How will the CLO market fare in 2022?

Vibrant Capital Partners explain their views on how they expect CLOs to perform in 2022

Once a niche, widely misunderstood asset class, CLOs have proven resilient across credit cycles, transforming into a core allocation for institutional investors. Today, the global CLO market is over US$1trn in size and includes participation from pension plans, insurance companies, and other mostly institutional investors who have reaped the rewards of CLOs' solid performance. In sum, the tailwinds are strong, and the narrative is positive.

We expect 2022, however, to be differentiating. On a macro level, market fundamentals and technicals are positive, and we anticipate corporate loan defaults to be benign. Importantly, there are risks that call for careful monitoring, including inflation, rate hikes, and Covid-19 variants. Furthermore, we expect asset class specific themes within the CLO asset class to also emerge, and CLO investors that successfully navigate these themes will come out on top.

The most critical question that remains unanswered concerns the timing of the existing US$1.2trn senior secured loan market's transition to SOFR. We anticipate Q1 to be a period of adjustment, with existing CLOs to begin transitioning to SOFR in Q2 and Q3 of 2022. Although the path forward is still uncertain, we believe many market participants are inadequately prepared in regards to technology, operations, and hedging – all of which can create short term volatility and opportunities to capitalise on mispricings across the CLO capital stack.

Although the market's current implementation has been rudimentary, we believe it will continue to evolve. In 2021, we saw a significant push, mainly from large CLO debt investors, towards inclusion of ESG guidance in CLO documentation across the US and Europe. CLO managers have also started to adopt comprehensive ESG policies that are being incorporated into their investment processes. That said, CLO transactions marketed with an ESG label were not materially different from a "non-ESG CLO" issued by the same CLO manager. We do not expect to see a material difference in collateral composition or pricing until we see a healthy degree of enforceability and accountability for non-compliance in ESG. However, in 2022, we do anticipate a subset of CLOs to begin incorporating true ESG metrics. Vibrant Capital opened one of the few CLO warehouses with a third-party manager incorporating a proprietary ESG scoring system.

CLOs are actively managed and manager selection is a crucial component of CLO investing. While good credit underwriting is a foundational requirement, different managers and management styles have performed well during different periods. For example, in 2019, a key determinant of manager performance was the ability to avoid the “idiosyncratic single-name" risk. In 2020, manager performance was driven by exposure to COVID-impacted sectors going into the year and trading decisions made during the year. Despite there being less dispersion in manager performance in 2021 than in the prior years as evidenced by a number of performance metrics including par build and change in average spread, we think that will change in 2022. “Spread compression” is a key risk facing CLO managers in the year ahead, and it will be crucial to align with managers that can navigate it without incrementally adding risk.

While we remain optimistic in the growing opportunity set within the CLO asset class, in 2022, we expect CLO markets to face multiple new themes that could cause near term volatility. As a result, the "long beta" strategy that worked in 2021 may not be as fruitful this year. Accordingly, we have gradually shifted our investment focus to ongoing organic creation of CLOs through opening long-term non-mark-to-market CLO warehouses combined with sourcing secondary opportunities driven by structural inefficiencies and market volatility. We believe that seasoned investors who have invested across market cycles and can evolve their investment strategy as needed will fare well as they invest in CLOs.

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