STRUCTURED CREDIT

What is a CLO?

INSIGHTS

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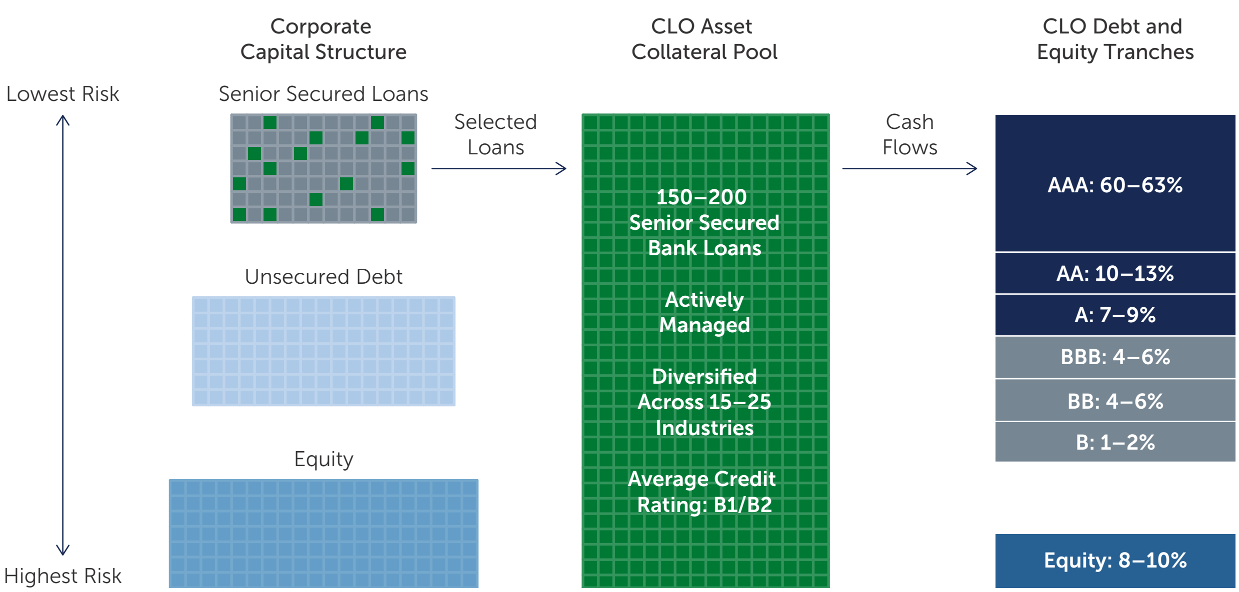
A collateralized loan obligation (CLO) is an actively managed securitized product backed by a highly diversified pool of leveraged loans. CLOs provide an efficient, scalable way of investing in floating-rate loans while offering structural protection that has historically performed well through multiple credit cycles.

To simplify, think of a CLO as a company that raises money from debt and equity investors to purchase a pool of 150–200 diversified senior secured first-lien corporate loans, "**the assets.**" These assets are also called leveraged loans and come from large well-known borrowers, such as United Airlines, Virgin Media and Burger King, that have below investment grade ratings and high levels of debt. The loans are floating rate and pay interest on a monthly or quarterly basis with a spread above an index (typically SOFR or LIBOR). Additionally, the senior secured nature of these loans has resulted in historically higher recovery rates compared to senior unsecured bonds.

Juxtaposed with the assets are the debt obligations, or "**the liabilities**," which are sliced into "tranches" that re-distribute the risk of direct exposure to the portfolio of loans by offering tiered credit enhancement and structural protections. A typical CLO structure combines five or more classes, from the senior most tranche rated AAA down to the most junior and highest-yielding debt tranche rated BB-. The tranches are floating rate like the assets and are due a coupon on a quarterly basis.

After paying off expenses and liabilities, a residual unrated "**CLO Equity**" tranche captures the excess spread (returns) that the assets generate. As the equity tranche is leveraged exposure to the underlying leveraged loans, it is the riskiest piece of the CLO structure; however, it can also be the most lucrative.

Figure 1: Typical CLO Structure



Source: Barings.

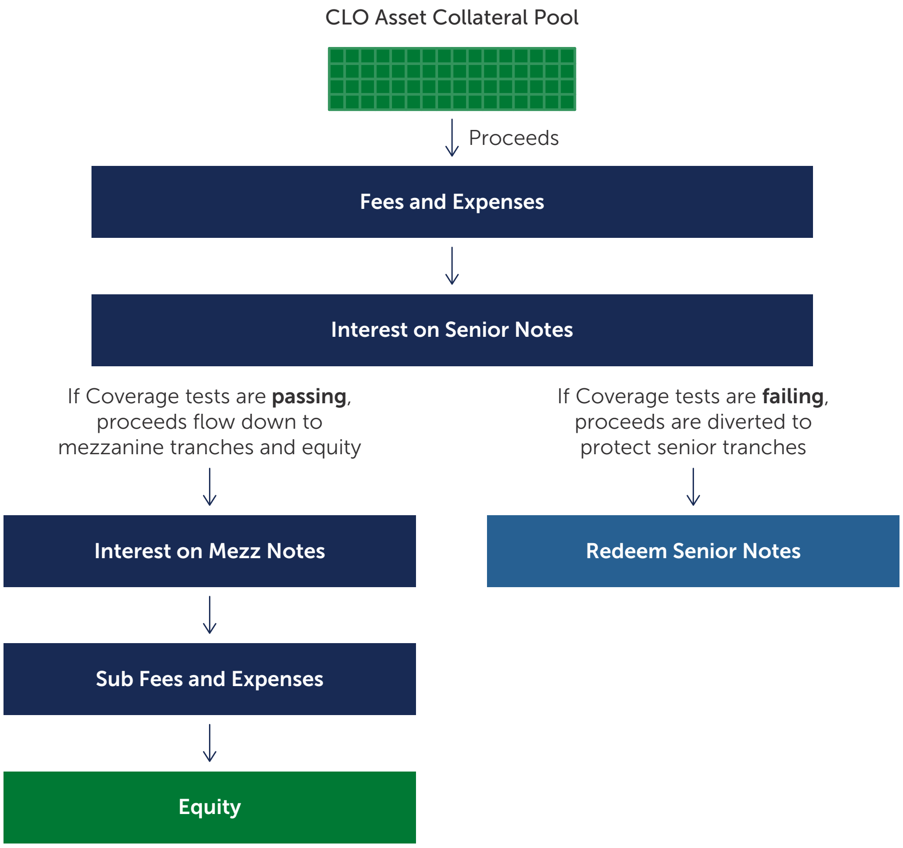
How CLOs Work

WATERFALL

Cash flows from the collateral pool are dispensed via a waterfall that pays the debt, in order, based on seniority, with the highest-rated tranches paid first, followed by the mezzanine tranches and, finally, the equity tranche. If the assets in the underlying collateral pool generate sufficient proceeds, the top tranche (the AAA senior-most tranche) is paid first, followed by the AA tranche and so forth. The equity tranche at the bottom catches all the remaining overflow.

However, should some assets perform poorly or default, CLOs employ early warning triggers to divert proceeds to protect the more senior tranches. One of these is called the overcollateralization test (OC Test). The OC Test ensures there is a sufficient ratio of assets to liabilities. If the OC Test ratio is breached, the payments that would have flowed through to equity are diverted to pay down senior classes or purchase additional assets until that ratio is back in compliance.

Figure 2: CLO Waterfall



Source: Barings.

Subordination

While payments are distributed in order of seniority, losses are applied in the reverse order. CLO equity is also called the first loss piece and typically absorbs the first 8–10% of losses, after which the losses start to impact the junior debt. The senior AAA tranche has the largest subordination levels, typically in the range of 35–40%, up from 25–28% during the Global Financial Crisis (the CLO 1.0 era).[1]

Active Management

The majority of CLOs are actively managed over the life of the deal. Collateral managers construct the portfolio during the ramp-up period and trade in and out of positions during the reinvestment period, with the intent to minimize credit losses and maintain or build par while navigating the investment constraints of a CLO.

CLO Lifecycle

A typical CLO has a 10–12 year life with multiple segments:

- **Warehouse (6–12 months):** The CLO manager receives financing from a warehouse provider to purchase the initial loans that make up the collateral pool before the closing date.
- **Ramp-up (1–6 months):** After the CLO's closing date, the CLO manager continues to purchase loans with the proceeds received from issuing debt tranches.
- **Reinvestment (1–5 years):** After the ramp-up period, the manager may trade in and out of loan collateral positions during the pre-defined trading period.
- **Non-call (1–2 years):** During the non-call period, the liability spreads will be locked into the rate issued at closing. After this period elapses, the majority equity investor has the right to call the deal and refinance the debt tranches at a lower spread should market conditions become attractive to do so.
- **Amortization (1–4 years):** After the end of the reinvestment period, the transaction will begin to pay down the tranches in order of seniority via the waterfall priority of payments set out in the CLO's governing indenture.

Who Buys CLO Tranches?

- **Senior Tranches (AAA–AA):** U.S. banks, Japanese banks, insurance companies, pension funds, endowments
- **Mezzanine Tranches (A–BB):** Insurance companies, asset managers, pension funds, endowments
- **Equity:** Asset Managers, hedge funds, private equity funds, family offices, pension funds, endowments

Since product inception in the mid-1990s, the CLO market has grown to over $1.3 trillion in size[2]. CLO tranches are actively traded in secondary markets, providing more transparent market values than other illiquid asset classes.

1. Source: Barings. As of December 31, 2022.
2. Source: BofA. As of March 14, 2025.

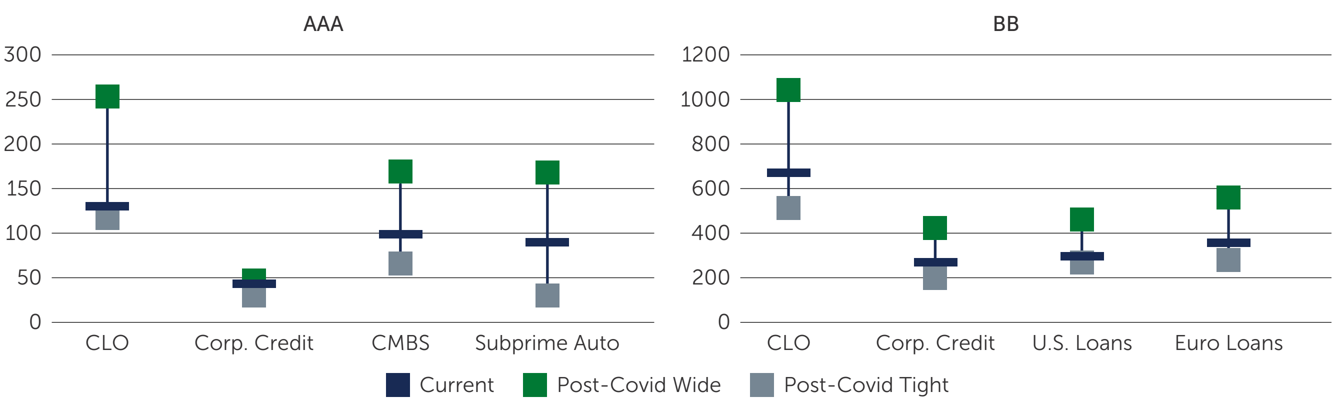
Why are CLOs Attractive?

CLOs combine compelling yields with structural enhancements.

CLOs tend to have higher spread pick-up than other similarly rated asset classes **(Figure 3)** while employing structural protections that provide investors with additional credit support in periods of distress. Further, the floating-rate aspect of CLO coupons creates a natural hedge and more stable prices in periods of rising interest rates compared to fixed-rate securities.

CLOs are often compared, unfairly, to collateralized debt obligations (CDOs), which played a significant role in the Global Financial Crisis. However, unlike residential mortgage-backed securities CDOs (RMBS CDOs), which were made up of subprime mortgages that often had little or no documentation, CLOs are backed by diverse pools of senior secured corporate loans from large companies with robust annual reporting and historically strong recovery rates.

Figure 3: CLOs Offer Attractive Spread Pick Up vs. Other Asset Classes



Post-Covid period beginning September 30, 2020.
CLO spread source: Bank of America Global CLO Research, as of April 30, 2025. CLO spreads represent the entire U.S. CLO market.
Subprime Auto Spread to Swap Source: Bank of America/Merrill Lynch. As of April 30, 2025.
CMBS and Corporate Credit Spread to Swap Source: Barclays. As of April 30, 2025.
U.S. and Europeans Loan Spread Source: S&P UBS. As of April 30, 2025.

Figure 4: CLOS VS. RMBS CDOS

	RMBS CDO	CLO
Collateral	RMBS (subprime, option ARM, Alt-A, jumbo mortgages)	Primarily corporate loans with some bonds
Asset Diversification	Geographic—housing ended up being highly correlated across the country	By industry and issuer—generally 10% per industry and 1–2% per obligor

Source: BofA.

In fact, since their inception, no AAA CLO tranche has ever defaulted, and other CLO debt tranches also boast significantly lower default rates than similarly rated corporate loans **(Figure 5)**. That historical performance illustrates the resiliency of the structural features embedded within CLOs and the benefits of dynamically managed collateral portfolios.

Figure 5: Historical CLO Default Rates

S&P US CLO Tranche Default History (1996–Q1 2024)				
Rating	Total Tranches	Defaulted Tranches	S&P 30-year U.S. CLO Cumulative Default Rate	S&P Avg U.S. Corp 5-year Cumulative Default Rate*
AAA	4,869	0	0.0%	0.4%
AA	3,281	1	0.03%	0.4%
A	3,010	5	0.2%	0.7%
BBB	2,787	9	0.3%	1.8%
BB	2,217	24	1.1%	7.4%
B	401	6	1.5%	18.1%

Source: S&P. As of April 2, 2024
*S&P U.S. Corp. Cumulative Default Rate is per S&P 1981–2023.

Accessing the Opportunity

Broadly speaking, there are two ways an investor can access CLOs:

1. DIRECTLY INVESTING IN CLO TRANCHES

This requires individual manager and CLO deal diligence. Investors must be well-connected to the platform and the deal placement agent in order to get access to a specific transaction and be in a position to negotiate deal specifics.

2. PARTNERING WITH A THIRD-PARTY CLO INVESTMENT MANAGER

This method outsources the deal and manager diligence to a broader structured credit team that can access multiple CLO managers' tranches in both the primary and secondary market. Strong CLO investment managers typically offer greater access to deal flow and market intelligence that may not be available through direct investment.

Why Barings?

Given the complex nature of the asset class, CLO investment requires specialist expertise. Whether investing directly or through a third-party manager, there are key characteristics to look for in a manager:

LARGE AND EXPERIENCED TEAM

Investors looking to maximize their CLO investment potential could benefit from partnering with a firm which has a well-resourced team of CLO portfolio managers, credit researchers, and traders. Teams with long, consistent track records across multiple market cycles are well-positioned to navigate different market conditions. In particular, CLOs are a complex and specialized asset class. Given they are different to other types of securitized credit in their structure, management style, and underlying collateral, a dedicated team is key to capitalizing on opportunities in this asset class.

ACCESS TO NEW OPPORTUNITIES

Managers with longstanding and active participation in the CLO ecosystem can often negotiate favorable terms for their clients, including allocations to coveted new issue CLO tranches, early "first looks" at primary and secondary market investment opportunities, and strong trade execution.

COMMITMENT TO UNDERWRITING

An effective CLO manager should employ rigorous, bottom-up fundamental credit analysis. In addition, CLO teams positioned within investment managers that have a broad public and private fixed income offering can benefit from leveraging the firm's wider research and market insights. For CLO tranche investors, it is imperative to have the resources and capabilities to qualitatively and quantitatively assess each CLO's collateral manager, the underlying portfolios, and the structural nuances of each CLO to better understand how they impact the quality and relative value of potential investments. In particular, the CLO tranche investment manager should be able to assess a specific CLO's:

COLLATERAL MANAGER

Investment style and process

Historical track record

Commitment to the high yield market

UNDERLYING COLLATERAL

Detailed breakdown ofthe entire portfolio

Leverage internal high yield research

STRUCTURE

Thorough review of the entire capital structure and payment waterfall

Consider additional features that will impact performance

Detailed legal documentation review

Cashflow stress analysis

RELATIVE VALUE

Large, well-resourced teams allow efficient deployment of capital across the capital structure

Use data systems, market observances, and collaborative effort to determine CLO tranche relative value

> *"CLOs tend to have higher spread pick-up than other similarly rated asset classes while employing structural protections that provide investors with additional credit support in periods of distress."*

Barings' CLO Capabilities

1998
Inception of Barings' CLO Platform

100+
CLOs Managed

Top 20
Global CLO Issuer by AUM

$50 B+
in Global CLO Capabilities

60
Dedicated Investment Professionals

CLO MANAGEMENT

Global BSL CLOs
$19 B+
in AUM

Private Credit CLOs
$3 B+
in AUM

CLO INVESTMENT

Structured Credit

$28 B+
in Senior CLO Tranche Investment AUM

$4 B+
in Mezzanine & Equity CLO Tranche Investment AUM

Source: Barings. As of March 2025.

Takeaway

CLOs offer a compelling opportunity for investors seeking diversified exposure to corporate credit with attractive risk-adjusted returns. Structured with built-in protections and backed by pools of senior secured loans, CLOs have demonstrated resilience across market cycles. Investors can access a wide range of risk-return profiles across the capital stack—from the relative safety of AAA-rated tranches to the higher return potential of CLO equity. Manager selection is a key driver of performance, as differences in credit selection, trading strategy, and portfolio management can significantly impact outcomes. With a disciplined, research-driven approach and the right partner, investors can uncover meaningful value in this dynamic and growing segment of the credit market.

Risks

As with any asset class, CLOs present risks investors should consider, including:

- **Credit Risk:** There is the risk that a change in the credit quality of the borrower will affect the market value of the underlying collateral position.
- **Default Risk of the Underlying Collateral Portfolio:** As defaults are realized in the collateral pool, the amount and value of the overall collateral available to re-pay the outstanding debt of a CLO diminishes. If sufficient collateral is lost from default and or other realized credit losses (sales below par by the manager), the ultimate additional loss capacity of all tranches is reduced. Defaults and other realized losses that result in very low collateral coverage can trigger an event of default, often giving senior classes the right to accelerate and liquidate the collateral portfolio.
- **Asset Manager Risk:** Active collateral management by a manager will change the risk profile of the collateral pool over time. Poor performance by the manager may increase the risk highlighted above.
- **Interest Rate Risk:** Derives from exposure to the floating rate index curve.
- **Liquidity Risk:** CLO tranches should be assumed to have limited liquidity.
- **Prepayment and Reinvestment Risk:** Stems from the possibility of unscheduled return on principle and the potential inability to reinvest proceeds.
- **Downgrade Risk:** Rating agencies actively review collateral performance as well as their own internal methodology, thus downgrades are possible.
- **Cash Flow Timing:** Based on many variables, including but not limited to, default rates, recovery rates, recovery timing, reinvestment tenor and yield and reinvestment quality and price that will impact the timing of cash flows changing the average life and realized yield.

Individual CLOs may also have terms that limit trading flexibility and other restrictions defined in their respective indentures. The legal documentation is highly complex and can contain inconsistencies or errors, creating potential risk and requiring significant interpretational expertise.

The list set forth here is not a complete list of the risks and other important disclosures associated with such investments and is subject to the more complete risk and disclosures contained in the applicable confidential offering documents.

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