**Positive outlook**

**Tapan Jain, portfolio manager at Hildene Capital explains his views on the CLO market**

2021 proved to be a banner year for the CLO market, from a returns perspective and also through the lens of the market's "maturity". Relentless issuance was met by strong demand that pushed the total market size through $1trn. CLOs are now the largest asset class within the securitised products space and have firmly moved out the realm of specialists and into the mainstream investor universe.

The outlook for CLOs in 2022 remains positive across the capital structure albeit with lower beta upside than 2021. Some new developments – both fundamental and technical, will likely come into play, which should provide opportunities for alpha generation and execution of structural options.

At Hildene, when it comes to structured credit investments, the process revolves around three key pillars.

The Value of the Assets: With respect to the broader leveraged loan universe that represents the CLO universe's asset base, CLOs stand to benefit from the strong economic backdrop and healthy credit fundamentals: leverage remains lower than post-GFC averages and interest coverage ratios are sustainable for most credits. Idiosyncratic credit impairments do remain a risk, particularly for those companies that are less able to pass rising input costs on to their customers. Highly levered companies that rely more heavily on floating rate debt may face difficulty in absorbing increased debt servicing costs as the Fed begins to hike rates without meaningful spread tightening. Broadly speaking, leverage loan borrowers remain healthy and the outlook for assets in CLO portfolios remain positive. Lastly, restructured and reorganised equity holdings in CLOs have continued to rally as energy and reopening companies specifically continue to outperform broader markets.

The value of the structure is another key pillar. Structural features unique to CLOs should similarly serve as meaningful performance drivers for the year ahead. A crucially important structural component of CLOs is the active management of the vehicle – for CLO investors, manager selection is a key part of the investment process. For CLO equity in particular, active management of CLOs is what creates an investment that is simultaneously long carry and volatility – and this is especially relevant in an environment in which idiosyncratic defaults and rate-driven volatility are likely to increase.

Beyond active management, other structural features will play a role in performance as well. For instance, there are numerous deals outstanding that took impairments through the pandemic and are currently, or close to, trapping cash and deleveraging. These features – while an important component of the asset class – are not always identified properly and can provide valuable trading opportunities.

The last pillar is the value of the options - optionality in CLO equity is often the most mis-priced component of the asset class, and there are still opportunities in the market to derive outperformance and generate value here. For one, the demand for floating-rate paper should increase as the Fed raises rates, driving CLO debt spreads tighter and bringing refi/reset options further into the money. Similarly, demand for floating-rate loans and monetisation of reorganised equity by managers should take equity NAVs higher, pushing call options further into the money as well. Finally, re-issuing or resetting deals is an attractive option to execute in order to monetise reorg equity that may not be fully priced, while reducing cost of financing in a rate rising, spread tightening environment.

CLO structures demonstrated their versatility and protective covenants through the pandemic in 2020, and saw solid outperformance through 2021 on the back of lower defaults. As the market continues to gain legitimacy and investors continue to enter the space, we are optimistic that the asset class is poised to experience another strong year for astute investors.

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