are a great diversifier. If you step back, a CLO is just a diversified compilation of senior secured loans of 150 or 200 issuers in LBOs in which private equity has invested. So, it is the same issuer ecosystem as private equity, taking a different slice of the capital structure, with a much better risk profile in a non-mark-to-market cashflow structure. If there is a default, private equity loses all its money, but the senior secured loans will have some recovery.

CLOs give similar total returns of mid-teens IRRs, along with almost immediate cashflow, unlike in private equity where value is back-ended. In a CLO, your distributions occur on a quarterly basis – there is no J-curve. So, any LP or GP invested in private equity should consider the CLO opportunity because it plays in the same zip code.

Q What are the latest developments in CLO equity?

We have talked about how the equity investment profile has moved from hedge funds and opportunistic credit into captive funds because of the US risk retention rules that came into play in 2016. Those rules went away in the US but caused CLO managers to start thinking about offering out captive funds to their client bases.

Historically, a third-party investor as the controlling equity was another cook in the kitchen for putting the CLO together. That could lengthen the time to construct a CLO, meaning the best window for issuance could have closed.

CLO managers themselves are now managing LP captive funds and issuing CLOs as control equity on behalf of the fund at the most opportunistic times. There are a lot of benefits to this because, as a manager, you see all the market movements in real time and are best positioned to take advantage of the market and create value for investors by acting swiftly in turbulent times.

Q Finally, what themes do you see impacting the market going forward?

We expect the market to continue to consolidate and gravitate towards the larger managers. As the CLO market becomes mainstream, we will see more issuance from larger shops that are able to handle scale, and investors will favour the liquidity that gets built into their investment thesis. It seems likely we will eventually reach a point where something like 30 percent of managers dominate 70 percent of issuance.

We are also going to see more investors entering up and down the capital structure and much more technology usage. The data that sits behind these transactions hasn't been easy to find but we are gradually seeing more transparency. There is a lot of room for us to employ generative AI to be more efficient and effective because there is a lot of documentation and analysis where we can capitalise on that. It will take time as compliance processes need to be developed, but that will be a big theme in future. ■