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CLO equity: Where does it fit in investor allocations?

Himani Trivedi
Managing Director, Head of Structured Credit

Loren Sageser
Managing Director, Private Credit Product Specialist

HIGHLIGHTS

- Classifying CLO equity – fixed income, equity or something else entirely
- Allocating CLO equity to investment portfolios by investor type, objectives and risk tolerance

CLO equity has garnered increasing levels of investor interest, primarily due to the potential for high returns driven by a robust yield profile – a relative rarity in today's low-yield investment landscape. Many investors view CLO equity as one of the few remaining pockets of inefficiency in the financial markets, since many otherwise-sophisticated investors shun the asset class due to perceived complexity, opacity, and (erroneous) connections with the toxic CDOs that became synonymous with the 2008 global financial crisis.

For investors able to move past these biases and consider CLO equity as a viable investment alternative, the next question is often: how should CLO equity be classified? Is it a fixed income instrument? An equity investment, as the name suggests? Or something else entirely? Choosing the right "bucket" for CLO equity is critical for investors seeking to optimize portfolio allocations.

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CLO EQUITY SITS AT THE INTERSECTION OF AT LEAST THREE KEY ASSET GROUPINGS

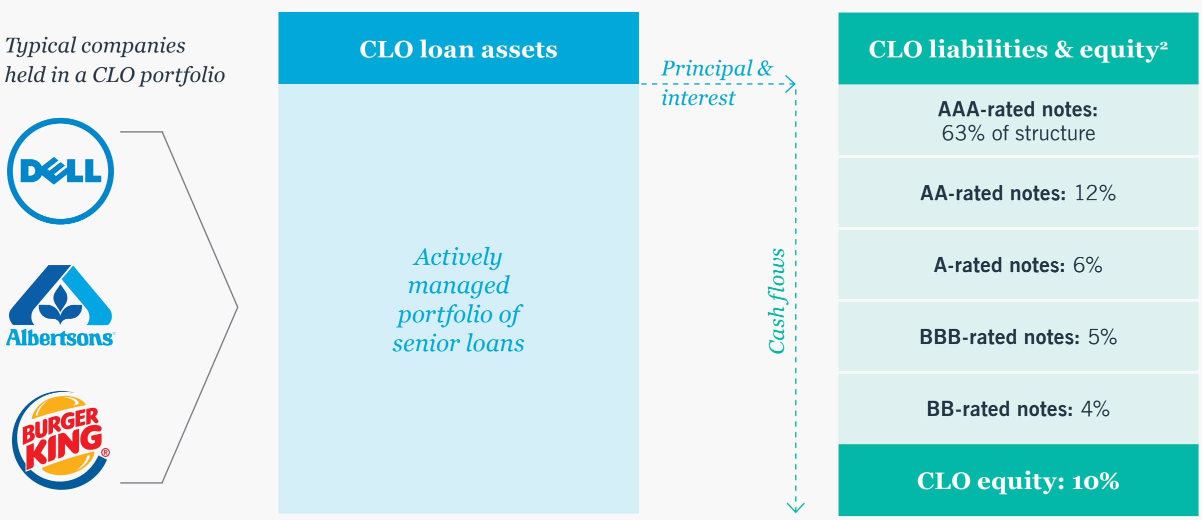
1. **Fixed income:** Since CLOs effectively bundle together corporate loans into diversified portfolios, they are closely linked with the ups and downs of the leveraged finance market, which is a subset of the broader fixed income space. CLO equity also pays regular quarterly distributions to investors, generating a yield-based return profile similar to other fixed income instruments.

2. **Equity:** Although they are ultimately composed of debt instruments, CLOs are also securitization vehicles with their own capital structures consisting of rated debt tranches all the way down to unrated equity. Risk levels increase with every step down in the capital structure, and when investor risk appetite decreases, CLO equity valuations often move in tandem with broader equity markets. However, the underlying risk in a CLO consists of senior secured loans to corporations, effectively limiting downside risk relative to "pure" equity markets exposure. The quarterly distributions paid by CLO equity tranches also serve to stabilize the return profile relative to equities.

3. **Alternatives:** Alternatives are a "broad brush" category which can refer to everything from private equity funds to distressed debt to opportunistic credit. CLO equity often falls into this classification due to illiquidity, complexity or other shared features with the universe of alternative investment options.

What is a CLO?

Collateralized loan obligations (CLO) are highly diversified, actively managed portfolios of first lien, senior secured loans with non-recourse, non-mark to market (MTM) leverage.[1]



Source: Nuveen

- A CLO **borrows** money (liabilities), it **invests** in collateral (bank loan assets) and has **residual value** (equity).

- CLO equity investors **profit from any gains** on the CLO's loan positions as well as from the cash flow arbitrage, generated by the difference between the yield on the collateral (loans) and cost of financing for the liabilities.

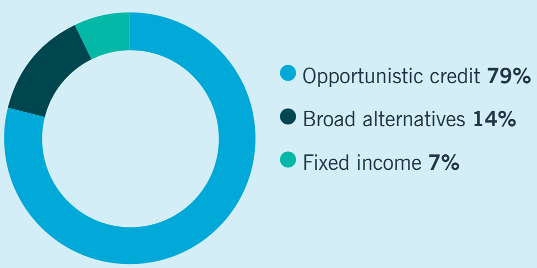
1 Some broadly syndicated loan CLOs may include up to 10% second lien senior secured loans. CLOs have credit event triggers that may have MTM impacts.
2 Illustrative CLO structure.

WHICH CLASSIFICATION IS APPROPRIATE?

As a manager of CLOs since the early days of the market, Nuveen has gathered input from a wide universe of CLO equity investors, and the answer is: it depends. The answer varies based on investor type, portfolio objectives and risk tolerance.

Where does CLO equity fit in a portfolio?

In June 2021, Nuveen hosted a discussion with members of the institutional investor and consultant communities exploring the role of CLO equity in broader investment portfolios, among other topics. During this discussion, we held an informal survey asking participants where they would consider allocating CLO equity within their portfolios. Below is a breakdown of the responses on this topic.



Survey was conducted informally and offered to internal Nuveen personnel as well as non-Nuveen attendees on a fully anonymous basis on 29 Jun 2021. Due to the survey's informal nature and small sample size, no specific conclusions can be drawn from the results and no representation is made as to the applicability of these results.

Option one: The alternatives bucket

One of the most popular destinations for CLO equity is in the alternatives bucket alongside private equity vehicles, such as LBO funds, private capital vehicles or venture capital funds. This tends to be the favored approach with many family office investors as well as public pensions, for a number of reasons.

Firstly, these investors tend to view CLO equity as a longer-term investment similar to traditional private equity funds which have 5+ year return horizons. CLO equity also tends to be considered an illiquid investment similar to a closed-end private fund. In addition, CLO equity typically targets a mid-teens return profile similar to alternative asset classes such as private equity – checking another box in this classification matrix. However, the return profile of CLO equity differs from that of traditional private equity investments due to its lack of J-curve. CLO equity returns are driven by quarterly cashflows beginning shortly after inception, unlike private equity funds, which can take multiple years to begin returning capital to investors. From this perspective, CLO equity can provide an attractive pairing for these longer-dated investments, front-loading cashflows and serving to smooth out the overall return profile of the broader alternatives bucket. This is of particular importance to pension-based investors who seek a consistent stream of cashflow-based returns in order to meet the needs of their plan constituents.

Some investors allocating CLO equity to the PE bucket point to an additional rationale, since many of the debt instruments held by a CLO are effectively loans to PE-backed companies. From this perspective, it can be argued that the equity tranche of a CLO effectively recreates the equity exposure held by private equity funds, since they are both effectively leveraged investments in corporations. However, unlike the concentrated portfolios of PE fund vehicles, CLOs are built around diversified portfolios of anywhere from 150 to 200+ underlying positions. Many investors view this as an important source of diversification in alternatives buckets, particularly in investment programs seeking to limit manager count or to reduce manager concentration risk. As an added benefit, the underlying portfolios of CLOs consist of relatively liquid bank loans which can be actively managed, unlike traditional PE funds. Managers have the flexibility to reposition exposures based on changing markets and risk appetites.

Option two: The fixed income bucket

For other investors, CLO equity sits within the fixed income bucket, sometimes alongside bank loans and high yield bonds or within a securitized sub-allocation. This is often the preferred approach of insurance-based investors, particularly those entities that purchase CLO equity directly rather than taking exposure via commingled private fund vehicles. Insurance entities, particularly reinsurance investors, may also gain exposure to CLO equity via non-payment insurance arrangements, effectively insuring the risk of loss for a funding counterparty in exchange for the return upside.

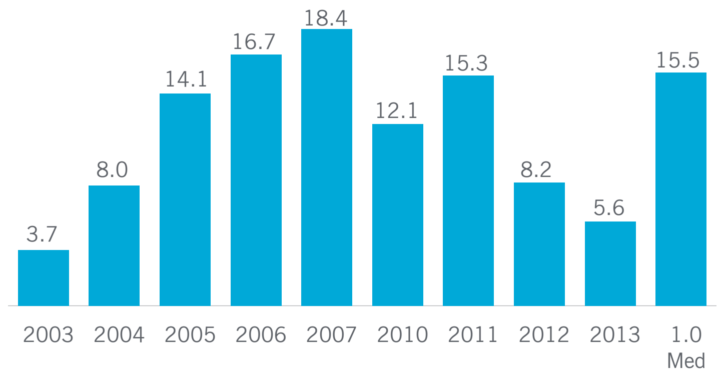
Investors who classify CLO equity within a fixed income allocation are often motivated by longer-term objectives which are aligned with the broader fixed income universe, particularly the theme of consistent income. And since CLO equity is essentially a floating rate instrument (given the floating rate nature of underlying CLO portfolios), it can also serve to reduce overall duration risk in a fixed income portfolio – an added benefit for investors concerned about the longer-term risk of rising rates.

Option three: Idiosyncratic or opportunistic credit

Many sophisticated institutional investors, such as larger-scale ($10B+) pension investors, consider CLO equity as an "idiosyncratic" credit allocation, similar to specialty finance, distressed investments, or esoteric ABS. This is motivated by a number of factors.

Similar to other non-traditional credit betas, CLO equity combines foundational credit characteristics with other idiosyncratic factors not typically found in "mainstream" asset classes. In particular, CLO equity effectively contains an embedded call option on credit spreads, driven by the term financing structure of CLO vehicles. Although it may sound counter-intuitive, a CLO equity investor can potentially benefit from periods of widening credit spreads — provided they are invested with a CLO manager skilled enough to minimize losses due to defaults. This is because CLOs are actively managed vehicles which can reinvest into new, higher-yielding bank loans when spreads widen.

Median equity IRRs of fully realized U.S. CLOs (%)



Sources: Intex, Wells Fargo Securities and BofA Global Research. **Past performance does not guarantee future results.**

CLO equity investors can benefit from an improved arbitrage given that the liabilities issued by a CLO (the CLO debt), is issued at coupons which stay fixed for the ~12-year life of the CLO. The most powerful proof statement of this phenomenon is the returns of CLOs issued immediately prior to the GFC, which far outstripped all other vintages of CLOs.

CONCLUSION

Our intentions for the future shape our decisions in the present; an investor's allocation decision with respect to CLO equity is ultimately underpinned by broader investment objectives. Since CLO equity can bring multiple benefits to a diversified portfolio, investors are often driven by a variety of objectives which in turn lead to multiple allocation options. For this reason, we find that there are many potential homes for CLO equity within investor portfolios, underscoring the multi-faceted nature of this enigmatic asset class.

For more information, please visit us at nuveen.com.

Endnotes

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