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How to Value CLO Managers: *Tell Me Who Your Manager Is, I'll Tell You How Your CLO Will Do*

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Collateralized loan obligations (CLOs) have proven by their significant outperformance during and after the past crisis to be a unique securitized product, especially compared with their asset-backed peers. Having a pool of loans as the underlying collateral that is actively managed by CLO managers has been the most important factor for this performance. Therefore, an astute CLO investor needs to analyze the manager as well as the collateral and the structure to make a sound investment decision.

In this article, we aim to lay out a framework to list the factors investors should consider while investing in CLO managers. We break down the factors that determine the overall characteristics of a manager into two categories: ones that we can qualitatively investigate and ones that we can analyze using the available track records.

QUALITATIVE MEASURES

Although there are significant amounts of historical data on the past performance of the CLO managers available to investors, many factors are very important for evaluating the overall characteristics of a manager that cannot be measured just by crunching numbers. Therefore, investors should keep an ongoing dialogue with the managers by having regular meetings to make sure they are on top of their current and future activities. In the interaction with managers, the focus should be the following factors.

Investment Philosophy

The most important factor for a manager is the consistency between the investment theme and the team. There is no right or wrong way when it comes to the approach to managing a CLO, but the results will be inferior if the investment philosophy is not a fit for the people who try to implement it. There is definitely no one-size-fits-all concept, and therefore, the way the team operates should be tailored to the strengths and weakness of its members.

Stability of the Platform

One of the pillars of investing has always been "going concern." CLOs are no exception. The stability of a CLO manager's platform is key to the ability to manage deals for the long term. Some managers are embedded in well-diversified business models, where the revenues are generated from various sources, while other managers are more dependent on their CLOs to be the backbone of their businesses. In either case, it is important to understand the future viability and stability of the investment management platform. Both of these examples have their advantages as well as their drawbacks. Generally speaking, a manager needs to be able to sustain the team and the business across multiple cycles by adapting to changing economic and market environments.

Investment Process

We acknowledge that having past experience is very valuable when it comes to managing a CLO, but being “street smart” is not sufficient to achieve good and, maybe more importantly, consistent, repeatable results in performance. An investment style too dependent on an individual manager’s talent can become a liability for investors. Managers need to have a well-defined process that is run by a team with relevant experience, yet such a process should not be too rigid, so that it becomes almost an algorithmic automation. Investors should be cautious of managers who depend on a single “star” portfolio manager who makes the calls based solely on his/her own experience.

Team Tenure and Experience

We consider a CLO management team to be no different from the senior management team of any corporate structure. Establishing a long-lasting business requires a team that has been working together for a long time with a low or limited turnover rate. On top of this, if the team or at least some of its members understand how the CLO structure is functioning, that brings a huge advantage. Managers that have a dedicated CLO specialist are always a plus in terms of designing the structure at the time of issuance and understanding the structure while it is in action.

Incentive and Organizational Structures

Investors should study the overall organizational structure of the CLO managers’ company to better lay out the incentives for individuals. The compensation and incentive structure should be aligned with the CLO investors, especially for the decision makers for the managed portfolios. In some cases, where the management company also has “skin in the game,” it is important to know the source of the capital commitment and how that sponsorship works within the company structure.

Other Factors

There is a broad list of qualitative measures for which the managers could be evaluated. For the scope of this article, a subset of those factors is listed. It is important to understand these “sometimes intangible” factors and how well they fit with each other.

QUANTITATIVE MEASURES

According to surveys among CLO investors, track record is the most important factor in evaluating a manager’s suitability for investments. Luckily for CLO investors, CLOs are arguably one of the most transparent investments, providing a lot of data about the manager’s individual trades, and so on. However, it is very important to filter and analyze those data carefully to avoid false conclusions based on either wrong analysis or too much noise.

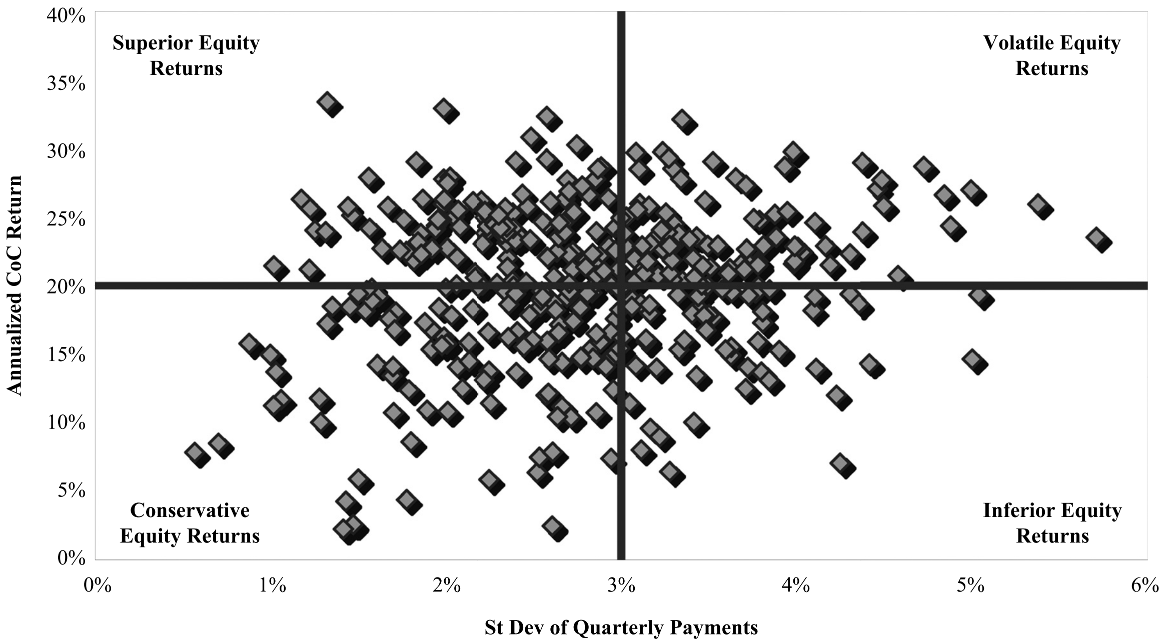
Equity Score

In almost every CLO manager pitch book, there is a chart or table that shows the performance of cash-on-cash returns of the subordinate notes. Although this is valuable information to get a sense of manager’s past performance, it is not complete by itself. Therefore, we calculate a so-called “equity score” for each manager.

There are three factors that are important for an equity tranche: cash-on-cash distributions since inception, the current sale and/or liquidation value, and the deal leverage. The total return for each equity tranche could be calculated by summing their distributions and its current asset value and then normalized to the deal’s original leverage. This way, investors might get a better sense of the overall performance of each equity investment. To incorporate the path-dependency of performance, it could be beneficial to take the volatility of the past cash distributions into account as well. This method might be helpful for investors to separate two managers that might have similar final returns even though each might have a different experience in achieving them. Exhibit 1 compares all CLO 1.0 (2005 or later vintage) deals from this perspective. The exhibit’s upper-left quadrant includes deals with superior equity returns achieved by relative low volatility (arguably the most desired outcome), while the bottom-right quadrant con-

EXHIBIT 1

CLO 1.0 Total Equity Returns and Volatility of Equity Cash Flows



tains the deals that have experienced high volatility with lower returns.

Mezzanine Score

In order to get the full picture of a CLO manager's performance, it is important analyze a manager's impact on mezzanine tranches. To do that, investors can focus on two metrics to which a mezzanine investment is most sensitive: extension or reduction in weighted average life of the deal and the cumulative portfolio gain or loss due to defaults and manager's trading actions. Given the market conditions, the ideal setup for a mezzanine 1.0 investor would have been a situation where the weighted average life of the deal was shortening more than initially expected (so that investor got his principal earlier) while the portfolio was having net positive par creation (leading to increase in subordination as a buffer to potential defaults). Exhibit 2 illustrates all 1.0 deals' (2005 or later vintage) maturity extensions as well as par creation/erosion. The bottom-right corner deals arguably had a positive outcome to their debt investors, while the upper-left corner deals underperformed relatively.

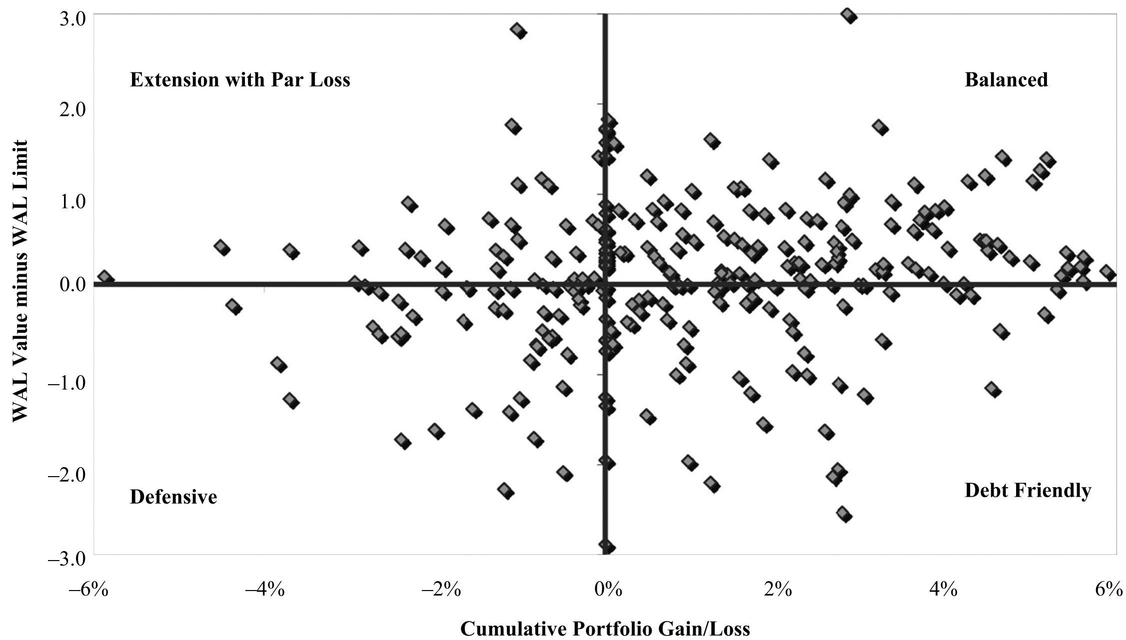
To put things into a full investment perspective, in Exhibit 3, Panel A, all the deals by their equity and debt scores (100% being the best and 0% the worst) are plotted on a deal-by-deal basis. In Exhibit 3, Panel B, the same results are then averaged and compared at the manager level. Although there are managers whose deals turned out to be great investments for equity at the expense of debt and vice versa, it is interesting to see that there are managers who were able to deliver good results for both equity and mezzanine, while some others were absolute underperformers for their investors across the capital stack.

Trader versus Investor

We put every manager across the spectrum of being either a market-value-focused, relative-value trader or fundamental-data-focused, buy-and-hold investor. Obviously each style is perfectly fine if it fits the management team and how they operate. When investment decisions are made, those styles should be taken into account to set the expectations appropriately for that manager. In Exhibit 4, we show the results of

Exhibit 2

Extension/Reduction in Weighted Average Life vs. Cumulative Portfolio Gain/Loss



a case study where we looked at the performance of six static CLO deals in Integral Funding CLO put together by six different managers. We compared them with the performance of those managers in their other actively managed deals that were issued at or around the same time. For example, the manager of Deal 1 is definitely a trader rather than a credit picker. Although its static deal underperformed, the actively traded one was a winner. The manager of Deal 2 tells a completely different story. The performance of their static and actively managed deals are very similar, which means that they are very good to put together a portfolio but their value added is limited by active trading.

Risk Taker versus Risk Averse

For a given CLO manager, it is very important to understand the process of risk management. This can be considered in conjunction with diversity (or lack thereof) as well. Some managers see diversity as a goal when it comes to optimizing their portfolios. For others, it is no more than a tool available to use if and when it is necessary. They would not be shy of taking concentrated risk for credits they believe are fundamentally bullet proof. Diversity, although preferred, should be considered with the manager's team structure and size. A relatively small team with limited resources to cover a broad universe of credits can fail to put together a diversified portfolio because they are not able to thoroughly analyze every credit they introduce to their portfolio. For those, creating a relatively concentrated portfolio makes more sense. To quantify these, investors can look at the historical Moody's weighted average rating factor (WARF) score, which gives a good indication of the manager.

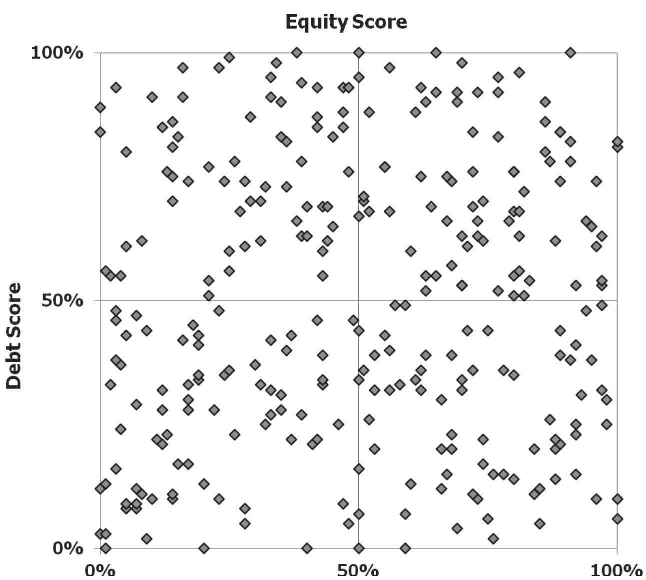
Alpha versus Beta

It is important to normalize the manager performance by the market environment in which they have operated. Investors need to dissect the alpha and the beta in each manager's returns. There are some managers who are alpha type who will underperform in a bull market but can deliver limited downside in a volatile bear market. On the contrary, beta managers do better in bull markets. Depending on where we are at the business cycle, it is important to distinguish the managers that would be the best fit for the upcoming market conditions.

EXHIBIT 3

Equity and Debt Performance

Panel A: Deal Level



Panel B: Manager Averages

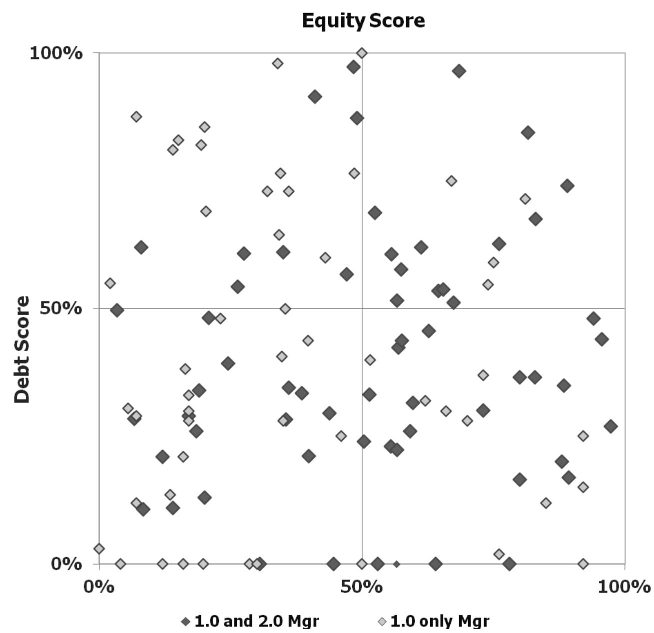
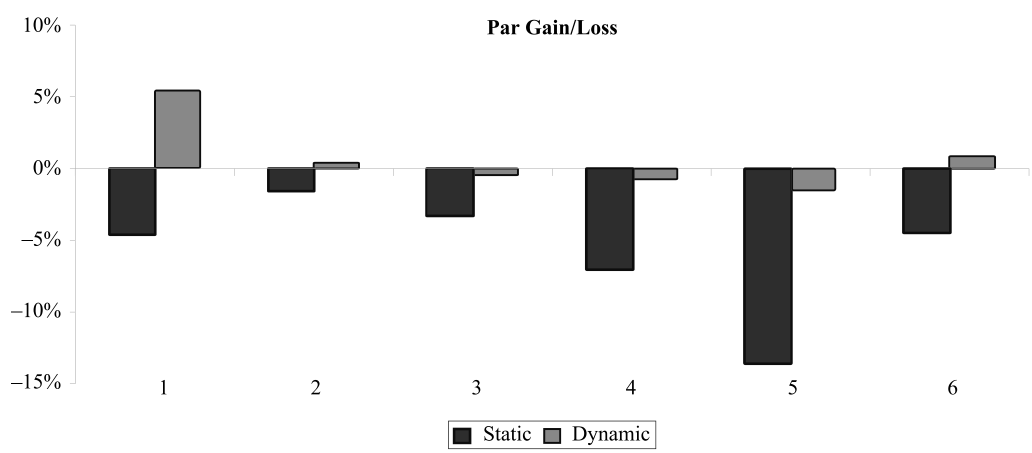


EXHIBIT 4

Performance of CLO Managers' Static and Actively Managed Deals



PUTTING ALL THE PIECES TOGETHER

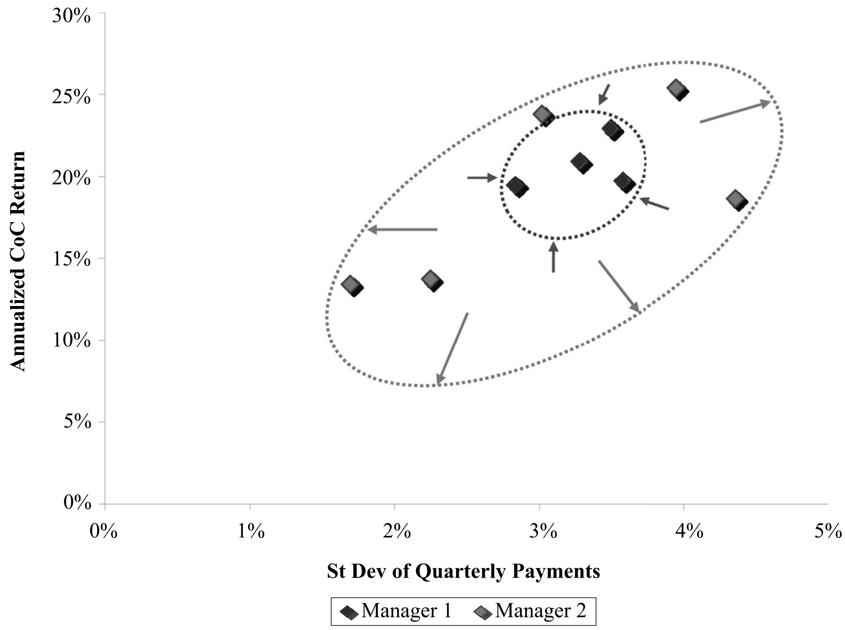
After analyzing the track record using both the qualitative and quantitative factors that we identified earlier, the last step for investors is to focus on the consistency, explicability, and repeatability of the manager's performance.

Consistency

The track record should draw a consistent picture. In other words, the performance across a manager's deals needs to be consistent. In Exhibit 5, we show the performance of two select managers' equity: annualized cash-on-cash return versus volatility of its interest

EXHIBIT 5

Annualized Cash-on-Cash Return vs. Volatility of Interest Distributions



distributions. Manager 1 consistently delivered similar equity performance, while Manager 2 had some deals that were high return/high volatility, and some others just the opposite. We like managers who can match Manager 1's statistics.

Explicability

Managers need to be able to understand how they create value, how they differentiate from competition, and what their strengths and weaknesses are. The performance (positive and negative) should be explicable. It is a necessary practice to confirm the story that the past performance numbers tell with what the manager tells. That is why we are strong advocates of meeting with the managers regularly and keeping the communication lines open all the time. If there are black boxes producing some of the numbers in the track record, that is not a good sign for investors.

Repeatability

The most important part of analyzing a manager's performance is to determine whether it is repeatable or not. The analysis should take into consideration the tools that were available to the managers at the previous cycle, such as structured credit buckets and revolvers, both of which are not available in the new environment. Also, the analysis should take into account the environment in which the track record has been developed and how it will differ in the upcoming market conditions.

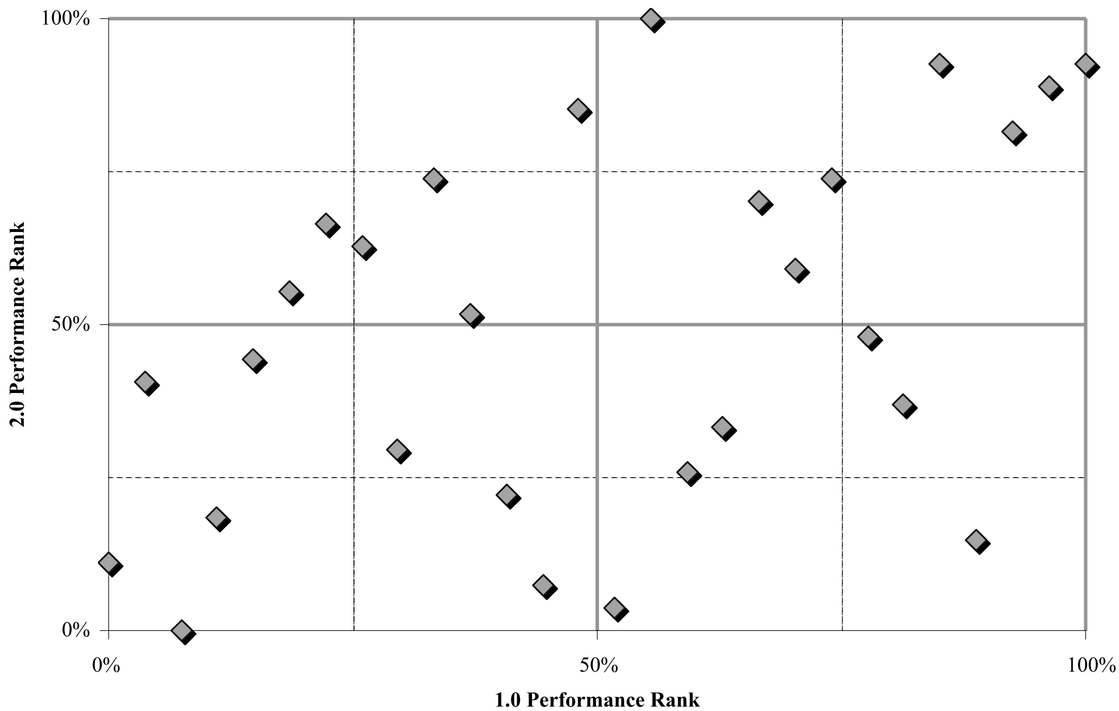
In Exhibit 6, we show the performance ranking of 2.0 CLO managers compared with their similar rankings for their 1.0 deals. Although there are managers that replicated their out- or underperformance, there are also some that improved or lagged their previous track record. It is very important to understand the reason for the diversion in performance to estimate the likelihood of a manager replicating its past performance.

CHOOSING THE RIGHT MANAGER, NOT THE BEST

Finally, investors should have a clear understanding of what type of a manager is a good fit for them. There are different objectives for different investors: the need for cash flows, mark-to-market stability, appetite for risk, liquidity, return targets, and so on. The investment criteria and restrictions will result in varying levels of appetite for different managers. It is important to

EXHIBIT 6

Ranking of CLO Managers' 2.0 vs. 1.0 Deals



be able to identify them correctly and invest in them sensibly.

For a value investor, the exercise in manager quality identification should be coupled with the analysis of relative value of the manager. This should include whether a manager should trade at a discount or premium to its peers and by how much. In the end, the ultimate goal is not to pick the best manager; the goal is to pick the best fit for your investment goals and return targets.

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