

CIFC

Asset
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CIFC Portfolio Intelligence

**Misread, Not Impaired:
Why CLO Equity
Deserves a Second Look**

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Featured Views and Insights

Over the last 12 months, CLO equity has faced a particularly challenging period relative to other asset classes. Outside of the broad COVID-19 market downturn in 2020, this stretch stands out as one of the more difficult one-year periods the asset class has experienced since performance tracking began. According to Citigroup CLO research, the CLO equity asset class is down approximately 33%¹ over the last year.

Following a drawdown of this magnitude, it is natural for investor confidence to be tested. Drops this far and this fast typically prompt investors, ourselves included, to step back and reassess their exposure and underlying conviction. Reevaluation is the right instinct. The key challenge is that this reassessment is occurring in the immediate aftermath of an unusually weak period, when sentiment is under the greatest strain and short-term performance can disproportionately influence perceptions.

Cumulative CLO Equity Return¹



Jay Huang
Senior Managing Director,
Head of Structured Credit
Investments

Mr. Huang joined CIFC in 2018 and has over 25 years of 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 their 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 with a B.S. in Applied Mathematics and Statistics and a minor in Computer Science.

Anatomy of a Distorted Arbitrage

To reevaluate clearly, we must first address the technical forces that converged to create this performance gap. One of the primary culprits has been a move of historical magnitude in the CLO Arbitrage.

In 2025, loan spreads (the assets) tightened by approximately 30 bps, while CLO liabilities tightened by only 4 bps.² This 26 bps decoupling is an extreme outlier. From our perspective, much of this distortion was fueled by the proliferation of “captive equity vehicles.”

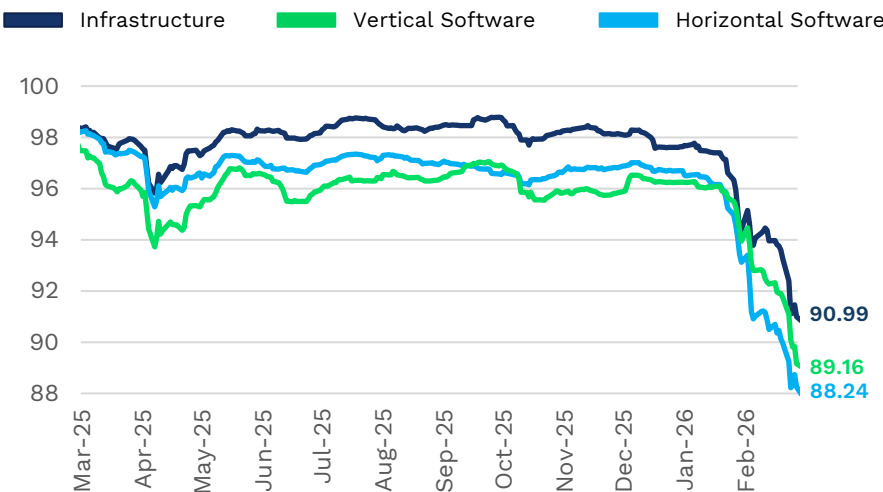
We found that captive equity funds were the primary engine of the 2025 market, funding more than 70% of new-issue volume. This captive demand appears to have allowed deals to price even as the arbitrage narrowed, with asset spread compression outpacing liability relief. While market-implied equity returns frequently dipped into the single digits, issuance remained resilient because these vehicles provided a stable source of capital.

This is precisely why we at CIFIC have not found new-issue equity to be attractive in over a year. We believe the reality of these potentially sub-optimal returns is finally catching up to these captive vehicles. As actual performance severely lags original projections, we expect the fundraising for future captive vehicles will inevitably stall, allowing the arbitrage to self-correct toward more rational, fundamentally driven levels.

The Software “Shadow” and the Technical Overshoot³

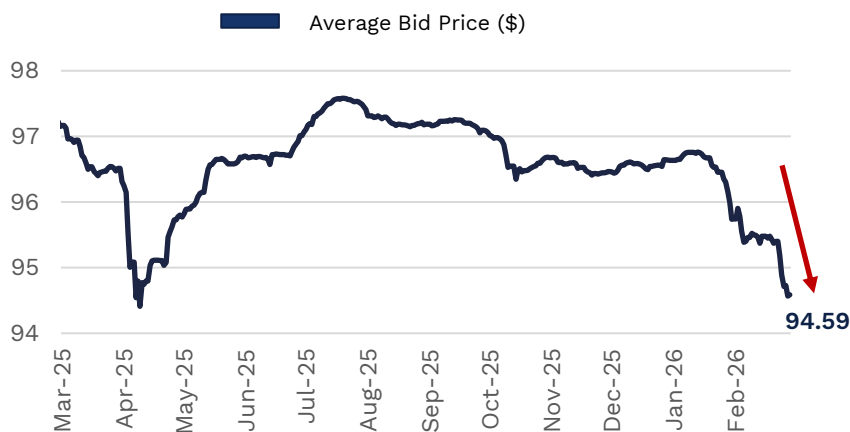
At the end of January 2026, the CLO market was hit by a second, more idiosyncratic blow: a sharp repricing in the software sector. Since the start of the year, the Morningstar LSTA US Leveraged Loan Index has declined from 96.64 to 94.59 as of February 28, 2026. This move was concentrated in the Software & Technology sector, where prices plummeted 7.9% due to “AI-driven” uncertainty.

Plunging Software Loan Prices⁴



This is where the distinction between price and value becomes critical. In our experience, when fear takes over, loan funds begin to see redemptions and the technicals start racing past the fundamentals, which we believe causes prices to detach from historical reality. Forced selling in a crowded exit doesn't ask about credit quality; it only asks for immediate liquidity.

Drive Sharp Decline across US loans⁵



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The 2008 Benchmark: A Hidden Margin of Safety

We believe the result of this technical overshoot is a profound disconnect in valuation. Loans have fallen to such a point that current prices, in many of CIFIC's CLO models, now imply a 5% annual default rate across the broadly syndicated loan universe over the next 12 months. To put that 5% into perspective, consider the heart of the Global Financial Crisis (2008–2010), where the average annual default rate for loans was approximately 5%.⁶

Perhaps even more telling is the extremity of the software-specific repricing. CIFIC's models suggest current prices imply that 10–15% of software loans will default over the next year. We believe this may be too punitive for several reasons:

- **Manageable Maturity Wall:** Software exposure within CLO portfolios currently benefits from a relatively extended maturity schedule, limiting near-term refinancing needs. Of the total balance of software loans currently held in U.S. broadly syndicated CLOs, 20 bps mature in 2026, and 4.8% reaches maturity in 2027.⁷ We believe these modest, very near-term maturities reduce immediate liquidity pressure, providing issuers with additional time and flexibility to manage market volatility and proactively address future maturity walls. That said, maturities begin to step up in 2028, and we will be closely monitoring refinancing conditions, as they could introduce incremental pressure depending on market and capital access dynamics.
- **CLO Exposure Skewed Higher Quality:** Due to the structural portfolio quality constraints inherent in CLO indentures and the benefits of active management, we find that software holdings within CLOs exhibit a higher quality profile than the broader leveraged loan universe. This credit tiering is supported by a lower concentration of distressed paper, as CCC-rated assets comprise only ~5% of software loans within CLOs, versus 10% of the overall broadly syndicated loan market.⁸
- **Operational Flexibility:** To the extent that higher profitability is critical for refinancing, we feel software companies have demonstrated that they can adjust their cost structures rather significantly, given most of their expenses are employee related. For instance, during the early phase of the COVID pandemic, many software credits reduced costs and improved margins noticeably.

By investing in CLOs today, we believe investors are acquiring exposure to a portfolio that reflects market pricing assumptions consistent with elevated default rates over the next 12 months, comparable to the three-year average observed during the Global Financial Crisis. Within the software sector specifically, it is our view that pricing implies that more than one in ten companies will fail—a rate that far exceeds anything we have witnessed in the modern history of enterprise software. This isn't just a discount; our assessment is that these assumptions indicate a built-in margin of safety against an outcome that the fundamentals simply do not support.

Liquidity Gaps as Opportunity

Our perspective is that the impact of the technical we described on the valuation of CLO equity has significantly altered the investment behavior of several prominent, publicly traded closed end CLO equity funds. As markdowns put pressure on regulatory leverage ratios, these vehicles have largely retreated from adding more CLO equity. Instead, they have implemented a strategic rotation into alternative asset classes characterized by lower mark to market sensitivity. The withdrawal of these historically significant buyers of CLO equity has created a technical supply demand imbalance, contributing to the wider yields and pressured levels currently observed across the asset class and further reinforcing the current entry point as a compelling buying opportunity.

Why We Believe the Implied Default Rate Looks too Punitive:

Near Term Maturities:
Minimal — 0.20% in 2026, 4.8% in 2027

Credit Quality:
CLO holdings skew higher quality (~5% CCC vs. ~10% market)

Operational Flexibility:
Software companies can cut costs quickly when needed

This isn't just a discount; these assumptions indicate a built-in margin of safety against an outcome that the fundamentals simply do not support.

What's next for CLOs?

The CLO equity asset class has experienced a historic decline in prices. A closer examination of the drivers behind this move shows us that while a portion is attributable to fundamentals, very little of the decline reflects actual credit losses. Some of the price weakness stems from uncertainty around future fundamentals; however, the overwhelming majority of the move has been driven by CLO-specific technical factors, which we believe are likely to reverse over time. Put differently, over the next 12–24 months, we believe CLO equity—particularly positions acquired in the secondary market at current trading levels—may generate returns comparable to those seen in 2023–2024, when the asset class delivered strong annualized returns.¹

However, we are also currently seeing a compelling opportunity in a specific high-conviction niche: stressed BB CLOs in the secondary market. These are originally rated BB tranches, typically issued 7–10 years ago, that we believe will ultimately take principal impairments. Because of this, they trade in the context of \$25–\$80. Since there are only a handful of investors capable of navigating this niche space, we consider these assets to trade at a significant discount to the underlying loan NAV. For the specialist, we believe this presents a differentiated target return with a margin of safety against a credit downturn.

End Notes

1. CITI Research “CLO Equity Total Returns”, data as of February 28, 2026. Please see the Disclaimer for a description of the Index.
2. Source: Bank of America, data as of January 29, 2026.
3. Source: CIFIC and Copyright © 2026 by Pitchbook Data, Inc. Morningstar LSTA Leveraged Loan Index, data as of February 28, 2026. See disclaimer for a description of the Index.
4. Source: Bank of America, Macaro Credit Desk Update, March 19, 2026.
5. Source: Copyright © 2026 by Pitchbook Data, Inc. Morningstar LSTA Leveraged Loan Index, data as of February 28, 2026. See disclaimer for a description of the Index.
6. Source: J.P. Morgan Leveraged Loan Index data as of December 31, 2025. Please see the Disclaimer for a description of the Index.
7. Source: Bank of America, CLO Factbook, data as of February 28, 2026.
8. Source: Morgan Stanley Research. “Global Loans & CLOs: R-AI-sing Dispersion in CLOs”, February 20, 2026.

Index Descriptions

The Invesco Senior Loan ETF (Fund) is based on the Morningstar LSTA US Leveraged Loan 100 Index (Index). The Fund will normally invest at least 80% of its total assets in the component securities that comprise the Index. The Index is designed to track the market-weighted performance of the largest institutional leveraged loans based on market weightings, spreads and interest payments. The Fund does not purchase all of the securities in the Index; instead, the Fund utilizes a “sampling” methodology to seek to achieve its investment objective.

The Morningstar LSTA Leveraged Loan Index is a market value-weighted index designed to measure the performance of the U.S. leveraged loan market based upon market weightings, spreads and interest payments.

US CLO Equity Return is published monthly by Citigroup. The return methodology calculates actual CUSIP-level CLO equity total returns using month-end prices from the Citigroup CLO trading desk and takes the average total return after excluding the outliers (top and bottom 5% percentile).

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