Benchmarking the art of CLO management

Theoretically, the composition of any asset pool can be tailored for securitizations or other purposes, with virtually no limits on its structure. The topic of benchmarking the CLOs versus the loan indices, or replicating the weights and exposure percentages, frequently resurfaces, especially when updated statistics on overlap across managers are released, or when a large corporate, managed by many managers across multiple vehicles, faces difficulties or, in the worst-case scenario, defaults.

Mirroring indices like the Morningstar LSTA US Leveraged Loan Index or the ELLI Loan Index for Europe can be a useful strategy for creating a diversified portfolio that includes "a little bit of everything". However, setting aside considerations related to features that cater to retail demand or active vs passive strategies, here are some key insights drawn from over 20 years of conversations (this stuff is not new, believe me), meetings, and reverse inquiries with colleagues and investors across the US, Europe, and Asia in structured finance—particularly in managed structures:

- The loan index and its associated risk are not appropriate for subordinated exposure (intended here as the equity piece) in a structure levered 10x. If, as some argue, they are suitable, does that suitability persist across all market conditions—most notably during downturns, moments of systemic instability, or in strongly bullish markets? Under what conditions does "knowing what you own" underperform an index strategy? If indices are not synonymous with "the market", should benchmarking be the primary goal of a passive allocation?
- How long does the manager plan to mirror the index? In cases where certain credits become not eligible, highly volatile, illiquid, non-tradable, or clearly headed toward default, would the manager consider adjusting the portfolio's strategy or the borrower universe in the pool?
- How is portfolio rebalancing handled in the event of credit substitutions or defaults? What procedures are in place to address these situations? If a credit portfolio manager edge, in general terms, comes from flexibility and not from constraints related to the composition of the asset pool, how this dilemma is solved in a CLO portfolio?
- Is the strategy of mirroring the index suitable for every manager? If not, what are the key limitations preventing certain managers from executing it? Could structural or operational constraints apply?

- What is the weighted average spread (WAS) of this "innovative portfolio" versus liabilities? What will be the cost of liabilities? What are the call dates for the structure? How is the weighted average life (WAL) test set up and managed?
- Equity performance has yet to be properly assessed and tested. To verify this, we would need to calculate the impact of cutting fees (primarily from the senior portion, the entire junior portion and performance fees) from the manager and reallocating the savings to the equity IRR in the waterfall. What would the result on IRR and cash flow coupons look like? What costs (loans are neither shares nor bonds) are associated with trading during portfolio rebalancing?

While I have my own answers to all of the questions above, finance seldom offers a single truth—every topic invites multiple interpretations. As I often say, when a manager persuades investors to allocate capital to a strategy, it demonstrates that the case was carefully constructed and aligned with a clear demand in the markets.

Investors in securitizations and portfolio managers should seek explanations to address the points mentioned above. Passive investing has its advantages, and letting the market work for you can be effective. Yet, historical data on CLOs suggest that some active and good managers have delivered not only better downside protection than their benchmarks but also outperformance during choppy periods or bullish credit conditions. This highlights the need for a balanced discussion, rather than relying on oversimplified assumptions, overstated concerns, or rigid absolutes.

"Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally"(John Maynard Keynes).