Investment Grade CLO Tranches for Insurers: A Relativist's Guide

Most insurers would concede that relative value often guides decision making. Higher interest rates have shifted insurers' focus, and previously niche asset classes have garnered more attention given their compelling advantages in today's environment.

The floating-rate debt tranches of collateralized loan obligations (CLOs), particularly tranches with investment grade (IG) ratings (AAA-BBB), are one such asset class attracting the interest of insurance companies. In an era of elevated interest rates, insurers may be able to capture greater yields in an asset class which has historically exhibited less default risk than corporate bonds.

With a typically significant allocation to fixed income, insurers may want to consider IG CLO tranches given their compelling characteristics*:

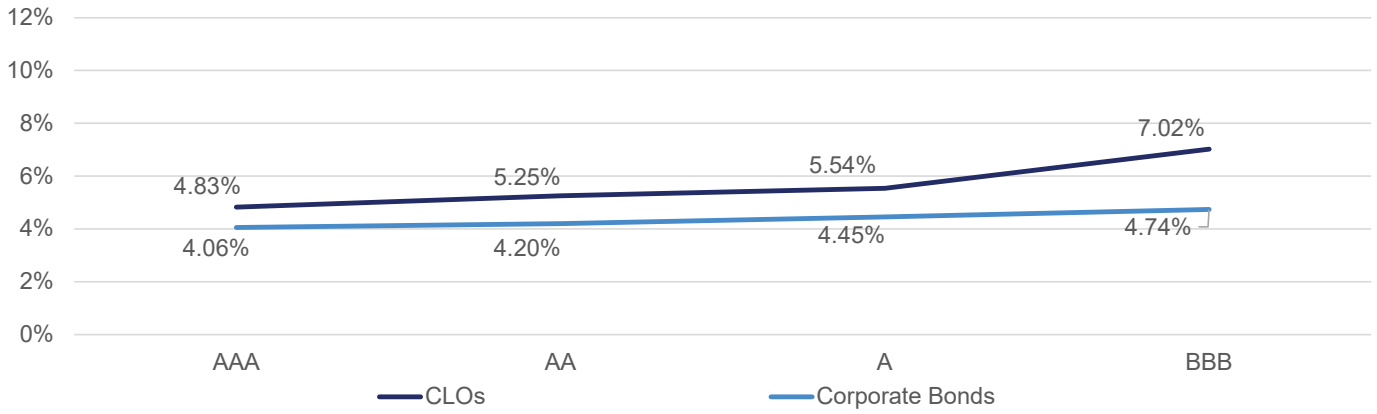
- Higher yields than similarly rated corporate debt
- Improved market liquidity
- Structural protections that support capital preservation.

Yield Advantage

Absolute yields for floating-rate assets increased considerably in tandem with the U.S. Federal Reserve's (the Fed) aggressive rate-hike campaign in 2022-23. Market conditions suggest interest rates may remain elevated through the end of 2025 and possibly beyond.

Coupons for CLO debt tranches (and the broadly syndicated loans that make up the CLO's collateral portfolio) are floating rate and quoted at a spread over a base rate, primarily the Secured Overnight Financing Rate ("SOFR"). The base rate typically resets every three months, which addresses the impact of interest rate volatility for investors.

Figure 1 - Comparative Yield of U.S. CLO Debt and Equivalently Rated U.S. Corporate Bonds



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As SOFR rose to over 5%, coupons on floating-rate assets increased to levels not seen since the Great Financial Crisis (GFC) of 2008-2009. With the Fed likely to support rates staying relatively higher for longer, SOFR-linked CLO debt coupons will likely remain elevated for some time. As such, there is a strong case to be made that yields for IG CLO debt tranches should continue to exceed comparably rated, longer-duration fixed rate assets. As Figure 1 illustrates, IG CLO debt tranches currently offer a significant yield advantage over their corporate bond counterparts (shown as a comparative yield-to-worst).

This pickup in yield reflects two misconceptions of the CLO asset class: perceived illiquidity and structural complexity.

*Please see associated risks at end.

Healthy Liquidity in a Growing Market

As the CLO asset class has grown over the last decade so has its acceptance among a broader base of insurers as well as the investment community overall, leading to greater liquidity. What was once the domain of large insurers and banks has evolved into a diverse group of institutions, asset managers, and even ETFs, making CLOs more accessible to a broad range of investor types.

Enhanced liquidity in the IG CLO tranche market provides investors with opportunities to actively trade and re-position portfolios. Figure 2 depicts the significant growth of the IG CLO tranche market over the last 10 years. Notably, the amount outstanding has more than doubled to over $750 billion while secondary trading volumes have increased at an even more accelerated pace.

Figure 2 also illustrates that, outside of a spike in volume in the early days of the COVID-19 pandemic, IG CLO tranche trading volumes have steadily increased over the last decade from an average of less than 15% of the market trading annually to over 20% three of the last four years.

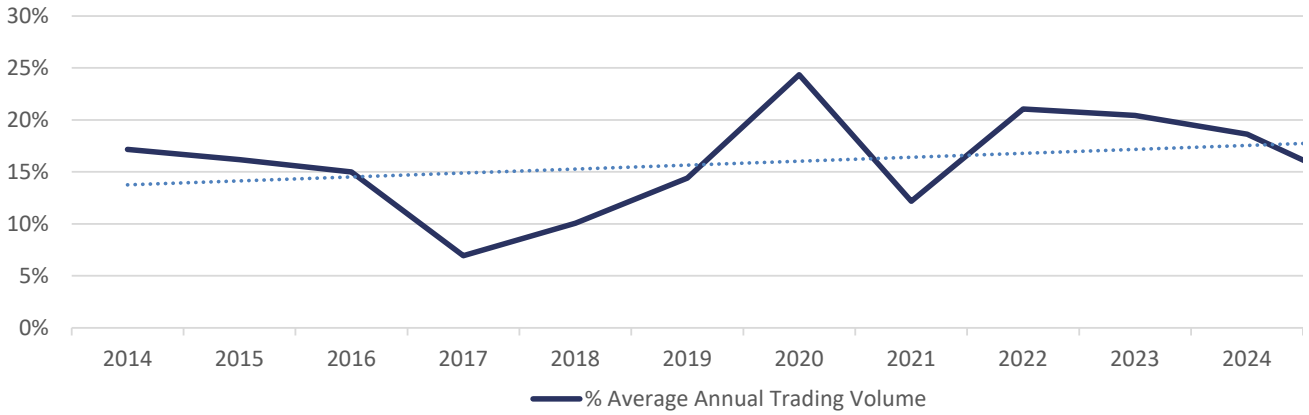
While IG CLO tranches may not have the same liquidity profile as high-grade corporate bonds, the relative increase in liquidity based on CLO market growth and a broadened investor base are important to consider when assessing CLO tranches' liquidity risk.

Figure 2 - A Growing and More Liquid Market

10-Year Growth of US IG CLO Tranche Market and Annual Trading Volume



Average Annual Trading Volume as % of Total IG CLO Tranche Market



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Structural Protections

While higher yields and healthy liquidity underscore the attractiveness of IG CLO tranches in today's market environment, these are further complemented by the compelling, historical risk-adjusted performance of the asset class.

IG CLO tranches have proven resilient to losses from underlying loan defaults through multiple credit cycles. Over the years CLO tranches have experienced significantly fewer defaults relative to corporate bonds and loans, reflecting the integrity of the CLO structure. In fact, per Moody's Analytics, AAA and AA rated CLOs have never experienced a loss of principal—including during the GFC (see Figure 3).

The CLO structure is designed to protect the principal and interest income of debt holders to varying degrees. For holders of the senior-most, investment grade debt tranches (often insurance companies), this provides a reliable income stream and supports consistent returns with lower volatility than corporate bonds. Various collateral quality tests serve to limit risk in the underlying loan portfolio; in the event of credit stress in the collateral pool, distributions to CLO equity investors (the most subordinated portion of the CLO capital structure) are redirected for the benefit of the CLO debt investors. The self-correcting nature of the structure supports the ability of the asset class to weather periods of credit stress and helps protect CLO debt investors from investment losses.

Figure 3 - Historical CLO Tranche Defaults 1993-2023 (Market-Wide)

		Default Rate
AAA RATED CLO DEBT	Never an Impairment	0.0%
AA RATED CLO DEBT	Never an Impairment	0.0%
A RATED CLO DEBT	1 / 2,384 Tranches Impaired	0.0%
BBB RATED CLO DEBT	23 / 2,266 Tranches Impaired	1.0%

Includes all US cash flow CLO tranches ever rated by Moody's as of year-end 2023. Impairment is defined as when investors receive — or expect to receive with near certainty — less value than would be expected if the obligor were not experiencing financial distress or otherwise prevented from making payments by a third party, even if the indenture or contractual agreement does not provide the investor with a natural remedy for such events, such as the right to press for bankruptcy. Source: ©2025 Moody's Investors Services, Inc., Moody's Analytics, Inc. and/or their licensors and affiliates – used with limited permission. (June 24, 2024). Past impairment rates are not indicative/a guarantee of future impairment rates.

Conclusion

For insurance companies, an allocation to investment grade CLO tranches is an investment in an established and growing asset class that provides incremental yield relative to other investment grade fixed income alternatives. Additionally, it complements an insurer's fixed income allocation, particularly in an environment of elevated yields. CLO market liquidity has increased steadily over the years, while the integrity of the CLO structure helps protect CLO debt investors during periods of market volatility. As a result, insurers and other investors have experienced compelling, long-term risk-adjusted returns over multiple credit cycles (see Figure 4).

Insurance companies considering IG CLO tranches should be diligent and consider managers with significant experience in CLO tranche investing. Allocators should seek CLO tranche investors with deep credit expertise, trading acumen, strong sell-side relationships, and the ability to discern relative value between collateral managers, tranches, and deal vintage in order to generate strong returns.

Conning and affiliate Octagon Credit Investors have a decade of experience working together to help insurers access and manage investments in CLOs. We share the view that a keen understanding of the loan market and the mechanics of the CLO structure are critical when gauging how a CLO will perform when stressed. Octagon's expertise and experience in the loan market are key benefits, especially when investing in securities rated A and lower.

Octagon's Investment Grade CLO Strategy can be accessed via a separate account or commingled strategy.

Figure 4 - Performance of IG CLO Tranches vs U.S. Corporates, 2012-2025 Q2

JPM CLOIE RATING	Ann. Return	Ann. Volatility	Sharpe Ratio
AAA	3.14%	2.02%	0.82
AA	4.12%	3.65%	0.72
A	5.48%	5.26%	0.76
BBB	7.46%	8.77%	0.68
US IG CORPORATES	3.36%	6.14%	0.30
US HY CORPORATES	5.96%	6.95%	0.64

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About Conning

Conning (www.conning.com) is a leading investment management firm with a long history of serving insurance companies and other institutional investors. Conning supports clients with investment solutions, risk modeling software, and industry research. Founded in 1912, Conning has investment centers in Asia, Europe and North America. Conning is part of the Generali Group.

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The J.P. Morgan Collateralized Loan Obligation Index ("CLOIE") is a benchmark to track the market for U.S. dollar-denominated broadly syndicated arbitrage CLOs. The CLOIE is divided by origination (pre- versus post-crisis) and is broken out further into six original rating classes (AAA, AA, A, BBB, BB, B). The index's returns were revised by J.P. Morgan on September 28, 2018, reflecting an update in the accounting of coupon reinvestment. The index is not assessed a management fee. It is impossible to invest directly in the index.

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