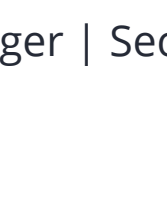


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Quick Views

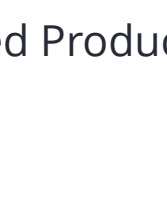
Interest rates

Accessing Floating-Rate Loans Through CLOs



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Head of U.S. Securitized Products John Kerschner and Associate Portfolio Manager Jessica Shill explain why investment-grade collateralized loan obligations (CLOs) may offer an attractive floating-rate option for fixed-income investors expecting interest rates to rise.

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Key Takeaways

- While most investors instinctually feel that rising interest rates are bad for bonds, the opposite is often true with floating-rate bonds.
- High inflation and expectations for rising policy rates have created demand for floating-rate securities, including CLOs. We expect this will persist as long as markets expect the U.S. Federal Reserve (Fed) to raise interest rates, or if the outlook for inflation remains uncertain.
- While their yields look attractive at current levels, CLOs have a history of seeing capital appreciation when the Fed is raising rates – as they are expected to do in the year ahead.

You Don't Have to Passively Accept Duration

Many investors also assume that an allocation to bonds requires a lot of exposure to the volatility of interest rates. This is understandable given how many passive (and even actively managed) bond funds are benchmarked to the Bloomberg U.S. Aggregate Bond index. The “Agg,” as it is commonly known, has almost become synonymous with “bonds.” But while the Agg has many advantages, low sensitivity to rising interest rates is not one of them. And while it does have a substantial allocation to mortgage-backed securities (MBS), which have lower durations (a measure of sensitivity to changes in interest rates), Treasuries make up the bulk of the index and the duration of its corporate bond allocation has risen substantially in recent years.¹

In an environment like today, where yields are low, inflation is high, and interest rates are expected to rise, investors need to be a little more thoughtful about how, not if, they should take bond exposure. Floating-rate securities, lower-duration asset classes (like MBS), or securities with higher yields are all viable options. And there are a variety of established markets that can provide some or all of these characteristics. For example, many commercial mortgage-backed securities (CMBS) are issued with floating-rate coupons. But the rapid growth of the floating-rate bank loan market and its more structured corollary, the collateralized loan obligation (CLO) market, deserve a closer look given their low interest-rate sensitivity, attractive yields, and diversity benefits.

The Bank Loan Market

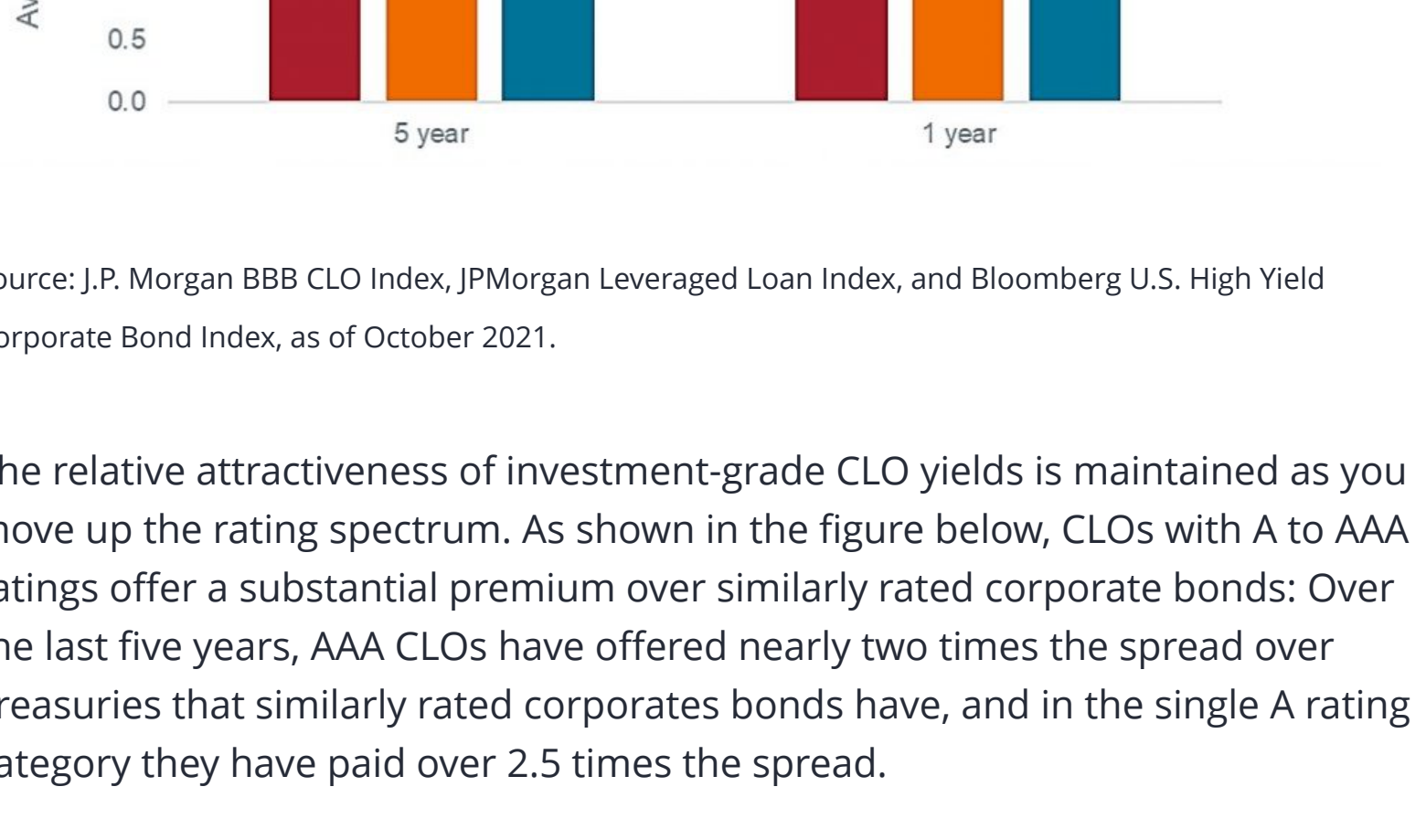
While governments and large corporations typically borrow by issuing bonds, there is a parallel – and rapidly growing – market of loans (not bonds) issued by U.S. banks to smaller companies seeking funding. These loans, originating from banks that fund themselves through the volatile interest rate markets, are mostly issued with floating-rate interest to help protect the bank from losses should interest rates rise. For the corporate borrowers, the floating-rate structure means their interest payments could rise or fall, making financial planning a little more complicated. But for investors, the floating-rate nature can sometimes be just what is needed: A security that pays more income if interest rates rise and is less sensitive to losses if fears of inflation push longer-maturity government or corporate bond yields higher.

The bank loan market goes by a few names but is often referred to as the “leveraged loan” market – a name which originates from its role in financing mergers or acquisitions, including leveraged buyouts. The credit ratings of these loans typically track this usage: They are overwhelmingly “high-yield” loans, with sub investment-grade credit ratings and thus yields which tend to look more like the high-yield corporate bond market.

For investors comfortable with high-yielding sub-investment grade risk, the bank loan market deserves a closer look as it has grown substantially in the last decade. At nearly \$1.6 trillion in June of this year, the floating-rate bank loan market is nipping at the heels of the fixed-rate U.S. high-yield market, which was only marginally larger at approximately \$1.7 billion in June 2021.²

Bank Loans with Higher Credit Ratings: CLOs

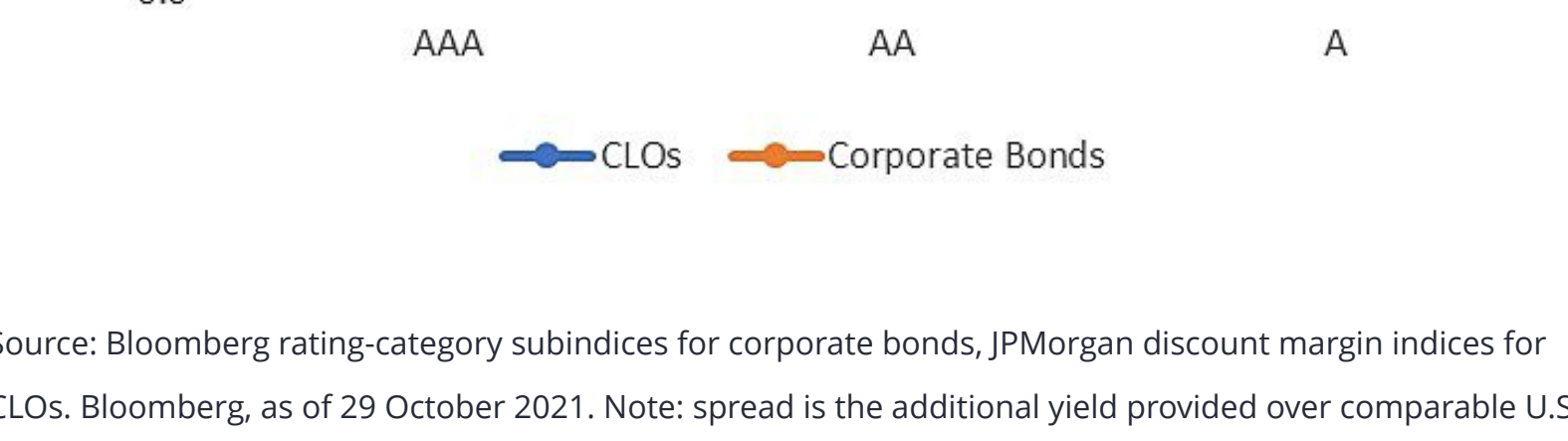
For investors who are *not* comfortable with sub-investment grade credit risk but still seek floating-rate exposure, the CLO market offers exposures over the range of investment-grade credit ratings, including AAA and BBB. As the bank loan market has grown, so has the U.S. CLO market (nearly tripling in the last decade to over \$800 billion) as CLOs are, in essence, portfolios of bank loans.³ They are also actively managed by a CLO manager who pools together different loans to create a portfolio in an attempt to produce a more diverse offering. Nevertheless, BBB rated CLOs have historically offered yields closer to the bank loan and high-yield corporate bond markets, as illustrated in the chart below.



Source: J.P. Morgan BBB CLO Index, JPMorgan Leveraged Loan Index, and Bloomberg U.S. High Yield Corporate Bond Index, as of October 2021.

The relative attractiveness of investment-grade CLO yields is maintained as you move up the rating spectrum. As shown in the figure below, CLOs with A to AAA ratings offer a substantial premium over similarly rated corporate bonds: Over the last five years, AAA CLOs have offered nearly two times the spread over Treasuries that similarly rated corporates bonds have, and in the single A rating category they have paid over 2.5 times the spread.

Figure 2: The Spread Advantage of CLOs over Corporate Bonds



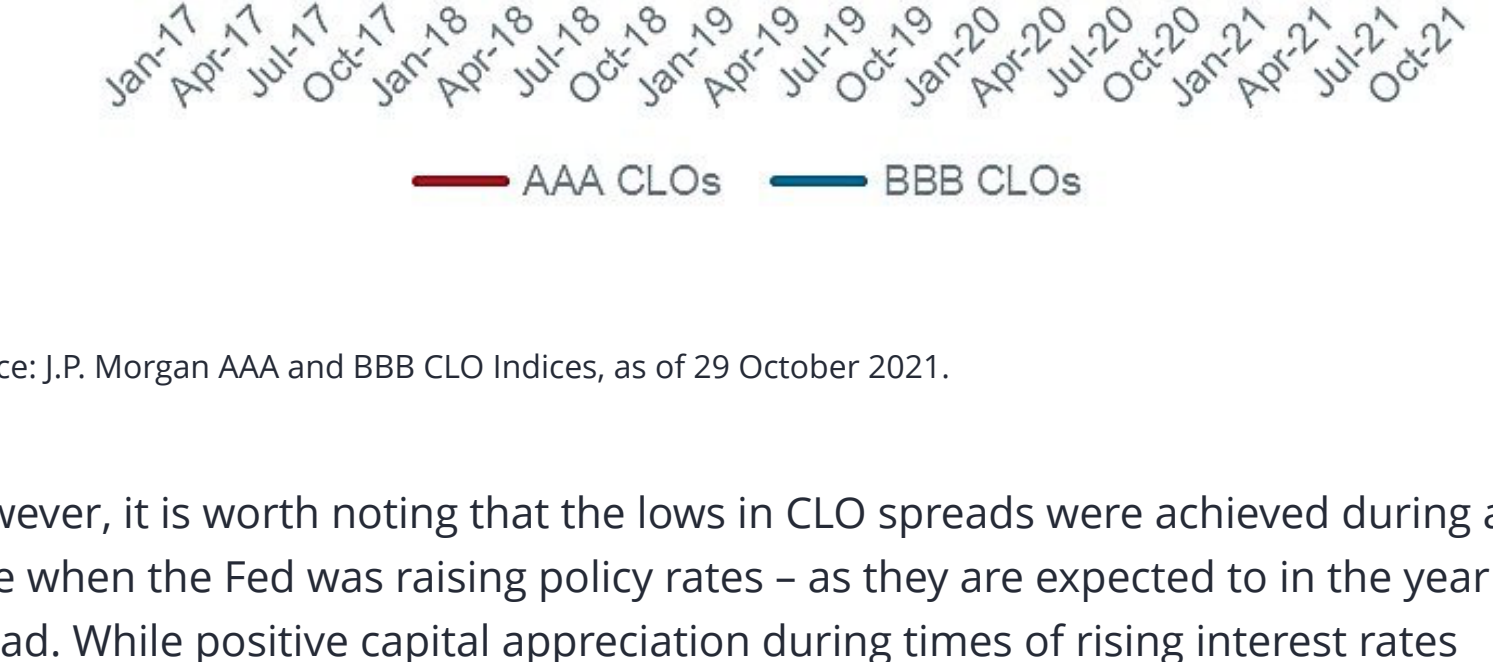
Source: Bloomberg rating-category subindices for corporate bonds, JPMorgan discount margin indices for CLOs. Bloomberg, as of 29 October 2021. Note: spread is the additional yield provided over comparable U.S. Treasuries.

The Near-Term Outlook for and Relative Value of CLOs

CLOs in both the highest investment-grade rating category (AAA) and the lowest (BBB) are currently trading near the tighter end of their recent range but are not yet near the lows seen in the last cycle, in the first quarter of 2018. Like other credit markets, they widened substantially as COVID-19 struck, then steadily recovered from the 2020 lows. For much of this year, spreads have been stable and thus, given their yield, offered an attractive risk-adjusted return in a period when Treasuries were relatively volatile.

In our view, the current mix of high inflation and expectations for rising policy rates has created demand for floating rate securities that has helped the stability of their spreads. And as long as the Fed is expected to raise interest rates – or the outlook for inflation remains uncertain – we expect this demand to be sustained. While spreads could tighten further (as of the end of October, AAA spreads were still 0.27% wider than their 2018 lows), we think both AAA and BBB rated securities are compelling even if they remain stable at current spreads given the yields they offer.

Figure 3: AAA and BBB CLO Spreads



Source: J.P. Morgan AAA and BBB CLO Indices, as of 29 October 2021.

However, it is worth noting that the lows in CLO spreads were achieved during a time when the Fed was raising policy rates – as they are expected to in the year ahead. While positive capital appreciation during times of rising interest rates may seem counter-intuitive, such is the nature of floating-rate securities. Between December 2017 and the end of November 2018, when the Fed raised interest rates 1.25%, the Agg lost 1.62%, the shorter-duration Bloomberg 1–3-year U.S. Government/Credit Index gained 0.82%, and the J.P. Morgan AAA CLO index rose 2.55%⁴. Over the course of the longer tightening cycle, from December 2015 to through November 2018, the Fed raised rates 2.25% and the AAA CLO index rose 8.63%, more than three times the return of the 1-3-year U.S. Government/Credit index⁵.

Nevertheless, when absolute yield levels across many fixed income markets are low, the yields on CLOs can look attractive regardless of their potential to see higher prices. Currently, the J.P. Morgan AAA CLO Index has an average yield near 2.2% and the BBB Index, which is still investment grade, is yielding nearly 5%.⁶ Relative to the Agg, an investment-grade benchmark, which currently offers a yield of 1.69%⁷, CLOs look attractive at both the lowest and the highest investment-grade ratings.

¹ Bloomberg, as of 15 November 2021.

² Securities Industry and Financial Markets Association, as of June 2021, and Bloomberg, as of 30 June 2021.

³ J.P. Morgan, as of 26 November 2021.

⁴ Bloomberg, as of 1 December 2021.

⁵ Bloomberg, as 31 November 2021.

⁶ Bloomberg, as of 30 November 2021. Indices are the J.P. Morgan CLO AAA Total Return Index and J.P. Morgan CLO BBB Total Return Index. Note that quoted yields are take into consideration the forward curve for LIBOR.

⁷ Bloomberg, as of 30 November 2021.

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Credit quality ratings are measured on a scale that generally ranges from AAA (highest) to D (lowest).

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Diversification neither assures a profit nor eliminates the risk of experiencing investment losses.

Fixed income securities are subject to interest rate, inflation, credit and default risk. The bond market is volatile. As interest rates rise, bond prices usually fall, and vice versa. The return of principal is not guaranteed, and prices may decline if an issuer fails to make timely payments or its credit strength weakens.

Mortgage-backed securities (MBS) may be more sensitive to interest rate changes. They are subject to extension risk, where borrowers extend the duration of their mortgages as interest rates rise, and prepayment risk, where borrowers pay off their mortgages earlier as interest rates fall. These risks may reduce returns.

Collateralized Loan Obligations (CLOs) are debt securities issued in different tranches, with varying degrees of risk, and backed by an underlying portfolio consisting primarily of below investment grade corporate loans. The return of principal is not guaranteed, and prices may decline if payments are not made timely or credit strength weakens. CLOs are subject to liquidity risk, interest rate risk, credit risk, call risk and the risk of default of the underlying assets.

Bank loans often involve borrowers with low credit ratings whose financial conditions are troubled or uncertain, including companies that are highly leveraged or in bankruptcy proceedings.

High-yield or "junk" bonds involve a greater risk of default and price volatility and can experience sudden and sharp price swings.

U.S. Treasury securities are direct debt obligations issued by the U.S. Government. With government bonds, the investor is a creditor of the government. Treasury Bills and U.S. Government Bonds are guaranteed by the full faith and credit of the United States government, are generally considered to be free of credit risk and typically carry lower yields than other securities.

Actively managed portfolios may fail to produce the intended results. No investment strategy can ensure a profit or eliminate the risk of loss.

Bloomberg U.S. 1-3 Year U.S. Government/Credit Index measures Treasuries, government-related issues and corporates with maturity between 1-3 years.

Bloomberg U.S. Aggregate Bond Index is a broad-based measure of the investment grade, US dollar-denominated, fixed-rate taxable bond market.

Credit Spread is the difference in yield between securities with similar maturity but different credit quality. Widening spreads generally indicate deteriorating creditworthiness of corporate borrowers, and narrowing indicate improving.

Duration measures a bond price's sensitivity to changes in interest rates. The longer a bond's duration, the higher its sensitivity to changes in interest rates and vice versa.