

Expectations for CLO Equity: Numbers, Facts, Projections

The recent ABS conference in Barcelona, together with the renewed attention surrounding CLO equity, has once again brought the subordinated tranche of CLO structures to the forefront of investor discussions. Having written and spoken about CLO equity on numerous occasions, I find myself agreeing with many of the observations made by analysts, CLO managers and investors. However, there are instances where the discussion would benefit from greater technical precision and a more nuanced assessment of the economics that ultimately drive CLO equity returns.

I am not attempting to take a contrarian position. The data (and in the CLO world we are certainly not short of it) would not support such a stance. Rather, as an independent advisor, I am less constrained by product-marketing considerations and therefore more inclined to focus on the structural and behavioral realities that ultimately determine outcomes for equity investors.

The first point worth emphasizing is that CLOs are not homogeneous instruments, and treating them as such often leads to superficial analysis. While this may appear self-evident, it is frequently overlooked in market commentary. CLOs are no longer the esoteric products they were perceived to be at the beginning of the 2000s. The asset class has grown, evolved and transformed itself into a more familiar segment of the credit fixed-income universe, albeit one that retains substantial structural differences from traditional instruments.

This is what I mean when I describe CLOs as a “commodity asset class”. They have matured within increasingly standardized frameworks established by debt indentures and rating agencies. The market now consists of a larger number of managers operating with comparable organizational structures, competing for a limited pool of broadly syndicated loans and, in many cases, the same investor base. Indeed, a significant proportion of CLO equity ultimately finds its way into relatively few hands.

Looking across CLO 2.0 transactions, equity returns tended to cluster within a relatively narrow range, often differing by only two to three percentage points of IRR. However, averages conceal important dispersion and pronounced heterogeneity.

Evaluating CLO performance today is considerably easier than it was during the CLO 1.0 era before the Global Financial Crisis, when information was scarce and transparency limited. Yet meaningful differences remain, supporting the case for

manager selection. CLOs are actively managed products, and managers do influence outcomes relative to market benchmarks.

Even within the same management platform, where collateral overlap between vehicles may reach 75% to 80%, it is incorrect to assume that two CLOs following the same investment philosophy will generate comparable returns. The determinants of equity performance extend well beyond manager identity. They include liability costs locked in at issuance, acquisition prices of the underlying collateral, the weighted average spread of the asset pool, the shape of the capital structure, the level of leverage embedded within the equity tranche, trading decisions made throughout the life of the transaction and the opportunities available to refinance or reset liabilities.

Consequently, equity returns are driven by a combination of variables rather than a single source (the PM) of value creation.

Among European managers, where collateral overlap is often closer to 45% to 55%, manager-specific credit selection and portfolio construction become even more important. Their influence is particularly visible during periods of market volatility, credit underperformance, rating migration and liability management exercises on borrowers' debt. As CLO structures approach the end of their reinvestment periods and transition into amortization, collateral quality, portfolio positioning and cumulative credit decisions become increasingly influential. At that stage, the structural advantages embedded at issuance, including day-one arbitrage conditions, tend to become less important than the decisions made throughout the life of the transaction.

A second point that deserves greater attention is the tendency to evaluate CLO equity through the narrow lens of quarterly distributions. CLO equity should instead be assessed using a total-return framework. The investment proposition combines a stream of excess-spread distributions with a residual claim on the future value of the portfolio. A substantial portion of expected returns is therefore linked not only to cash flows generated during the life of the transaction but also to the terminal value ultimately realized when the CLO is called.

This distinction is particularly relevant in the current environment. While many analysts correctly emphasize the attractive cash-yield characteristics of CLO equity, far less attention is given to the substantial decline in projected returns across outstanding transactions. Setting aside realized IRRs on redeemed transactions, which are inherently backward-looking, average unrealized IRRs across the market have fallen from approximately 14-15% to below 8% within approximately fifteen months. Such a development cannot be explained solely by lower cash distributions resulting from asset-side repricing. It requires a deeper examination of projected future cash flows, reinvestment opportunities, refinancing economics, liability costs and assumptions regarding terminal value.

Comparisons between CLO equity and other asset classes are also frequently made but often lack analytical rigor. Comparisons with private credit and private equity typically rely on headline IRR figures while overlooking the fundamentally different mechanisms through which returns are generated. Private credit strategies derive most of their returns from contractual coupon income, while private equity returns are generally driven by enterprise value creation and multiples expansion. CLO equity occupies a distinctly different position within the risk-return spectrum. It represents a leveraged residual exposure to a dynamically managed portfolio of senior secured loans (and bonds). Returns are generated through structural arbitrage, active reinvestment, portfolio management and embedded leverage. Comparing headline returns without decomposing their underlying drivers can therefore produce misleading conclusions. Similarly, comparisons with traditional fixed-income products are conceptually flawed. CLO equity is not a fixed-income instrument in any conventional sense. It is the residual claimant within a leveraged securitization structure and therefore exhibits a fundamentally different risk profile. In many cases, a more meaningful comparison may be with lower-rated CLO debt tranches, particularly B-rated notes, which can offer an attractive combination of carry and convexity while exhibiting significantly different downside characteristics.

Entering into the details. "What gets measured, gets managed" (Peter Drucker).

Many analyses fail to adequately explain why performance dispersion among European CLO equity investments increased so materially following the pandemic. In my view, 2020 represented a defining moment for the asset class. Prior to COVID-19, managers operated in an environment characterized by abundant liquidity, zero interest rates, historically low default rates and generally benign credit conditions. Excluding the weakest quartile of performers, outcomes across managers were relatively similar.

The pandemic forced managers to make allocation decisions under conditions of extreme uncertainty. They were required to assess the resilience of underlying issuers exposed to lockdowns, supply-chain disruptions and abrupt changes in consumer behaviour. For many platforms, this represented the first genuine test of portfolio construction and credit-selection capabilities under severe market stress.

The inflation shock and aggressive monetary tightening cycle that began in 2022 created a second, and arguably more significant, layer of complexity. Rising funding costs, deteriorating interest-coverage ratios and increasingly divergent sector performance generated substantial differences in borrower and loan outcomes. These developments amplified the importance of credit selection, sector allocation, trading discipline and risk management. Managers who successfully navigated these challenges preserved par value, protected overcollateralization cushions and maintained reinvestment flexibility (the principal lever for me drawing on two decades of experience in CLOs). By contrast, others suffered substantial par erosion, resulting in materially weaker equity performance.

As a result, manager dispersion widened considerably. Recent vintages have not always delivered attractive risk-adjusted return profiles despite the strong yield environment-cash flows- experienced by CLO equity investors during 2024. This development reinforces the idea that CLO equity is not a homogeneous asset class. Performance increasingly reflects the interaction of market timing, manager execution, structural choices and external circumstances.

Viewed from my perspective, the recent past, the present and the outlook can be assessed through a few key considerations.

The conditions under which the capital structure is issued and the loan portfolio is assembled continue to exert a significant influence on future returns. Manager decisions regarding portfolio construction, trading activity and reinvestment strategy have become increasingly important, particularly as transactions approach the end of their reinvestment periods and managers operate with a smaller eligible investment universe. This observation is especially relevant in the European market, where approximately one-third of outstanding CLOs had exited their reinvestment periods by the end of 2023. Given the diversity of documentation governing these transactions, managers often faced materially different constraints and investment opportunities, further contributing to performance dispersion across vintages. Structural differences in reinvestment periods and non-call dates, once relatively uncommon, have also become more significant determinants of performance. The post-pandemic environment forced managers to focus on liability management to a degree rarely seen before, making decisions on the liability side of the CLO as important as credit selection on the asset side. Some platforms were late in adapting to this new reality.

The growing presence of bonds within CLO portfolios has introduced an additional layer of complexity by adding interest-rate risk alongside credit risk. At the same time, many strategies adopted by managers over recent years should be understood as responses to extraordinary market circumstances rather than purely proactive initiatives. The sequence of events that followed CLO issuance—including the pandemic, inflation shock, monetary tightening cycle and repeated episodes of market volatility—created challenges that were largely beyond managerial control. Occasionally, the responses in the portfolios fell short of expectations.

Perhaps the most interesting observation is that manager performance persistence appears to have weakened since 2020. Managers that delivered strong results in one vintage were often unable to replicate those outcomes in subsequent transactions. Likewise, weaker performers or new managers were not necessarily destined to remain at the bottom of the rankings. Strong and weak performance became less repeatable, particularly across the most recent vintages, suggesting that market conditions and PM investment ability have become a more important determinant of outcomes than they were in previous periods. This pattern is clearly visible across the last five vintages. The last five years of CLO printings provide

indeed compelling evidence of interesting facts. Managers that embraced greater systemic risk did not consistently outperform portfolios driven by stronger alpha generation or excess returns. At the same time, a number of credit platforms revised their investment philosophies to adapt to a changing and challenging credit landscape. These changes, while often gradual, had a meaningful impact on portfolio positioning and contributed to increasingly differentiated performance outcomes across managers and vintages (and inside the same manager).

“You don’t have to hold a position in order to be a leader” (Henry Ford).

Taken together, these observations suggest that future CLO equity performance will increasingly depend on the interaction between transaction-specific characteristics, manager execution and market timing. The key question for investors evaluating 2026 vintage is no longer whether CLO equity can generate attractive returns. Rather, it is whether current market conditions provide sufficient compensation for the growing importance of execution risk, structural complexity and manager-specific decision-making. In a market characterized by tighter arbitrage and wider dispersion, successful investing may depend less on exposure to the asset class itself and more on selecting the right transaction, at the right time, with the right manager.

I will not revisit this subject for a while. I close this text with a thought from Isamu Noguchi, one of the most influential sculptors and designers of the 20th century: *“You can study how to do something and then do it, otherwise do it and then discover how you did it”*.

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