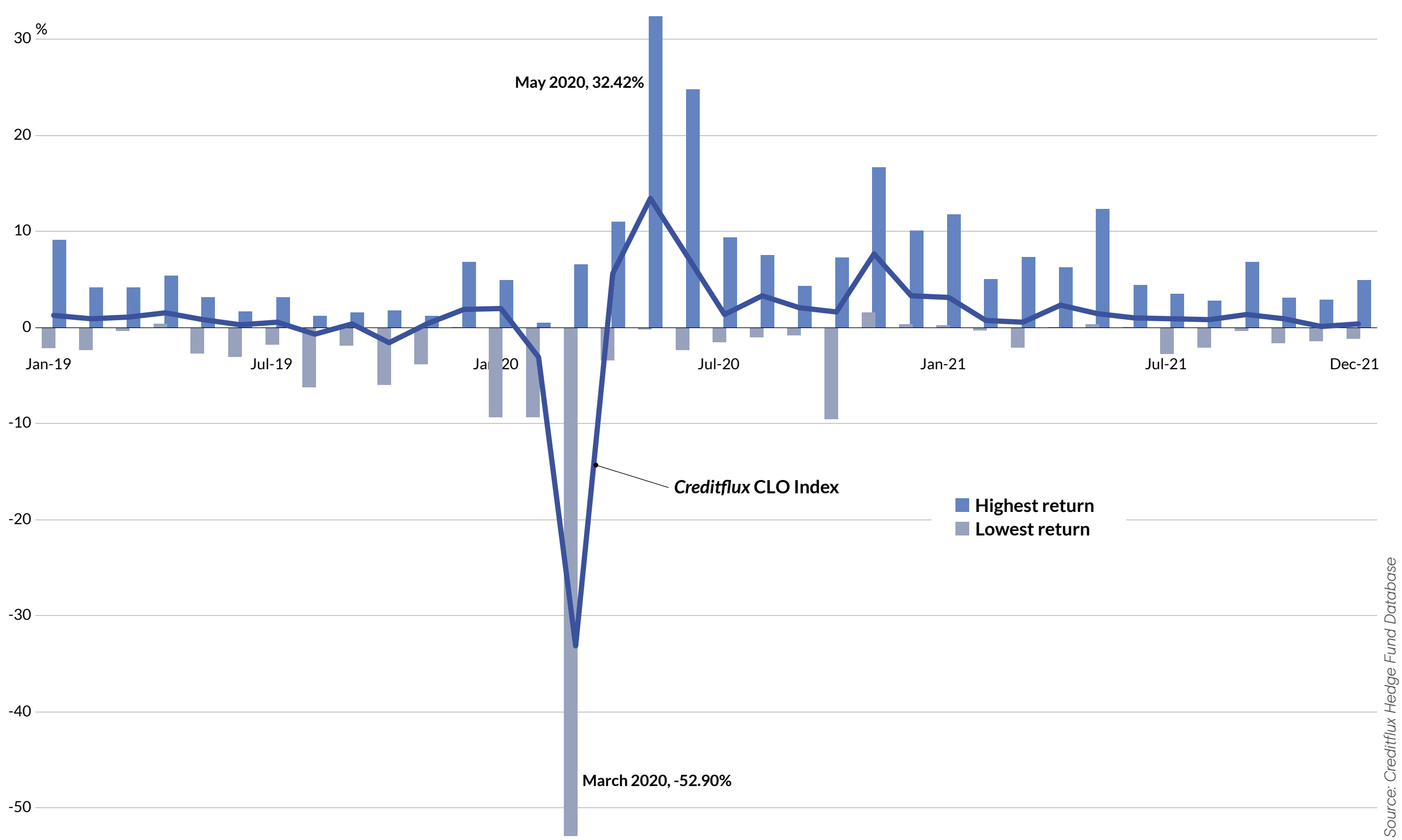
HY fund is exception to rule of CLOs

CLO funds have had back-to-back years of outperformance versus credit, proving the asset class is a great place to invest, rain or shine. But a Wasserstein HY fund was the star performer in 2021

CLO index vs credit hedge funds highest and lowest returns 2019-21



by **Michelle D'Souza & Robin Armitage**

CLO funds dominated *Creditflux*'s 2021 credit hedge fund rankings, but US high yield fund Wasserstein Debt Opportunities beat the competition to clinch first spot. It returned 52.95%, outperforming the *Creditflux* US HY index (which was up 7.63%).

Rajay Bagaria, president and chief investment officer at the firm, says the high yield strategy avoided beta and pursued less-followed segments, which had greater potential for price inefficiency and idiosyncratic event catalysts. High yield spreads at around 390bp heading into 2021 suggested a low margin for error.

Lupus Alpha secured second spot with its European CLO mezz and equity fund, Lupus Alpha CLO Opportunity Notes II. It was one of four managers (including CIS, Flat Rock and Wasserstein) to achieve back-to-back top 10 spots. Alcentra's corporate distressed debt fund, Alcentra Global Special Situations Fund, rounded off the top three with 29.18%, beating the *Creditflux* index's 16.74%.

CLOs outperform in ups and downs

Six CLO funds made our top 10, as the *Creditflux* CLO index returned 14.92% in 2021 (up from 2.99% in 2020).

Managers tell *Creditflux* that resets of 2020 deals largely attributed to stellar performances in 2021, with the lower cost of funding and extended cash-flows giving funds a bump in terms of valuation. Resets

Top 30 credit hedge funds by 2021 returns

Rank	Fund	Manager	Category	Return (%)
1	Wasserstein Debt Opportunities Fund	Wasserstein	US high yield	52.95%
2	Lupus Alpha CLO Opportunity Notes II	Lupus Alpha	CLOs	36.30%
3	Alcentra Global Special Situations Fund	Alcentra	corporate distressed	29.18%
4	BK Opportunities Fund VI	Crystal	CLOs	29.01%
5	Oxford Gate Master Fund	Oxford	CLOs	28.01%
6	CLO Alpha Compartment Taunus	CIS	CLOs	27.26%
7	Wollemi Investments	Fair Oaks	CLOs	26.96%
8	Serone European Special Situations Fund	Serone	corporate distressed	24.47%
9	Flat Rock Opportunity Fund	Flat Rock	CLOs	24.14%
10	Hildene Opportunities Fund II	Hildene	credit multi-strategy	23.98%
11	NZCG Fund	Guggenheim	US high yield	23.87%
12	Lupus Alpha CLO Opportunity Notes I	Lupus Alpha	CLOs	22.63%
13	Spire Partners Credit Strategies Sub-Fund	Spire	credit multi-strategy	22.24%
14	Pictet Alt - Distressed & Special Situations	Pictet	corporate distressed	22.17%
15	Alcentra Structured Credit Opps Fund II	Alcentra	CLOs	21.89%
16	Millstreet Credit Fund	Millstreet	corporate long-short	20.42%
17	Priority Income Fund	Prospect	CLOs	19.11%
18	Alegra ABS 2	Alegra	CLOs	18.65%
19	EJF Debt Opportunities Fund	EJF	structured finance	18.06%
20	Owl Creek Credit Opportunities Fund	Owl Creek	credit multi-strategy	17.79%
21	CIFC CLO Opportunity Fund III	CIFC	CLOs	17.57%
22	Athena Fund	Prytania	structured finance	17.48%
23	BK Opportunities Fund IV	Crystal	CLOs	17.27%
24	Acer Tree Funds	Acer Tree	credit multi-strategy	17.23%
25	AG Corporate Credit Opportunities Fund	Angelo Gordon	corporate distressed	17.05%
26	BK Opportunities Fund V	Crystal	CLOs	16.83%
27	Marathon Securitized Credit Fund	Marathon	structured finance	16.33%
28	Alegra ABS 1	Alegra	CLOs	16.17%
29	CIFC CLO Opportunity Fund II	CIFC	CLOs	16.09%
30	Hildene Opportunities Fund	Hildene	structured finance	15.97%

Reset par flushes helped returns

Inés Bartsch
Chief executive officer
CIS Asset Management

of 2020 European CLOs cut cost of debt by an average 44.5bp, while US CLOs cut 47.5bp, according to *Creditflux* data.

Inés Bartsch, chief executive officer at CIS Asset Management, says: "As we invested in CLOs throughout covid, several of those deals that reset/refinanced were beneficial for equity, especially as they ramped up around Q2 2020. For example, reset par flushes contributed to our 6.86% return in September 2021."

Michael Hombach, portfolio manager at Lupus Alpha, agrees that resets helped. "We positioned ourselves well while investing in short deals that had no added premium being paid. All these deals extended their reinvestment period and weighted average life, and increased in price. At the same time, they paid out in terms of valuation price. We had an annualised January payment in 2021 of 14% (notional)."

Fair Oaks Capital has been a long-time advocate of the control CLO equity strategy. Miguel Ramos Fuentenebro, partner at the firm, says the benefits shone through in 2021. "Investing in control equity means you can have a dialogue with the manager to decide key parameters while ensuring the portfolio and structure reflects your view as equity holders," he says. "We have done deals with short non-call periods in 2020 for example, to maximise optionality."

Fuentenebro believes the Wollemi Investments fund highlights the ability to make good returns with a conservative portfolio.

"The CLOs in the fund tend to have a lower spread than the market and more conservative portfolios. Applying appropriate assumptions to these portfolios supports attractive returns while facilitating future optimisation via, for example, resets," he says. "It's not all about aggressively high portfolio spread and a couple of high distributions, followed by potential pain."

Olivier Gozlan, portfolio manager at Crystal Funds, says he attributes his CLO fund's success last year to three factors. "2021 was a stronger year, supported by price and new entrants in CLOs (both on the sell side and buy side), which provided some liquidity. We also had intensive trading activity." Gozlan adds that Crystal sacrificed some liquidity and looked for yield if the team were comfortable with fundamentals and credit analysis.

Reorg equity in CLOs was also a theme in 2021. US CLOs could hold non-loan assets following the Volcker rule amendments in October 2020. Debdeep Maji, senior managing director at Oxford Funds, says his firm targeted CLOs that used this flexibility.

"Through 2020, certain CLO managers held loans through bankruptcies or restructurings and took their recoveries in the form of reorganised equity in those companies," says Maji. "In the secondary market, we targeted deals that held reorg equity as

> **Increasing spreads will have an impact**
>
> Stamatia Hagenstein
> *Portfolio manager*
> Lupus Alpha

these profiles were often overlooked and not properly valued by the market."

Serone, meanwhile, was one of two distressed managers in the top 10. Ralph Herrgott, head of special situations, attributes performance to an 'event-rich' year, with event-driven or hedged trades contributing to 69% of returns. Synergies with the firm's CLO strategies and trading within the fund's portfolio (turnover and volume of 128% and 257%, respectively) also helped, he says.

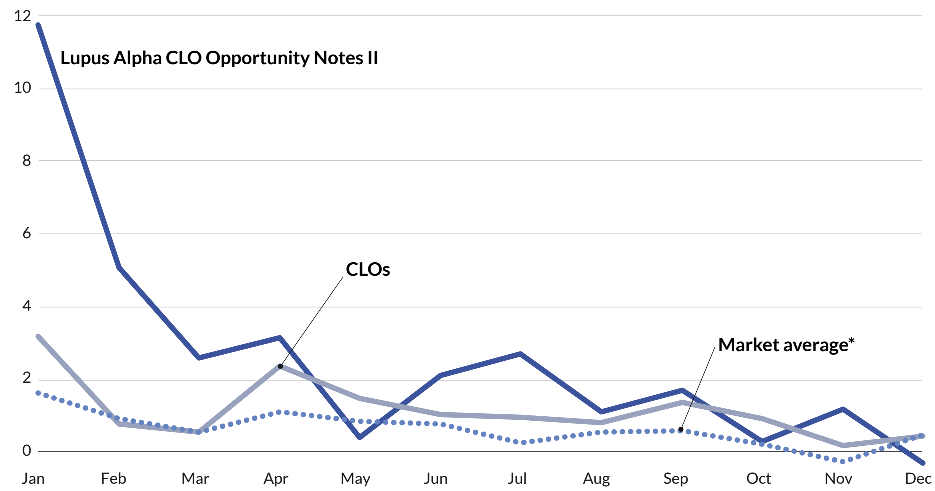
Managers prepare for volatility

Volatility will be a key theme in 2022 with credit managers needing to navigate geopolitical risks stemming from Russia's aggression in Ukraine, Fed rate hikes and inflation.

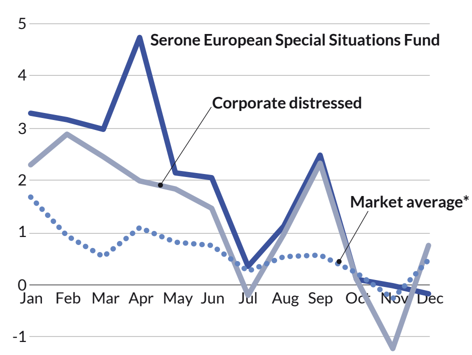
Stamatia Hagenstein, portfolio manager at Lupus Alpha, says the CLO arbitrage could benefit deals with locked liabilities that are still in their reinvestment period and are able to invest into wider asset spreads. "We saw this in our CLO fund after the financial crisis, where the spread of the underlying assets jumped from 250bp to 450bp," she says. "We don't expect this to happen now, but if you are able to increase asset spreads from 10-25bp, it will have a beneficial impact on equity prices and cash outs."

Maji expects to see opportunities in the CLO secondary market in 2022. "It's been an interesting year so far in our market because until recently, loan prices were relatively strong despite the overall backdrop of the high yield and the equity markets," he says. "Because of that dynamic, we've seen certain CLO equity profiles trading in the secondary market well below their liquidation NAVs, and we've managed to source a few interesting control blocks."

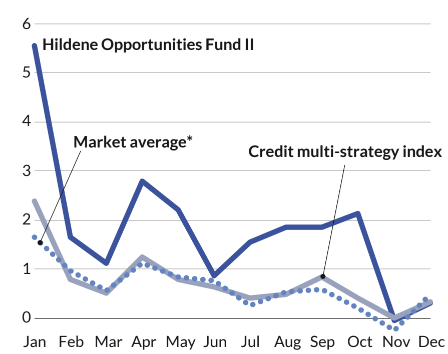
Monthly returns 2021: CLOs (%)



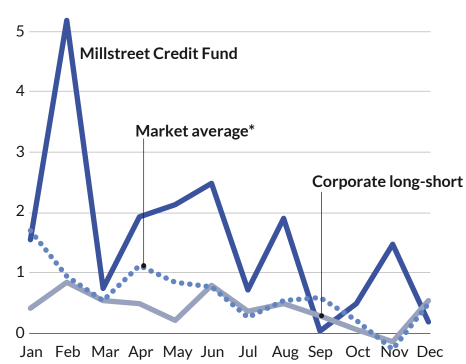
Corporate distressed



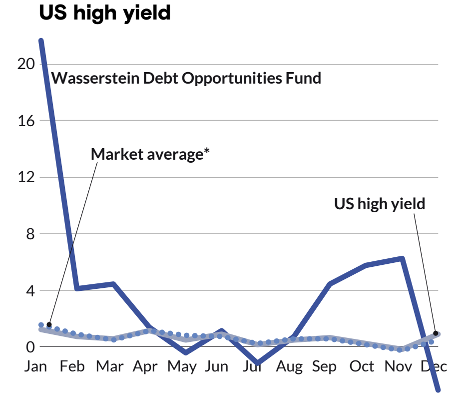
Credit multi-strategy



Corporate long-short



US high yield



*Market average figures are taken from all other funds in the database. Source: Creditflux Hedge Fund Database

For high yield, Bagaria argues that rate hikes will drive capital outflows, creating a technical price dislocation divorced from fundamentals and leading to substantial opportunities. "Unlike equities, where you can debate sales multiples and the proper long-term discount rate, high yield valuation is grounded in free cash-flow and a contracted maturity," he says. "For managers in a position of strength, the inflationary backdrop creates opportunities to produce greater than 20% net returns in 2022."

Herrgott agrees. "The monetary policy stance and rising input cost environment will likely lead to dispersion in the Euro HY market," he says. He expects to see mis-pricings and a "balanced event set between re-financings, M&A and restructuring".