March 2022

CLOs: Attractive Risk-Reward Opportunities in Corporate Credit

Global financial markets have recently experienced meaningful volatility, and many asset classes have reversed the positive returns that persisted since mid-2020. One primary economic difference between 2020 and 2022 is that inflation has now risen to a level that is prompting the Federal Reserve to unwind the easy monetary policy it began in response to the COVID-19 pandemic. Tighter Federal Reserve policy is creating asset price volatility as market participants are expecting higher interest rates and slower economic growth.

Rising interest rates are an obvious risk for fixed coupon bond returns. One way to hedge interest rate risk is to invest in floating rate securities whose coupon rates reset higher over time as interest rates rise. Since the coupons are reset on a regular basis, their prices do not tend to fall as much as fixed-coupon bonds. A less obvious risk is that higher interest rates can significantly slow the economy or lead to a recession which increases credit risk for bondholders. Credit risk can take the form of downgrades or defaults. Investors often mitigate credit risk by purchasing bonds from higher quality issuers. However, in a rising rate environment, higher quality bonds can be more sensitive to rising interest rates because their coupons are typically lower.

Collateralized Loan Obligation ("CLO") debt and equity securities are one of the few investments in corporate credit that offer attractive yields while managing interest rate and credit risks.

CLOs are legal structures created by investment banks and asset managers that offer investors the ability to invest in cash-flowing securities backed by a diversified pool of leveraged loans. Multiple investors contribute capital into the CLO through purchasing CLO securities, and the manager of the CLO uses that capital to invest in a diversified portfolio of leveraged loans. The interest from the underlying leveraged loans is used to pay the interest on the CLO securities. Managers of CLOs underwrite the leveraged loan issuers for credit risk. Investors should consider a CLO manager's approach to underwriting since leveraged loans are rated below investment grade and a CLO manager's approach to trading because loans experience periods of price volatility during financial market stress.

Mick Clowers, Director of Research, joined Preserver in 2018 as Senior Investment Associate. He works with the Chief Investment Officer and Operational Due Diligence team to conduct investment research on new and existing investments. Prior to joining Preserver, Mick served as a Portfolio Manager (2011-2017) and the Director of Portfolio Management (2017-2018) at Legacy Wealth Management. He graduated from the University of Memphis with a B.B.A. in Finance. He obtained his Certified Financial Planner certification in 2014. He is also a CFA charterholder.

We believe that CLO securities are attractive for multiple reasons. First, the underlying loan collateral and the CLO securities have floating interest rates, providing a hedge against interest rate risk. Second, CLO structures are segmented into multiple debt and equity securities that offer different risk-reward profiles, which allows investors to select the CLO securities which best represent their desired amount of credit risk. Third, CLO securities have experienced lower default rates over time relative to similarly rated corporate bonds. Lastly, CLO securities are currently offering higher yields than corporate bonds with similar credit-ratings.

The following table compares the prices and yields of similarly rated CLO securities and corporate bonds. It is important to note that the credit ratings of CLO securities are based on their seniority in the CLO capital structure, rather than the credit ratings of the underlying leveraged loans.

	Price as of 12/31/21	Yield as of 12/31/21
Investment Grade Corporate Bonds - A rated	109.05	2.11%
CLO Securities - AAA rated (higher rating)	99.96	1.97%
Investment Grade Corporate Bonds - BBB rated	110.38	2.55%
CLO Securities - BBB rated	98.91	4.41%
High Yield Bonds - BB rated	106.06	3.30%
CLO Securities - BB rated	97.13	8.11%

While more complex in structure than corporate bonds, Preserver believes that CLO securities currently offer one of the best risk-reward opportunities in corporate credit due to their floating rate exposure, attractive yields and lower historical default rates.