Collateralized Loan Obligation (CLO)

A collateralized loan obligation (CLO) is a single security backed by a pool of debt. Often these are corporate loans that have a low credit rating, or leveraged buyouts made by a private equity firm to take a controlling interest in an existing company. A collateralized loan obligation is similar to a collateralized mortgage obligation (CMO), except that the underlying debt is of a different type and character - a company loan instead of a mortgage.

With a CLO, the investor receives scheduled debt payments from the underlying loans, assuming most of the risk in the event that borrowers default. In exchange for taking on the default risk, the investor is offered greater diversity and the potential for higher-than-average returns.

How a Collateralized Loan Obligation (CLO) Works

Loans – usually first-lien bank loans to businesses – that are ranked below investment grade are initially sold to a CLO manager, who bundles multiple (generally 100 to 225) loans together and manages the consolidations, actively buying and selling loans. To fund the purchase of new debt, the CLO manager sells stakes in the CLO to outside investors in a structure called tranches. Each tranche is a piece of the CLO, and it dictates who will be paid out first when the underlying loan payments are made. It also dictates the risk associated with the investment, since investors who are paid last have a higher risk of default from the underlying loans. Investors who are paid out first have lower overall risk, but they receive smaller interest payments as a result. Investors who are in later tranches may be paid last but the interest payments are higher to compensate for the risk.

There are two types of tranches: debt tranches and equity tranches. Debt tranches are treated just like bonds and have credit ratings and coupon payments. These debt tranches are always in the front of the line in terms of repayment, although within the debt tranches there is also a pecking order. Equity tranches do not have credit ratings and are paid out after all debt tranches. Equity tranches are rarely paid a cash flow but do offer ownership in the CLO itself in the event of a sale.
A CLO is an actively managed instrument: managers can – and do – buy and sell individual bank loans in the underlying collateral pool in an effort to score gains and minimize losses. In addition, most of a CLO's debt is backed by high-quality collateral, making liquidation less likely and making it better equipped to withstand market volatility.

[Important: CLOs offer higher-than-average returns because an investor is assuming more risk by buying low-rated debt.]

Special Considerations for a CLO

Some argue that a CLO isn't that risky: A study by Guggenheim Investments, an asset management firm, found that from 1994 to 2013, CLOs experienced significantly lower default rates than corporate bonds. Even so, they are a sophisticated investment, and typically, only large institutional investors purchase tranches in a CLO.

This means companies of scale, such as insurance companies, quickly purchase senior level debt tranches to ensure low risk and steady cash flow. Mutual funds and ETFs normally purchase junior-level debt tranches with higher risk and higher interest payments. If an individual investor invests in a mutual fund with junior debt tranches, that investor takes on the proportional risk of default.