# The income advantage: How CLOs can provide better yield without reducing quality

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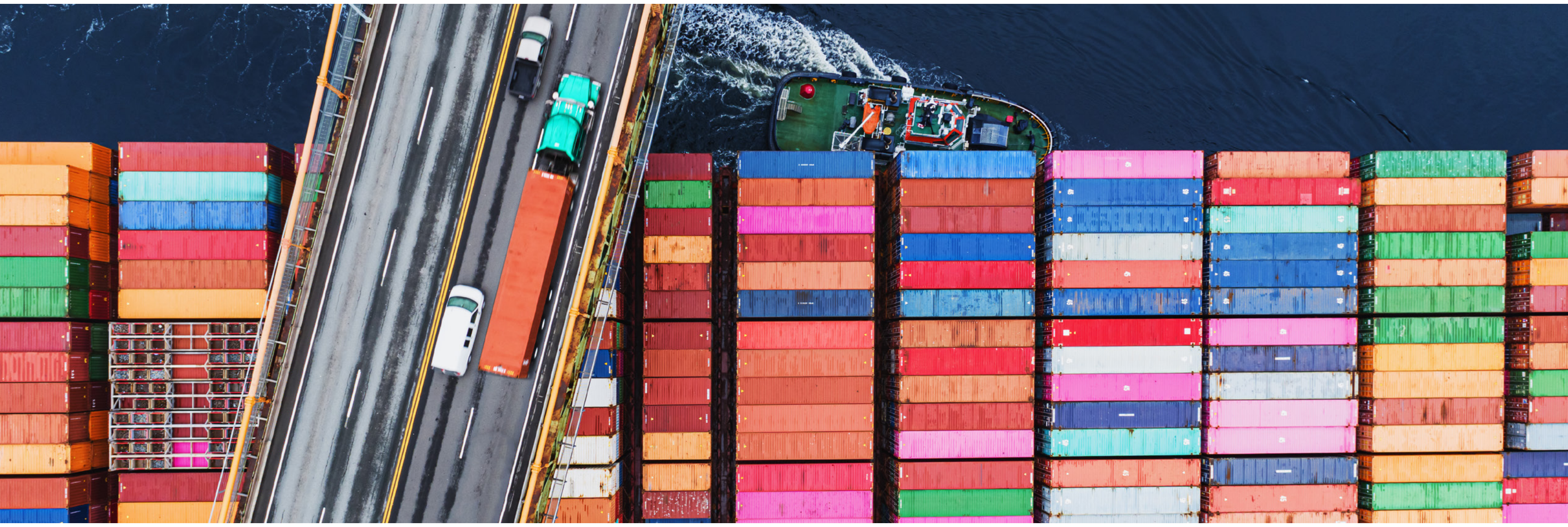


Today's market backdrop requires new ways of thinking about income generation. Investors seeking an income advantage face two main challenges:

1. How to avoid volatility caused by interest rates rapidly rising, like they did in 2022.
2. How to move up the yield spectrum without compromising on quality.

Few fixed income asset classes can satisfy these dual needs. Higher yields can often come with more interest rate risk (i.e. longer term bonds which are more sensitive to rising interest rates) or more credit risk (i.e. bonds of lower quality companies).

Collateralized Loan Obligations (CLOs) can help solve these challenges.

## Wider access to an institutional asset class

CLOs have a long history as an investment vehicle traditionally used by institutions, such as banks and pensions, seeking higher yielding and higher quality assets. With access to this once exclusive asset class opening to a wider audience, CLOs are an important consideration for all investor portfolios.

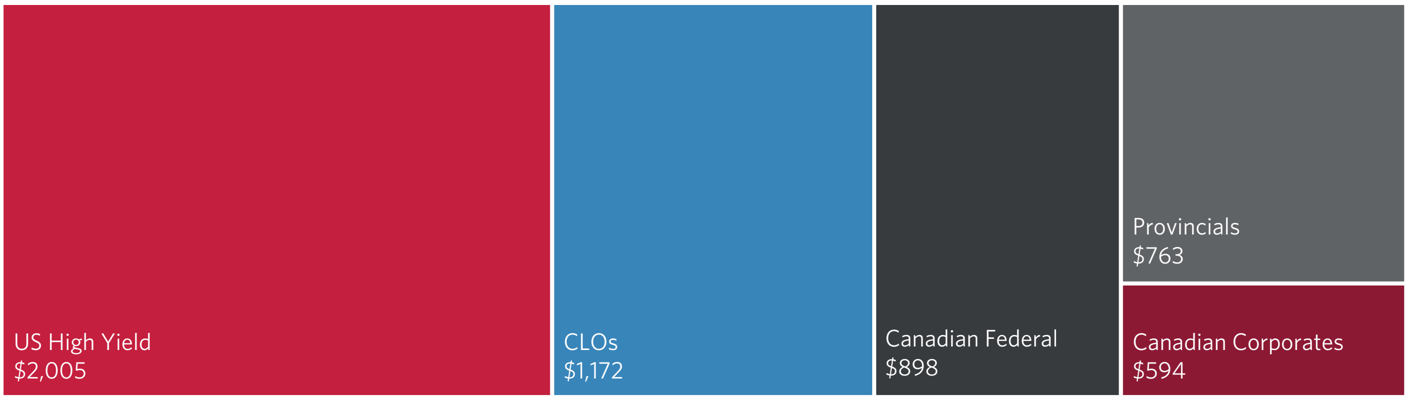
While CLOs sound complex, they include two main ingredients:

1. Bank loans – loans issued by banks to corporations to help fund operations, expansion, and other business activities. These loans carry credit ratings below investment grade.
2. Securitization – CLOs are simply a grouping of these bank loans. The act of securitization combines a variety of loans to create a bond. The loans often include a diverse range of borrowers, with varying credit quality. As underlying loans make interest and principal payments, which then flow through to bond holders.

These bank loans are made to some of the largest and mid-sized companies in the United States including corporations like Verizon and American Airlines. CLOs consist of highly diversified loans spread across over 300 individual borrowers and across more than 25 different industries. By combining a diverse range of loans, the CLO is often considered higher quality than any one loan on its own. The whole is greater than the sum of its parts. Uniquely, CLOs are usually divided into tranches of varying credit quality, so an investor can tailor their desired exposure.

Although relatively new to retail investors, the CLO market is large and well-established, eclipsing the size of other bond markets.

**Size of CLO market compared to more familiar bond markets ($billions)**

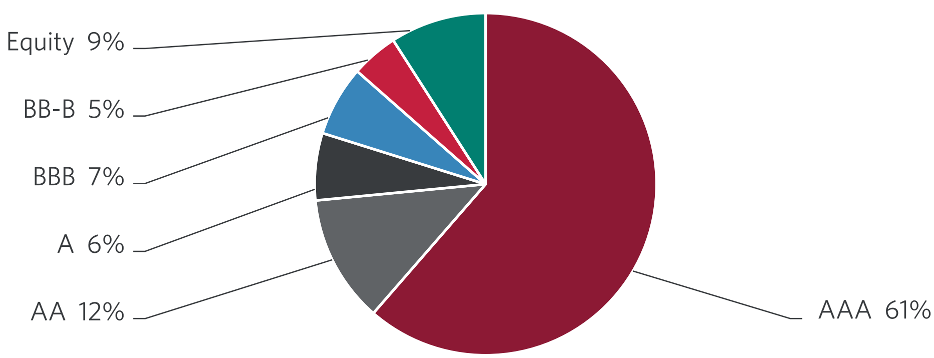



Source: JPMorgan, Bloomberg
Based on market value, Canadian dollar equivalents
As of February 2025

## Quality capture

CLO investments are offered in different levels of quality – all the way from equity-like risk to AAA rated quality. This variety allows investors to choose the type of risk they want to take relative to the yield they wish to capture. The majority of CLO exposure available to investors is in the highest-quality, AAA-rated portion (at approximately 60% of the market).

**CLO market by credit quality**

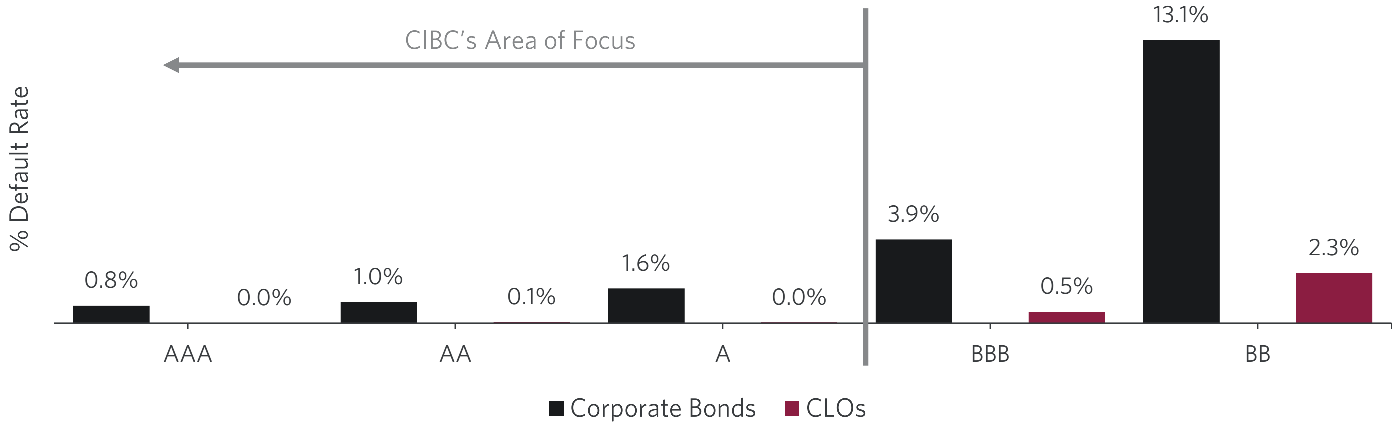



Source: JPMorgan
Based on market values - As of February 2025

CLOs across the board have proven their credit quality through business cycles, even compared to broadly held corporate bonds. Through the Global Financial Crisis of 2007-2009, the European sovereign debt crisis of 2010, the energy crisis of 2014, and the COVID-19 pandemic, CLOs have exhibited near zero default rates, even in lower rated sections of the market. This compares favourably to highly-rated public corporate bonds which have averaged 1.1% default rates for the same period.

CLOs have achieved this high quality through their fundamental diversification across hundreds of loans and sectors, as well as structural enhancements that help shield investors from default risks.

**Default rates: CLOs vs traditional corporate bonds**



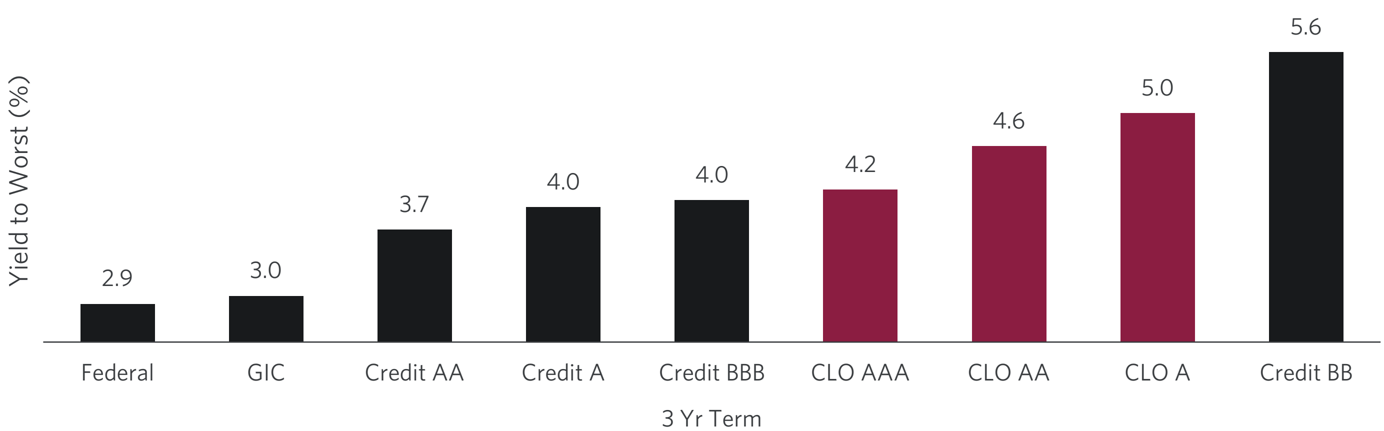

Source: Standard & Poor's
Based on 10 year cumulative default rates
CLO timeframe = 1997-2023 / Corporate Bond timeframe = 1981-2023
As of December 2024.

# How AAA CLOs provide an income advantage over traditional bonds

Investing in high quality CLOs can provide investors a strong balance between attractive yield and lower risk – the "income advantage".

Consider the relative yields available to investors buying AAA CLOs versus other fixed-term debt instruments. These high quality CLOs offer yields that rival other parts of fixed income markets which are either lower quality or carry more interest rate risk.

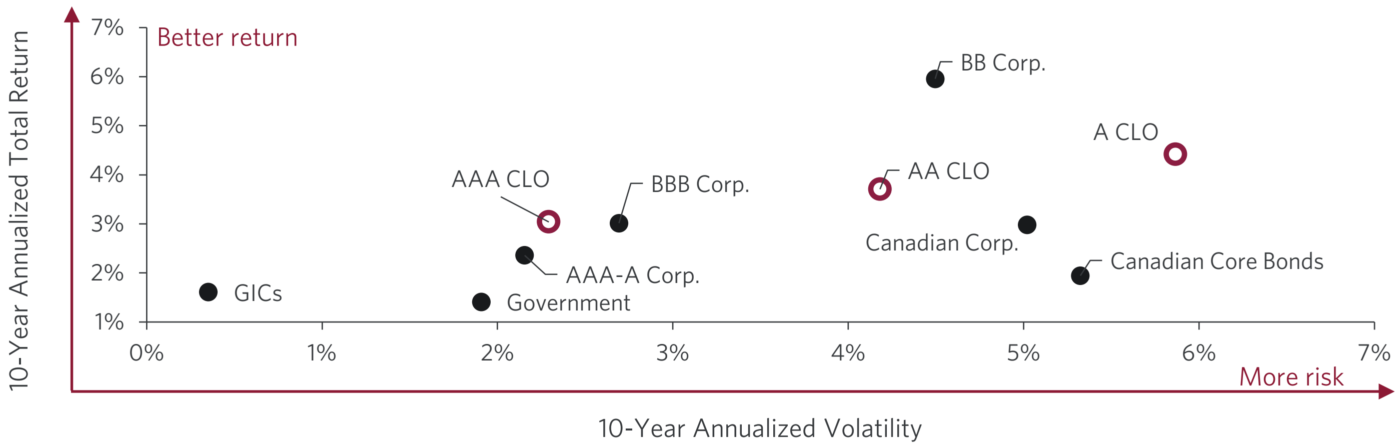
**Better yield without sacrificing quality**




Source: JPMorgan, ICE BofA, Bank of Canada, Evolve ETFs
Based on CAD-equivalent yields
As of January 2025

When we compare risk and return over the long term we see that high quality CLOs provide strong absolute returns and lower volatility versus other fixed income asset classes.

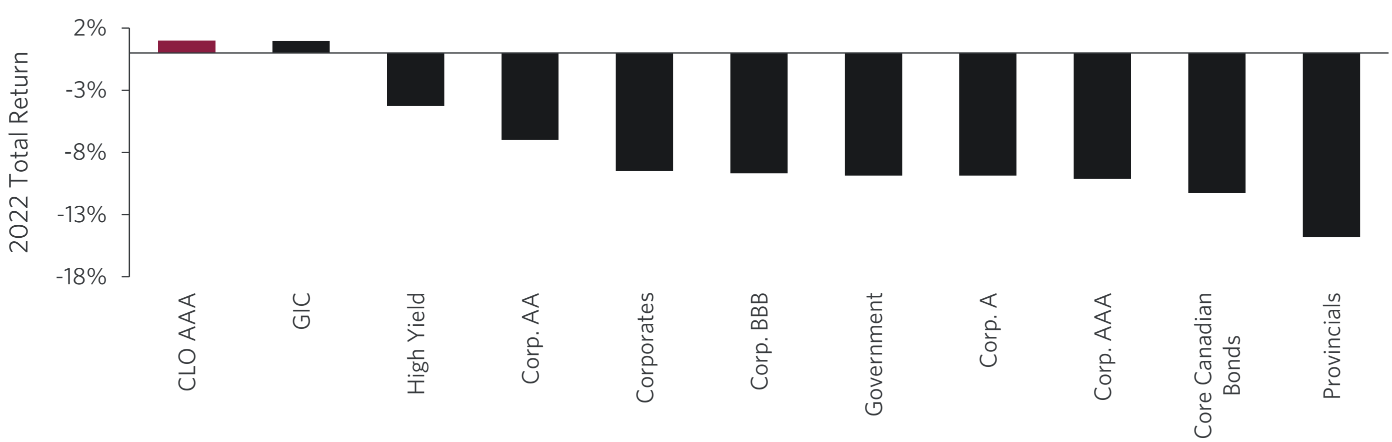
### Risk-return comparison: CLOs vs other fixed income




Source: JPMorgan, ICE BofA,
Based on ICE BofA 1-3 Yr. Canada Government, Canada AAA-A Corporate, Canada BBB Corporate, Canada Broad Corporate, Canada Bond, and Canada BB High Yield Indices. GIC proxied by running 3 year non-redeemable GIC rate with reinvestment.
As of January 2025

The same can be said when looking at exposure to interest rate risk across fixed income investment options. CLOs offer some of the best yields without taking on significant interest rate risk. For example, in 2022 when interest rates rose aggressively, the broad Canadian bond market returned negative 11%. In contrast, AAA-rated CLOs were positive 1% for the same year.

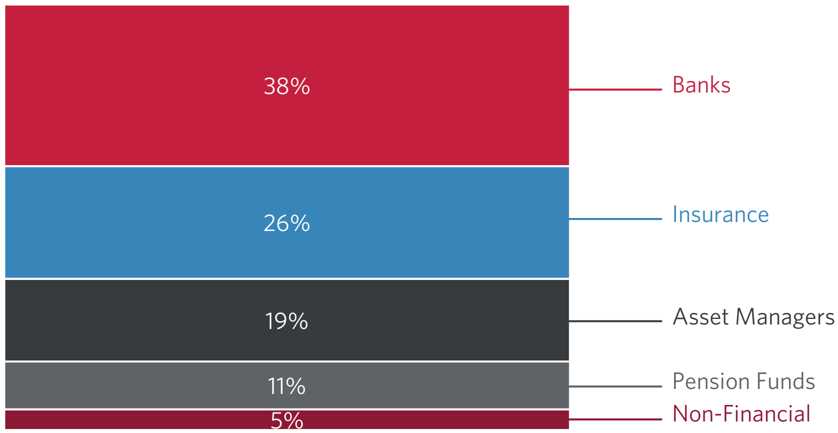
### 2022 returns during a period of rapidly rising rates




Source: JPMorgan, Bloomberg
Based on Bloomberg Canada Government, Provincial, Corporate (AAA/AA/A/BBB) Indices and Bloomberg US High Yield Index. GIC proxied by running 3 year non-redeemable GIC rate with reinvestment.
As of December 2022

Many institutional investors have harvested the income advantage by investing in high quality CLOs, capturing attractive yields with minimal interest rate risk and better credit quality profiles. Institutions have long known the benefit of holding AAA CLOs as part of their investments. This includes some of the world's largest banks, insurance companies, and pension funds.

**Participants in AAA CLO market: Dominated by banks and insurance companies**



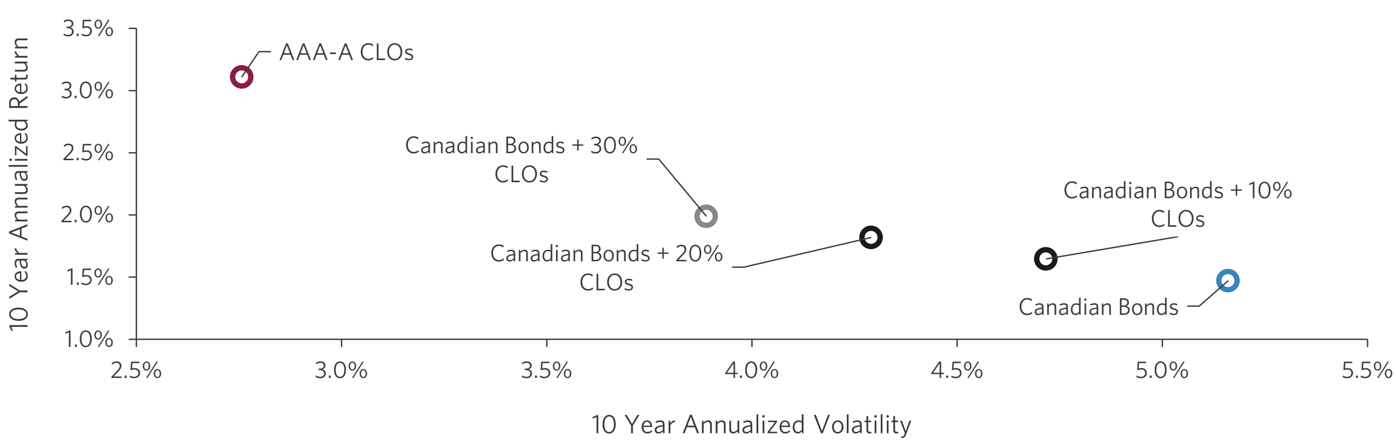

Source: US Treasury Department
Due to rounding, amounts presented herein may not add up precisely to the total.
As of June 2020

Banks and insurance companies dominate as holders of AAA rated CLOs given they operate in highly regulated industries where riskier investments require more buffer capital (money put aside to cover potential losses) to be held. This makes banks and insurance companies some of the most astute investors when it comes to maximizing yield potential while keeping risk low. Within these regulatory frameworks, AAA-rated CLOs receive low risk weightings which requires less buffer capital. This speaks to the quality of the instruments as assessed by regulators and the largest institutional investors.

# A welcome addition to fixed income portfolios

Adding CLOs to existing fixed income portfolios can help increase yield and reduce risk through lower correlation of returns and by offsetting the interest rate risk embedded in other fixed income investments. High-quality CLOs added to a core bond portfolio has helped to reduce return volatility and increase total returns.

**Risk-return improvements by adding CLOs to a core bond portfolio**




Source: JPMorgan, Bloomberg
Based on Bloomberg Canada Aggregate Bond Index and CLO AAA-A proxy portfolio (80% JPMorgan CLOIE AAA Index / 15% JPMorgan CLOIE AA Index / 5% JPMorgan CLOIE A Index) with monthly rebalancing
As of December 2024

The same applies for yield versus interest rate risk. The addition of high quality CLOs also increases portfolio yield and reduces interest rate risk.

**Yield improvement and interest rate risk reduction by adding CLOs to a core bond portfolio**


Source: JPMorgan, Bloomberg
Based on CAD-hedged yields and duration
Based on Bloomberg Canada Aggregate Bond Index and CLO AAA-A proxy portfolio (80% JPMorgan CLOIE AAA Index / 15% JPMorgan CLOIE AA Index / 5% JPMorgan CLOIE A Index)
As of January 20, 2025

# CIBC Asset Management's approach to investing in CLOs

With falling short-term interest rates and high levels of volatility, now is the time for investors to consider CLOs. Investors can benefit from the following:

- Access to a historically institutional asset class, favoured by banks, insurance companies and pension funds.
- Improve yields and potential total returns by adding CLOs to a bond portfolio.
- Maintain high quality exposure.
- Minimize exposure to interest rate risk in a volatile rate environment.

CLO investing requires dedicated and in-depth credit research expertise to understand both the quality of loans in portfolios and the structure. At CIBC Asset Management we approach these factors with multiple lines of defense to ensure we are investing in the best risk-adjusted opportunities.

This includes:

a. Loan research – conducted by dedicated credit analysts monitoring loans for signs of stress in underlying fundamentals.
b. CLO manager research – in-depth research on the loan managers who originate and manage the underlying loans ensuring they have long track records originating loans and understand how to manage loans through different credit cycles.
c. Portfolio research – ensuring the portfolio owns a highly diversified set of CLOs that avoids concentration in a single borrower, industry, and CLO manager.

CIBC has a 9 person dedicated credit research team that specializes in analyzing risks of corporate bonds, CLOs and other credit instruments. They specialize by industry and assess bond's credit quality independent of rating agencies and corporate management.

## Contact your CIBC representative to learn more about how to invest in CLOs.


## About CIBC Asset Management

At CIBC Asset Management, we believe that every customized investment solution begins with research and rigour. We specialize in a variety of investment solutions such as equities, fixed income, currency management, liability-driven investments, asset allocation, and responsible investments.

Across a spectrum of investment solutions, we commit to robust research. Dedicated sector and regional analysts focus on industry research and security-specific idea generation. Our investment professionals leverage deep and diverse expertise by sharing proprietary research across asset-class teams. By sharing insight across asset class teams, we maximize opportunities to add value to our client portfolios.



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