What is a CLO?

Collateralized loan obligations (CLOs) are actively managed investment products comprised of a diversified pool of leveraged loans that generate cash flow as they are repaid. CLOs allow investors to access the leveraged loan asset class in an efficient and structured way.

What are leveraged loans?

The leveraged loan asset class has grown tremendously, resulting in increased liquidity and institutional scale over the last two decades. Once considered to be niche, at over $1 trillion[1] today, the asset class is now of a size on par with that of high yield bonds.

Put simply, CLOs are entities that purchase hundreds of leveraged loans made to non-investment grade corporate borrowers across diverse industries. Leveraged loans are floating rate loans, which typically produce higher income in higher interest rate environments compared to fixed rate loans or high yield bonds. They are typically the most senior security in a corporate borrower's capital structure and therefore are entitled to be paid back before any high yield bonds or common equity of the company in the event of a bankruptcy or default. These loans are usually rated by the ratings agencies and secured by the company's assets (inventory, real estate, property, and equipment) and have historically had higher recovery rates compared to unsecured loans and high yield bonds.

As borrowers pay the interest (and eventually, the original borrowed amount) on their loans, these cash flows go to the CLOs who own the loans and are then redistributed by the CLO to its investors according to a specific schedule of payments, pre-determined by the structure of the CLO.

Features of CLOs

CLOs bundle corporate leveraged loans into structures that are divided into tranches (slices) or layers of risk and sold to investors depending on their differing risk-return objectives. The unique features of the structure are summarized below:

- **Tranche:** French for "slice," a CLO is comprised of several tranches of risk. In a typical CLO, roughly 75% to 90% of the structure is created to be floating rate senior and mezzanine debt tranches, with the remainder consisting of the equity tranche. CLO debt tranches are typically rated investment grade (most likely to be repaid) at the most senior level down to below investment grade (less likely to be repaid) by ratings agencies. The equity tranche will experience losses first, due to the payment priority structure, if any underlying loans default.
  - **Senior debt tranche:** The tranche with the lowest yields, lowest risk of principal loss, and the first to receive cash flows (principal and interest payments) that come to the CLO from the pool of leveraged loans.
  - **Mezzanine debt tranche:** This tranche offers higher yields than the senior tranches, but only receives cash flows after the senior tranches have been paid, so has higher risk of loss than the senior tranches.
  - **Equity tranche:** The equity tranche is last to receive the cash flows (principal and interest payments from the leveraged loan pool) but is structured such that if all the loans continue to pay their principal and interest, this tranche will have

[1] As of September 2023.

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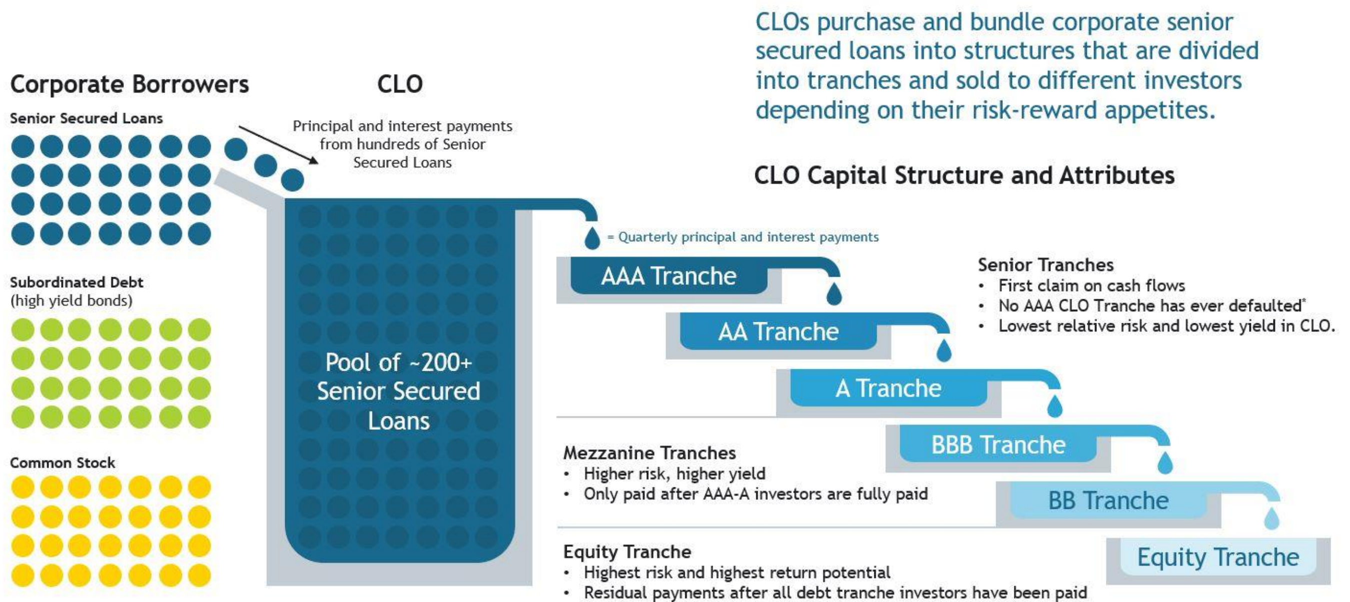
the highest returns in the CLO structure. Conversely the equity tranche will also take losses first if the loans default on their payments to the CLO.

- **Priority of payments:** Often referred to as the "payment waterfall", this refers to the sequential order in which cash flows derived from the underlying loans are allocated to the CLO fund investors. Put simply, investors in the highest-rated tranche receive interest and principal payments first while investors in the lowest-rated tranche – typically the equity tranche - receive payments only after all investors in higher-rated tranche are paid back in full. Note that investors may choose which debt tranches in which to invest.

Economically, a CLO's equity tranche, while potentially the highest returning, is also the riskiest portion of the CLO. If some of the loans stop making payments (default) those payments will not reach the equity tranche and the equity tranche's return will be lower. The priority of cash flows and sequence of losses is diagramed in Exhibit 1 below.

Exhibit 1: Understanding CLO structures



Source: SEI. For illustrative purposes only.

Why do people invest in CLOs?

CLOs allow investors to access the leveraged loan asset class in an efficient and targeted way and offer a wide array of securities across the risk spectrum.

CLOs typically offer investors higher yields than comparably rated government and corporate bonds. Further, the floating interest rate payments (a spread above a benchmark rate) provide higher income in rising interest rate environments than fixed rate instruments.

CLOs employ a variety of mechanisms to limit, detect, and correct any deterioration of underlying loans. Moreover, a typical CLO holds over 200 individual leveraged loans that are spread across many different industries. This high level of diversification helps mitigate the default risk of any single company or industry. In short, CLOs are but another tool for diversified return enhancement.

What are the risks of CLOs?

With any investment strategy, there is investment risk. Some risks of CLOs include:

- **Complexity:** CLOs are complex investment vehicles that have unique features which are briefly outlined above. The various tranches have different levels of risks, while payments to investors follow a specific priority schedule. As such, it is recommended that investors conduct proper due diligence before investing in a CLO product.

- **Credit Risk:** By their nature, CLOs are exposed to the credit risk of the underlying loans. If the underlying loans default – meaning, the borrow fails to repay the loan – then this can result in losses for investors.

- **Prepayment Risk:** Though this may not seem at first to be a risk, in the event the underlying loans are paid in full before their maturity date, investors may miss out on potential future interest income.

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- **Reinvestment Risk:** As the fund receives cash proceeds from interest and ultimately full payments on the underlying loans, the fund manager may reinvest this cash into additional loans for a specified period of time. There is a risk, however, that newly purchased loans may not generate as much cash flow as the original loans.

Glossary

Default: Failure to repay a loan.

Interest Rate: The fixed amount of money that an issuer agrees to pay the bondholders. It is most often a percentage of the face value of the bond. Interest rates constitute one of the self-regulating mechanisms of the market, falling in response to economic weakness and rising on strength.

Interest rate risk: The possibility of a change in the value of a security, especially a bond, resulting from a rise in interest rates.

Leveraged loan: A loan extended to borrowers that already have considerable amounts of debt or a poor credit history. Lenders consider leveraged loans to carry a higher risk of default, and as a result, a leveraged loan is more costly to the borrower.

Liability: An obligation, in this case, to make a payment.

Recovery rate: The extent to which principal and accrued interest on defaulted debt can be recovered, expressed as a percentage of face value.

Security: Another name for investments such as stocks or bonds. The name 'securities' comes from the documents that certify an investor's ownership of stocks or bonds.

Yield: Annual percentage rate of return on capital. The dividend or interest paid by a company expressed as a percentage of the current price.

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