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Investment Case White Paper

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

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Given their higher relative yields, "built-in" risk protection and historical outperformance in periods of rising rates, now is a good time to better understand collateralized loan obligations (CLOs), how they're structured and how they fit within a fixed income portfolio.

CLOs are securitized, actively managed portfolios of leveraged loans. They have historically offered a compelling combination of an attractive yield and strong risk profiles. The strong historical performance of the asset class is a testament to the built-in risk protections resulting from how CLOs are structured. In addition, CLOs are floating rate instruments, which means their coupons reset each quarter along with prevailing interest rates, resulting in low price sensitivity to changes in interest rates. This has led to CLOs historically outperforming in periods of rising rates, like the environment we are in today.

Topics in this white paper include:

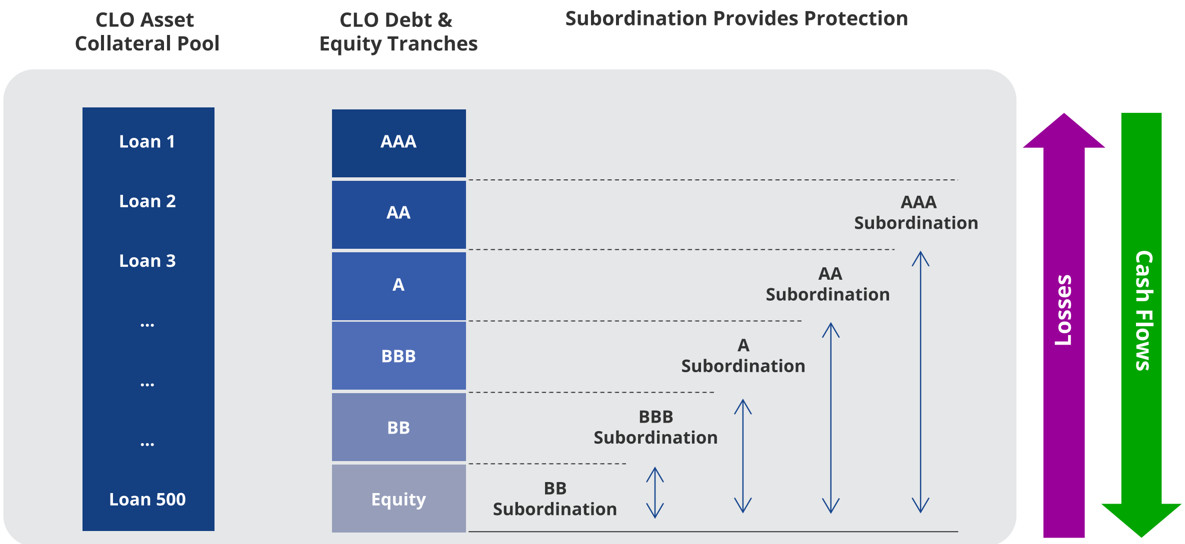
- The structure of CLOs, including their built-in risk protection
- Historical track record relative to other corporate debt categories
- What makes CLOs even more compelling in the current environment
- An analysis of how CLOs fit into a broader fixed income portfolio
- The importance of an actively managed approach

What Is a CLO?

A CLO is a portfolio of predominantly senior secured loans that is securitized and actively managed. 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, lowest to highest in order of riskiness.

Cash flows from the underlying loans of a CLO are used to pay interest on the debt tranches, and get distributed based on a "waterfall" whereby cashflows are paid sequentially starting with the senior-most tranche until each tranche has been paid its full distribution. Equity-tranche holders receive the residual distributions, net of costs. Principal distributions are similarly applied first to the most senior tranches.

Understanding the Structure of CLOs

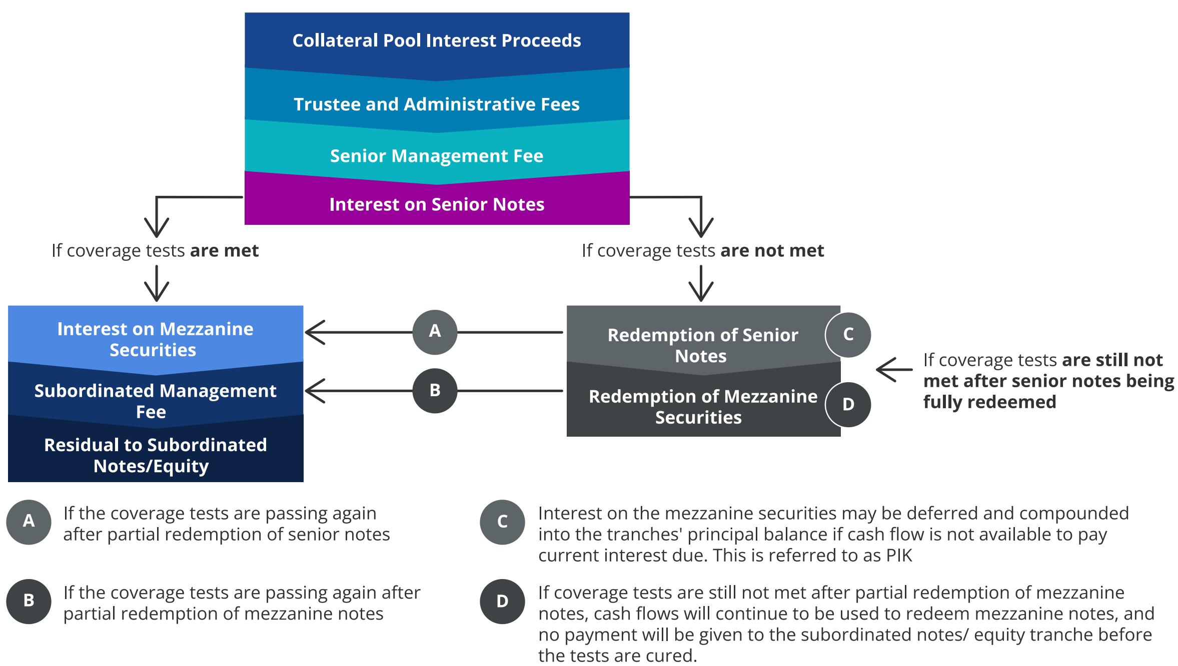


Source: PineBridge Investments. This is not an offer to buy or sell, or recommendation to buy or sell any of the securities mentioned herein.

The strong historical performance of the asset class is a testament to the built-in risk protections of CLOs, which starts with the strength of its underlying collateral, i.e. the likelihood the collateral pool will continue to generate sufficient cash flow over the life of a CLO. Leveraged loans (the underlying collateral of CLOs) are senior and secured, meaning they have the senior-most claim on all the issuer's assets in the event of a bankruptcy. Historically, leveraged loans' senior secured status has consistently led to lower default rates and higher recoveries compared to unsecured high-yield bonds. CLOs further reduce risk by creating diverse portfolios of leveraged loans—typically 150–250 borrowers—and actively managing that portfolio.

The structure of CLOs also helps mitigate risk. For example, coverage tests are a vital mechanism to detect and correct collateral deterioration, which directly affects the allocation of cash flows. All CLOs have covenants that require the manager to test the portfolio's ability to cover its interest payments monthly. As shown below, if the tests come up short, cash flows are diverted from more junior tranches to pay off the most senior tranches first, until these failures are cured.

CLOs Are Structured to Minimize Defaults



Source: VanEck. This is not an offer to buy or sell, or recommendation to buy or sell any of the securities mentioned herein.

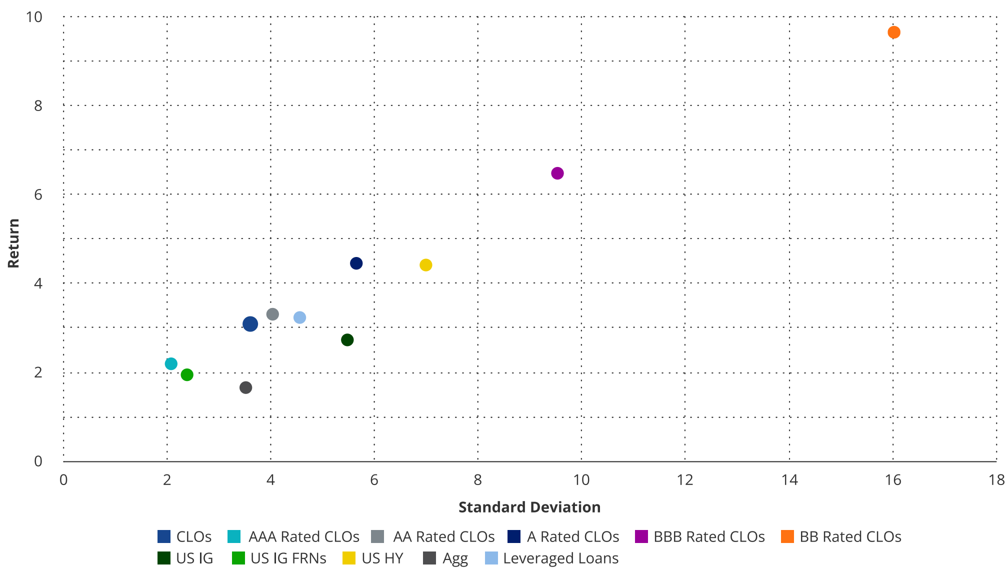
CLOs are also actively managed vehicles—i.e., they have a **reinvestment period** during which the manager can buy and sell loans within the portfolio and reinvest within the parameters set forth by the governing documents. Managers can add value by reinvesting and positioning portfolios to increase returns in benign economic environments and protect against downside risk during weaker economic times.

Benefits of Investing in CLOs

CLOs have historically offered a compelling combination of an attractive yield and strong risk profiles. Over the long term, CLO tranches have offered higher yields and historically performed well relative to other corporate debt categories, including leveraged loans, high yield bonds, and investment grade bonds, and have significantly outperformed at lower rating tiers. The built-in risk protections of CLOs have resulted in a track record of strong risk-adjusted returns versus other fixed income asset classes, particularly for investment grade-rated CLO tranches.

CLOs Track Record of Strong Risk-Adjusted Returns vs. Other Asset Classes

10 Years as of 1/31/2023



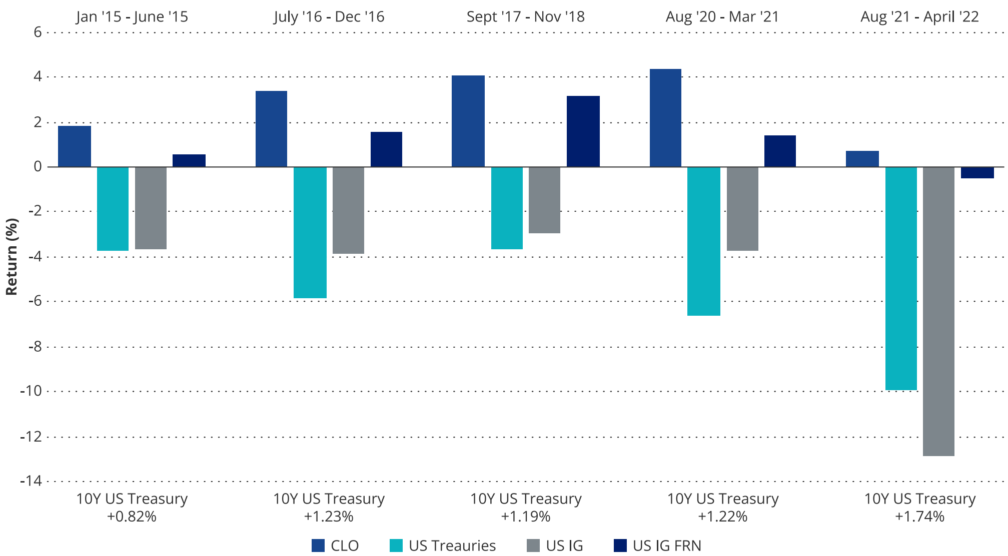
Source: Morningstar. CLOs represented by J.P. Morgan CLO Index; AAA Rated CLOs represented by J.P. Morgan CLO AAA Index; AA Rated CLOs represented by J.P. Morgan CLO AA Index; A Rated CLOs represented by J.P. Morgan CLO A Index; BBB Rated CLOs represented by J.P. Morgan CLO BBB Index; BB Rated CLOs represented by J.P. Morgan CLO BB Index; US IG represented by ICE BofA US Corporate Index; US HY represented by ICE BofA US High Yield Index; Agg is represented by the ICE BofAUS Broad Market; US IG FRNs represented by MVIS US Investment Grade Floating Rate Note Index; Leveraged Loans represented by S&P/LSTA Leveraged Loan 100 Index. 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.

CLOs have been tested during two major market crises. Through both the Global Financial Crisis and COVID-19 drawdown, the asset class experienced far fewer defaults than corporate bonds of the same rating. For example, among the nearly 20,000 U.S. CLOs issued from 1996-2021 and rated by S&P, only 60 experienced defaults, primarily in non-investment grade rated tranches. And the performance is even better for investment grade CLOs. In the higher rated AAA and AA CLO tranches, there have been zero defaults. This resilience, combined with the potential for upside returns, makes the asset class compelling for long-term minded investors, in our view.

Why CLOs Are Even More Compelling in the Current Environment

In addition to higher yields and stronger risk profiles, CLOs are floating rate instruments, which means their coupons reset each quarter along with prevailing interest rates. This results in low price sensitivity to changes in interest rates. In a rising rate environment, such as the one we are in currently, CLO investors may actually benefit from higher coupons. As the chart below highlights, this feature has helped CLOs historically outperform in periods of rising rates. This includes the recent period of rising rates from August 2020 to October 2022.

CLOs Historically Outperformed in Rising Rate Environments



Source: VanEck, Morningstar and JP Morgan as of 12/31/2022. CLOs are represented by the JPM CLOIE Index, US Treasury is the ICE BofA US Treasury Index, US IG is the ICE BofA US Corporate Index and US IG FRN is the MVIS US Investment Grade Floating Rate Index. 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.

How CLOs Fit into a Broader Fixed Income Portfolio

The enhanced yields and credit spreads provided by CLOs may help to maintain an attractive overall yield for an income focused portfolio. Although CLOs can introduce volatility if credit spreads widen, their historical default loss rate is extremely low, both on an absolute basis and relative to similarly rated bonds and loans.[1] Thus, investors have been able to earn a higher level of income with significantly lower default risk.

The floating rate nature of CLOs means there is very little sensitivity to interest rates. Investors looking to shorten their overall duration might consider an allocation to CLOs from their investment grade or high yield fixed coupon investments. In addition, each CLO typically contains at least 150-250 unique issuer exposures. As high yield borrowers, these issuers won't overlap with investment grade exposures, providing additional issuer diversification. Furthermore, overlap with high yield portfolios may also be relatively low, as a growing universe of issuers access funding only through the loan market.

CLOs are also becoming increasingly common allocations in core bond portfolios. Of the top 20 mutual funds in Morningstar's Intermediate Core Bond and Intermediate Core-Plus Bond categories, representing approximately $750B of assets, all but three had allocations to CLOs.[2] This is despite traditional U.S. aggregate bond indices, which represent the broad investment grade investment universe, generally not including CLOs.

The benefits that CLOs provide in a core bond portfolio are straightforward: yield, quality and diversification. Yields on CLOs are particularly attractive now and significantly above long-term averages and what can be found in other fixed income asset classes. For example, CLOs, on average, provided a yield-to-worst of 6.49% on 1/31/2023, compared to 4.33% on the aggregate and 5.05% on U.S. corporate bonds.[3]

[1]Source: S&P Global Ratings.
[2]Source: Morningstar Direct
[3]Source: J.P. Morgan and ICE Data Indices. CLOs represented by the J.P. Morgan CLO Index; Agg bonds represented by ICE BofA US Broad Market Index; US corporates represented by ICE BofA US Corporate Index.

These high yields are driven by several factors. Short-term rates have risen significantly over the past year, and because CLOs are floating rate, this is reflected in higher coupons. Yields on CLOs are also high because of the spread over the risk-free rate that they provide. Right now that spread pickup is particularly compelling relative to historical averages. That suggests that a certain degree of risk is being reflected in CLOs prices currently. Given the possibility of weaker corporate earnings and economic growth ahead, we believe this makes CLOs attractive relative to other credit asset classes, such as high yield bonds, where spreads have remained tight versus historical averages.

From a quality perspective, investment grade CLOs do not require a core bond investor to take additional credit risk. The risk of default in senior CLO tranches is extremely low given the many built-in risk protections they offer, such as high levels of subordination. As a result, defaults in the underlying portfolios need to be multiples greater than historical averages for several years in a row to experience a default, even in lower rated investment grade CLO tranches.

CLOs may diversify a core bond portfolio in several ways. First, the floating rate exposure makes them less sensitive to changes in interest rates, and therefore they exhibit low correlation to fixed rate bonds, with a 5-year correlation to core bonds of only 0.25. Second, because CLOs are backed by portfolios of senior secured leveraged loans, the credit exposure is different from the investment grade corporate borrowers that have significant presence in aggregate benchmarks.

How Investors Can Access CLOs

Until recently, it has been difficult for investors to add exposure to CLOs. The market is largely institutional, and investors such as banks, insurance companies and hedge funds often purchase CLOs directly or invest through institutional separate accounts, which often carry minimums of $50M to $100M. Actively managed multi-sector or core bond funds may include an allocation to CLOs, but investors cannot control the level of exposure and it may vary significantly over time. The **VanEck CLO ETF (CLOI)** provides access to investment grade CLOs, and may be an attractive way to efficiently access this market with the liquidity, transparency and low cost features of an ETF.

While CLOs can be an effective hedge against rising interest rates, they remain complex instruments that require a high degree of expertise. Because CLOs are issued and managed by asset managers, the most critical decision a CLO investor can make is the selection of a manager, which isn't an easy decision. Each CLO manager creates their own portfolios using their own investment style. And while historical performance varies greatly among managers, there are several key traits that successful managers share. Experience is the most important. There's no substitute for deep CLO management experience, which provides the combination of credit expertise, access to new deals, trading acumen, risk management, and understanding of the unique needs of CLO tranche and equity investors to generate strong returns. The benefit of having managed CLO portfolios before, during, and after the financial crisis is incalculable.

An experienced CLO tranche portfolio manager must perform rigorous due diligence on CLO managers to understand their capabilities and style, and tier them accordingly. However, the analysis does not end there. Each CLO is unique, even those managed by the same CLO manager. CLO tranche portfolio managers must understand the loan collateral and structural features that drive ultimate returns. This involves cashflow modelling and access to underlying CLO portfolio information, as well as real time pricing information to identify potential value.

Lastly, a CLO tranche portfolio manager must take into account overall exposures in terms of vintage, manager, and underlying sector exposure. It is also important to conduct ongoing monitoring to identify potential early warning signs in the CLO portfolios. A CLO tranche portfolio manager who can identify relative value across the CLO capital stack can add value by allocating to more attractively valued segments while avoiding those that are overpriced. Relative value analysis between primary and secondary market deals also plays a role, and a CLO investor must have both access and trading expertise to source attractive deals. From a risk management perspective, the CLO tranche portfolio manager must manage downgrade risk, as well as liquidity and have the ability to "de-risk" the portfolio in periods of market stress.

In short, a passive approach is simply not feasible in the CLO space, and there is significant room to add value through an active approach that has flexibility to identify attractive value.

An Active Approach to Selecting Securities and Constructing a CLO Portfolio

CLOI is actively managed by PineBridge Investments, the fund's sub-advisor. PineBridge draws on its decades of CLO market experience and the credit expertise of its leveraged finance team to identify credit and CLO manager risk within a CLO. Their process is summarized below:

1. **CLO Manager Due Diligence:** Based on a systematic due diligence process, PineBridge classifies CLO managers, and focuses investments on those with an established process and team.
2. **Re-underwrite CLO:** PineBridge collects and analyzes fundamental loan-level data using its proprietary credit platform, which drives portfolio credit analysis, risk measurement and optimization. The team reviews each CLO's structure and documentation, which—combined with the collateral analysis and stress-test analysis—is the basis of the investment analysis.
3. **Construct Portfolio:** Portfolios are constructed by PineBridge using both bottom-up deal selection from the re-underwriting process and a top-down overlay that incorporates the group's credit views.
4. **Risk Monitoring:** There is ongoing compliance and risk monitoring, as well as regular reviews of the portfolio and CLO-specific metrics that can result in rebalancing. Various portfolio and performance metrics act as "credit review triggers" and form the basis of the sell discipline.

CLOI aims to mitigate downgrade and default risk, which is done by stressing CLO tranche cashflows through loan-by-loan and portfolio level changes in default rates, recovery rates and interest rates, among other factors. The portfolio is monitored for early warnings that might signal a change in fundamentals.

IMPORTANT DISCLOSURES

J.P. Morgan Collateralized Loan Obligation Index (CLOIE) tracks US dollar denominated, broadly syndicated, arbitrage CLOs..

J.P. Morgan CLO AAA Index is a subset of the CLOIE index that only tracks the AAA rated CLO.

J.P. Morgan CLO AA Index is a subset of the CLOIE index that only tracks the AA rated CLO.

J.P. Morgan CLO A Index is a subset of the CLOIE index that only tracks the A rated CLO.

J.P. Morgan CLO BBB Index is a subset of the CLOIE index that only tracks the BB rated CLO.

J.P. Morgan CLO BB Index is a subset of the CLOIE index that only tracks the BB rated CLO.

MVIS US Investment Grade Floating Rate Index (MVFLTR) consists of U.S. dollar-denominated floating rate notes issued by corporate issuers and rated investment grade by at least one rating agency.

ICE BofA US 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.

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

S&P/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.

ICE BofA US Treasury Index measures the performance of U.S. dollar denominated U.S. Treasury Bills publicly issued in the U.S. domestic market.

ICE BofA US Corporate Index tracks the performance of US dollar denominated investment grade corporate debt publicly issued in the US domestic market.

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An investment in the VanEck CLO ETF (CLOI) may be subject to risks which include, among others, Collateralized Loan Obligations (CLO), debt securities, LIBOR Replacement, foreign currency, foreign securities, investment focus, newly-issued securities, extended settlement, affiliated fund, management, derivatives, cash transactions, market, Sub-Adviser, operational, authorized participant concentration, new fund, absence of prior active market, trading issues, fund shares trading, premium/discount, liquidity of fund shares, non-diversified, and seed investor risks. The Fund 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 Fund.

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