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CLO Cheat Sheet: How To Answer Questions About CLOs

> CLOS have delivered the most attractive risk-adjusted returns in fixed income over the past decade, but they are often deemed "too complex". This guide helps you address your clients' questions.

Collateralized Loan Obligations (CLOs) have delivered the most attractive risk-adjusted returns in fixed income over the past decade. However, understanding their key components—such as credit quality, high yield, duration, and simplified access through ETFs—can be challenging. This piece aims to provide a straightforward explanation of CLOs, highlighting their benefits to investment portfolios, and includes links to resources for deeper exploration of specific topics.

What is a CLO?

- CLOs are securitized, actively managed and diversified portfolios of corporate bank loans.
- CLOs typically hold anywhere from 200-300 loans from corporate issuers spread across various sectors and industries.
- The underlying collateral (the leveraged loans) of CLOs are senior and secured, meaning they have the senior-most claim on all the issuer's assets in the event of bankruptcy.

Dive Deeper

A Guide to Collateralized Loan Obligations (CLOs)

The Power of CLOs: Higher Yields and Built-In Risk Protection

Are CLOs a new investment vehicle? And how big is the CLO market?

- No, institutional investors have had access to CLOs for about three decades. However, most financial advisors and individual investors only recently gained access to the asset class with the advent of CLO ETFs.
- The global CLO market reached the $1T benchmark size in 2021 and is now approximately equal in size to the U.S. high yield bond market.
- While banks and insurance companies are the primary institutional owners of CLOs historically, retail investors have continued to gain a presence in the CLO market, with over $10B in CLO AUM across ETFs.

How are CLOs structured?

- Each CLO issues a series of floating rate bonds, along with a first-loss equity tranche. The tranches differ in terms of subordination and priority—and, thus, rank lowest to highest in order of riskiness (and return).
- The cash flows generated from the underlying portfolio of loans is used to pay interest sequentially to CLO debt holders, starting with the most senior AAA tranche.
- Remaining cash flows are then paid to the AA, A, BBB, and BB tranches.
- The equity tranche receives the residual cash flows once all of the senior and mezzanine tranches have been paid in order.

- Losses are absorbed first by the equity tranche, and to the extent that losses exceed the value of the CLO equity, by the debt tranches starting with the most junior tranche first.
- Due to credit enhancements, priority of cash flows, diversification, active management and other risk protections, most tranches earn investment grade ratings despite the underlying leveraged loans themselves having below investment grade ratings.

Are CDOs the same thing as CDOs?

- CDOs, or collateralized debt obligations (CDOs) are a vehicle that hold a variety of debt instruments including bonds or mortgages (including subprime mortgages).
- CDOs are not the same thing as CLOs. CDOs were at the forefront the GFC (not CLOs!).

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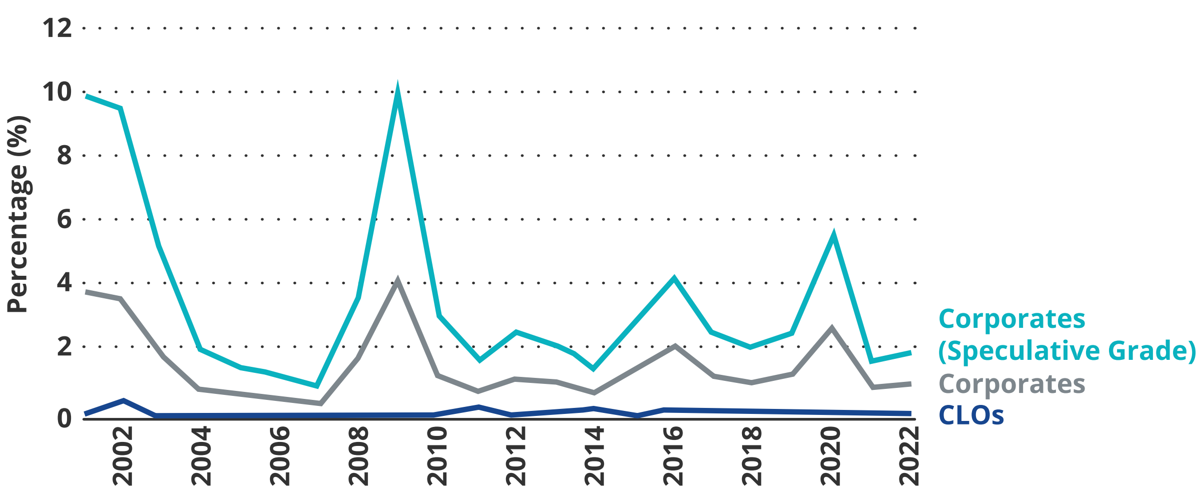
CLOs vs. CDOs: Understanding the Difference

How did CLOs perform during the last two market crises?

- CLOs experienced fewer defaults than corporate bonds of the same rating during and in the years following the global financial crisis (and also during the COVID-19 drawdown). No AAA or AA rated CLO has ever defaulted, and default rates even at the BBB level are extremely rare historically.
- In the most recent COVID-19 drawdown, CLOs experienced a lower return drawdown than leveraged loans and high yield bonds, and a similar drawdown to investment grade corporate bonds.

CLOs Are More Resilient to Defaults

Annual global defaults rates[1]: CLO vs Corporates (2001 – 2022)



Source:[1] S&P Global: Default, Transition, and Recovery: 2022 Annual Global Leveraged Loan CLO Default And Rating Transition Study. 2CLO Spotlight: Thirty Years Strong: U.S. CLO Tranche Defaults From 1994 Through First-Quarter 2024. Past performance is not indicative of future results Past performance is not indicative of future results. This is not an offer to buy or sell, or recommendation to buy or sell any of the securities mentioned herein. Default rate for CLOS and Corporate includes all rated entities. Corporate (Sec-grade) includes only companies rated BB+ and below.

How do changing interest rates impact CLOs?

- CLOs are floating-rate instruments with quarterly resets, similar to bank loans giving them an average duration of approximately 0.25 years. Because the coupon resets with prevailing short-term rates, investors earn higher income if rates are elevated or increasing, while coupons will decrease if short-term rates decline.

- With nearly zero interest rate duration, CLOs can be thought of as a pure credit instrument and an excellent complement with a negative correlation to a fixed coupon asset such as intermediate and long term U.S. Treasuries.

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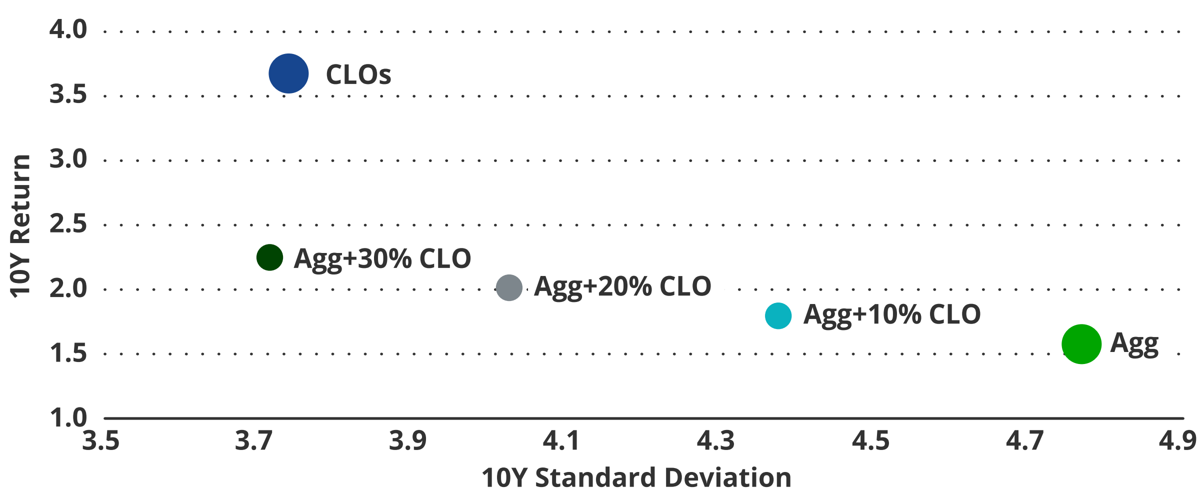
CLOs: Not Just for Rising Rates

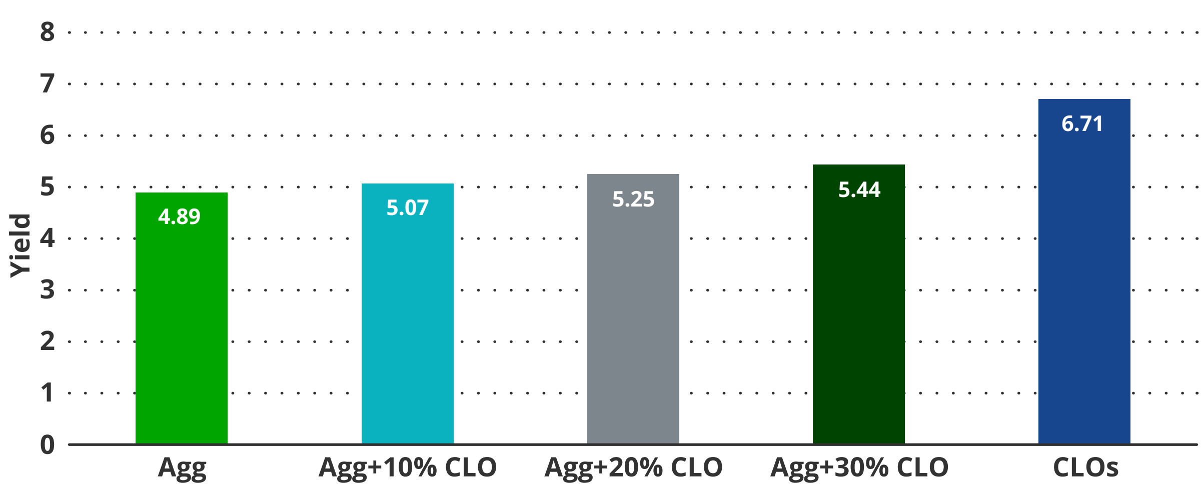
What are the main benefits of investing in CLOs?

- **Attractive yields**
- **Attractive Carry**
- **Near Zero Duration**
- **Low Volatility**
- **Low Default Rates**
- **Low Correlation to Traditional Fixed Income**

Adding CLOs Provided Better Outcomes



...And Better Yields



As of March 31, 2024 Source: JP Morgan and ICE Data Services. CLOs refers to the J.P. Morgan Collateralized Loan Obligation Index (CLOIE) and Agg refers to the ICE BofA U.S. Broad Market Index. CLO Yield to Worst represents yield to call for premium priced securities or to maturity when priced at a discount to par based on forward reference rates. See index descriptions at the end of this presentation. Past performance is not indicative of future results. This is not an offer to buy or sell, or recommendation to buy or sell any of the securities mentioned herein. For illustrative purposes only. Please see important disclosures regarding hypothetical performance at the end of this presentation.

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Get to Know CLOs with William Sokol

CLOs: Too Good to Be True?

Why Invest in CLOs?

Is CLO investing better suited for active management?

- Replicating an index of CLOs is extremely difficult or essentially impossible, and significant opportunity to add value through active management exists due to the unique characteristics of the CLO market.
- The CLO asset class is not homogenous and there are significant opportunities to add value through security selection and top-down positioning. But you need specialized knowledge and experience to identify these opportunities.
- Just one CLO can have over 300 underlying loans and have unique structural features. You need a manager who can drill down and analyze the portfolio at the individual loan-level, in addition to analyzing the CLO manager and understanding and stress-testing the structure itself.

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Looking Beyond AAA Rated CLOs Pays Off

Where do CLOs fit in my portfolio?

- CLOs can be used in a portfolio in a variety of ways as both a complement to the core, an income producing alternative asset, or as a component to a high quality short duration cash+ bucket.
- CLOs are not in the Bloomberg Aggregate Bond Index (the Agg) and have a near zero correlation to the Agg, therefore they offer Agg-benchmarked investors a strong portfolio diversifier and yield enhancer within their core bond portfolio.
- CLOs can also be used to adjust the overall duration of a core bond portfolio without a meaningful change to the overall credit profile.
- CLOs are not considered a core fixed income asset and therefore can be used as an income producing alternative asset.
- CLOs may be an attractive way for senior loan investors concerned about deteriorating fundamentals to decrease risk, as CLO investors benefit from built-in risk protections while maintaining exposure to the loan market, including the floating rate exposure.
- For investors utilizing short duration high quality cash enhancement vehicles that seek to out yield treasuries with a high margin of safety, CLOs can be an excellent component.

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CLOs Now a Core Necessity

IMPORTANT DISCLOSURES

Index descriptions:

J.P. Morgan CLO Index is comprised of U.S. dollar denominated arbitrage CLOs of broadly syndicated loans.

AAA Rated CLOs represented by J.P. Morgan CLO AAA Index is a subset of the J.P. Morgan CLO Index that only tracks the AAA rated CLO.

AA Rated CLOs represented by J.P. Morgan CLO AA Index is a subset of the J.P. Morgan CLO Index that only tracks the AA rated CLO.

A Rated CLOs represented by J.P. Morgan CLO A Index is a subset of the J.P. Morgan CLO Index that only tracks the A rated CLO.

BBB Rated CLOs represented by J.P. Morgan CLO BBB Index is a subset of the J.P. Morgan CLO Index that only tracks the BB rated CLO.

BB Rated CLOs represented by J.P. Morgan CLO BB Index is a subset of the J.P. Morgan CLO Index that only tracks the BB rated CLO.

ICE BofA U.S. Corporate Index (C0A0) tracks the performance of U.S. dollar denominated investment grade corporate debt publicly issued in the U.S. domestic market.

ICE BofA U.S. High Yield Index (H0A0) tracks the performance of U.S. dollar-denominated below investment grade corporate debt publicly issued in the U.S. domestic market. Qualifying securities must have a below investment grade rating. Original issue zero coupon bonds, 144a securities, both with and without registration rights, and pay-in-kind securities, including toggle notes, qualify for inclusion. Eurodollar bonds, taxable and tax-exempt U.S. municipal, warrant-bearing, DRD-eligible and defaulted securities are excluded from the Index.

ICE BofA U.S. Broad Market (US00) tracks the performance of U.S. dollar denominated investment grade debt publicly issued in the U.S. domestic market, including U.S. Treasury, quasi-government, corporate, securitized and collateralized securities.

Morningstar LSTA U.S. Leveraged Loan 100 Index seeks to mirror the market-weighted performance of the largest institutional leveraged loans as determined by criteria based upon market weightings, spreads, and interest payments.

The S&P 500® Index consists of 500 widely held common stocks covering industrial, utility, financial and transportation sector; as an Index, it is unmanaged and is not a security in which investments can be made.

Please note that VanEck may offer investments products that invest in the asset class(es) or industries included in this commentary.

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An investment in a Collateralized Loan Obligation (CLO) may be subject to risks which include, among others, debt securities, LIBOR Replacement, foreign currency, foreign securities, investment focus, newly-issued securities, extended settlement, management, derivatives, cash transactions, market, operational, trading issues, and non-diversified risks. CLOs may also be subject to liquidity, interest rate, floating rate obligations, credit, call, extension, high yield securities, income, valuation, privately-issued securities, covenant lite loans, default of the underlying asset and CLO manager risks, all of which may adversely affect the value of the investment.

All investing is subject to risk, including the possible loss of the money you invest. As with any investment strategy, there is no guarantee that investment objectives will be met and investors may lose money. Diversification does not ensure a profit or protect against a loss in a declining market. Past performance is no guarantee of future results.

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