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CLOs: Helping Insurers Manage Duration Risk Amid Rising Interest Rates

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In response to the inflation spike that began in the latter half of 2021, the U.S. Federal Reserve (the Fed) is expected to continue to raise interest rates over the course of 2022 and 2023. Rising rates can present a challenge for insurance company portfolios that typically allocate a significant portion to fixed income securities. However, floating-rate debt instruments (i.e., those with coupons that increase as market interest rates rise) may help mitigate interest duration risk in diversified fixed income portfolios. Herein, we highlight one such floating-rate debt strategy: collateralized loan obligation (CLO) securities, also known as CLO debt tranches.

What is a CLO?

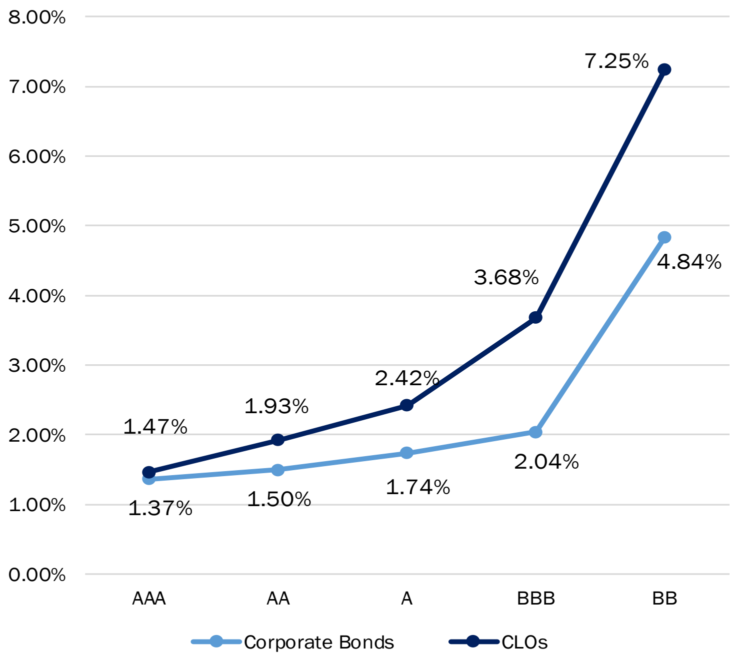
A CLO is a securitization backed by a diversified portfolio of senior secured floating-rate loans (also known as broadly syndicated loans or bank loans) that is financed using proceeds from the issuance of debt and equity securities. CLO debt obligations are divided into rated classes of notes, or tranches, typically ranging in rating quality/seniority from AAA to BB based on prioritization of interest and principal payment. The combined rated notes typically represent 90% of the CLO structure and CLO equity represents the remaining 10%. The broadly syndicated loans comprising a CLO's collateral portfolio are rated below investment grade, generally senior to other outstanding debt within a company's capital structure, secured by the assets of the borrowers, and bear a floating-rate coupon tied to an industry benchmark interest rate that adjusts periodically.

Competitive Risk-Adjusted Returns

CLOs have gained attention from insurers and other institutional investors owing to their competitive yields and the proven resilience of the CLO structure over multiple credit cycles. As illustrated in Figure 1, CLO debt securities currently offer higher yields compared to other types of fixed income securities of similar quality, reflecting the relative complexity, lower liquidity, and regulatory requirements of CLOs. In the nearly 30-year history of the asset class, there has never been a default among a CLO tranche rated AAA or AA. Furthermore, the long-term historical default rate of 0.1% among A-rated tranches supports our view that investment grade CLO debt securities are "risk remote." Compelling yields and comparatively low historical default rates for CLO debt tranches suggest that CLO tranche investors have generally been well compensated for the assumed risk.

CLO securities may also offer diversification benefits to an insurer's broader investment portfolio. As Figure 2 demonstrates, CLO securities have a reduced or negative correlation to assets commonly held in insurance portfolios.

Figure 1 Average Comparative Yield of U.S. CLO Debt Securities & Comparably Rated U.S. Corporate Bonds



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Supportive Technical Dynamics and Credit Fundamentals

Demand for floating-rate assets from institutional and retail investors alike was extremely robust in 2021. New CLO issuance totaled $186.7 billion for the full year 2021—more than double the amount priced in 2020 and well above the previous calendar-year record reached in 2018.[1] Retail investors likewise embraced floating-rate loans in 2021: following $26.9 billion of outflows in 2020, retail loan fund inflows totaled $45.4 billion in 2021.[2] As the focus has shifted to Fed policy and the Fed's timing to impose rate hikes and commence reducing its $8.9 trillion balance sheet,[3] we expect strong demand for floating-rate assets, including loans and CLO debt tranches.

Figure 2 Negative or Reduced Correlations of CLO Securities to Other Asset Classes

	CLO AAA	CLO AA	CLO A	CLO BBB
Long U.S. Treasury Bonds	- 0.19	- 0.20	- 0.21	- 0.23
S&P 500	0.54	0.55	0.56	0.54
U.S. Investment-Grade Corporate Bonds	0.56	0.56	0.54	0.51
U.S. T-Bills	- 0.24	- 0.30	- 0.32	- 0.19
Senior Secured Loans	0.92	0.93	0.91	0.89

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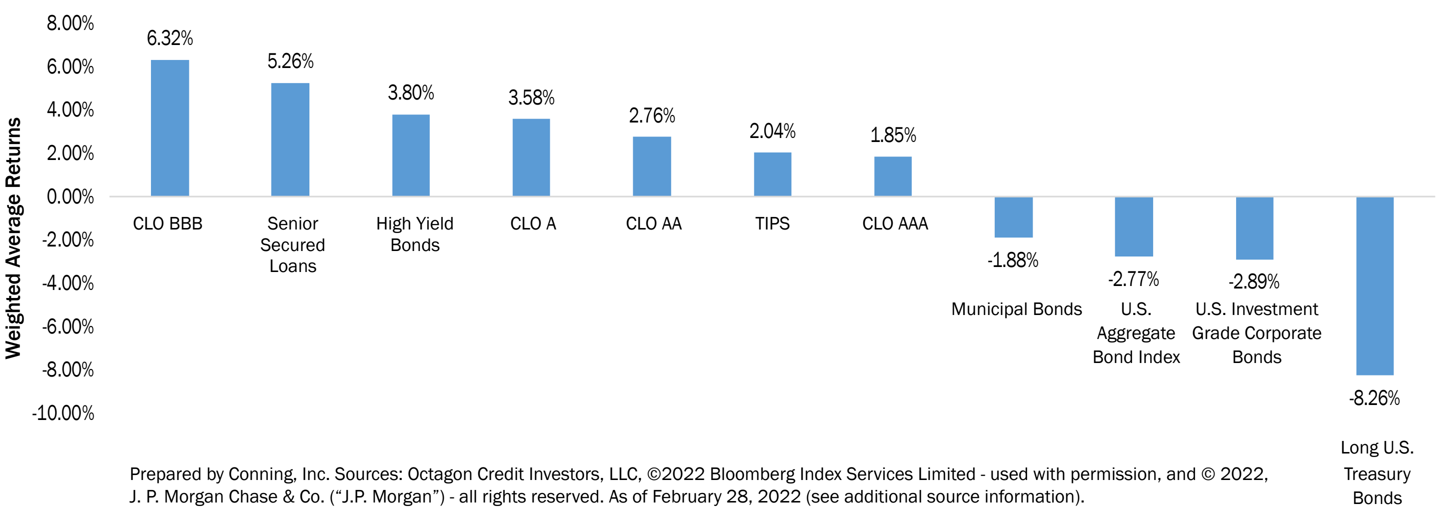
The full-year 2021 default rate for bank loans was 0.29%, just off the June 2007 all-time low of 0.14%.[4] Despite recent macro-driven volatility, credit stress indicators suggest a benign near-term default outlook. For example, loans priced below 80 currently represent less than 2% of the loan market (as measured by the S&P/LSTA Leveraged Loan Index as of 3/31/2022), and the share of loans rated CCC is approximately 5%, a dramatic decline from the 11% peak reached in mid-2020.[5] By and large, below investment grade borrowers have demonstrated improving credit fundamentals, supported by ample corporate liquidity and strong earnings growth. Loan facility upgrades consistently outnumbered downgrades in 2021, underscoring improving credit quality among loan issuers.[6] Receding tail risk in loan collateral supported improvements in CLO fundamentals over the course of 2021.

CLO Growth in Insurance Portfolios

Institutional investors, including insurance companies, have invested in CLO securities for over two decades. In recent years, CLO debt tranches have attracted increased attention from insurers. According to NAIC data, as of year-end 2020, U.S. insurers' CLO exposure increased by 23% to $192.9 billion in book/adjusted carrying value from about $156.9 billion at year-end 2019.[7] The majority of U.S. insurers' CLO exposure is in higher-rated tranches, with approximately 80% of securities rated BBB or higher (not including BBB-) as of year-end 2020, consistent with the year prior. Higher-rated CLO securities are also of interest to insurers because of their lower risk-based capital charges.

While 10 large U.S. insurance groups accounted for 45% of the U.S. insurance industry's total CLO exposure in 2020,[7] Conning and Octagon continue to see growing interest in CLO tranche investments from insurance clients. Furthermore, certain clients who are more familiar with the asset class have sought opportunities to invest further down the capital stack, beyond investment grade securities (rated AAA, AA, A, and BBB) in pursuit of higher yields.

Figure 3 Debt Asset Classes - Performance When 10-Year U.S. Treasuries Rose >=100 Bps



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Manager Experience Remains Highly Valuable

Given the interest rate outlook, many insurers would be well-advised to consider an allocation to floating-rate assets such as CLO debt tranches. As Figure 3 illustrates, CLO debt tranches and bank loans have historically outperformed other debt assets since 1999 during periods when the 10-year U.S. Treasury increased by 100 basis points or greater.

Octagon Credit Investors, a CLO manager since 1999 and one of the first in the asset class, and its affiliate Conning believe that investment expertise is crucial when investing in CLO securities, in both good market environments and bad. Of paramount importance in selecting CLO securities is a deep understanding of the technical and fundamental aspects of the CLO and bank loan markets, the CLO structure and documentation variances, CLO manager strategy, and historical performance.

In our view, CLOs may offer benefits to insurers in a rising rate environment by virtue of their floating-rate coupon, and from a portfolio diversification perspective. However, each insurance portfolio is unique and investment objectives should drive all portfolio decisions. Our shared goal is to help insurers better understand the opportunities in the CLO and bank loan markets and how investing in these asset classes may align with their long-term portfolio objectives.

RELATED CONTENT

Collateralized Loan Obligations (CLO) Fact Sheet *- A short piece on how CLOs work and the benefits of investing in the asset class. Click here to learn more.*

CLO Risks Factors

Risk factors include but are not limited to the below; for further discussion of material risks, please refer to Conning's Form ADV Part 2A.

Structure: CLOs often involve risks that differ from those associated with other types of debt instruments. The complex structure of the security may produce unexpected investment results not based on default or recovery statistics. Ratings agencies may downgrade their original ratings of CLO debt tranches. Majority equity holders retain the right to call or refinance/reprice a CLO, creating cash flow variability for minority equity and debt holders.

Liquidity: CLOs may be difficult to value and may constitute illiquid investments. Valuation of structured credit products are provided by third parties, based on models, indicative quotes, and estimates of value, in addition to historical trades. There is inherent difficulty in valuing these assets, and there can be no assurances the assets can be disposed of or liquidated at the valuations established, or that published returns will be achieved.

Default: During periods of economic uncertainty and recession, the incidence of modifications and restructurings of investments may increase, resulting in impairments to the underlying asset value and reduced "subordination" to the CLO liabilities.

Regulatory: CLOs are susceptible to changing regulations, influencing eligibility of certain investments, risk retention requirements, and other factors that can influence availability and liquidity.

LIBOR: CLO debt and bank syndicated loans historically used LIBOR as an interest rate benchmark, which is currently being phased out, with new instruments being issued with an alternative rate and all existing instruments tied to LIBOR required to transition by June 30, 2023. Replacement of LIBOR could adversely affect the market value or liquidity of CLO securities and/or loans, and pose tangential risk for markets and assets that do not rely directly on LIBOR. On July 29, 2021, the Alternative Reference Rates Committee formally recommended CME Group's forward-looking Term SOFR rate as the replacement rate for U.S. dollar LIBOR, however, there is uncertainty with respect to replacement of LIBOR with proposed alternative reference rates, and it is possible that different markets might adopt different rates, resulting in multiple rates at the same time and a potential mismatch between CLO securities and underlying collateral, the effects of which are uncertain at this time, and could include increased volatility or illiquidity. In addition, operational and technology challenges during the transition from LIBOR as well as inconsistent communication from issuers could result in delayed investment analyses and reduced investment opportunities.

General Market and Economic Conditions: Changing economic, political, regulatory or market conditions, interest rates, general levels of economic activity, the price of securities and debt instruments and participation by other investors in financial markets may affect the value of CLOs and all other asset classes.

Paul Norris is a Managing Director and Head of Structured Products at Conning and oversees the team involved in the research and trading of structured securities. Prior to joining Conning in 2017, he was a hedge fund portfolio manager focused on mortgage derivatives. Previously, Mr. Norris was head of securitized products at Dwight Asset Management, where he led a team of portfolio managers, traders and analysts, and also has served as director of mortgage and non-mortgage investments at Fannie Mae. Mr. Norris earned a BS in finance from Towson University and an MBA from the University of Maryland.

Gretchen Lam is a Senior Portfolio Manager at Octagon. Ms. Lam is a member of Octagon's Investment Committee and serves as a Portfolio Manager across CLOs, Separately Managed Accounts and Commingled Funds. Ms. Lam oversees the Firm's Structured Credit (CLO debt & equity) investment strategies. Ms. Lam is a member of Octagon's & Conning's Global DEI (diversity, equity and inclusion) Council and a member of the Firm's ESG (environmental, social, and corporate governance) Committee. Prior to becoming a Portfolio Manager, Ms. Lam oversaw Octagon's investments in the software, business services, finance & insurance, paper & packaging, gaming & lodging, homebuilding and real estate industries. She was also responsible for the structured credit exposure held in Octagon's CLO vehicles. Prior to joining Octagon in 1999, Ms. Lam attended Babson College where she graduated summa cum laude with a BS in investments. She received her CFA Charter in 2006.

About Octagon Credit Investors, LLC

Octagon Credit Investors, LLC (www.octagoncredit.com) is a below-investment grade corporate credit investment adviser with more than 25 years of experience managing CLOs, bank loans and high yield bonds on behalf of institutional investors. In 2016, Conning acquired a majority stake in Octagon.

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 insurers and pension plans, with investment solutions, risk modeling software, and industry research. Founded in 1912, Conning has investment centers in Asia, Europe and North America.

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Disclosures

All investment performance information included in this document is historical. Past performance is not a guarantee of future results. Any tax-related information contained in this document is for informational purposes only and should not be considered tax advice. You should consult a tax professional with any questions.

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Additional Source Information

Figure 1

Average calculated based on daily data for the period 10/01/2021 to 12/31/2021.

Yield calculated by adding spread to 3-month LIBOR for the respective tranche for primary (i.e., new issue) USD CLOs. CLO spreads represent USD CLO market pricing levels broken out into six original rating classes (AAA, AA, A, BBB, BB).

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.

Figure 2

Correlation of underlying assets is intended to convey a measure of diversification of the underlying assets of the respective product, based on Conning's assessment of the ultimate risk of loss for the underlying assets of the respective product. Correlations based upon return data from January 2012 to December 2021. Long U.S. Treasury is represented by the Bloomberg U.S. Treasury 10-20 Year Index, S&P 500 is represented by the S&P 500 Index Total Return Index, U.S. Investment-Grade Corporate Bonds are represented by the Bloomberg US Corporate Index, U. S. T-Bills are represented by the Bloomberg U.S. Treasury Bill Index, and Senior Secured Loans are represented by the S&P Leveraged Loan Index. Past performance is not a guarantee of future results.

Figure 3

From January 1, 2012 to February 28, 2022. Senior Secured Loans are represented by the S&P Leveraged Loan Index, High Yield Bonds are represented by the Bank of America Merrill Lynch US High Yield Bond Index, TIPS are represented by the Barclays TIPS Index 0-5 Year, U.S. Investment Grade Corporate Bonds are represented by Barclays Corporate Bond Index, Aggregate Bonds are represented by the Barclays Aggregate Bond Index, which encompasses Investment Grade, taxable fixed-rate bonds, Municipal Bonds are represented by the Barclays Municipal Bond Index 22+ Yr, Long U.S. Treasury Bonds are represented by the Barclays U.S. Treasury Bond 10-20 Year Index, CLO AAA tranches are represented by the CLOIE AAA Index, CLO AA tranches are represented by the CLOIE AA Index, CLO A tranches are represented by the CLOIE A Index, and CLO BBB tranches are represented by the CLOIE BBB Index. An investment cannot be made directly in an index. Past performance is not a guarantee of future results.

Footnotes

[1] Leveraged Commentary & Data (LCD), "LCD Quarterly Review – Fourth Quarter 2021," January 6, 2022.

[2] Leveraged Commentary & Data (LCD), "Leveraged loan break prices slip to 4-month low in December 2021," January 11, 2022.

[3] The Board of Governors of the Federal Reserve System, "Recent balance sheet trends – Total Asset of the Federal Reserve," https://www.federalreserve.gov/monetarypolicy/bst_recenttrends.htm, accessed May 2, 2022.

[4] Leveraged Commentary & Data (LCD), "Leveraged loan default rate holds at 0.29% in default-free December 2021," January 3, 2022.

[5] Leveraged Commentary & Data (LCD), "Leveraged loan default rate stays close to record lows, at 0.29%," February 1, 2022

[6] Leveraged Commentary & Data (LCD), "2021 Wrap: Leveraged loans post solid returns in year of blowout issuance," January 3, 2022.

[7] National Association of Insurance Commissioners, "U.S. Insurers' Collateralized Loan Obligation (CLO) Exposure Jumps Almost 23% at Year-End 2020," Analysts: Jennifer Johnson and Jean-Baptiste Carelus, September 8, 2021, https://content.naic.org/sites/default/files/capital-markets-clo-special-reports-ye-2020.pdf

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