CIFC Asset Management

CIFC Portfolio Intelligence

This Is Your Biggest Risk When Investing in CLOs

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Featured Views and Insights

In the world of institutional investing, few asset classes are as misunderstood as collateralized loan obligations ("CLOs"). The financial media often conflates volatility with risk, leading to a fundamental misreading of what makes CLOs compelling. As we navigate today's market dynamics, it is time to separate perception from reality.

Jay Huang, Senior Managing Director and Head of Structured Credit Investments

Mr. Huang is a Senior Managing Director and Head of Structured Credit Investments at CIFC. He has over 25 years' experience in structured finance trading and portfolio management. Prior to joining CIFC, Mr. Huang spent 16 years at Citigroup, where he was managing director and global head of its CLO, CDO and distressed Structured Investment Vehicle trading business. Prior to joining Citigroup, he worked at Salomon Smith Barney on the CDO structuring desk from 2000 to 2002. Mr. Huang graduated from Carnegie Mellon University with honors in 2000, with a Bachelor of Science in Applied Mathematics and Statistics and a minor in Computer Science.

The Real Risk in CLO Investing

We believe the primary risk associated with investing in CLO debt is not credit deterioration, but rather short-term price volatility. While this may appear counterintuitive, historical data presents a compelling narrative. In our view, despite exhibiting greater price volatility than corporate bonds, CLOs have demonstrated notable credit performance. Between 1994 and 2019, the default rate for CLO tranches was just 0.03% – less than one-tenth that of corporate bonds.[1] This track record underscores the structural resilience of CLOs across multiple economic cycles, including the Global Financial Crisis.

Let us be direct: we believe the biggest risk in CLO debt investing is not credit losses – it is short-term mark-to-market volatility. This belief might seem illogical, but the data above shows a clear story.

So Why the Volatility?

The CLO market remains a relatively small and specialized segment, comprising approximately 200 to 300 active participants globally – almost exclusively institutional investors. This exclusivity is largely driven by regulatory requirements that limit retail access. In contrast, the corporate bond market is vastly broader, with hundreds of thousands of investors worldwide, spanning both retail and institutional segments. As a result, a single large CLO investor adjusting their portfolio can impact prices more dramatically than economic fundamentals would justify. CLOs' higher volatility versus corporate bonds is simply the nature of a more specialized, institutional-only market where sophisticated investors can still find inefficiencies. Yet, this volatility is routinely misconstrued as signaling higher credit risk – a costly misconception that sophisticated investors have been quietly exploiting for years.

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The Volatility Misconception

A common misperception in the broader market narrative is that higher volatility is often interpreted as higher default risk. Historically, CLOs have experienced higher mark-to-market volatility than corporate bonds. When observers see CLO spreads widen more than corporate bonds during market stress, the typical assumption is that the higher volatility must signal greater default risk. This is precisely backwards.

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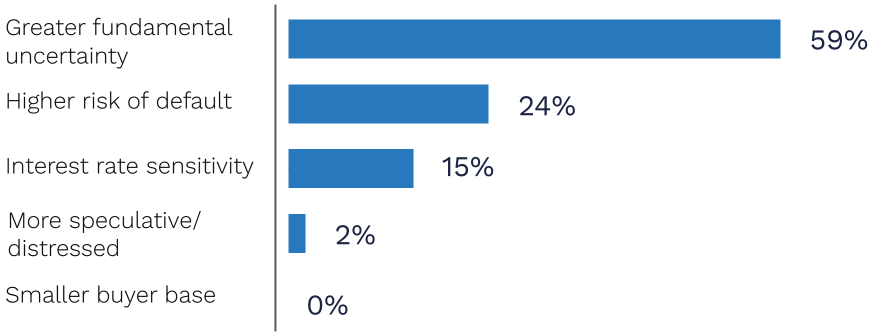
To illustrate this point, we recently polled sophisticated institutional investors at a corporate credit conference with a simple question: "When one credit security is more volatile than another, what do you intuitively assume about the more volatile security?"

Poll Results: What Investors Think Causes Volatility



Even among sophisticated investors, 83% conflate volatility with fundamental risk. We believe this misconception creates a compelling opportunity for those who understand the distinction, as illustrated by the data shown below.

Moody's CLO Tranche Defaults vs. Corporate Default History (Cumulative)[2]

Rating	CLO (30 Year)	Corporate (20 Year)
AAA	0.00%	0.12%
AA	0.00%	1.70%
A	0.03%	4.78%
BBB	0.85%	7.61%
BB	1.92%	25.78%
B	2.23%	50.07%
Total	0.49%	—

We believe the 30-year CLO history is particularly meaningful, as it encompasses the full lifecycle of the product since inception, including the early years when structures were still evolving and evolving and through multiple periods of volatility.. During this complete history, including periods when CLOs were less robust than today's versions, default rates remained dramatically lower across every rating category. At the BBB level, for example, corporates bonds defaulted nearly nine times more frequently than CLOs. Yet CLO spreads often exhibited greater volatility. Why? Because volatility reflects market structure, not underlying credit quality.

In our view, CLOs are engineered for imperfection. We underwrite these structures to survive Global Financial Crisis-level default scenarios. They are not priced assuming everything goes perfectly – they are designed in the expectation that things will go drastically wrong. The short-term price swings reflect market technicals, not credit fundamentals.

"In our view, CLOs are engineered for imperfection. We underwrite these structures to survive Great Financial Crisis-level default scenarios."

The Opportunity in Understanding

For institutional investors who understand this distinction, periods of technical volatility create compelling entry points. Consider the long-term performance data below.

BB CLOs have delivered +294% total returns since 2012, dramatically outperforming:[3]

US High Yield Corporate Bonds: +110%

US Leveraged Loans: +93%

BBB CLOs have achieved +161% returns, significantly beating:[3]

US Investment Grade Bonds: +52%

US Leveraged Loans: +93%

Despite this massive outperformance, CLOs continue to trade at wider spreads due to their higher volatility. But here is the critical insight: BB CLOs have maintained manageable volatility premium to high yield bonds during 95% of markets. It is the brief 5% of dislocated markets that drive the exaggerated risk narrative.[4]

In non-dislocated markets, BB CLOs offer just 1.2% more annualized volatility than high yield bonds (5.0% versus 3.8%) while delivering over 200bps of additional yield. During dislocations, that volatility gap widens dramatically, in our opinion, but not because of credit concerns.[5]

Consider what happens during market stress such as that seen in March 2020.

When 50 CLO investors step away to observe volatility, that represents perhaps 20% of the entire CLO market. When 50 corporate bond investors do the same, it is a rounding error in their massive, established investor base of hundreds of thousands. This structural reality means CLO prices gap out more severely during stress periods – creating mark-to-market losses that fool observers into believing there is deteriorating credit quality when it is simply a temporary supply-demand imbalance in a specialized market.

This costly misconception – confusing technical pressure with fundamental risk – is precisely what we believe sophisticated investors have been quietly exploiting for years. These dislocations create exceptional entry points for those who understand the difference, turning others' perceived fear into their opportunity.

Our Approach: Time Arbitrage

Given these dynamics, we advocate for a phased entry strategy over 6-12 months. Our extensive simulations show this approach captures substantial total return potential while reducing the volatility of committed capital. No other strategy we have analyzed delivers comparable risk-adjusted outcomes across market cycles.

We think that the beauty of CLO investing is that if enough time elapses, fundamental value typically prevails over technical noise. Patient investors who understand the difference between volatility and risk can access attractive yields while others, based on their misconceptions, flee.

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Looking Forward

As CLO ETFs continue to mature and bring new participants into the market, we expect improved liquidity and efficiency over time. But during this transition, those who can distinguish between price volatility and credit risk will find exceptional opportunities.

The question for institutional investors is not whether they can stomach volatility – it is whether they will allow short-term technical dislocations that do not reflect underlying credit risk to derail their long-term investment strategy.

We welcome the opportunity to share our research on navigating CLO volatility and look forward to discussing our strategic approach with you.

1. Source: Moody's, 1994-2021.
2. Source: Moody's Ratings report: Structured Finance, June 24, 2024, and Moody's Ratings report: Annual Default Study, February 26, 2024.
3. Source: Bloomberg - J.P. Morgan Collateralized Loan Obligation Index (CLO Index), Bloomberg USD Liquid Investment Corporate Index (BLQCTRUU Index), Bloomberg US Corporate High Yield Index (LF98TRUU Index). Data as of May 22, 2025.
4. Source: JP Morgan CLOIE BB Index (JCLOBBPS Index), Bloomberg US Corporate High Yield Yield-to-Worst (LF98YW Index), Bloomberg USD Liquid Investment Grade Corp TR Index Unhedged USD, LCD and CIFC. Data as of May 31, 2025. Gross performance shown does not reflect the deduction of management fees and expenses. This estimate is subject to change without notice. CLO Equity yield ranges from 15%-25%. Past performance is not indicative of future returns.
5. Source: Citigroup, JP Morgan Levered Loan Index, Bloomberg US Corporate High Yield Total Return Index, JPM CLOIE. Data as of May 31, 2025.

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