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Structured credit in a diversified portfolio.

How an allocation to structured credit can benefit investment portfolios.

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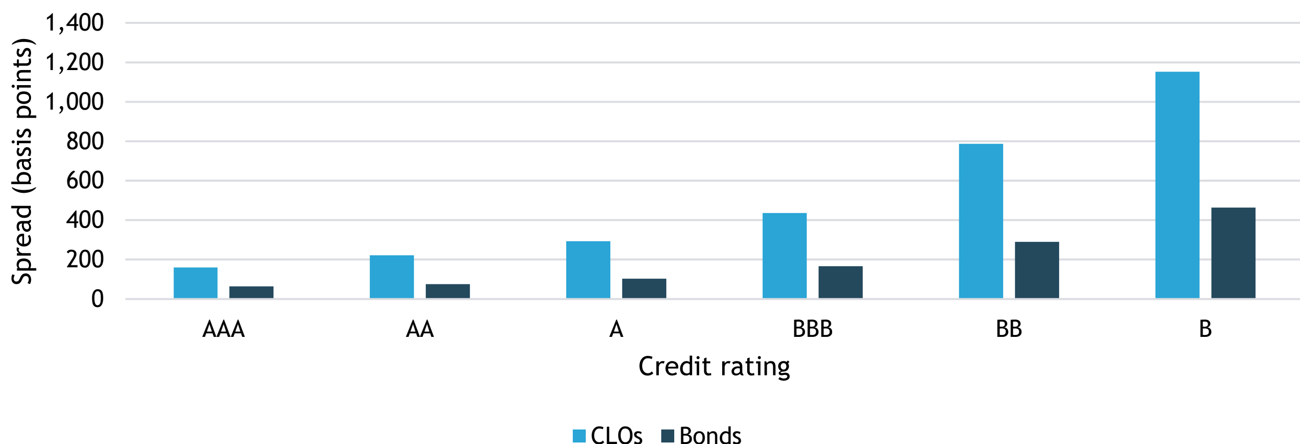
SEI has long believed that a strategic allocation to structured credit in general, and collateralized loan obligations (CLOs) in specific, has the potential to improve investment outcomes. With characteristics that can enhance both diversification and returns, we believe that CLOs are a valuable complement to traditional stock and bond allocations. Given their potential for alpha generation, diversification benefits, and minimal interest-rate sensitivity, CLOs can play an important role in an investment portfolio.

Alpha generation

CLO debt tranches generally offer higher expected returns relative to comparably rated corporate credit. Whether it is due to their perceived complexity (leading to a “complexity premium”), lack of investor familiarity, or benchmarking and tracking-error constraints, CLO debt tranches generally offer considerably higher spreads than corporate bonds with comparable ratings. CLO equity tranches potentially carry higher expected returns than typical publicly traded stocks as well. Exhibit 1 compares the average spreads of CLOs against comparably rated bonds, demonstrating this spread advantage up and down the credit spectrum.

Exhibit 1: Average spreads by rating (CLO tranches versus bonds)



Source: SEI, BofA, ICE, Datastream. Spreads are weekly averages calculated each Thursday between January 2015 and April 2024. CLO spreads provided by BofA; bond spreads provided by ICE indices for each rating. Spreads are presented by rating strictly for ease of illustration, and CLOs and bonds with similar ratings will not necessarily experience similar levels of risk. Past performance is no guarantee of future results.

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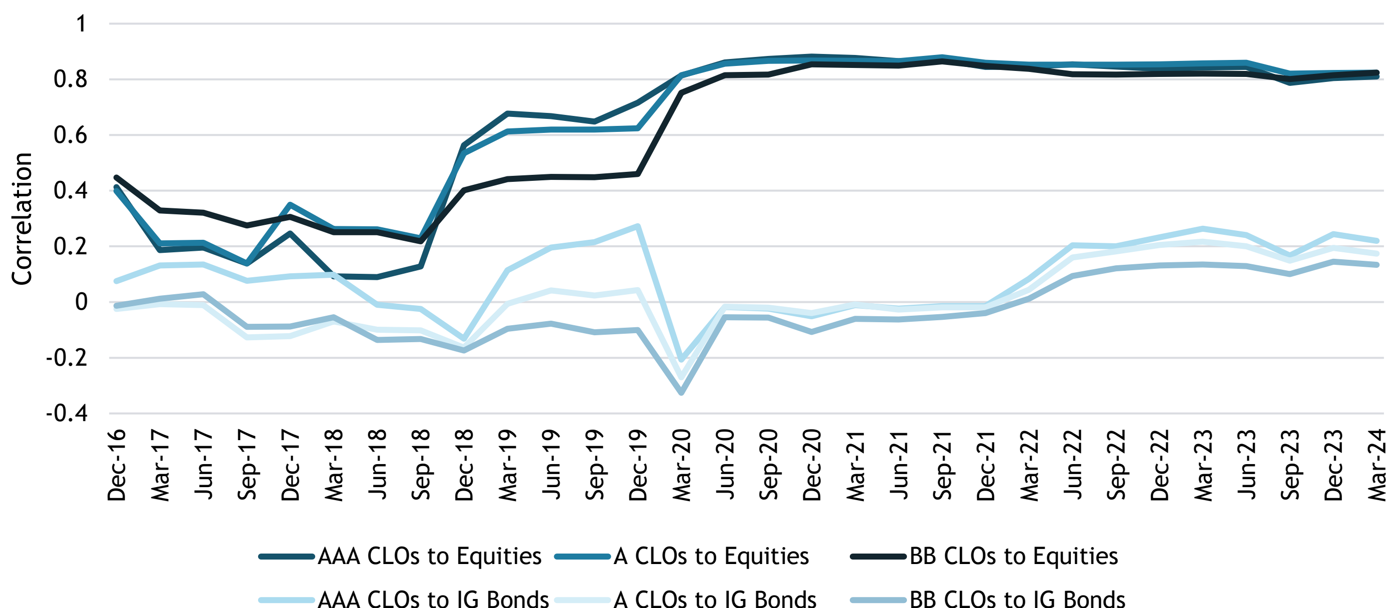
This presents both a compelling beta story for CLOs (through strong risk-adjusted returns for the asset class as a whole), as well as a valuable alpha opportunity. Due to the asset class' relative inefficiency, skilled CLO managers can capitalize by leveraging their networks to find new deal opportunities, and investing in the tranches and deals where they see the most value. An allocation to CLOs allows for both active security selection within a particular ratings tranche, as well as dynamic allocation across the various tranches to identify the most attractive opportunities. These dynamics highlight how CLOs can potentially offer higher expected returns than their counterparts in traditional assets classes—but they also offer diversification benefits.

Diversification

The general economic, credit, and liquidity environments primarily drive CLOs returns, in contrast to other fixed-income asset classes, where performance is driven more by the level and direction of interest rates. As a result, most CLO tranches have exhibited higher correlations to equities than to longer-duration investment-grade bonds. This has held true even for the highest-quality tranches; while they have exhibited far less volatility than their lower-rated counterparts, their risk is still driven largely by the same set of underlying credit factors, leading to a lower correlation to investment-grade bonds than to equity.

In terms of how CLOs perform in relation to equities, while their correlation has been positive, it is important to consider that it has not been perfectly positive (as represented by a correlation coefficient of +1). As long as the asset classes do not exhibit perfect positive correlation, an allocation to each should inherently yield diversification benefits (since the total portfolio's expected risk will be lower than that of the weighted average of its components). This underscores how CLOs can offer valuable diversification benefits in the context of a total portfolio that includes both stocks and investment-grade bonds. Exhibit 2 shows the historical correlations of CLO tranches against both equities and bonds.

Exhibit 2: Rolling five-year correlations of CLO tranches to equities and bonds



Source: SEI, J.P. Morgan, Datastream. Quarterly data in USD from January 2012 through March 2024. "AAA CLOs" represented by the JP Morgan CLOIE AAA Index; "BBB CLOs" represented by the JP Morgan CLOIE BBB Index; "B CLOs" represented by the JP Morgan CLOIE B Index; "Equities" represented by the S&P 500 Index; "IG Bonds" represented by the Bloomberg U.S. Aggregate Bond Index.

Minimal interest-rate sensitivity

Because a CLO's underlying loans (and debt tranches) are typically floating rate, they tend to exhibit very little interest-rate sensitivity. This means that when interest rates rise, CLOs' underlying loan payments (and the CLO tranches through which they pass) tend to rise as well. This can be an attractive feature for a portfolio with higher-than-desired levels of duration in a rising interest-rate environment. Investors with traditional stock-bond allocations suffered a rude awakening in 2022 when both asset classes delivered weak returns amid rising interest rates. In contrast, since CLO payments are based on a spread above a floating rate (the Secured Overnight Funding Rate (SOFR)), they actually benefited from the increase in rates. Not only were CLO asset prices less impacted by the move higher (since bond prices fall when rates rise), their coupons also increased over the period. Structured credit's performance in 2022 reflects how the asset class has performed in rising-rate environments; structured credit should outperform traditional fixed-income allocations when rates rise faster than expected. While structured credit has its share of risks (liquidity risk, credit risk, etc.), interest-rate risk is hardly one of them.

Risks

While interest-rate risk is not a major concern for structured credit, the asset class still has its fair share of risks. One of these is credit risk, the risk that a security might default and not deliver its expected return, or even its initial investment back to investors. Another is liquidity risk, which is the risk that one will not be able to dispose of an asset quickly without impacting its price. Both risks affect each tranche differently, with the equity tranches most affected, and the higher-rated tranches enjoying greater credit protection and more liquidity.

Conclusion

Given its various benefits, we believe that structured credit has an important place in an investor's portfolio. It has the potential to provide higher expected returns, diversification benefits, and a degree of mitigation from interest-rate risk when introduced to a traditional allocation of stocks and bonds. Importantly, given their diversification potential and higher expected returns relative to comparably rated corporate credit, we believe that CLOs can be employed in a manner that either increases expected return without increasing risk, or reduces expected risk without sacrificing potential return. CLOs' minimal interest-rate sensitivity, less-than-perfect correlation to traditional asset classes, and potential for alpha generation provide considerable potential value in the context of a total portfolio. Taken together, we believe a portfolio can enhance expected risk-adjusted returns by with an allocation to CLOs as a complement to more traditional asset classes.

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Glossary

Alpha is a measure of performance on a risk-adjusted basis, calculated by a comparison of the volatility of the portfolio versus its benchmark on a risk-adjusted basis. A positive alpha of 1.0 means the fund outperformed its benchmark index by 1%, while a negative alpha indicates underperformance.

Beta is a quantitative measure of the volatility relative to a benchmark. A beta above 1 indicates volatility greater than the benchmark, while a beta below 1 indicates lower volatility than the benchmark.

Collateralized loan obligations (CLOs) are securities that have been created by pooling smaller high-yielding fixed income assets such as bank loans. These pools are then packaged into various tranches (a slice or portion of a structured security) according to credit quality, maturity, etc.

CLO debt tranches represent the relatively less risky CLOs pools, with credit-quality ratings akin to fixed income.

CLO equity tranches represent the riskiest CLOs pools, with the highest potential for return.

Credit risk refers to the risk of default on a debt investment, whereby a lender would not receive either their principal, interest, or both.

Interest-rate risk is the risk that a change in interest rates could affect an asset's value.

Liquidity risk is the risk that an asset will be unable to be converted into cash, especially in a short timeframe, without an impact on its price.

Spread is the additional yield, usually expressed in basis points (one basis point equals 0.01%), that an index or security offers relative to a comparable-duration index or security (the latter is often a risk-free credit, such as sovereign government debt). Spread sectors generally includes non-government sectors where investors demand higher yields above those of government bonds for assumed increased risk.

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There are risks involved with investing, including loss of principal. Diversification does not protect against market risk. Collateralized loan obligations (CLOs) and other structured finance securities may present risks similar to those of the other types of debt obligations and, in fact, such risks may be of greater significance in the case of CLO and other structured finance securities. In addition to the general risks associated with investing in debt securities, CLO securities carry additional risks, including: (1) the possibility that distributions from collateral assets will not be adequate to make interest or other payments; (2) the quality of the collateral may decline in value or default; (3) CLO equity and junior debt tranches will likely be subordinate in right of payment to other senior classes of CLO debt; and (4) the complex structure of a particular security may not be fully understood at the time of investment and may produce disputes with the issuer or unexpected investment results.

CLOs are subject to liquidity risk. CLOs may invest in securities that are subject to legal or other restrictions on transfer or for which no liquid market exists. The market for certain investments may become illiquid due to specific adverse changes in the conditions of a particular issuer or under adverse market or economic conditions independent of the issuer. The market prices, if any, for such securities tend to be volatile and the Fund and CLO managers may not be able to sell them when it desires to do so or to realize what it perceives to be their fair value in the event of a sale. CLO portfolios tend to have a certain amount of overlap across underlying obligors.

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