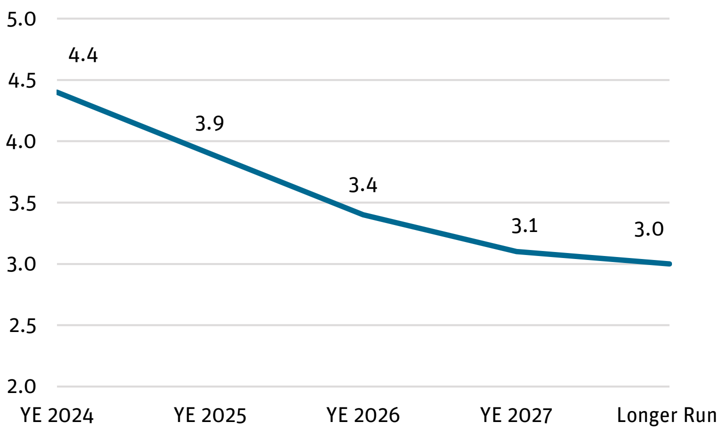
Overlooked Risks in AAA-Rated CLOs

While AAA-rated collateralized loan obligations (CLOs) performed well for risk-averse investors from 2022 to 2024, Angel Oak believes that recent market developments suggest a pivot to lock in higher yields and diversify short-duration allocations. The Federal Reserve is projecting that monetary policy will result in lower short rates (Figure 1), while recent geopolitical uncertainty has also increased the probability of an economic slowdown. This would create a two-pronged stressed scenario for AAA CLOs — diminished floating-rate coupons and lower income paired with potential spread widening and accompanying price depreciation.

Last year, flows into ETFs were a significant driver of demand for AAA-rated CLO tranches as investors sought fixed-income strategies that performed well during the rate rise of 2022 and 2023. Looking for a yield enhancement over 5-year Treasuries, they increasingly turned to ETFs offering exposure to high-quality CLO tranches. This surge in demand led to substantial outperformance for this 5-year floating-rate sector, but it limits the opportunity set in 2025.

Figure 1: FOMC Summary of Economic Projections
Median Fed Funds Rate (%)



Source: Federal Reserve as of 3/19/25.

The current levels of geopolitical uncertainty and associated market volatility have increased the probability of economic turbulence. This could cause outflows from investors rotating back into money market funds, a development that may result in spread normalization for AAA CLOs. In fact, spreads for this asset class have already widened from 112 basis points at January month-end to 130 basis points as of 3/14/25, an 18-basis point increase.[1]

CLOs tend to be floating rate, whereas other elements of the securitized credit market tend to be fixed rate. Floating-rate securities will not appreciate as much if short rates decline, while widening spreads can result in substantial price deterioration due to spread duration (Figure 2).

Figure 2: Scenario Analysis of Diversified Portfolio of AAA-Rated CLOs

Scenario	Price	Yield	Spread	Rate Duration	Spread Duration	WAL	Return – Immediate Shock
Interest Rates -100	100.00	4.13	133	0.08	4.10	4.59	0.08%
Interest Rates -50	100.02	4.63	133	0.08	4.05	4.59	0.04%
Current	100.04	5.12	133	0.08	3.99	4.59	0.00%
Credit Spreads +50	98.01	5.64	183	0.02	3.97	4.59	-1.99%
Credit Spreads +100	96.07	6.15	233	-0.03	3.95	4.59	-3.99%

Source: Angel Oak internal analysis from publicly available data as of 3/21/25.

We believe investors should consider diversifying away from a concentration in floating-rate AAA-rated CLOs and into investment-grade fixed-rate securitized assets with substantial credit enhancement that could benefit from declining rates.

[1]Source: Bank of America Historical Spreads Report as of 3/21/25.

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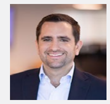
Agency Mortgage-Backed Securities (AMBS): Securities issued or guaranteed by the U.S. government or a GSE.
Basis Point (bps): One hundredth of one percent and is used to denote the percentage change in a financial instrument.
Bloomberg U.S. Corporate Investment Grade Index: An index that measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD-denominated securities publicly issued by U.S. and non-U.S. industrial, utility and financial issuers.
Collateralized Loan Obligation (CLO): A single security backed by a pool of debt.
Current Coupon: Refers to a security that is trading closest to its par value without going over par. In other words, the bond's market price is at or near to its issued face value.
Duration: Measures a portfolio's sensitivity to changes in interest rates. Generally, the longer the duration, the greater the price change relative to interest rate movements.
Federal Funds Target Rate: A target interest rate set by the central bank in its efforts to influence short-term interest rates as part of its monetary policy strategy.
Floating Rate: A floating-rate security is an investment with interest payments that float or adjust periodically based upon a predetermined benchmark.
FOMC Dot Plot: A chart summarizing the Federal Open Market Committee's outlook for the federal funds rate. Each dot marks where a respective FOMC member expects the federal funds rate to be at the end of a particular period.
Secured Overnight Financing Rate (SOFR): A broad measure of the cost of borrowing cash overnight collateralized by U.S. Treasury securities.
Spread: The difference in yield between a U.S. Treasury bond and a debt security with the same maturity but of lesser quality.
Weighted Average Life (WAL): Average length of time that each dollar of unpaid principal on a loan, a mortgage or an amortizing bond remains outstanding.
Yield Curve: The U.S. Treasury yield curve refers to a line chart that depicts the yields of short-term Treasury bills compared to the yields of long-term Treasury notes and bonds.



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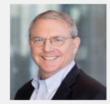

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