Janus Henderson INVESTORS

The diversification benefits of adding floating-rate CLOs to fixed income portfolios

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Portfolio Managers John Kerschner, Nick Childs, and Jessica Shill discuss how adding floating-rate collateralized loan obligations (CLOs) to traditional fixed-rate bond portfolios may improve risk-adjusted returns.

The issue of diversification has roared back to the forefront of investor concerns in 2022, as equity and fixed income markets experienced unprecedented concurrent drawdowns. The Bloomberg U.S. Aggregate Bond Index (Agg) and the S&P 500® Index are down 10.8% and 16.2%, respectively[1]. For many investors, fixed income is considered "the diversifier" to their equity holdings, but disappointingly, they have not seen much diversification benefit from bonds in 2022.

In response, some investors are looking to new asset classes to diversify their portfolios. Liquid alternatives, unlisted real estate, and cryptocurrencies have garnered more attention, and their inclusion in traditional stock-bond portfolios is on the rise. While we believe this form of *inter*-asset class diversification (diversification between asset classes) provides benefits when done well, we think investors should not overlook the importance of *intra*-asset class diversification (diversification within asset classes).

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Key takeaways

- With the Bloomberg U.S. Aggregate Bond Index comprising 100% fixed-rate debt, investors seeking improved risk-adjusted returns might consider adding floating-rate CLOs to their bond allocations.
- Exhibiting ultra-low duration, attractive yields, strong credit ratings, and low combined correlation to equities and fixed income, the addition of CLOs may result in improved risk-adjusted returns.
- As the Federal Reserve readies itself for more potential rate hikes – and signals that it expects the federal funds rate to remain higher-for-longer – CLOs stand to benefit from a higher rate regime as their coupons continue to reset in lockstep with changes in short term rates.

[1] Year to date, as of 31 August 2022.

Diversifying the diversifier

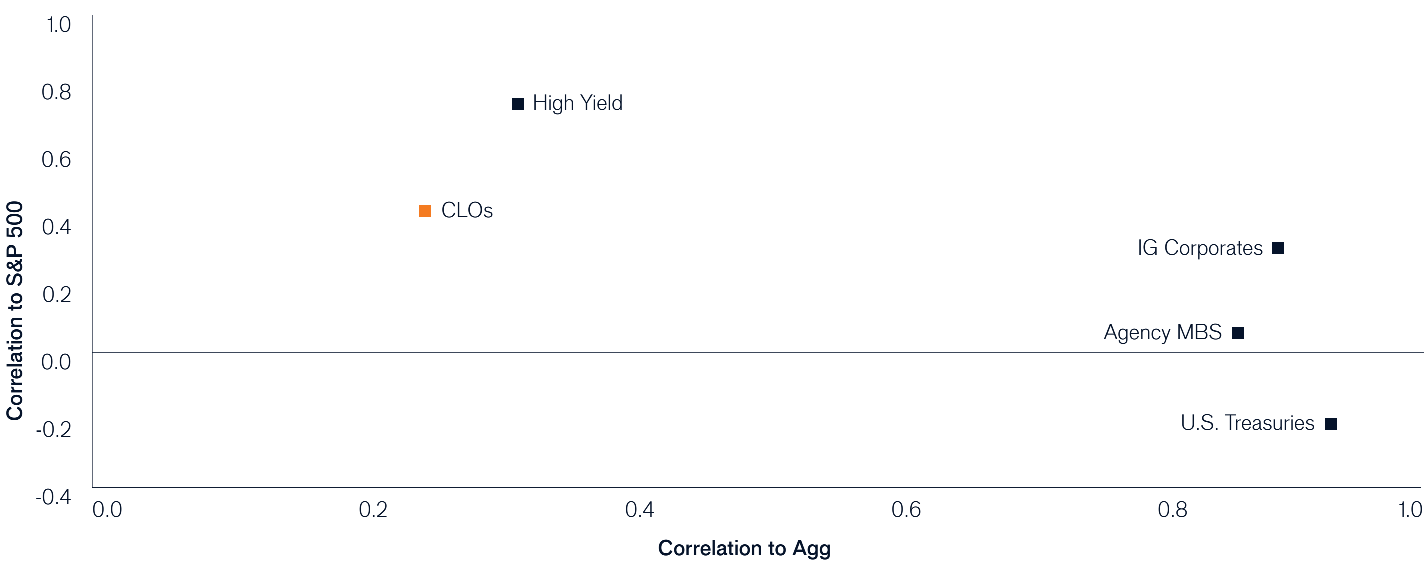
While investors might consider their portfolios well-diversified in terms of sector, spread, and duration exposure, where we see an opportunity for further diversification is in fixed versus floating-rate allocations.

The Agg, the Bloomberg 1-3 Year U.S. Gov/Credit Index (1-3 Year Gov/Credit), and the Bloomberg U.S. Corporate High Yield Index (High Yield) are all comprised of 100% fixed-rate bonds. Therefore, portfolios that are exclusively allocated to these indexes are wholly inversely correlated to changes in interest rates. In addition, many fixed-rate sectors exhibit high correlations to one another, thereby limiting the diversification benefits of adding more fixed-rate sectors to bond allocations.

What is missing from many bond portfolios, in our view, is a fixed income asset that benefits from rising rates. For this purpose, investors might consider floating-rate CLOs. CLOs typically have high credit ratings – over 80% of CLOs are issued with an A credit rating or higher[2]. And while the underlying assets of CLOs are bank loans, because CLOs are portfolios of loans that are actively managed by a specialist CLO manager, they have had lower default rates than the broader loan market. Furthermore, the CLO structure favors higher tranches, so for a AAA rated CLO to default, 80% of the loans in the pool would need to go bad. To give some perspective, the highest loan default rate experienced during the Global Financial Crisis (GFC) was 12%[3].

For multi-asset portfolios, we consider CLOs to be a good diversifier because of their low *combined* correlation to equities and fixed income. In contrast, investment-grade corporates (IG corporates), agency mortgage-backed securities (MBS), and U.S. Treasuries may exhibit low correlations to equities, but are all highly correlated to the Agg and to one another. Inversely, High Yield exhibits a lower correlation to the Agg, but is more highly correlated to equities, as shown in Exhibit 1.

Exhibit 1: CLOs display low combined correlation to U.S. equities and U.S. fixed income



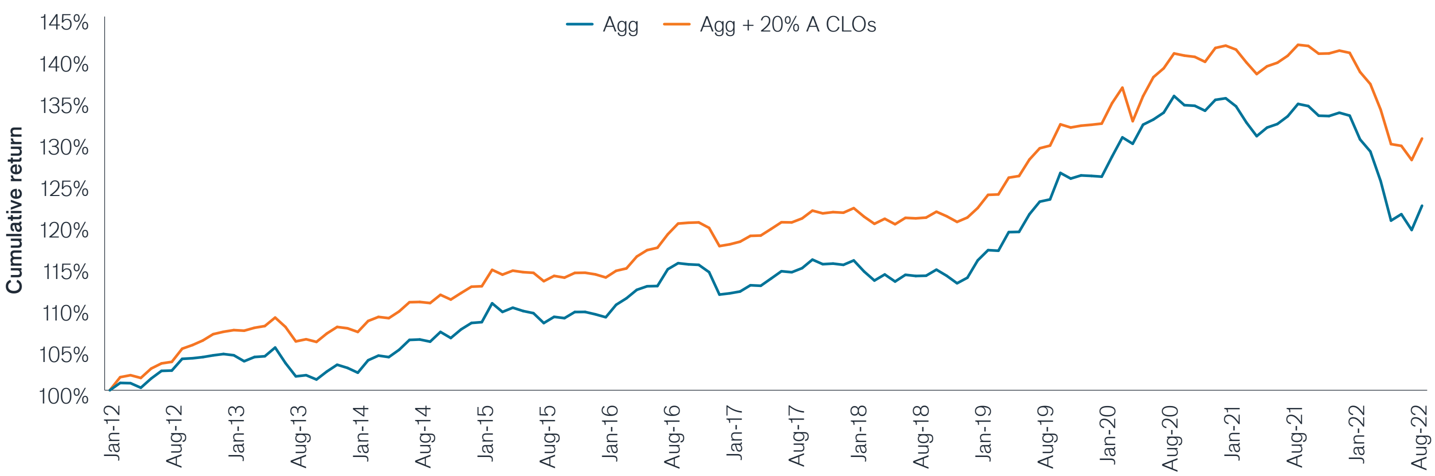
Source: Bloomberg, as of 31 July 2022.
Note: Monthly correlations for the 10-year period ended 31 July 2022. Please see end page for indices used to represent asset classes.

[2] JPMorgan, as of 31 March 2021.
[3] JPMorgan, "CLOs: not the CDOs of yore," June 2020.

If we drill down to the asset class level, adding a 20% allocation of A rated CLOs to the Agg has resulted in improved risk-adjusted returns since 2012, as shown in Exhibit 2. Further, the addition of CLOs to a bond portfolio comprised of the Agg and High Yield would have resulted in higher risk-adjusted returns, and an upward shift in the efficient frontier, as shown Exhibit 3.

Exhibit 2: Comparing cumulative returns since 2012

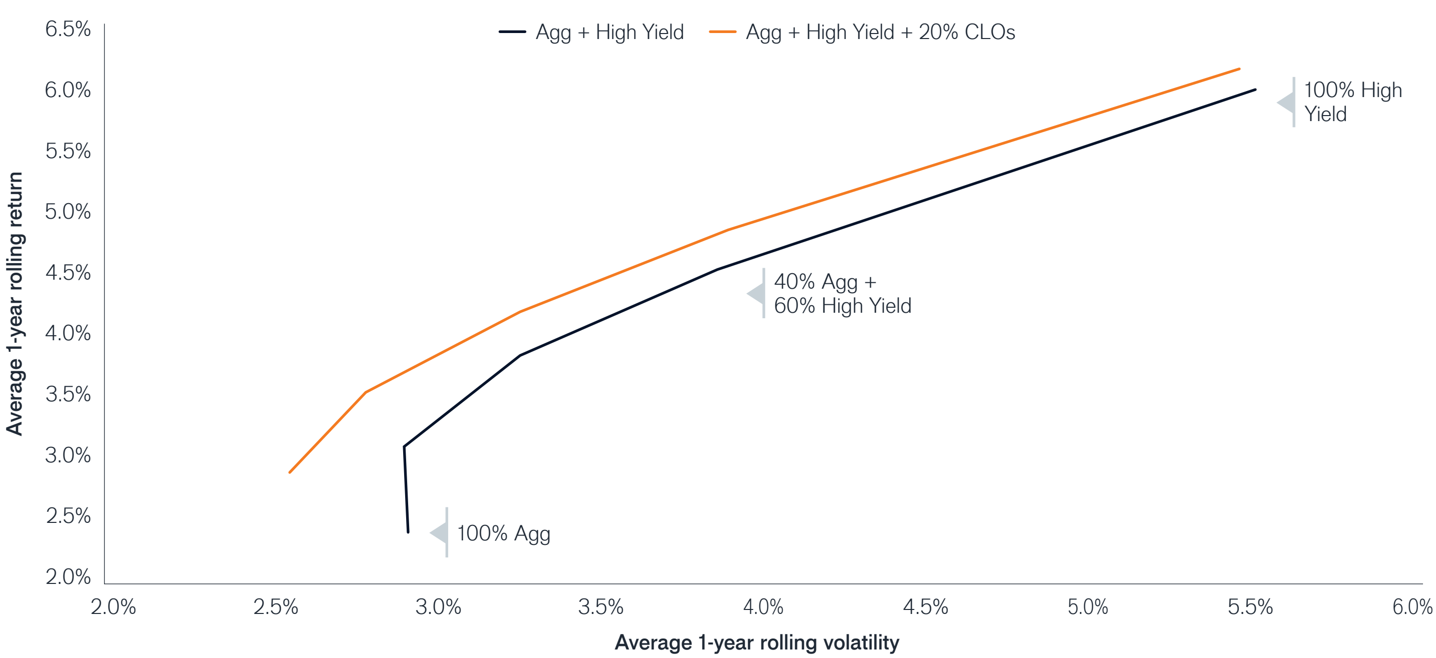
Adding CLOs to the Agg has improved risk-adjusted returns



Source: Bloomberg, Janus Henderson Investors, as of 31 July 2022. Hypothetical backward-looking illustration showing cumulative total returns. Please see end page for indices used to represent asset classes.

Past performance is no guarantee of future results.

Exhibit 3: Impact of adding CLOs to a two-asset bond portfolio



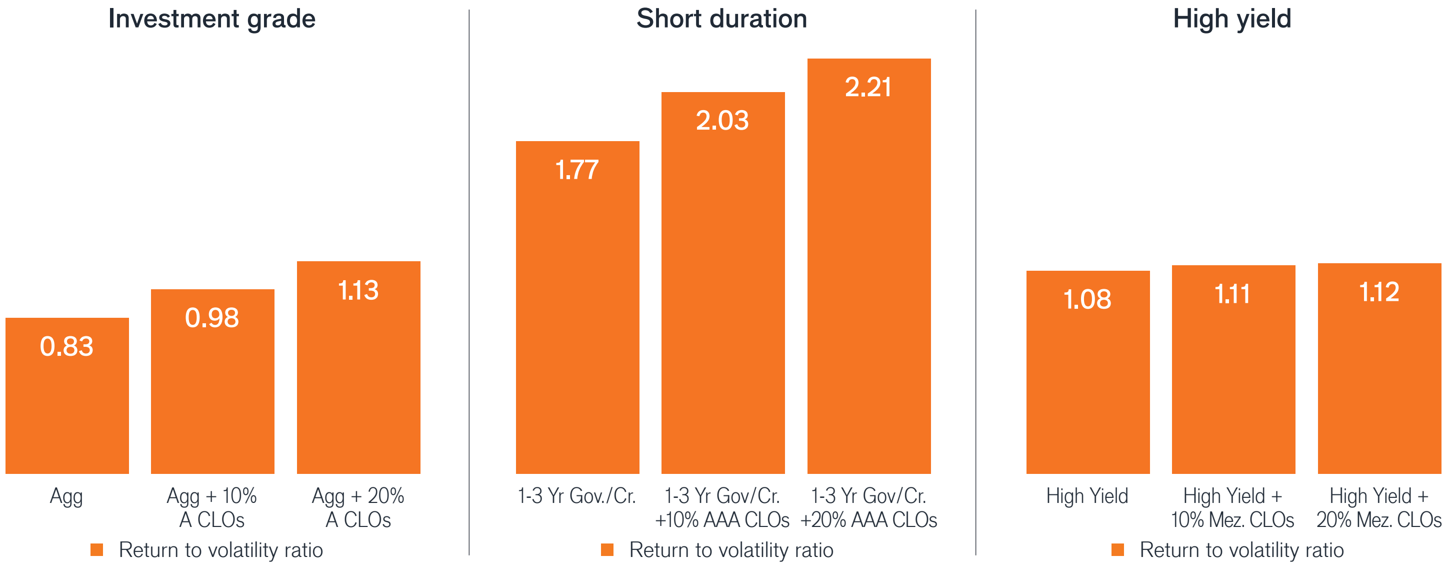
Source: Bloomberg, Janus Henderson Investors, as of 31 July 2022.

Note: Agg + High Yield: Average rolling 1-year returns and volatility (standard deviation) from 1 January 2012 to 31 July 2022. Agg + High Yield + 20% CLOs: 20% A rated CLOs added to Agg allocation, 20% Mezzanine CLOs added to High Yield allocation. Please see end page for indices used to represent asset classes.

Past performance is no guarantee of future results.

Drilling down further to the sector level, the addition of CLOs would have resulted in an increase in return-to-volatility ratios, as shown in Exhibit 4. This is particularly important to investors who follow a risk-budgeting approach. If one can allocate risk more efficiently, it could free up risk in the budget that can be spent in other parts of the portfolio with higher return potential.

Exhibit 4: The addition of CLOs would have improved return-to-volatility ratios



Source: Bloomberg, Janus Henderson Investors, as of 31 July 2022.

Note: Return to volatility ratios: Average rolling 1-year returns over average rolling 1-year volatility (standard deviation) from 1 January 2012 to 31 July 2022. Please see end page for indices used to represent asset classes.

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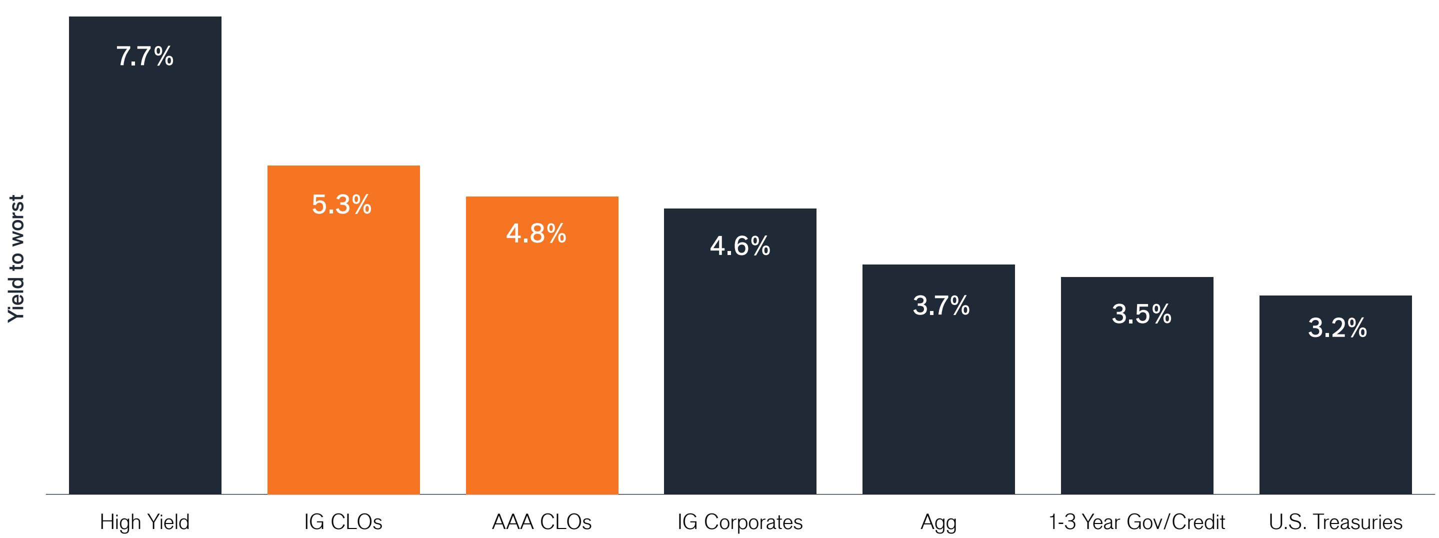
Short term rates: Higher for longer?

The present level of – and expectations for – short-term interest rates are key drivers of returns on CLOs. Because CLO yields are set relative to short term benchmark rates, they are ultimately driven by the level of the federal funds rate. In its fight against persistently high inflation, the Federal Reserve (Fed) has aggressively raised its benchmark lending rate by 2.25% within the first 6 months of 2022, with futures markets pricing in at least an additional 1.25% before year-end. This increase in short-term rates has been positive for CLOs, as coupons continue to reset higher with each step up in interest rates. The result is that, in our view, yields on CLOs look attractive relative to alternative fixed income assets, as shown in Exhibit 5.

Exhibit 5: CLO yields look attractive relative to alternatives

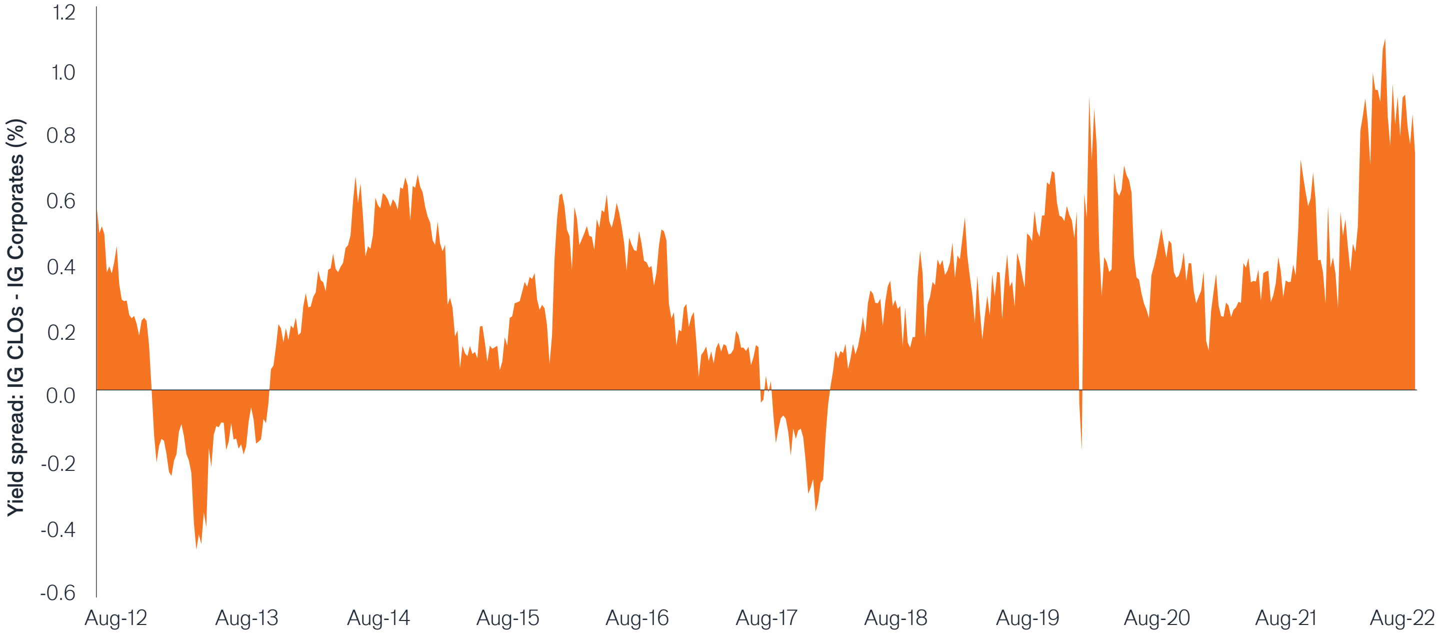


Source: Bloomberg, JP Morgan, as of 19 August 2022.

Past performance is no guarantee of future results.

At present, CLOs are offering more yield spread over investment-grade corporates than at any point in the last 10 years, as shown in Exhibit 6. In our view, the additional yield and inherently ultra-low duration makes CLOs a compelling option for investors looking to diversify an existing corporate bond allocation.

Exhibit 6: Yield spread of CLOs over investment-grade corporates at historical highs

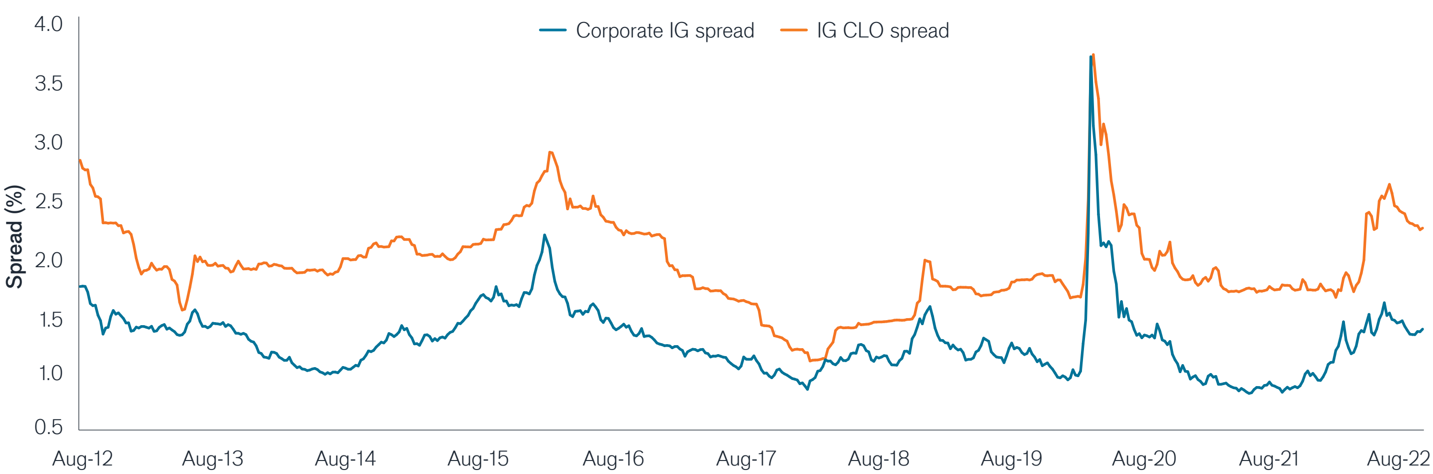


Source: Bloomberg, JP Morgan, as of 19 August 2022.
Past performance is no guarantee of future results.

Looking beyond yields, we think that CLOs also look attractive on a spread basis relative to IG corporates, as shown in Exhibit 7. After some tightening in relative spreads in Q1 of 2022, CLO spreads widened sharply as investors turned to their most liquid holdings to raise cash during the sell-off in Q2. If relative spreads tighten back to historical averages, it could provide a tailwind for CLOs' relative returns.

Exhibit 7: CLO spreads vs. corporate IG spreads

CLO spreads have widened sharply relative to corporate IG in 2022

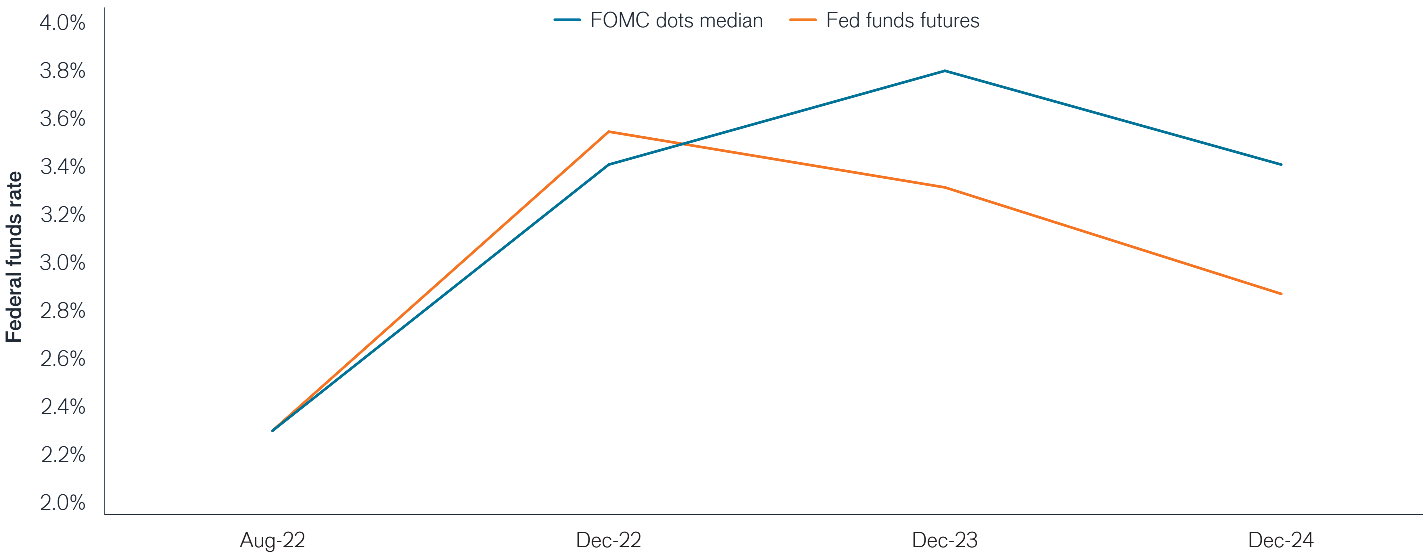


Source: Bloomberg, JP Morgan, as of 19 August 2022. CLO spreads are calculated using CLOIE Index discount margin (DM) and compared to option-adjusted spread over Treasuries for investment-grade corporates.
Past performance is no guarantee of future results.

While we believe the case for the addition of CLOs is compelling based on the current data, the question that remains is what the progression of the federal funds rate will be through 2023 and 2024. There is much debate on this issue. Even the market and the Fed disagree on this, with the federal funds futures pricing in year-end rates of 3.29% and 2.88% in 2023 and 2024, respectively[4]. This contrasts with the median of the Federal Open Market Committee (FOMC) dot plot, which has factored in year-end rates of 3.75% and 3.375% in 2023 and 2024, respectively, as shown in Exhibit 8.

Exhibit 8: Median of FOMC dot plot projections vs. fed funds futures

The futures market is pricing in a more dovish Fed than the Fed itself



Source: Bloomberg, as of 18 August 2022.

The difference in these forecasts comes down to the expected trajectory of inflation and the possibility of economic slowdown. In our opinion, the futures market is implying that inflation will come down and economic growth will slow to such an extent that the Fed will have to start cutting rates again in 2023 to boost potentially lackluster economic growth. But there is no consensus on this view, most notably not from the Fed, as it is signaling that rates will have to stay higher for longer to tame inflation. We tend to side with the Fed on this one, and while we do not know how high they will have to go to bring inflation under control, we do not believe they will be in a position to make substantial cuts in 2023. What does this all mean for CLOs? We think short-term rates will have to remain higher for longer, which should continue to provide support for coupon rates in particular, and for the asset class in general.

[4] As of 18 August 2022.

Indices used to represent asset classes: High Yield (Bloomberg U.S. Corporate High Yield Index), CLOs (JP Morgan CLOIE Index), IG corporates (Bloomberg U.S. Corporate Investment Grade Index), agency MBS (Bloomberg U.S. Agency MBS Index), U.S. Treasuries (Bloomberg U.S. Treasuries Index), Agg (Bloomberg U.S. Aggregate Bond Index), 1-3 Yr Gov/Cr. (Bloomberg 1-3 Year U.S. Gov/Credit Index), AAA CLOs (JP Morgan AAA CLOIE Index), A CLOs (JP Morgan A CLOIE Index), , Mez. CLOs (JP Morgan Mezzanine CLOIE Index).

About the Authors

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John Kerschner is Head of US Securitised Products at Janus Henderson Investors and a Portfolio Manager on the Multi-Sector Credit strategy and the Mortgage-Backed Securities and AAA CLO ETFs. John primarily focuses on mortgage-backed securities and other structured products. Prior to joining Janus in 2010, John was director of portfolio management at BBW Capital Advisors. Before that, he worked for Woodbourne Investment Management, where he was global head of credit investing. John began his career at Smith Breeden Associates as an assistant portfolio manager and was promoted several times over 12 years, becoming a principal, senior portfolio manager and director of the ABS-CDO group.

John received his bachelor of arts degree in biology from Yale University, graduating cum laude. He earned his MBA from Duke University, Fuqua School of Business, where he was designated a Fuqua Scholar. John holds the Chartered Financial Analyst designation and has 32 years of financial industry experience.

Nick Childs, CFA

Portfolio Manager

Nick Childs is a Portfolio Manager at Janus Henderson Investors, a position he has held since 2018. He is responsible for co-managing the Mortgage-Backed Securities, AAA CLO and the Sustainable & Impact Core Bond ETFs. He was a securitised products analyst for both US and global multi-sector fixed income portfolios at the firm from 2017 to 2022. Prior to joining Janus, Nick was a portfolio manager at Proprietary Capital, LLC from 2012 to 2016 where he managed alternative fixed income strategies specialising in MBS, absolute return investing. He also managed all major US interest rate and MBS risks, modelling borrower behaviour and MBS deal structure, and advancing market-neutral hedging strategies. Before that, he was vice president at Barclays Capital in capital markets, where he focused on securitised products from 2007. Earlier, he was vice president at Lehman Brothers. He began his career at State Street Global Advisors in 2003.

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Jessica Shill is an Associate Portfolio Manager and Securitised Products Analyst at Janus Henderson Investors responsible for the AAA and BBB CLO ETFs. Jessica became associate portfolio manager in 2020 and has held the analyst position since joining the firm in 2019. Prior to this, she was an intern and an analyst for the Wells Fargo Investment Portfolio.

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