Why CLOs Matter (Last of a Series)

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They're big, they're bad, and now that they're back, the end of the world is upon us.

No, we're not referring to the latest *Transformers* instalment*: Age of Extinction.*Though we're compelled to point out that seems an equally appropriate headline for the obituary so many market observers seem eager to write about CLOs' demise-by-Dodd-Frank.

But just as film critics heap scorn on the machine vs. machine franchise (even as the three prior films grossed over $3 billion world-wide), collateralized loan obligations face significant regulatory headwinds and media nay-saying despite being extremely popular with investors, managers, and arrangers.

Yes, as this bull loan market heads into its fourth year, signs of rational exuberance abound. JPM now estimates as much as $100 billion in CLO issuance will hit the market during 2014, up sharply from earlier estimates.

Not just larger overall volume, but the number of new $1 billion (or more) vehicles has caught analysts by surprise. Onex Credit Partners, Apollo Credit Management, and this week, CSAM, have printed such behemoths, with others rumored in production.

No surprise that, with significant fee income at stake, arranging banks are more than willing to jam the pipeline with as many vehicles as investors will take.

How long will the spigot stay on? It's accepted wisdom among loaners that this surge in is temporary. Like much about Dodd-Frank, the rule that managers must hold 5% of the total CLO as equity brings unintended consequences; in this case, driving managers to lock in capacity before risk retention is finalized this year, and effective two years after.

What will new models look like? Expect more equity than pre-crisis (1.0) or possibly post-crisis (2.0) versions. Also, banks will be discouraged from holding all but the most vanilla of triple-A tranches. That leaves the door open for hedge fund and other lenders.

That influx of new investors has caused triple-A spreads to tighten, as our Chart of the Week shows. But so have asset spreads, though not to levels seen earlier in the year. That makes the arbitrage trickier, although equity returns still remain in the high single-digit to low double-digit range.

If the long history of CLOs demonstrates anything, it's that bankers are ingenious in finding innovative ways to bundle loans for sale.

And as prodigious as they've been at buying loans, CLOs are only one tool available to the institutional investor. Superior returns still depend on superior credit selection; no securitization works if the underlying assets aren't sound. Through regulatory hurdles, credit crises, and economic cycles, loans have long proved their value as an asset class.

So don’t be surprised if the death of CLOs ends up being greatly exaggerated. After all, wasn’t the last Transformers movie entitled *Revenge of the Fallen*?