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CLO investors are taking a nuanced approach to applying manager tiers that goes way beyond using AUM as a proxy

Investors no longer rely on simplistic tiering models to price CLOs

The CLO market over the past few years has seen some profound shifts in CLO debt price tiering. Decades-old and brand-new CLO collateral managers alike need to spend more time than ever curating debt investor relationships in an increasingly competitive landscape.

Only a few years ago, CLO collateral manager tiering was quite distinct, based mostly upon assets under management, tenure and historical loan portfolio performance. Investors today, however, no longer rely on these simple measures to price CLO investments. Instead, an increasingly granular system has upended the status quo.

Historically, tiering was relatively clear-cut, with tier one consisting of the largest household names, tier two containing mid-sized CLO collateral managers on the rise, and tier three consisting of new, small CLO collateral managers, or those whose portfolios contained above market risk. Some may even have whispered about a tier four.

Under this system, CLO arrangers could easily identify proper pricing of one tier's bonds against another's, with triple As often separated by less than 10 basis points. Nowadays, these tiers are less clearly defined and the basis between the lowest and highest tiered CLO collateral managers hovers near all-time wides. In this environment, CLO collateral managers have been partitioned into those that have made it into the "Ivy league" and those who have not. Let's call these the "others".

Ivy league managers

Today's small group of Ivy leaguers consist of those whose broad global distribution network provides them with an all-weather ability to issue. Over the past few years, we've observed this group shrink by count while substantially growing by AUM. Within this group there are further delineations that investors need to consider as sometimes "access" does not itself mean that pricing will be the tightest.

The "others" group, on the other hand, consists of many different CLO collateral managers, ranging from new entrants to those which have issued for a decade but have a more limited triple A investor following. These CLO collateral managers are the most vulnerable to market volatility.

In the end, this shift has created two clear points that investors need to consider. First, the basis in pricing between these groups can be significant, and even within the groups investors may differentiate based on recent performance or a special relationship. CLO investors today are increasingly sophisticated, not only in data analysis but also in the softer issues that can lead to under- or out-performance. For example, CLO collateral managers often grow quickly through the absorption of a smaller platform. However, that same acquirer will often end up issuing less in the years that follow as CLO investors wait to watch the platform digest the acquisition.

Second, although today's new CLO collateral managers sit often on a level playing field with much of the market, this is potentially unjustified. Investors today are willing to leverage relationships and look granularly to consider which CLO collateral managers have the best chance to make the Ivy league. This sets most of the "others" on a pretty equal footing — even if their relative performance warrants otherwise. This has given some new CLO collateral managers an easy climb up the ranks if they have strong investor relationships that can start from the middle with a clean slate. Notably, in 2021–22 approximately 25% of issuance came from CLO collateral managers with less than two years of CLO issuance history.

Despite the changes in tiering, movement upward both within and between tiers still requires the same recipe:

- A strong track record of credit underwriting through different cycles
- A long-term plan for serial CLO issuance and the capital to back it up
- A passport with stamps from all over the globe.

Over time it is likely that tiering will shift again, perhaps back to the historic norm as the basis between the Ivy league and the others becomes less dramatic. This compression in tiering often occurs in more benign markets. However, we expect to see more pricing differentiation over time, not less.

We'll continue to see pricing shifts up and down the capital structure that require even more specific expertise the further down the stack you are. After all, being tier one for triple A does not alone translate into superior equity performance.

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