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CLO Investing for Late Cycle Income

At the latter stages of business and capital markets cycles, it is rare to find many asset classes or strategies with attractive, safe yields. The current business cycle is the second longest in U.S. history, while the current equity bull market that began March 2009 is the second longest in U.S. history. The U.S. yield curve has flattened substantially as the Federal Reserve has raised short-term rates significantly. Intermediate-term rates have risen slightly in anticipation of higher inflation and long-term rates have struggled to rise in part due to investor liability management and global geopolitical events. Due to record stock buybacks and high stock prices, dividend yields are paltry. The S&P 500 Index dividend yield is less than the 10-year U.S. Treasury bond. High yield corporate bonds have experienced record issuance in recent years and historically tight yield spreads. Typically, at this point in the business and capital markets cycles, income-seeking investors should shift toward higher quality and shorter duration bonds. However, investment grade fixed income has been unusually weak as duration has hurt returns and deteriorating underwriting standards and large supply have diminished the quality of the investment-grade bond universe. BBB-rated bonds (the riskiest type of investment grade bonds, represent 40% of all investment grade bonds. While we think corporate credit could be the epicenter of the next debt crisis, structured credit offers attractive yields and a better downside risk profile.

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Collateralized loan obligations (CLO) are a type of structured credit comprised of diverse pool of senior-secured bank loans to below-investment grade companies. CLOs issue long-term debt and equity tranches to finance the purchase of bank loans. The CLO tranches include senior debt (low risk & first claim on cash flows), mezzanine debt (moderate risk & second claim on cash flows) and equity (higher risk & residual claim on cash flows). Each tranche has different risk and return profiles, priority claims on cash-flow distributions, and risks of loss.

CLOs have several favorable attributes including historically solid credit performance and floating interest rates. The senior secured bank loans have lower default rates and higher recovery rates relative to high yield bonds and they have floating rate coupons which are more stable during rising-rate environments. CLO security selection requires fundamental and quantitative research to evaluate underlying credit risks, structural characteristics and legal factors. These complexities create alpha opportunities for skilled sponsors and CLO Equity managers.

Global CLO equity offers attractive yields, between 8-12% in the U.S. and 12-15% yields in Europe. CLO Equity capitalizes on the structural arbitrage available to the sponsor (firm that creates the CLO). Sponsors can borrow at LIBOR + 100-125 bps to purchase a portfolio of loans that yield LIBOR + 200-300 bps. After interest payments are made to debt holders, the residual cash flows from the excess spread are paid to equity holders, resulting in higher residual returns to CLO Equity holders. The low level of interest rates, tighter loan spreads and LIBOR-based financing costs have increased CLO returns as older vintage CLOs are refinanced or reset. In addition, unprecedented strong demand for new bank loans and the repricing of existing loans at lower interest rates has been a tailwind for CLO transactions. While we think now is the time to be cautious about leveraged loans in general, CLO Equity provides an outsized yield with downside risk protection if the economy falters. CLO Equity was one of the most resilient asset classes during the Great Recession generating positive returns for most vintages with a default rate less than 2%.

CLO Equity is investible to institutional investors through structured credit hedge funds, separate accounts and a small number of listed securities. These listed securities create accessibility for retail investors. One of the listed securities is the Fair Oaks Income Fund (FAIR:LON). Fair Oaks Income Ltd. is a United Kingdom listed closed-end investment company that invests in U.S. and European CLOs, of which the majority of positions are CLO Equity holdings. A second listed security is the relatively new, XAI Octagon Floating Rate and Alternative Income Term Trust (XFLT). XFLT is an interval fund that invests in senior-secured, floating rate securities, CLO debt and equity and other opportunistic credit. As of June 28, the distribution yield was 9.0% paid monthly, based on a 4% discount to NAV.

For those investors looking for income, CLO Equity offers attractive, late-cycle income with built-in downside protection based on high cash on cash returns, senior-secured collateral and structural arbitrage.