From Niche to Strategic: The Institutional Case for CLO BBs

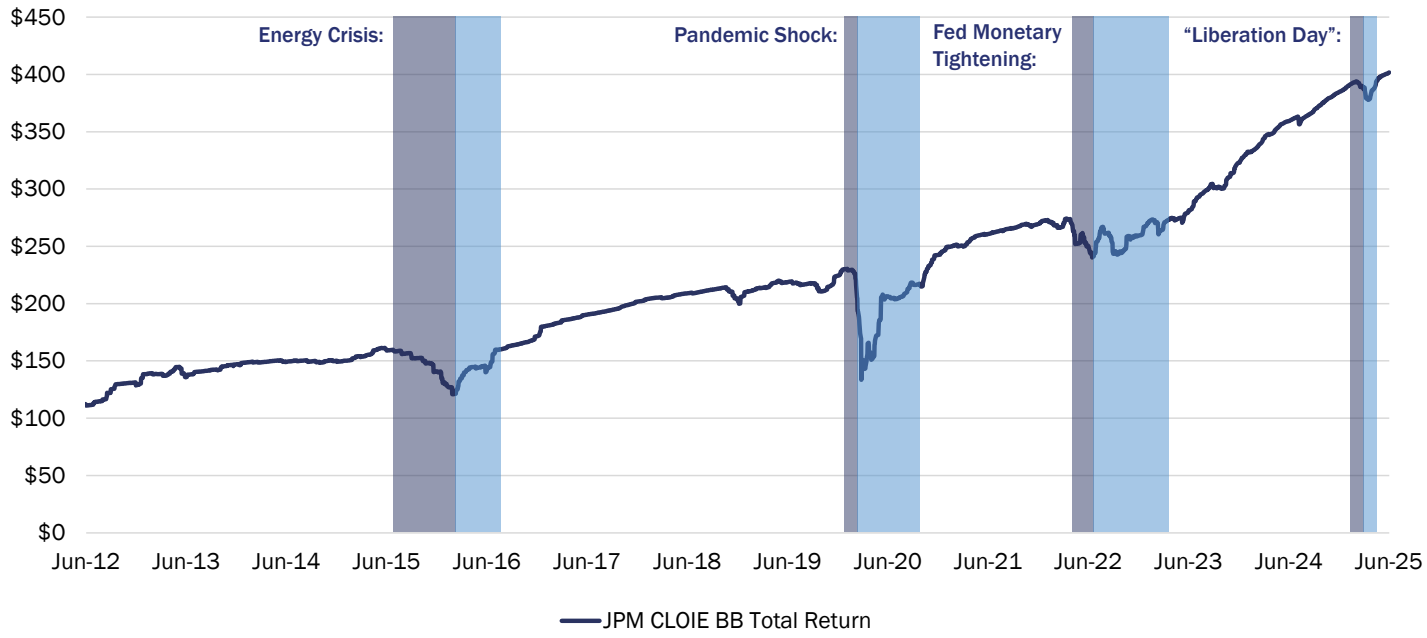
In recent years, the landscape of collateralized loan obligation (CLO) BB-rated tranches has undergone a quiet but profound transformation. Once viewed as niche, volatile instruments offering a complexity premium to compensate for perceived risk, CLO BBs are now being re-evaluated by a new generation of informed, globally diversified investors. This shift—accelerated by regulatory catalysts, structural resilience, and evolving market dynamics—has ushered in an era of stability and broadened appeal. As this paper explores, the coming of age of CLO BBs signals not just a change in perception but a redefinition of risk, return, and opportunity in this corner of the structured credit markets.

A Shifting Risk-Return Profile

The risk-return profile of BB-rated CLO tranches is undergoing a fundamental shift. Historically viewed as high-beta instruments vulnerable to market stress, these tranches are now being reassessed by a new wave of sophisticated institutional and retail market participants entering the space. These participants are approaching CLO BBs strategically rather than tactically. Their demands for more data and market color are improving transparency for the asset class and their greater numbers and activity result in more consistent trading and price discovery, helping improve liquidity. This evolution is challenging a long-held assumption that BB tranches are inherently fragile during periods of volatility and recovery prospects are lengthy and limited.

This evolution became particularly apparent during President Trump's April 2025 "Liberation Day" tariff event, which sparked a global selloff in risk assets including a sharp, approximately 20% peak-to-trough drop in the S&P 500. Notably during this turmoil CLO BBs declined by less than 10%, according to JPM CLOIE data, and rebounded swiftly, an outcome that diverged from past episodes of market stress, as illustrated in Figures 1 and 2. For instance, during the November 2015-February 2016 energy credit crisis and the February-March 2020 COVID-19 shock, CLO BB tranches suffered significant drawdowns and prolonged recoveries. The new resilience raises a compelling question: what changed in the CLO BB landscape to produce such a markedly different outcome?

Figure 1 - JPM CLOIE BB Drawdowns & Recoveries – Total Return



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Figure 2

Drawdowns of 10% & Subsequent Recoveries

Start	Trough	Days to Trough	Drawdown at Trough	Recovery Date	Days to Recovery (from Trough)
6/25/15	2/25/16	245 days	-25.04%	9/6/16	196 days
2/4/20	3/25/20	50 days	-42.06%	11/19/20	239 days
4/13/22	7/14/22	92 days	-12.39%	4/21/23	281 days
	Average:	**129 days**	**-26.50%**		**238 days**

1H 2025 US Tariff Announcement Drawdown & Subsequent Recovery[1]

Start	Trough	Days to Trough	Drawdown at Trough	Recovery Date	Days to Recovery (from Trough)
3/5/25	**4/16/25**	**42 days**	**-4.08%**	**5/14/25**	**28 days**

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[1]The highlighted drawdown is selected at Octagon's discretion and does not reflect an exhaustive list of drawdown periods.

The Evolving Role of the Informed Buyer

Institutional investors have long been informed participants in CLOs but their approach is evolving. Today's buyers are not only well-versed in the mechanics and protections embedded within the CLO structure, but their comfort level has also led to deploying that knowledge more strategically. Rather than tactically entering and exiting BB-rated tranches based on short-term market dislocations, investors are increasingly maintaining persistent exposure.

This shift is particularly evident among yield-starved investors such as pension funds, insurance companies, sovereign wealth funds, and family offices. These allocators are utilizing BB-rated CLO tranches as part of a broader portfolio strategy, seeking to capture enhanced yield while maintaining a disciplined risk or ratings profile. Their investment horizons and liability structures align well with the cash flow profiles of CLOs, making persistent exposure both feasible and attractive.

This more strategic posture reflects a deeper institutional understanding of the structural resilience of CLOs, which have weathered multiple credit cycles since the late 1990s. BB tranches in particular are no longer viewed through the lens of volatility and headline risk. Instead, seasoned investors interpret price dislocations as potential entry points, not red flags – an approach that has helped reduce volatility and enhance liquidity in the asset class. While it remains to be seen whether this more stable and persistent participation will compress the complexity premium traditionally associated with CLO BBs, current spreads still offer attractive compensation relative to the actual risk of loss – especially when compared to similarly rated fixed income alternatives.

What Changed? The Risk Retention Catalyst

The BB-rated CLO tranche market experienced a pivotal shift following the implementation of the U.S. Risk Retention Rules in December 2016. This legislation was originally designed to address the excesses of the RMBS market that contributed to the Great Financial Crisis (GFC). Despite not being a systemic risk and unlike other asset classes with strong K Street representation, these rules were extended to CLOs. As a result, CLO managers found themselves in a bind: the rules required them to retain 5% of each deal—prompting them to seek external capital through innovative "Risk Retention" funds. Risk Retention Vehicles not only solved a compliance challenge but also sparked a global investor education campaign. Investors were educated on why a product that starts with a "C" and ends with an "O" was not the GFC villain it was misperceived to be.

Even after the rules were overturned by U.S. courts in 2018, momentum continued. Captive CLO equity funds, originally born out of necessity, evolved into a strategic capital source and are still ubiquitous today. Their continued presence has broadened investor participation and deepened market understanding, particularly around mezzanine tranches. The shift in perception has been beneficial for BB-rated CLO debt. Once overlooked, BB tranches are now appreciated for their compelling risk-adjusted returns. Even with this expanding buyer base, CLO BB tranches remain attractive, offering ~10% yields with lower historical default risk than similarly rated corporate debt (see Figure 3), thanks to the structural subordination inherent in CLOs.

Figure 3 - Low Historical Impairments

Original S&P Rating	Total Tranches	Count of Impaired Tranches	U.S. Cumulative Impairment Rate[2,3]		
U.S. CLO 2.0 (2010-2023)				U.S. Corporate (1981-2023) 10-Year	U.S. Corporate (1981-2023) 5-Year
AAA	3,840	0	0.00%	0.81%	0.40%
AA	3,112	0	0.00%	0.98%	0.40%
A	2,582	0	0.00%	1.61%	0.62%
BBB	2,355	0	0.00%	3.87%	1.76%
BB	1,919	9	0.47%	13.08%	7.11%
B	396	11	2.78%	24.30%	17.18%

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[2]Original rating counts as of Dec. 31, 2023. CLO tranche default counts as of April 1, 2024.
[3]Average cumulative default rates for corporates by region (1981 to 2023) (%), 10-Year and 5-Year time horizon, (March 28, 2024). Source: S&P Global Ratings Credit Research & Insights and S&P Global Market Intelligence's CreditPro.

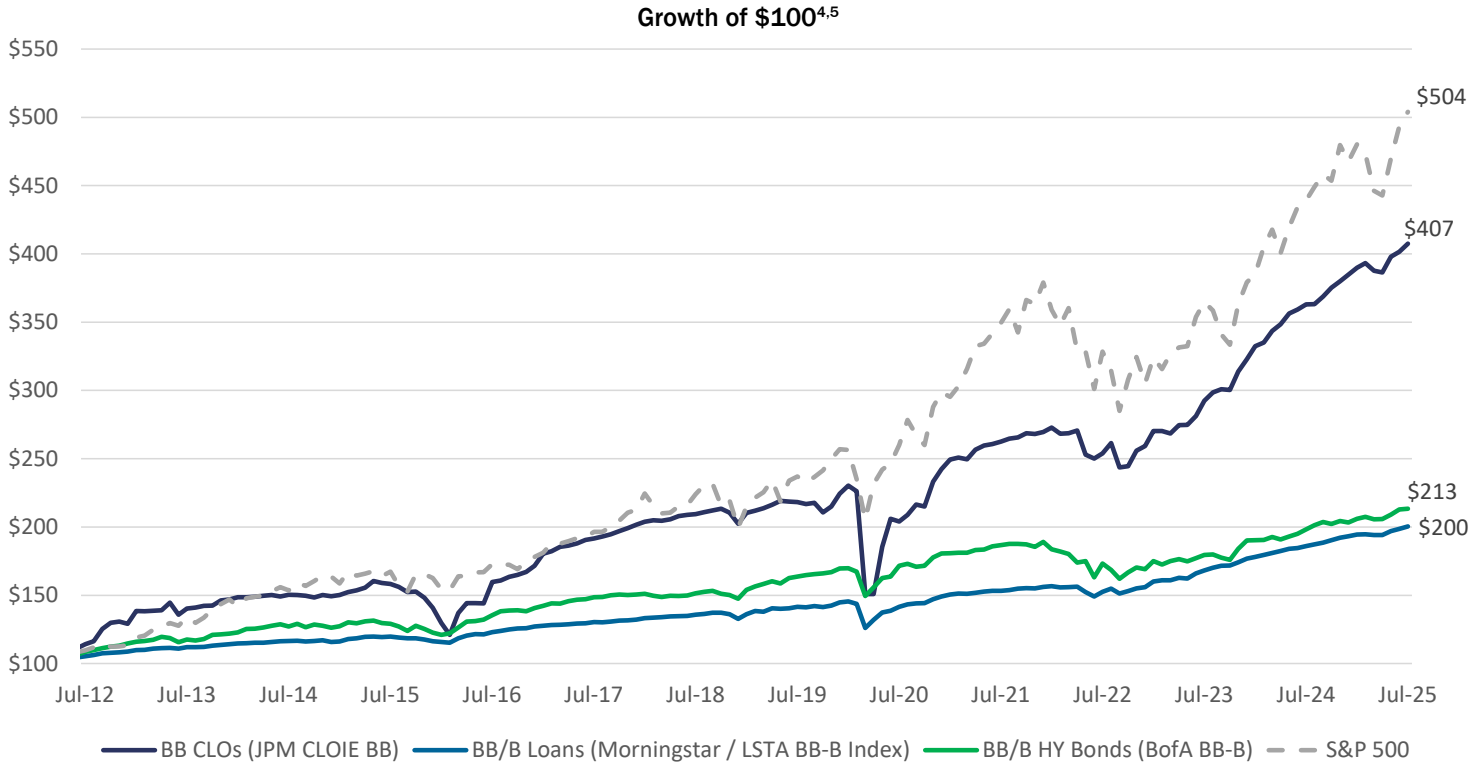
CLO BBs: The "Utility Player" of Debt Instruments:

BB-rated CLO tranches are increasingly being recognized as the "utility players" of debt instruments—a nod to baseball's most adaptable and reliable team members who can seamlessly fill multiple roles as needed. Once the domain of opportunistic hedge funds, these tranches have evolved into valuable components of portfolio construction. Investors are implementing CLO BBs as a strategic tool to enhance fixed income returns, integrating them into broader strategies aimed at yield optimization and diversification. Their versatility, resilience, and ability to enhance risk-adjusted returns make them invaluable vehicles for investors navigating today's complex credit landscape.

Today, a wider spectrum of investors is embracing CLO BBs as a long-term strategic allocation. Pension funds are incorporating them as return enhancers within senior loan portfolios. Family offices are drawn to their high cash flow and equity-competitive total return potential, appreciating the current income they provide. Meanwhile, private wealth managers are turning to CLO BBs as a floating rate alternative to high-yield bonds, attracted by their higher income and built-in structural protections. (See Figure 4 for a historical performance comparison.)

This broadening investor base suggests a future characterized by lower long-term volatility and potentially tighter spreads, ultimately leading to a more favorable risk-return tradeoff. Of course risks remain, particularly in the context of CLO BB ETFs where liquidity mismatches could trigger short-term dislocations. However, such episodes are likely to be brief and may present compelling entry points for informed investors. In the meantime, the asset class continues to deliver excess relative returns and remains, in many respects, underappreciated.

Figure 4 - CLO BBs Have Historically Outperformed Similarly-Rated Bank Loans & HY Bonds



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[4]Represents growth of $100 based on compounded monthly returns of the various indices noted. Assumes full reinvestment of distributions received.
[5]"BB CLOs" is representative of returns of the JPMorgan CLO BB Index; "BB/B Loans" is representative of returns for the Morningstar LSTA BB/B Leveraged Loan Index; "BB/B High Yield Bonds" is representative of returns for the BofA US BB/B High Yield Bond Index; S&P 500 represented by the S&P 500 Index Total Return Index. These returns do not reflect a deduction in fees. It is impossible to invest directly in these indices. Past performance is not a predictor of future market performance. (Data as of July 31, 2025)

Conclusion

As the structured credit landscape continues to evolve, BB-rated CLO tranches have matured into a long-term strategic allocation for a wide range of investors. Once considered niche and opportunistic, they now reflect a more stable, resilient, and well-understood asset class. Regulatory catalysts, improved liquidity and transparency, and a more sophisticated investor base have helped reposition CLO BBs as reliable sources of income and diversification. Their performance during recent market shocks, combined with attractive risk-adjusted returns and structural protections, underscores their transformation.

Risks remain, particularly in the context of ETFs where liquidity mismatches can lead to short-term dislocations. However, these episodes are increasingly viewed as tactical entry points rather than systemic threats. We are now seeing a broader redefinition of risk and opportunity in modern credit markets, and CLO BBs have become central to long-term portfolio strategy.

ENDNOTES

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RISK FACTORS ASSOCIATED WITH CLO DEBT INVESTING MAY INCLUDE (BUT ARE NOT LIMITED TO):

COMPLEXITY: CLOs often involve risks that are different from, or more acute than, risks associated with other types of debt instruments:

- The complex structure of the security may produce unexpected investment results
- 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 uncertainty for minority equity and debt holders

LIQUIDITY RISK

- CLOs may be difficult to value and may constitute illiquid investments

DEFAULT RISK OF UNDERLYING CLO INVESTMENTS

- 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 tranched CLO liabilities

REGULATION

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

SOFR RISK

- CLO debt and bank syndicated loans historically used LIBOR as an interest rate benchmark. On June 30, 2023, following a multi-year transition away from LIBOR, all USD LIBOR tenors ceased to be representative. Accordingly, most CLO debt notes and bank syndicated loans now use CME Term SOFR as a reference rate (with a minority of bank syndicated loans referencing 6-month USD LIBOR or synthetic USD LIBOR). Some CLOs have experienced or may experience a degree of mismatch between their liabilities and assets after June 30, 2023, with certain CLOs' issued securities tied to Term SOFR and certain of their underlying collateral tied to LIBOR (or vice versa). In addition, different assets may have adopted different credit spread adjustments as part of their transition to SOFR, further contributing to a possible mismatch between CLO assets and liabilities. The aforementioned mismatch may be greater at certain points in the future versus others, and the basis risk created by this mismatch could potentially have a negative impact on returns for CLO equity noteholders. Moreover, different assets will reference Term SOFR rates for different periods of time, e.g. 1-month or 3-month. While CLO securities will typically reference 3-month Term SOFR, leveraged loans can reference different rates or time periods; accordingly, it is likely that CLOs will experience a mismatch between the CLO securities (debt and equity issued by the CLO) and underlying leveraged loan collateral. Such a mismatch could result in the CLO not collecting sufficient interest proceeds on underlying collateral to make interest payments on the CLO debt. This could result in deleveraging a CLO or could impact returns for CLO debt and equity holders.

CLO MANAGEMENT

- The activities of any CLO will generally be directed by a collateral manager; consequently, the success of any CLO will depend, in large part, on the expertise of the collateral manager's investment professionals. Underlying assets in a CLO "turn over" over time due to sales and repayments

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

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