PRIVATE MARKETS
institute

CLO playbook

A guide to effectively leveraging CLOs in an investment portfolio

nuveen
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Collateralized loan obligations (CLOs) were once the exclusive domain of large institutional investors. Today, they are accessible to a broad array of investors through a variety of structures. This evolution presents an exciting opportunity to add a developed, institutional-grade investment solution to an investment portfolio.

CLOs have the potential to deliver value beyond traditional strategies. They offer several valuable benefits, including historically higher income and lower defaults compared to similarly rated corporate bonds, as well as diversification to a core bond allocation.

This playbook is designed to equip you with the knowledge and tools to effectively integrate CLOs into investment strategies, helping you improve portfolio outcomes so you can achieve your investment objectives.

KEY TAKEAWAYS

1 CLOs have long been used by institutional investors and are newer to the wealth investing space.

2 CLOs may help meet evolving needs for more sophisticated investment solutions.

3 CLOs offer investors the potential for significantly higher yields than traditional fixed income investments, with lower default risk.

4 Various CLO fund structures offer liquidity and risk/return characteristics that align with a range of client goals.

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ANATOMY OF A CLO: WHAT SETS THEM APART

What is a CLO?

CLOs are structured credit investments that consist of a diversified, actively managed portfolio of broadly syndicated senior loans issued by large, well-established companies, such as Hilton, Dell and Burger King. These pools of actively managed loans are securitized — or repackaged — into interest-bearing securities of varying degrees of risk and yield (tranches), which are then sold to investors based on their risk-return objectives. These tranches range from AAA-rated senior debt to unrated equity.

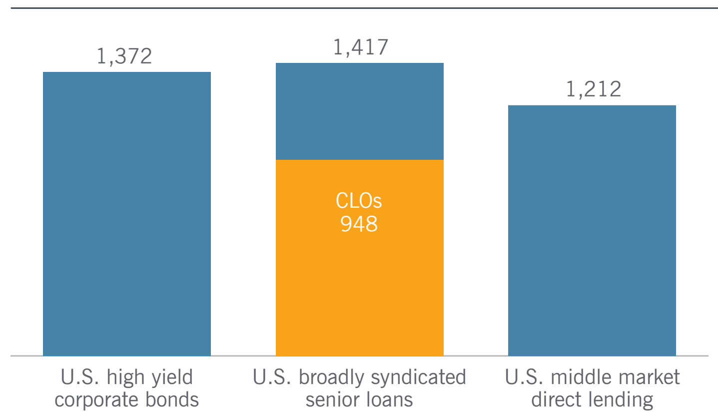
The CLO market currently accounts for nearly 70% of syndicated loan demand, as illustrated in figure 1.[1] The investor base — which includes banks, pension funds, insurance companies and asset managers — has broadened in recent years, as illustrated in figure 2, powering increased liquidity and market depth. Investors who adopt CLO strategies can take full advantage of recent trends in this active and growing market, which plays a critical role in financing the companies that underpin the U.S. economy.

Key features

Senior secured loans: CLOs primarily invest in first-lien senior-secured loans, which have priority over other forms of debt in the event of borrower default. These loans typically achieve higher recovery rates compared to corporate bonds, contributing to the resilience of CLO portfolios.

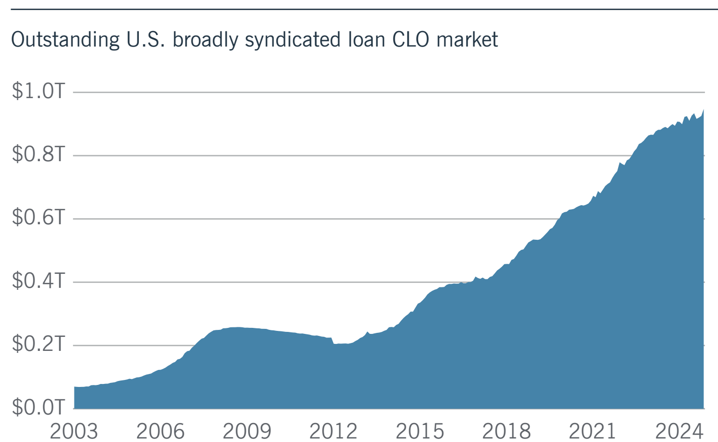
Floating rates: Typically, CLOs are a floating-rate asset class, meaning their cash flows adjust as interest rates change. The debt tranches pay a fixed spread over a base floating rate, typically the secured overnight financing rate (SOFR). For the equity tranche, returns are derived from the residual cash flows after all debt tranches are paid. With near-zero interest-rate duration, CLOs have minimal interest rate risk and low correlations to other fixed income sectors.

Figure 1: CLOs now make up a majority of the investor base in the broadly syndicated loan market



Sources: Bank of America CLO Factbook, Dec 2024; Preqin, June 2023; U.S. Federal Reserve, June 2023.

Figure 2: The CLO market has grown significantly in recent years



Source: Bank of America CLO Factbook, Dec 2024.

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Non-mark-to-market leverage: Traditional leveraged investments, such as some hedge funds or structured products, generally use mark-to-market leverage — meaning assets in these portfolios are continuously revalued based on current market conditions. As a result, managers may need to sell holdings or post additional collateral when asset values drop. In contrast, CLOs employ non-mark-to-market leverage, which relies on fixed terms and thresholds established at the CLO's inception. This structure serves to prevent forced liquidations and helps ensure that the collateral value and cash flows remain sufficient to support the debt tranches — even if the market value of the underlying loans temporarily declines.

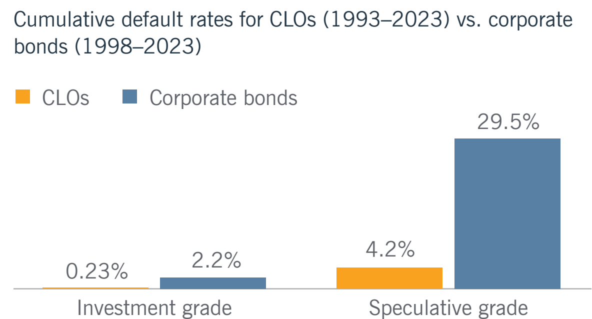
Waterfall structure: As illustrated in figure 3, cash flows to tranches follow a specific order of priority. This "waterfall" structure gives each tranche a unique level of risk and return.

1. AAA-rated tranches receive payments first, which means they have the lowest risk of default. They also generate the lowest yields and return.
2. Other investment-grade tranches (AA to BBB) provide a higher yield and entail incrementally more risk than more senior tranches.
3. Junior tranches (BB to equity) absorb losses first, starting with equity. These tranches also offer the highest yield and return potential.

This unique combination of features has supported the ability of CLOs to weather various economic cycles. As shown in figure 4, over the past 30+ years, CLOs have experienced minimal default rates in investment-grade tranches. Even during challenging periods, such as the Global Financial Crisis or the COVID-19 market disruption, CLOs' robust structures and active management provided steady income distributions and limited losses. This track record underscores their ability to deliver consistent performance for investors across market environments.

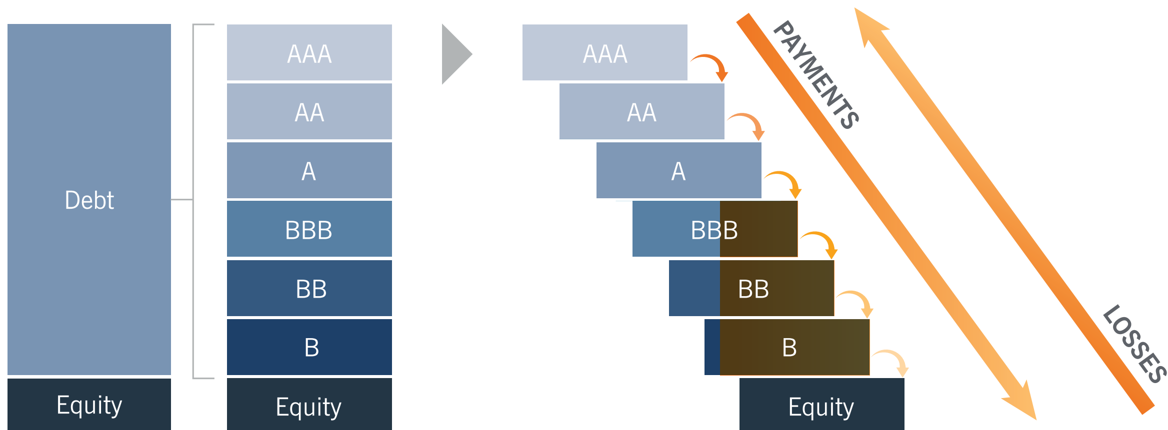
Figure 4: Historic default rates for CLOs are far lower than for traditional bonds

Cumulative default rates for CLOs (1993–2023) vs. corporate bonds (1998–2023)



Sources: Corporates: 10-year horizon average cumulative issuer-weighted global default rates by alphanumeric rating, 1998-2023 from Moody's "Default Trends – Global: Annual default study: Corporate default rate to moderate in 2024 but remain near its long-term average"; CLOs: US CLOs, 10-year horizon WR-unadjusted cumulative impairment rates by original rating, 1993-2023 from Moody's "Impairment and loss rates of global CLOs: 1993-2023

Figure 3: Cash flow waterfall establishes the relative risk and return potential of each tranche



Source: Nuveen. For illustration purposes only.

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BENEFITS FOR INVESTORS

CLOs can offer potential benefits to a client portfolio, providing opportunities for enhanced yield, diversification, active risk management and opportunistic capital deployment.

Enhanced yield

CLOs typically deliver higher yields compared with traditional fixed income investments, as shown in figure 5. This yield advantage stems from three main factors. First, securitization allows CLOs to segment risk and yield across various tranches, amplifying returns for the junior-most tranches through the structure's inherent leverage. Second, the complexity of CLOs provides a premium for investors willing to analyze and participate in a market that is often misunderstood, and investors are compensated with higher yields for the effort required to navigate this more complex market. Finally, CLO managers actively manage loan pools, taking advantage of market volatility to rotate out of credits with deteriorating fundamentals and into higher-yielding opportunities.

Diversification

In general, CLOs have low correlations with traditional equities and bonds, as well as minimal interest rate risk, making them a valuable tool for portfolio diversification, particularly during periods of volatility.[2] In addition, each CLO portfolio is a diversified mix of loans to 150 – 200+ companies across industries, sub-sectors and credit ratings. This diversification reduces concentration risk and helps provide a more stable return profile for investors.

Active risk management and opportunistic capital deployment

In contrast to private credit funds, where managers often lack the ability to exit underperforming positions, CLO collateral managers can utilize the liquidity in the underlying loans to capitalize on market dislocations and minimize risk by shifting allocations across industries or issuers. This flexibility can be especially valuable during periods of market volatility, when loans from fundamentally strong companies may become undervalued, creating opportunities to buy high or higher quality assets at discounted prices.

Setting the record straight: Misconceptions about CLOs

✗ **MISCONCEPTION**

CLOs are similar to CDOs, which contributed to the 2008 Global Financial Crisis.

✓ **FACT**

CLOs did not contribute to the crisis. In fact, they performed well in 2008 and in the years since then. While both CLOs and collateralized debt obligations (CDOs) are structured credit products, their underlying assets differ significantly. CDOs involved in the 2008 crisis were often backed by subprime mortgages or other high-risk assets. In contrast, CLOs are backed by first-lien, senior-secured corporate loans made to companies that are often household names, diversified across sectors and vintages, and CLOs include structural safeguards to protect investors.

✗ **MISCONCEPTION**

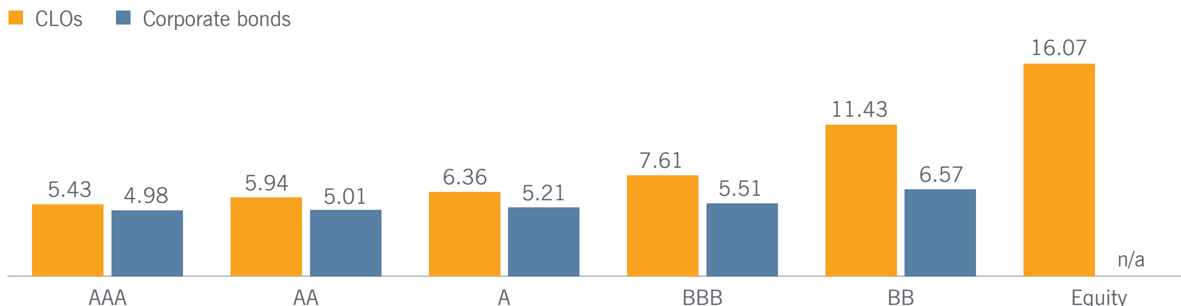
CLOs are highly illiquid and hard to trade.

✓ **FACT**

Although investment-grade CLO tranches tend to be less liquid than Treasuries or investment-grade corporate bonds, they have active secondary markets with daily trading. Below-investment-grade tranches tend to be less liquid but are generally not considered illiquid investments in normal market environments.

Figure 5: CLOs typically offer higher yields than similarly rated corporate bonds

Debt yields by investment rating



Sources: Nuveen, Bloomberg, JPMorgan and Bank of America as of 31 Dec 2024. **Representative indexes: Investment grade corporates AAA-BBB:** Bloomberg U.S. Corporate Investment Grade Index; **High yield corporates BB-B:** ICE BofA US High Yield Index; **Investment grade and high yield CLOs AAA-BBB:** J.P. Morgan Collateralized Loan Obligation Index (CLOIE); **CLO equity:** US BSL CLO Equity Distributions (IO) median. Different benchmarks, economic periods, methodologies and market conditions will produce different results. There is no assurance that any asset class or index will provide positive performance over time. **It is not possible to invest directly in an index.** Yield: The yield quoted is yield-to-maturity except for CLO equity which is the median annualized U.S. broadly syndicated loan obligations equity distribution.

PORTFOLIO IMPLEMENTATION

Portfolio positioning

CLOs can serve a variety of roles in portfolios, depending on an investor's objectives, risk tolerance and time horizon:

- ***Alternative to short-term or short-duration bonds:*** With low interest-rate duration and relatively high income, investment-grade-rated CLO debt can serve as a compelling, uncorrelated substitute for core short-term fixed income.
- ***Complement to high yield bonds:*** Below-investment-grade CLOs can offer higher income (with lower interest-rate duration) than similarly rated high yield bonds, while also providing additional structural protections that help reduce default risk.
- ***Complement to private equity:*** Unlike private equity vehicles, which often entail long lock-up periods and delayed (or J-curve) returns, CLO equity can generate cash flows quickly and consistently. This steady income stream can make CLO equity a natural complement to longer-term illiquid investments.
- ***Interest rate hedge:*** Because yields on debt tranches are tied to a base floating rate, CLOs can serve as an effective hedge against interest rate risk when paired with fixed-rate bonds in a fixed-income portfolio.

Aligning investment vehicles with intended outcomes

Investors can access CLOs through a variety of fund structures that differ in liquidity and risk/return characteristics.

- ***ETFs:*** CLO-focused exchange-traded funds (ETFs) combine liquidity with ease of trading, including market pricing and no minimum investment size. They may be suitable for retail investors who prioritize accessibility.
- ***Interval funds:*** Interval funds often blend below-investment-grade and equity tranches. This option provides higher income potential while allowing periodic redemption opportunities, and may appeal to investors willing to accept the structure's liquidity constraints.
- ***Private funds, direct investments and SMAs:*** For ultra-high-net-worth individuals, private funds offer access to specialized CLO strategies, including single-manager equity-only strategies. Institutional investors can also consider direct investments or separately managed accounts (SMAs) to target specific parts of the CLO capital structure. These approaches enable customization but may require a substantial capital commitment and offer only limited liquidity.

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QUESTIONS TO ASK WHEN SELECTING A CLO MANAGER

Selecting the right CLO manager is essential for achieving strong returns and managing risks effectively. Here are some key questions to consider:

1. How much CLO experience does the manager have?

Why it matters: CLOs have unique and complex deal structures and various transaction terms that can influence returns. Managers with deep expertise in evaluating transaction documentation — such as covenants, call protections and subordination terms — can better identify nuances that impact the performance of different CLO tranches. In addition, look for a manager with a proven track record of preserving capital and maintaining portfolio performance across multiple market cycles and credit environments.

2. What is their investment approach?

Why it matters: Managers who take an active, relative value approach may be able to manage risks and optimize returns for investors more effectively than those with more passive, buy-and-hold styles.

3. How extensive is their research and risk management process?

Why it matters: Managing CLO investments requires meticulous credit analysis and an ability to anticipate potential risks in the underlying loan portfolio. Managers with a robust and disciplined process are better equipped to identify credits with deteriorating fundamentals and take quick action to protect the portfolio.

4. Does the CLO team form well-researched views on loan collateral fundamentals?

Why it matters: CLO teams with access to a broader leveraged finance team that invests across non-CLO loan portfolios and high yield bonds have an information advantage. The CLO manager can leverage in-depth research to gain deeper insight into individual loans. This capability supports the manager's ability to identify relative value opportunities — particularly at the lower end of the quality spectrum — and quickly respond to shifting market conditions.

5. How strong are their secondary market trading capabilities?

Why it matters: Active participation in the secondary market allows managers to take advantage of mispricings and relative value opportunities. A skilled manager with a history of success in trading across market environments can rotate between CLO structures, sectors or specific tranches to optimize risk-adjusted returns.

To learn more about whether CLOs might be right for you, contact your Nuveen representative.

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Endnotes

1 Sources: Bank of America CLO Factbook, Oct 2024; Preqin, June 2023; U.S. Federal Reserve, June 2023.

2 Sources: Nuveen and Bloomberg, Sept 2024

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For term definitions and index descriptions, please access the glossary on nuveen.com.

Important information on risk

All investments carry a certain degree of risk, including loss of principal, and there is no assurance that an investment will provide positive performance over any period of time. Derivative instruments for hedging purposes or as part of the investment strategy may involve risks such as liquidity risk, interest rate risk, market risk, credit risk, or management risk. There is no guarantee that the use of these instruments will succeed in mitigating volatility and interest rate risk. Any investment in collateralized loan obligations or other structured vehicles involves significant risks not associated with more conventional investment alternatives.

Credit risk may be heightened for the portfolios that invest a substantial portion of their assets in "high yield" debt or loans with low credit ratings. These securities, while generally offering higher yields than investment-grade debt with similar maturities, involve greater risks, including the possibility of interest deferral, default or bankruptcy, and are regarded as predominantly speculative with respect to the issuer's capacity to pay dividends or interest and repay principal.

Issuers of high yield securities may be highly leveraged and may have fewer methods of financing available. The prices of these lower grade securities are typically more sensitive to negative developments, such as a decline in the issuer's revenues or a general economic downturn, than are the prices of higher-grade securities. The secondary market for high yield securities may not be as liquid as the secondary market for more highly rated securities, a factor which may have an adverse effect on a portfolio's ability to dispose of a particular security. There are fewer dealers in the market for high yield securities than for investment grade obligations. The prices quoted by different dealers may vary significantly and the spread between the bid and ask price is generally much larger than for higher quality instruments. Under adverse market or economic conditions, the secondary market for high yield securities could contract further, independent of any specific adverse changes in the condition of a particular issuer, and these instruments may become illiquid. As a result, a portfolio could find it more difficult to sell these securities or may be able to sell the securities only at prices lower than if such securities were widely traded.

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