



Investment Perspectives

Time to Consider CLO Equity

While collateralized loan obligation (CLO) debt investing may seem mainstream, CLO equity remains underappreciated despite its advantages for sophisticated investors.



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KEY TAKEAWAYS:

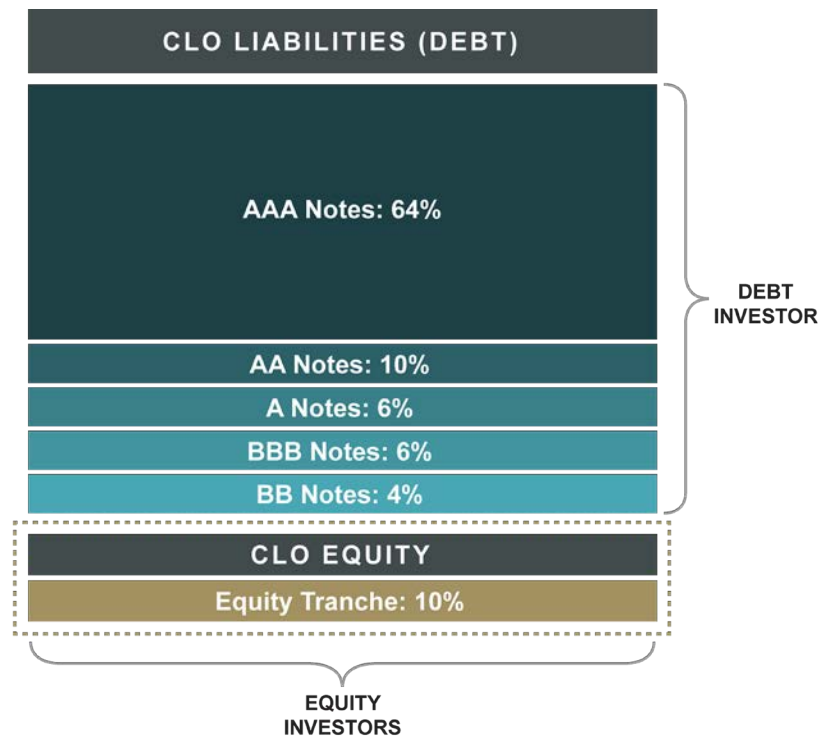
- The CLO structure provides several key features that have helped to maintain or improve CLO equity's historically consistent, front-loaded cash flow experience.
- CLO equity offers higher potential risk-adjusted returns, along with a differentiated and attractive cash flow profile.
- A CLO's underlying debt collateral is actively managed, which allows a skilled manager the flexibility to buy and sell loans to potentially mitigate credit risk and enhance return in multiple investment environments.

Over the last 18 months, the formation of CLOs has skyrocketed, and for good reason. The structure and characteristics of CLOs may offer something for investors of all risk tolerances, from the most loss-averse to the most return-seeking. From a regulatory standpoint, CLOs have supported the growth of the bank loan market, as banks have reduced lending in response to balance sheet regulations following the global financial crisis (GFC). As a result of this demand from a wide range of investors, new issuance is at an all-time high. In fact, the CLO market is now approximately 70% of the size of the roughly \$1.5 trillion bank loan market, up from around 40% a decade ago, according to J.P. Morgan research in July 2024.

While CLO debt enjoys a vast and varied constituency of investor types, from insurers and banks to pension funds and asset managers, CLO equity tends to have a narrower pool of investors. Part of this has to do with the relative opportunity size of CLO equity versus CLO debt. However, we believe a lack of appreciation by investors of what CLO equity offers is a bigger driver. In our view, CLO equity offers a set of return and cash flow characteristics that can appeal to a wide range of return-seeking investors.

Explaining the CLO Capital Structure

CLOs are special purpose vehicles (SPVs) that invest in a diversified pool of leveraged bank loans. These loans are packaged together, and the funding for these structures is raised through investors in different tranches (primarily debt, with some residual equity), 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 (see Figure 1). The highest-rated (AAA) tranches receive payments first and have lower risk of loss, while the equity tranche represents the "first-loss" capital but offers higher potential upside. The CLO vehicle is actively managed by asset managers with resources and experience in leveraged credit. There are various phases of the CLO lifespan, namely warehousing, the ramp, the reinvestment period, and finally the amortization period. During all of these phases, some combination of equity investor capital and debt capital is required. To learn more about potential opportunities in CLO debt, visit [Investment Brief: Addressing Key Questions on CLOs](#).

**Figure 1. An Example of the Capital Structure of a CLO**

Source: Bloomberg. Percentages within each tranche are hypothetical estimates based on a typical CLO structure. For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment.

Equity holders occupy the bottom piece of the CLO waterfall structure familiar to many securitized investors and are entitled to the residual coupon interest generated by the entire collateral pool after all of the CLO debt holders have been paid. Positioned as the first-loss portion of the investor pool, equity owners stand to benefit from the spread between yield on the CLO collateral and CLO liabilities. This spread, commonly referred to as “arb” (short for arbitrage), historically has been the primary driver of CLO equity returns and can be thought of in a similar light as the net-interest margins that banks profit from. Like banks, CLO managers strive to maximize this spread, with more in income being generated by the collateral pool (similar to the loans that a bank makes) than is needed to pay the CLO debt tranches (similar to the deposits that a bank pays out). Anything that negatively impacts the arb reduces returns to equity holders, and anything that improves the arb helps the equity holders’ return. It is also important to note that, as the bottom 10% of the capital structure, both positive and negative developments for the arb are amplified via the leverage inherent in the structure. For example, a 0.10% increase in the arb roughly translates to a 1% increase in return to equity holders, all else equal.

A Better Match Between Assets and Liabilities

There are several structural features of the CLO vehicle that can work to the equity holder’s advantage. For one, both CLO collateral and debt are floating rate, keyed to the Secured Overnight Financing Rate (SOFR), which helps to eliminate one source of basis risk. Second, CLO debt’s spread to SOFR is locked in for the entirety of the CLO’s term, typically 10 years, which can isolate from unwelcome asset/liability mismatch issues. In general, mark-to-market (MTM) adjustments or “haircuts” as well as “depositor flight” are not major CLO risks. Third, but certainly not last, is the section of the CLO lifecycle known as the reinvestment period.



An Opportunity for Active Management—The Reinvestment Period

Unlike other securitized products, CLOs are different in that the underlying collateral is actively managed. After a CLO is issued, the manager can, for a period of time, buy and sell loans within the collateral pool. This reinvestment period generally runs around five years and affords managers the ability to actively buy and sell loans in an attempt to mitigate credit risk and generate additional return. An opportunity for a manager to sell a loan at par and swap into a loan with an identical spread to SOFR at \$97 may not seem particularly exciting for an equity investment at first blush, but the leveraged nature of CLO equity can turn that three-point pull to par into a potential 30% return impact on equity. This ability to build par is a core goal for the collateral manager. Likewise, managers seek to avoid par burn, which occurs when losses are realized either through trading or loan impairments.

What Are the Potential Investment Benefits for CLO Equity Investors?

From an investment viewpoint, we believe there are several potential benefits for CLO equity holders, including:

- Portfolio diversification.
- A differentiated cash flow experience.
- The potential for attractive returns in multiple investment environments.

Portfolio Diversification

CLO equity offers diversification from several perspectives. First, the underlying loan pool is typically highly diversified, comprised of 200-300 loans to well-established corporate issuers. Second, CLO equity offers portfolio diversification in the form of low correlation of returns to other risk assets (see Figure 2). This stems in part from the ability of collateral managers to help take advantage of periods of volatility that may negatively impact other asset classes. Since CLO capital is effectively “locked in,” managers can take advantage of opportunities to buy discounted collateral when others are forced to sell due to liquidity needs.

Figure 2. CLO Equity Has Historically Shown Lower Correlation to Other Asset Classes

Return correlation of CLO equity to stock and bond indexes, January 2013–October 2024.

| | CLO Equity | Investment Grade Bonds | Leveraged Loans | High Yield Bonds | Russell 2000 Index® | S&P 500® Index | CLO AAA |
|------------------------|------------|------------------------|-----------------|------------------|---------------------|----------------|---------|
| CLO Equity | 100% | 17% | 66% | 49% | 45% | 35% | 46% |
| Investment Grade Bonds | | 100% | 46% | 72% | 45% | 56% | 50% |
| Leveraged Loans | | | 100% | 79% | 62% | 59% | 89% |
| High Yield Bonds | | | | 100% | 76% | 79% | 66% |
| Russell 2000 Index® | | | | | 100% | 85% | 48% |
| S&P 500® Index | | | | | | 100% | 47% |
| CLO AAA | | | | | | | 100% |

Source: Citigroup Global Markets, Inc. Data as of October 2024. Returns are based on iBoxx Liquid HY Index, iBoxx Liquid IG Index, and iBoxx Liquid Leveraged Loans Index. The historical data shown above are for illustrative purposes only and do not represent any specific portfolio managed by Lord Abbett or any particular investment. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment. **Past performance is not a reliable indicator or guarantee of future results.**



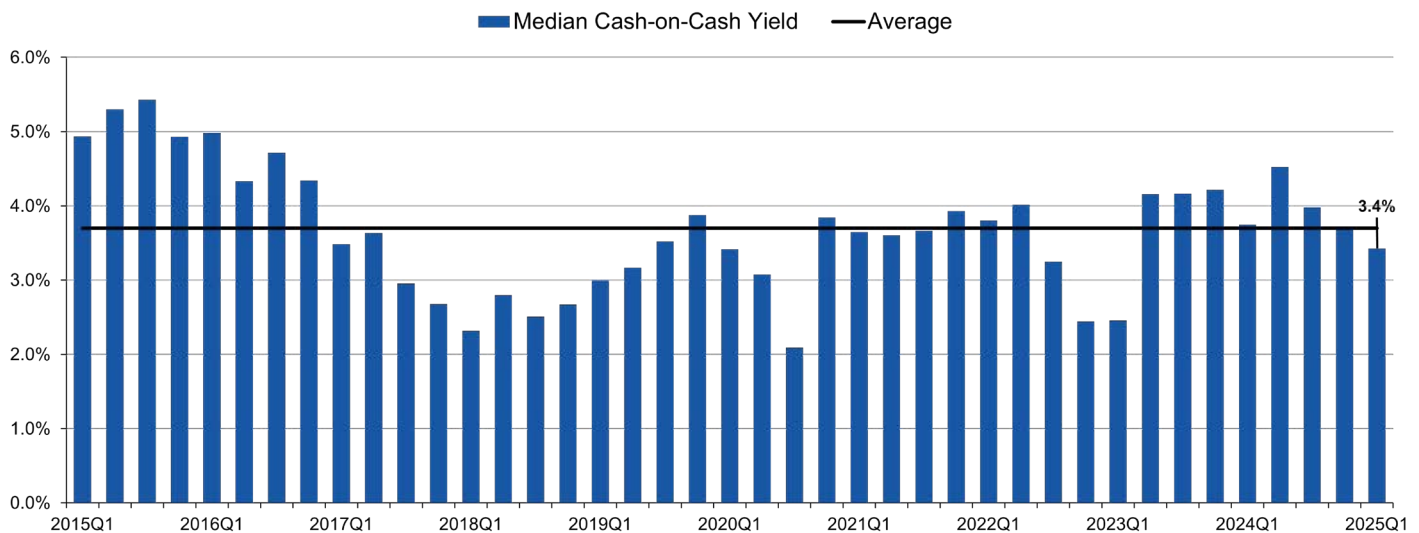
Differentiated Cash Flow Experience

CLO equity offers a cash flow profile that is very different from other investments offering double-digit return profiles, notably private equity. More specifically, CLO equity provides quarterly, front-loaded cash flows, reflecting the character of its underlying fixed-income collateral, while still offering a potentially higher return. That stands in contrast to asset classes, such as private equity and venture capital, that can offer a similar level of historical return but deliver those returns on a back-end basis following an extended “J curve” — an initial investment that experiences negative returns followed by improving and positive returns in later periods.

What’s more, for investors allocating to CLO equity through an actively managed fund, equity commitments are drawn down over time as opposed to all at once. This means that the investor’s fully out-of-pocket capital commitment is relatively short lived; not too long after the final amount of committed capital is called down, cash begins flowing back to investors in the form of income distributions. Additionally, the front-loaded nature of the cash flows delivers what can be thought of as “temporal seniority,” progressively reducing investor’s out-of-pocket, at-risk exposure through potential early return of capital. And while the utility offered through the periodic, front-loaded cash flows is not captured in any return metric, the optionality for investors to direct cash-in-pocket to new investments or spending needs has value, in our view.

Figure 3. CLO Equity Historically Has Experienced Positive Cash Flows

Quarterly cash-on-cash (CoC) yields Q1 2015 to Q1 2025



Source: Bank of America (BoFA) Global Research as of February 2025. Data set based on vintages from 2012-2023. CoC measures the periodic cash flow received by a CLO equity investor relative to the total cash invested. The historical data shown above are for illustrative purposes only and do not represent any specific portfolio managed by Lord Abbett or any particular investment. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment. **Past performance is not a reliable indicator or guarantee of future results.**

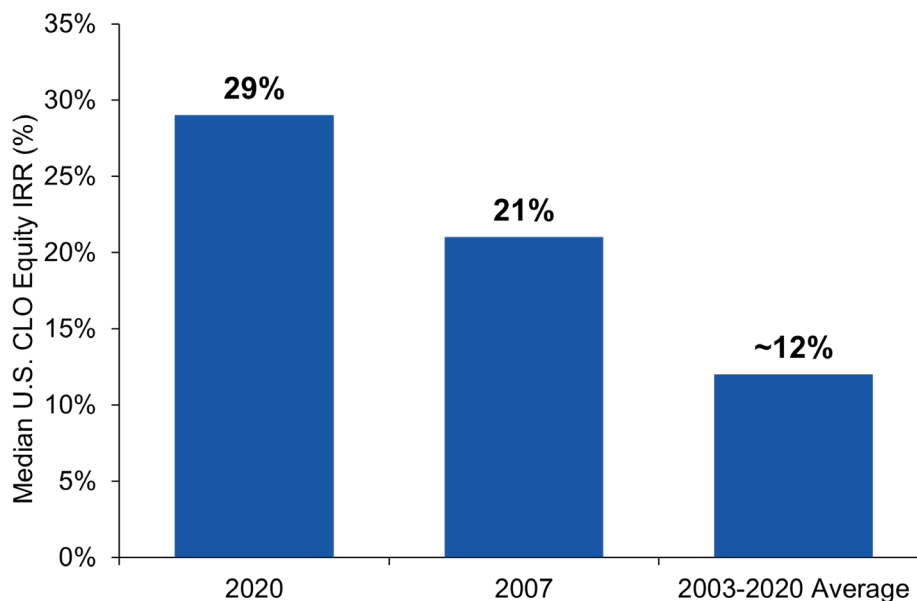


Potential for Attractive Returns in Multiple Investment Environments

Under typical conditions, CLOs do not mark loans to market, thereby protecting investors across the entire structure from short-term volatility. As a consequence, CLO managers can potentially take advantage of periods of volatility by acquiring discounted assets, locking in cheaper valuations, which can build par and improve the equity's return profile. Take, for example, an environment like 2007/2008 or 2020 (see Figure 4). As bank loan spreads widened and prices fell, skilled managers still in their ramping/reinvestment periods were able to buy discounted collateral in a forced sellers' market, which led to above-average returns for vintages of CLO equity that were originated in those years. On the other hand, in an environment where CLO spreads are tightening (2023-2024), once outside of the non-call period, equity owners can refinance at a lower spread level, decreasing the cost of debt service. All else equal, this can increase the arb and accrue to equity in the form of higher returns. Finally, in a stable spread environment, the consistent quarterly cash flows from a CLO equity investment can provide attractive current income even if the market is directionally unchanged.

Figure 4. CLO Equity Returns Can Be Strong Following Periods of Market Volatility

U.S. CLO median redeemed deal internal rate of return (IRR), 2020, 2007, and the historical average from 2003–2020



Source: Bank of America (BoFA) Global Research as of February 2025. Median IRR data comprised of redeemed deals from vintages 2003-2020 and weighted average. A vintage is the year the CLO was originated. The historical data shown above are for illustrative purposes only and do not represent any specific portfolio managed by Lord Abbett or any particular investment. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.

Past performance is not a reliable indicator or guarantee of future results.

A Final Word: Selecting the Right Manager

For investors in both CLO debt and equity, manager selection can be critical to the investment experience. Equity's stake in the success of the collateral manager is straightforward, as the levered portion of a structure holding risk assets, credit selection, valuation acumen and risk mitigation are key skillsets for a manager to possess. We believe that managers who have experience investing in bank loans across multiple cycles, deep knowledge of the CLO structure, and extensive relationships in the leveraged credit markets are best positioned to succeed in this space.

CLO Equity Portfolio Applications:

1. Complement existing "J curve" alternative allocations (i.e., venture capital or private equity) with a front-ended, consistent cash flow experiences.
2. Complement existing credit allocations with a low correlation asset class that has exhibited strong risk-adjusted returns even in difficult market environments.



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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.

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Glossary & Index Definitions

Amortization is an accounting method used to lower the book value or principal value of a loan or an intangible asset over a specific time period. The amortization period of a CLO occurs following the reinvestment period. During the amortization period, cash flows from the CLO assets are used to pay down the debt.

Arbitrage in CLOs is the difference between the CLO debt coupon payments and the coupon payments received from the loan issuers.

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. Bank loans are typically floating rate and priced at a spread over a referenced rate.

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.

A CLO waterfall distributes payments to different tranches of debt and equity from highest to lowest or top to bottom. The higher tranches have the highest claim on payments while lower-rated tranches receive payments in order of seniority. The equity tranche receives the remaining payments or cash flows last, after all debt tranches have been paid.

A basis point is one one-hundredth of a percentage point.

Marked to market means the price or value of a security, a portfolio, or an account is recorded, or marked, to reflect its current market value rather than its book value.



Non-call period is the time when the CLO's debt tranches can't be called or refinanced.

Ramp or ramp-up period is when the CLO manager uses the proceeds from the issuance of the CLO to buy additional assets. This takes place after the CLO transaction has closed.

The Secured Overnight Financing Rate (SOFR) is a broad measure of the cost of borrowing cash overnight collateralized by Treasury securities.

A special purpose vehicle is a legal entity or company that is created separately from a parent company and generally for a certain purpose. SPV's operations are often only for the purchase and financing of specific assets or projects. One of the common reasons for creating a SPV is for the securitization of loans.

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.

Tranches are a collection of securities that are separated and grouped based on various characteristics and sold to investors. Tranches can have different maturities, credit ratings, and yields—or interest rates.

Warehousing is the period when the portfolio of loans for a CLO is built. It takes place before the CLO transaction closes and when the CLO issuer purchases or commits to purchasing a portfolio of loans or bonds.

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 IBBox Liquid High Yield Index measures the U.S. dollar-denominated, sub-investment-grade, corporate bond market. The index includes bonds with a minimum one year to maturity and a minimum amount outstanding of \$400. Bond types include fixed-coupon, step-up, bonds with sinking funds, medium-term notes, callable, and puttable bonds.

The IBBox Liquid Investment Grade Index measures the U.S. dollar-denominated, investment-grade, corporate bond market. The index includes bonds with a minimum three years to maturity and a minimum amount outstanding of \$750. Bond types include fixed-coupon, step-up, bonds with sinking funds, medium-term notes, callable, and puttable bonds.

The iBoxx USD Leveraged Loan index represents the main sections of the U.S. dollar-denominated, leveraged loan market. Index constituents are derived using selection criteria such as loan type, minimum size, liquidity, credit ratings, initial spreads, and minimum time to maturity.

S&P 500® Index is widely regarded as the best single gauge of large-capitalization U.S. stocks. The index includes 500 leading companies and captures approximately 80% coverage of available market capitalization.

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