FUND IN FOCUS: Lupus alpha expects 'reasonable' performance for CLO fund in H2 2016 after exceptionally volatile year.

CapitalStructure
28/07/2016

After launching a CLO fund during one of the most volatile periods in recent history, Lupus alpha Asset Management expects smoother conditions to prevail during H2 2016.

The firm's EUR 35.5m **Lupus alpha CLO High Quality Invest**, a rare UCITS-compliant CLO fund, started life 12 months ago, investing in investment-grade European CLOs.

"We entered the market at one of the worst periods for spread developments of the past five years," said Norbert Adam, portfolio manager at Lupus alpha. Market tensions culminated in February, when bond prices across the board posted sharp drops.

Only in two instances in recent years had market conditions been so difficult – following the Fukushima nuclear disaster and during the sovereign debt crisis in 2011, he said.

At the beginning of the year markets switched to risk-off mode amid concerns about developments in China and a fall in emerging market currencies and commodity prices. In the European CLO market, liquidity dried up and performance turned firmly negative. "Triple B CLOs performed like the iTraxx Crossover Index, which is not too surprising since most trading books use the Crossover as a hedge tool," said Mr. Adam.

"During February the number of dealers actively bidding halved. Some days, trading volumes dropped to single million euros. The sizes of trading books have shrunk because of new regulations, and the wide bid/offer spread made it challenging to sell or make switches".

"We had to explain to our clients that this was a liquidity situation, not a quality problem. We know more or less every client in our funds; we spoke to them and told them they had to take a medium-term perspective, which they understood."

"After the Brexit referendum, we said the same: it is better not to react hastily."

But this liquidity situation was not specific to CLOs: in February liquidity dried up in European corporates and other segments of the ABS market, Mr. Adam noted.

Performance suffered. The high grade fund, which aims to achieve returns in the +3% to +3.5% area, was around 50% allocated in Triple B CLOs, which ended up tracking the widening of the high yield indices. "The carry of the Triple Bs was eroded by the spread widening and the long spread duration," said Mr. Adam.

Lupus alpha is now thinking about a future CLO investment-grade fund which reduces volatility by targeting increased investments at the Double A or Single A level. From an investor perspective that would entail aiming for a lower risk but also a lower return target.

The performance of the current CLO high quality fund is gradually improving: the return was -1.35% in the first six months of the year, but has now recovered to 0% year-to-date. The performance of the higher-rated part of the portfolio is around +2%.

The pension funds and high net worth individuals that invested in Lupus alpha High Quality Invest are typically looking for investment-grade credit products providing yields over 2%. Another consideration for these investors is sometimes to diversify their allocation - especially when they have already reached their limit in other asset classes. In addition, less regulated investors with more risk appetite invest in the CLO equity note. Currently, institutional investors such as private wealth managers have invested more than EUR 20m in the CLO notes managed by Lupus alpha.

Muted impact from Brexit

In June Brexit could have disrupted the markets but in the end its impact has been quite muted. "The outcome of the vote had not been anticipated but this was a short-lived situation," said Mr. Adam. "We got more conservative as we knew bid/offer spreads would widen and this would make it difficult to sell or do switches."

"We are comfortable with the CLOs we hold. We think the originator structures are solid and collateral managers have told us they will adapt to the new environment and they will take steps necessary to ensure their transactions comply with EU regulations."

Going forward, Mr. Adam thinks fundamentals will be supportive, with CLOs benefiting from the good credit quality of European loans. "Collateral leverage is on the rise, but the level of equity contribution is also increasing, reaching 50% when this level was around 30% some time ago." He also pointed out that the risk of rating migration of CLO tranches appears to be very limited.

Mr. Adam does not expect huge changes in market conditions in the second half of the year and thinks the market will most likely "return to normal". In his view liquidity is likely to remain at current levels, as the retrenchment of some European banks is likely to be offset by the involvement of some US banks.

He expects the funds' performance to be "reasonable" in the second half, with the yield for the high grade CLO fund staying around its medium term target of 3% to 4%. Spreads for high yield bonds and Triple B rated CLOs are seen as likely to converge, while Single B rated CLOs are likely to post gains after experiencing an exceptionally large widening this year. CLO equity returns, which are around 3% to 4% year-to-date, are likely to increase to 10%.

Fact sheet:
Lupus alpha
Founded in 2000, based in Frankfurt
60 employees working in asset management
EUR 8bn of assets under management
CLO investments exceed EUR 770m
Portfolio management team includes Norbert Adam, Stamatia Hagenstein, Michael Hombach and Klaus Ripper
CLO clients include pension funds, private wealth and less regulated institutional investors in the German-speaking countries

Link to Lupus alpha CLO High Quality Invest fund

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