Viewpoint

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ASSET MANAGEMENT | WHITE PAPER

CLOs: A Distinct Income Opportunity in Today's Environment

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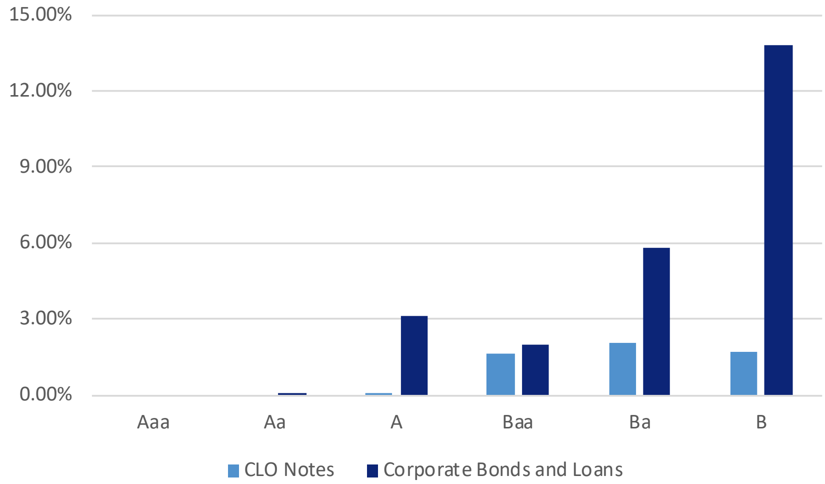
A decade of historically low interest rates has forced insurers to seek an expanded array of portfolio income sources. At the same time, insurers still aim to balance their income needs with concerns for duration and credit risk. Insurers may find value in collateralized loan obligations, or CLOs, which offer exposure to diversified pools of senior secured loans (i.e. bank loans). CLO securities (i.e. tranches) feature floating interest rates, which help to minimize duration.

CLO tranches can offer favorable spreads relative to similarly rated corporate debt (i.e. investment grade bonds), providing a yield premium without sacrificing credit quality. The asset class also provides capital preservation through structural protections and investor-oriented covenants. Finally, in a rising interest rate environment, CLO debt tranches' floating-rate coupon may provide higher yields for investors and act as an interest-rate hedge for insurance portfolios that often have significant fixed income exposure.

While CLOs may be a new asset class for some insurers, institutional investors have invested in CLO debt and equity tranches for more than two decades. Over the last several years, the CLO market has evolved and created opportunities across a broader investor base that has grown to include investment managers, pensions, endowments, corporations and insurance companies. Moreover, insurers also often seek high-quality investment options and should find some comfort in this fact: there has never been a default on a CLO security rated AAA or AA in the asset class's 25-year history (see Figure 1). Conning recommends that its insurance clients consider an allocation to the CLO asset class due to the structural integrity, capital efficiency and strong historical performance demonstrated by CLOs.

Figure 1 Cumulative U.S. CLO Tranche Defaults vs U.S. Corporate Bond Defaults (Moody's Ratings)[1, 6]



*As of December 31, 2018, the CLO market share of institutional loans outstanding was 50%, while loan mutual fund and ETF market share was 13%. Source: ©2019 Thomson Reuters®, Leveraged Loan Monthly – Year-end 2018. Used with limited permission.

Actively Managed, Diversified Pool of Loans

A CLO is a structured credit vehicle comprised of an actively managed and diversified portfolio of senior secured loans (typically 150-300 loans). These senior secured loans are made by banks to companies (i.e. borrowers) rated below investment grade and are secured by the assets/collateral of the borrower. The loans are generally senior to other outstanding debt within a company's capital structure.

CLOs are managed by firms with credit expertise, which actively buy and sell bank loans based upon proprietary investment research and analysis. CLOs comprise a substantial component of loan market demand today. At the end of 2018, the roughly $585 billion U.S. CLO market owned approximately half of the supply of outstanding senior secured loans.*

With respect to diversification, CLOs purchase senior secured loans issued to companies across an array of industries, thereby offering broad sector exposure.

Borrowers that issue loans may not necessarily issue high yield bonds, which thereby offers another layer of diversification for insurers by providing access to credits they may not have prior portfolio exposure to. Notably, loans have also historically demonstrated a low correlation to U.S. investment-grade corporate credit and equities, as well as a negative correlation to U.S. Treasury bonds.

Bank loans generally offer higher yields than investment grade bonds (reflecting the higher risk profile of the borrower) and such yields fluctuate with market interest rates. Loan interest rates are commonly tied to the London Interbank Offered Rate (LIBOR) and pay a spread above that benchmark. Bank loans offer lower duration risk for investors since LIBOR typically resets every 30 or 90 days. CLO debt tranches also possess floating-rate coupons, which may benefit investors in a rising rate environment.

Structural Integrity, Capital Efficiency and Strong Historical Performance

In terms of structure, a CLO finances its loan purchases by issuing securities, or tranches, ranging in quality from AAA-rated debt to equity. While each CLO debt tranche is rated by at least one major rating agency (i.e. Moody's, S&P or Fitch), the CLO equity tranche is not rated and does not have a set coupon.

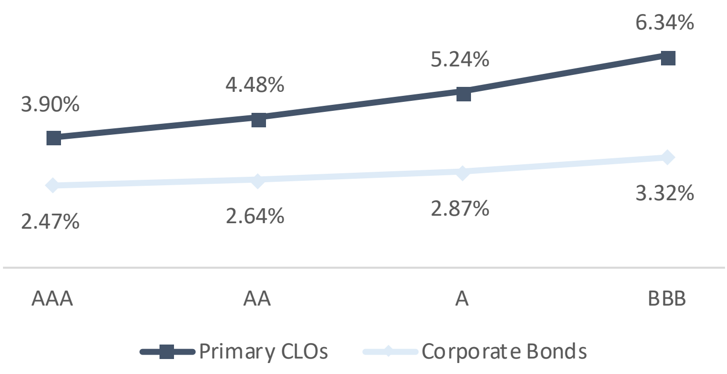
As discussed, a CLO purchases bank loans from sell-side banks and collects the cash generated by the loans' interest payments. The CLO, in turn, apportions those interest cash flows to pay coupons to its investors in a cascading or "waterfall" fashion, from the most senior debt tranche to the most junior tranche (equity). Investors of the AAA-rated tranche are paid first, followed by the next most senior (AA-rated), and the next (A-rated), etc. Any remaining cash after all CLO debt investors and deal expenses are paid is distributed to CLO equity investors. Defaults and credit losses in the underlying loan portfolio are first absorbed by the equity tranche.

Numerous tests and covenants are designed to help protect CLO investors' capital, including credit quality requirements, and minimum interest and collateralization levels. For example, covenants typically require that the underlying senior secured loan portfolio meets an average credit rating. A CLO's performance-based tests help ensure that the structure meets its cash-flow distribution obligations, thereby supporting capital preservation.

In terms of capital efficiency, CLOs may also benefit insurers, as the higher-quality debt tranches – those rated AAA, AA and A – carry an NAIC 1 rating.

Lastly, CLO securities may be attractive to insurers given their lower historical default rates versus similarly rated corporate bonds (see Figure 1) and comparatively attractive yield premiums (see Figure 2). It is worth repeating that there has never been a default on an AAA or AA-rated CLO security. CLOs are typically non-mark-to-market vehicles, and while valuations may fluctuate, CLOs are structurally equipped to withstand market volatility.

Figure 2 Average Comparative Yield: U.S. CLO vs Equivalently Rated U.S. Corporate Bonds[2, 3, 6]



Value of Manager Experience

Despite the potential benefits, CLOs may be a new or unfamiliar asset class for certain investors. As such, Conning encourages insurers seeking CLO exposure to consider a highly skilled manager with deep fundamental credit and deal-structuring expertise, as well as experience issuing and managing CLOs through various market cycles. Insurers should also strongly consider partnering with an asset manager well-versed in the distinct needs of managing insurance portfolios, since incorporating CLO exposure into a portfolio requires a sophisticated understanding of how the asset class can best fit within an insurer's overall investment strategy.

Other Investment Risks and Considerations

CLOs may be outside of an insurer's investment guidelines, thus requiring investment committee review prior to investing. CLOs, even those backed by a pool of U.S. senior secured loans, are typically domiciled offshore and may be subject to limitations applicable to foreign country allocations on regulatory filings. CLOs often involve risks that are different from risks associated with other types of debt instruments (i.e. investment grade corporate bonds). Importantly, CLOs present risks associated with leverage, potential periodic illiquidity, valuation swings and loss of capital. Mezzanine debt and equity tranches are residual in right of cash-flow payment and the aforementioned risks may be greater in these tranches.

Doug McDermott joined Octagon Credit Investors in 2016 and serves as a Managing Director of Business Development and Client Portfolio Manager, with responsibilities for product development, capital formation and investor relationships. He came to the firm from Deutsche Bank, where he was most recently Managing Director & Head of Loan Sales. Previously he was an investment banker in Deutsche Bank's Financial Sponsors and Leveraged Finance Groups and was an attorney at Simpson Thacher and Bartlett, specializing in mergers & acquisitions and securities transactions. Mr. McDermott earned a BA in government & law from Lafayette College and a JD from Boston College Law School, and holds FINRA Series 7, 63 & 24 registrations.

About Octagon Credit Investors, LLC

In 2016, Conning acquired a majority stake in Octagon Credit Investors, LLC (www.octagoncredit.com), a below-investment grade corporate credit investment adviser. Octagon has more than 20 years of experience managing CLOs, bank loans and high yield bonds on behalf of institutional investors.

About Conning

Conning (www.conning.com) is a leading investment management firm with a long history of serving the insurance industry. Conning supports institutional investors, including pension plans, with investment solutions and asset management offerings, award-winning risk modeling software, and industry research. Founded in 1912, Conning has investment centers in Asia, Europe and North America.

Disclosures

1. Source: ©2018 Moody's Analytics. U.S. corporate cumulative default rate represents the total number of defaulted US corporate loans and bonds divided by to total number of U.S. corporate loans and bonds rated by Moody's for each respective ratings category from 1993-2017.

2. Source: ©2019 J.P. Morgan Chase & Co. ("J.P. Morgan") - all rights reserved. Information has been obtained from sources believed to be reliable, but J.P. Morgan does not warrant its completeness or accuracy. The Index is used with permission. The Index may not be copied, used or distributed without J.P. Morgan's prior written approval. MorganMarkets analysis conducted 7/17/2019.

3. Average calculated based on daily data for the period 4/1/2019 to 6/30/2019.

4. Yield calculated by adding discount margin to 3-month LIBOR for the respective tranche for primary (i.e. new issue) USD CLOs.

5. Portfolio yield for J.P. Morgan U.S. Liquid Index ("JULI") investment grade corporate bond index is shown. Includes only securities with maturities of 3-5 years and excludes emerging market bonds.

6. Prepared by Conning, Inc. Source: Octagon Credit Investors, LLC. Past performance is not a guarantee of future results.

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