



# Opportunities for Generating Alpha in the U.S. CLO Market

U.S. CLO debt offers high average yields due to persistent complexity and liquidity premiums, with return dispersion providing opportunities for generating alpha through active management

April 2023

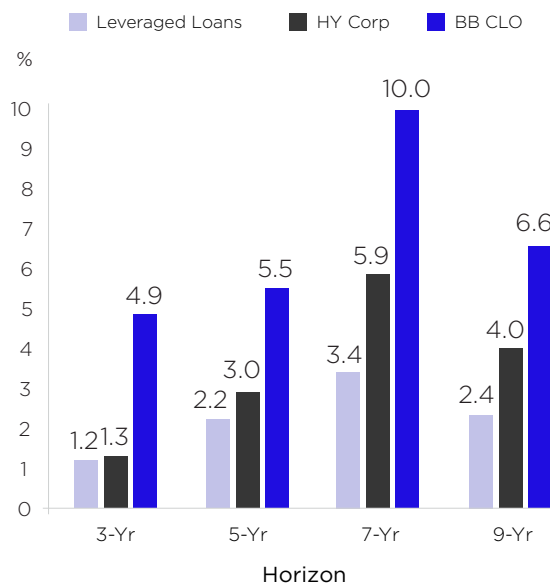
## CLO debt offers strong average returns due to persistent complexity and liquidity premiums

CLO debt securities have historically delivered strong positive returns across a wide range of economic environments: Exhibit 1, below, shows that BB-rated CLO bonds have outperformed leveraged loans and high yield corporate bonds over the past 3-year, 5-year, 7-year and 9-year horizons. Pretium believes CLO debt has the potential to continue to outperform other assets with comparable ratings profiles: Exhibit 2, for example, shows that BB CLOs currently offer average yields of 13.7%, 6.5% above the yields available on similarly rated corporate bonds. Exhibits 1 and 2 represent the average opportunity accessible through the CLO market – that is, by passively allocating to the entire universe of outstanding BB CLO debt instruments, an investor can earn high average returns relative to the returns available from competing asset classes due to the persistent presence of a CLO complexity premium.

### EXHIBIT 1

**BB CLOs have historically delivered high returns compared with returns on leveraged loans or high yield bonds**

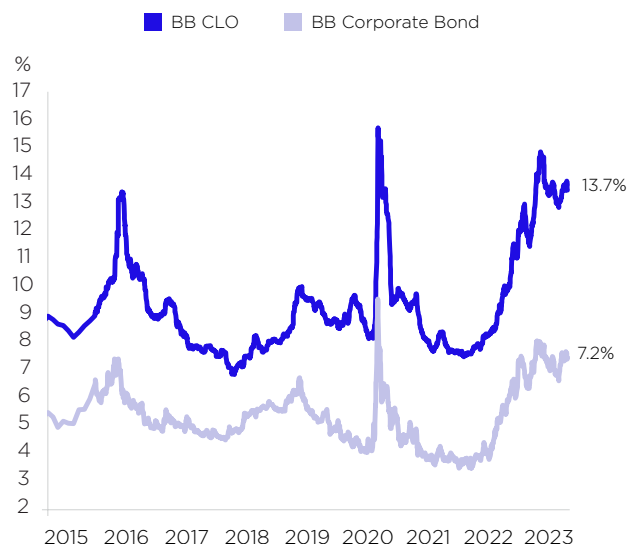
BB CLO, leveraged loan, and high yield corporate bond annualized total return by horizon (through 1/31/2023)<sup>1</sup>



### EXHIBIT 2

**CLO debt continues to offer high average yields compared with similarly rated corporate bonds**

BB CLO vs. BB corporate bond yields<sup>2</sup>



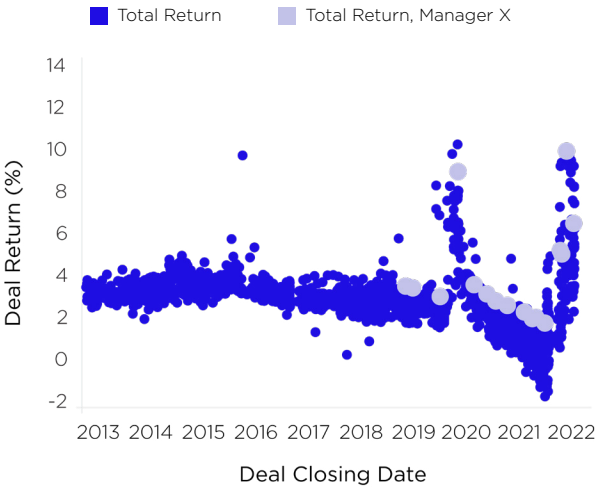
CLO debt offers significant alpha opportunities

In addition to the opportunity for earning strong average index-level returns, the CLO market also features a meaningful amount of return dispersion across different CLO transactions; as a result, there is potential for earning additional alpha returns through judicious active selection of specific CLO bonds. Exhibit 3, for example, shows the annualized total unlevered returns of the underlying loan portfolios for the population of CLOs issued between 2013 and 2022: for a typical quarterly vintage of CLO transactions (e.g., those issued in 2019Q2), the range of loan portfolio returns exceeds 200bp. Given the degree of natural leverage embedded within CLO transaction structures, this amount of return dispersion across loan portfolios translates into an even larger amount of dispersion in returns for junior CLO debt and equity tranches, providing an alpha-rich environment for active CLO investors.

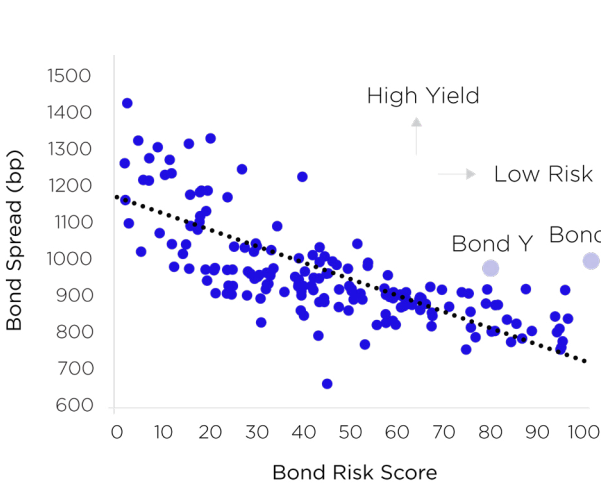
Exhibit 3 highlights one potential means by which active CLO bond investors might outperform the index – namely, by identifying specific CLO managers whose loan portfolios consistently manage to deliver high average returns. In this Exhibit, the loan portfolio returns delivered by one particular CLO manager, here labeled as “Manager X”, are seen to frequently come in near the high ends of the ranges of returns of CLOs issued in nearby time periods. CLO bond investors with tools for and expertise in monitoring CLO manager performance may thus be able to generate alpha by over-allocating to CLO bonds issue by such high-performing managers.

Exhibit 4 shows an alternative sample screen that may be used to actively select CLO bonds with high return potential. The chart in this Exhibit compares the yields on BB CLO bonds traded in the secondary market in the month of February 2023 to a proprietary quantitative measure of risk levels of the bonds. The bond yield and the aggregated risk measure levels are fairly highly correlated, with high risk bonds usually trading at wide spread levels, suggesting the CLO market is roughly efficient. However, there are bonds, such as the ones labeled “Bond Y” and “Bond Z” in the chart, which appear to have high yields relative to the measured amount of risk. CLO investors aided by tools that can similarly help identify bonds with high risk-adjusted yields thus have the potential to generate positive alpha and deliver returns above those earned by the broad CLO index.

**EXHIBIT 3**  
**CLO loan portfolios exhibit significant dispersion in total returns**  
Annualized total return, 1/2013 – 6/2022 CLO loan portfolios (through 2/28/2023)<sup>3</sup>



**EXHIBIT 4**  
**CLO bonds can be identified with high yields relative to their estimated risk levels**  
BB CLO bond spread vs. estimated bond risk score<sup>4</sup>



The CLO asset class has grown significantly over the past two decades, in large part because of the consistently strong performance of the sector through a wide range of economic scenarios including the global financial crisis episode. The CLO sector offers strong index-level return potential given the high average yields available across the sector’s bonds; there are also meaningful opportunities for earning alpha, or extra returns above the average CLO index, via active management. The potential for earning high returns from CLOs in the current environment suggests that many investors who allocate to sectors such as high yield corporate bonds could benefit from investing as well in CLO debt.

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## Sources

1. Bloomberg, Markit, Palmer Square, Pretium. Leveraged loan, high yield bond, and CLO returns are derived from the Markit iBoxx USD Liquid Leveraged Loans Total Return Index, the Bloomberg High Yield Corporate Bond Total Return Index, and the Palmer Square BB CLO Total Return Index, respectively, Data as of January 2023. Bloomberg, Pretium. Data as of February 2023.
2. Bloomberg, Pretium. Data as of February 2023.
3. Pretium. Data as of January 2023.
4. Pretium. Data as of February 2023.