



## Investment Perspectives

# Investment Brief: Addressing Key Questions on CLOs

*As investor interest in collateralized loan obligations grows, we examine the important characteristics of the asset class—and its relevance for investors.*



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Over the last year, collateralized loan obligations (CLOs) have garnered increased attention from investors. With attractive spreads and historically low defaults compared to other areas of fixed income, we believe the asset class deserves attention. We have been investing in CLOs for over a decade across our fixed income strategies.

But while CLOs are achieving wider recognition, the asset class remains unfamiliar to many investors. Here, we offer an overview of CLOs and address some of the most common questions we receive.

## What are CLOs?

At a high level, CLOs are structured financial products backed by a pool of loans, typically leveraged corporate loans. These loans are packaged together and sold to investors in different tranches, each representing varying levels of risk and return. The cash flows from the underlying loans are distributed to investors based on the seniority of the tranche they hold—senior tranches receive payment first and have lower risk, while junior or equity tranches bear more risk but offer higher potential returns.

This process of pooling and structuring risk has historically allowed a CLO manager to issue debt, on average among all the tranches, more cheaply than the rates on the loans it is buying, enabling the manager to profit from the spread over time.

## Why would investors want CLO debt?

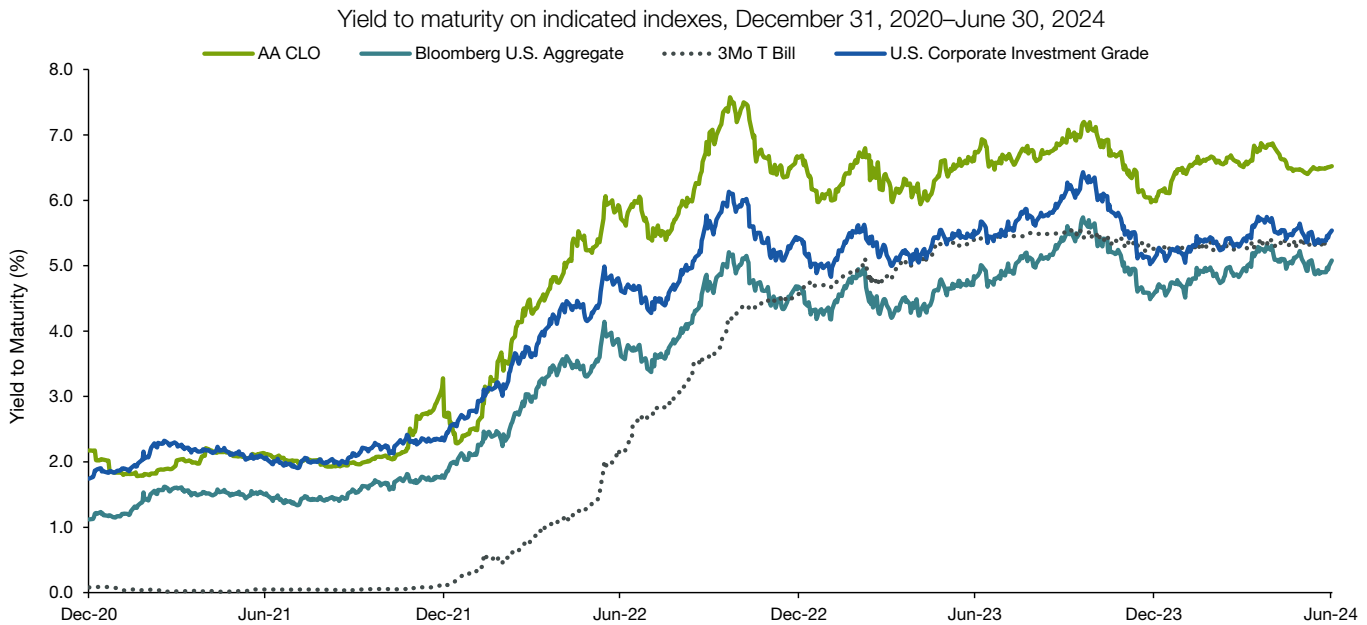
The investors in CLO debt receive high quality, diversified, floating rate loan exposure; CLO debt typically offers better spreads than corporate bonds of the same rating, and historically fewer defaults, based on data from S&P Global.

We strongly advocate for diversifying fixed income exposure in investment portfolios, including CLOs along with other asset classes, to balance risk and earn the additional carry available in corporate bonds, loans, and securitized products. We think CLOs are particularly effective for balancing fixed income portfolios because both the credit orientation and the floating rate feature help diversify the rate exposure that is often the most dominant risk in most fixed income portfolios.

In addition, the substantial yield advantages, as shown in Figure 1, can help provide protection against credit and interest rate volatility.



Figure 1. Comparing CLO Yields to Other Types of Investment-Grade Fixed Income



Source: Bloomberg. U.S. Corporate Investment Grade= Bloomberg U.S. Corporate Bond Index. AA CLO= J.P. Morgan Collateralized Loan Obligation Index (AA-rated segment). Bloomberg U.S. Aggregate=Bloomberg U.S. Aggregate Bond Index. 3 Month T Bill=Three-month U.S. Treasury bill.

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## What’s driving the opportunity in CLOs?

Traditionally, this spread has been compensation for less liquidity rather than actual default experience, which has been near zero for investment-grade CLOs, based on S&P Global data. The primary buyers of CLOs were banks and insurance companies taking advantage of a capital cost arbitrage on the rating, but they tended to buy and sell at the same time, leaving the market volatile and without liquidity in times of stress.

In the last few years, though, a wider array of buyers, including retail investors through exchange-traded funds (ETFs), has come to the market seeking protection from rising rates. The benefit for the CLO market has been greater investor awareness, more trading, and increased liquidity. Data from Trace cited in a recent Top Chart report show that weekly trading volume in CLOs roughly quadrupled from the end of 2014 through June 30, 2024.

In addition, CLOs have had a greater opportunity set since the global financial crisis (GFC) of 2008–09, as banks curtailed lending in response to balance sheet regulation imposed by the 2010 enactment of the Dodd-Frank Act. The appetite for leverage among corporate issuers remains and CLOs have supported the syndicated bank loan market to fill that need.



## What is the default experience of investment-grade CLOs?

CLOs do have principal risk, because they are sensitive to defaults in the loan pool, and liquidity and market risks due to fluctuations in credit spreads and market conditions.

The collateralization and prioritization of the debt tranches leads to a wide stratification of probabilities of principal loss and consequent yields over those tranches. An AAA-rated tranche of CLO debt will have around 40% in subordinate tranches, meaning that the loans bought by the CLO would have to generate 40% in principal losses before generating losses for the AAA tranche. Given historical recoveries in the 40% range for bank loans, this would mean over 65% of loans would need to default over the life of the CLO for that to happen. Trailing 12-month default rates for bank loans sit at 3.1% as of June 30, 2024, according to S&P Global; looking at recent history, defaults peaked at levels around 12% before quickly falling in each of 2009, 2002, and 1990, nowhere near levels that would cause losses for the AAA tranche.

While reinvestment periods and triggers that direct capital flows make the math not quite that simple in practice, the general safety of the AAA tranche (and even the AA- and A-rated tranches) is something that has not been tested throughout the GFC, the COVID-19 pandemic, and other market shocks, as shown in Figure 2.

**Figure 2. Default Rates on Investment-Grade CLOs**

Data as of June 30, 2024

CLO Rating	Default Rate
AAA	0.00%
AA	0.00%
A	0.00%
BBB	0.01%

Source: S&P Global. Latest available quarterly data.

**Past performance is not a reliable indicator or guarantee of future results.** Due to market volatility, the asset classes depicted in this chart may not perform in a similar manner in the future. For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment.

## What is the CLO “feedback loop,” and how might it benefit the market?

One of the things that separates CLOs from less well-conceived structures, in our view, is what can be considered a self-regulating ecosystem of issuance. The capital requirements for forming a CLO are relatively high, and the risks to equity are substantial, requiring a mid to high teens percentage equity return to compensate for those factors. If underwriting standards loosen or defaults increase, a quick feedback loop ensures the cost of debt rises for the sponsor, making the structure uneconomical for the equity investors in the CLO, or, alternatively, the sponsor is forced to tighten underwriting standards.

It's that tight feedback loop that leads to a stable market structure, in our view, something much different than, for example, subprime mortgages before the GFC. In that market, lending standards loosened for decades, drawing on conventional wisdom that home prices would continue to appreciate, and enabled by offloading of risk to third parties, which kept the market unchecked until a small slowdown created a large problem.



## What about the potential for negative convexity?

The CLO manager's ability to refinance a CLO can lead to negative convexity in times of falling rates, as this refinancing option shortens the life of the security and caps the value near par, a condition that explains some of the increased spread when compared to instruments with a similar credit rating but more call protection.

We believe interest rates are entering a period of more certainty as the variance in U.S. inflation data begins to narrow from month to month. This means the option of refinancing (the option an owner of a CLO tranche is short) is worth less and the refinancing risk is less, making the high carry featured by CLO debt more attractive.

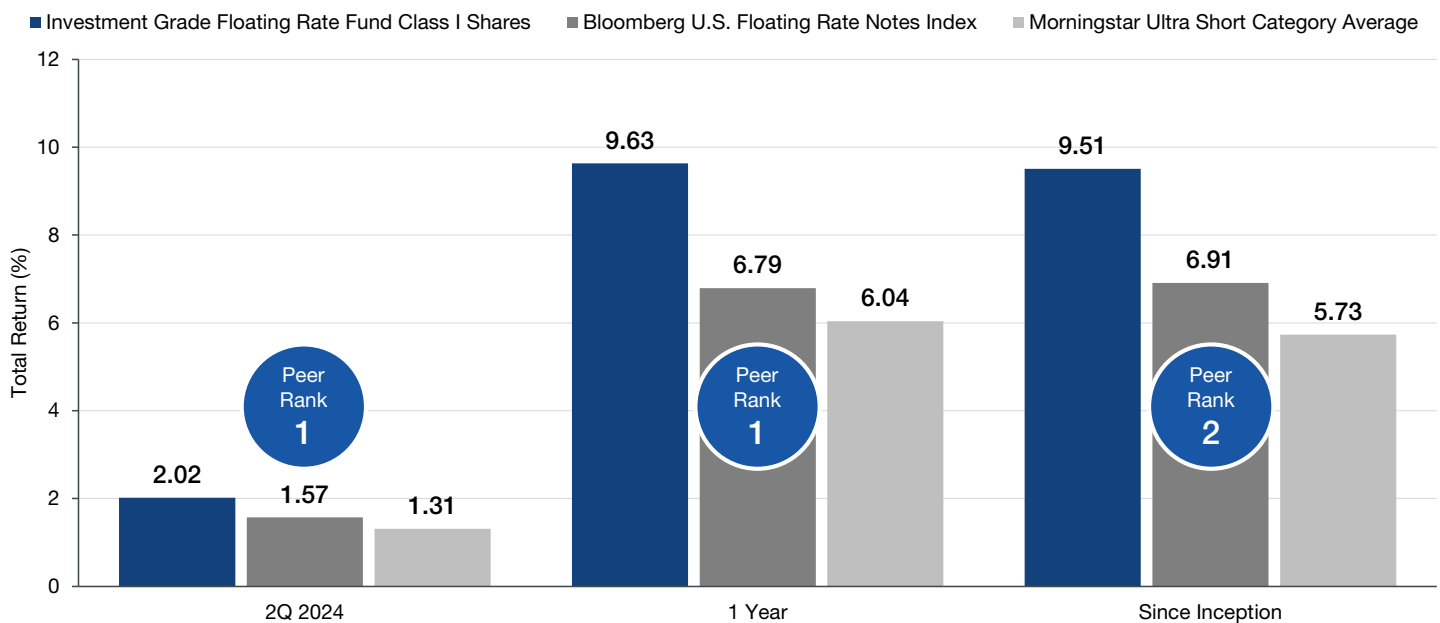
## Why consider an active approach to CLO investing?

Over the last few years, there have been several investment products created to focus on investment-grade floating rate assets, including CLOs. We believe a flexible and diversified approach to investing in investment-grade floating rate instruments can have an advantage over a single asset class or rules-based structure, especially as market environments change and the opportunity set evolves.

At Lord Abbett, we have a deep and experienced team of investment professionals who have been investing in corporate and securitized credit for decades. The Lord Abbett Investment Grade Floating Rate Fund was launched in 2023 to provide clients with access to high quality floating rate investments, with a concentration in CLOs but the flexibility to find relative value in syndicated loans, ABS, CMBS, RMBS, and floating rate corporate bonds. Since that time we have proven our ability to use an active approach to best the floating rate index and peers in the category, as shown in Figure 3.

**Figure 3. Historical Performance of Lord Abbett Investment Grade Floating Rate Fund (I Shares)**

Data as of June 30, 2024



Gross expense ratio (06/30/2024): 1.75%. Net expense ratio (06/30/2024): 0.35%.

Source: Lord Abbett and Morningstar. As of 06/30/2024.

Performance data based on total return at net asset value, including the reinvestment of dividends and capital gains, if any, but does not reflect deduction of any front-end sales charges which are not applicable for Class I Shares. Class I Shares are available only to institutional investors and certain others, including retirement plans.

Past performance is not a reliable indicator or guarantee of future results. Current performance may be higher or lower than the performance data quoted. The investment return and principal value of an investment in the Fund will fluctuate so that shares, on any given day or when redeemed, may be worth more or less than the original cost. You can obtain performance data current to the most recent month-end by calling Lord Abbett at 888-522-2388 or referring to lordabbett.com. The Investment Grade Floating Rate Fund I share Morningstar US Ultrashort Bond total return rankings as of 06/30/2024 were 1% (3/259) for the second-quarter period, 1% (5/252) for the one-year period, and 2% (6/249) since inception (05/04/2023).



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### Lord Abbett Investment Grade Floating Rate Fund

**New Fund Risk:** The Fund is recently organized. There can be no assurance that the Fund will reach or maintain a sufficient asset size to effectively implement its investment strategy.

**A Note about Risk:** The Fund is subject to the general risks associated with investing in debt securities, including market, credit, liquidity, and interest rate risk. The value of investments in debt securities will fluctuate in response to market movements. When interest rates rise, the prices of debt securities are likely to decline, and when interest rates fall, the prices of debt securities tend to rise. The Fund invests in various types of high quality, investment grade debt securities but may also invest in high yield, lower-rated debt securities, sometimes called junk bonds that may involve greater risks than higher rated debt securities. These securities carry increased risks of price volatility, illiquidity, and the possibility of default in the timely payment of interest and principal. The Fund may invest in foreign or emerging market securities, which may be adversely affected by economic, political, or regulatory factors and subject to currency volatility and greater liquidity risk. The Fund may invest in derivatives, which are subject to greater liquidity, leverage, and counterparty risk. The fund performance history at this time is very limited; therefore, performance achieved during its initial period of investment operation may not be replicated over longer periods and may not be indicative of how the Fund will perform in the future. These factors can affect Fund performance.

Asset allocation or diversification does not guarantee a profit or protect against loss in declining markets.

No investing strategy can overcome all market volatility or guarantee future results.

The value of investments and any income from them is not guaranteed and may fall as well as rise, and an investor may not get back the amount originally invested. Investment decisions should always be made based on an investor's specific financial needs, objectives, goals, time horizon, and risk tolerance.

Market forecasts and projections are based on current market conditions and are subject to change without notice. Projections should not be considered a guarantee.

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### Equity Investing Risks

The value of investments in equity securities will fluctuate in response to general economic conditions and to changes in the prospects of companies and/or sectors in the economy. While growth stocks are subject to the daily ups and downs of the stock market, their long-term potential as well as their volatility can be substantial. Value investing involves the risk that the market may not recognize that securities are undervalued, and they may not appreciate as anticipated. Smaller companies tend to be more volatile and less liquid than larger companies. Small cap companies may also have more limited product lines, markets, or financial resources and typically experience a higher risk of failure than large cap companies.

### Fixed-Income Investing Risks

The value of investments in fixed-income securities will change as interest rates fluctuate and in response to market movements. Generally, when interest rates rise, the prices of debt securities fall, and when interest rates fall, prices generally rise. High yield securities, sometimes called junk bonds, carry increased risks of price volatility, illiquidity, and the possibility of default in the timely payment of interest and principal. Bonds may also be subject to other types of risk, such as call, credit, liquidity, and general market risks. Longer-term debt securities are usually more sensitive to interest-rate changes; the longer the maturity of a security, the greater the effect a change in interest rates is likely to have on its price.

The credit quality of fixed-income securities in a portfolio is assigned by a nationally recognized statistical rating organization (NRSRO), such as Standard & Poor's, Moody's, or Fitch, as an indication of an issuer's creditworthiness. Ratings range from 'AAA' (highest) to 'D' (lowest). Bonds rated 'BBB' or above are considered investment grade. Credit ratings 'BB' and below are lower-rated securities (junk bonds). High-yielding, non-investment-grade bonds (junk bonds) involve higher risks than investment-grade bonds. Adverse conditions may affect the issuer's ability to pay interest and principal on these securities.

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### Glossary & Index Definitions

**Bank Loans or Leveraged Loans** are loans extended to companies or individuals that already have considerable amounts of debt. Lenders consider leveraged loans to carry a higher risk of default and, as a result, a leveraged loan is more costly to the borrower.

**Call protection** refers to protection from investment risk to bond investors that exists by limiting the conditions under which a bond issuer may elect to call (redeem) bonds before a bond's stated maturity date.

**Carry** is the difference between the yield on a longer-maturity bond and the cost of borrowing.



**Collateralized Loan Obligation (CLO)** is a special purpose vehicle (SPV) with securitization payments in the form of different tranches. Financial institutions back this security with receivables from loans. Collateralized loan obligations are the same as collateralized mortgage obligations (CMOs) except for the assets securing the obligation. CLOs allow banks to reduce regulatory capital requirements by selling large portions of their commercial loan portfolios to international markets, reducing the risks associated with lending.

**Convexity** measures the relationship between bond prices and bond yields, which shows how a bond's duration changes with interest rates.

**Duration** is a measure of the sensitivity of the price (the value of principal) of a fixed-income investment to a change in interest rates.

**Spread** is the percentage difference in current yields of various classes of fixed-income securities versus Treasury bonds or another benchmark bond measure. A bond spread is often expressed as a difference in percentage points or basis points (which equal one-one hundredth of a percentage point). The option-adjusted spread (OAS) is the measurement of the spread of a fixed-income security rate and the risk-free rate of return, which is adjusted to take into account an embedded option. Typically, an analyst uses the Treasury securities yield for the risk-free rate.

**Yield** is the income returned on an investment, such as the interest received from holding a security. The yield is usually expressed as an annual percentage rate based on the investment's cost, current market value, or face value. **Yield-to-maturity (YTM)** represents the expected return (expressed as an annualized rate) from the bond's future cash flows, including coupon payments over the life of the bond and the bond's principal value received at maturity. **Yield-to-worst** refers to the lesser of a bond's (a) yield-to-maturity or (b) the lowest yield-to-call calculated on each scheduled call date.

**The Bloomberg U.S. Aggregate Bond Index** represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities.

**The Bloomberg U.S. Corporate Bond Index** includes all publicly held issued, fixed-rate, nonconvertible investment-grade corporate debt. The index is composed of both U.S. and Brady bonds.

**The Bloomberg U.S. Floating-Rate Note Index** measures the performance of USD-denominated, investment-grade, floating-rate notes across corporate and government-related sectors. This index is not part of the U.S. Aggregate Index, which is a fixed coupon index.

#### Bloomberg Index Information

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**Ultrashort bond portfolios** invest primarily in investment-grade U.S. fixed-income issues and have durations of less than one year (or, if duration is unavailable, average effective maturities of less than one year). This category can include corporate or government ultrashort bond portfolios, but it excludes international, convertible, multisector, and high yield bond

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