



Insights

Floating Above the Rest

**The compelling case for European
AAA-rated CLOs**

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Marketing communication for Institutional and Informed Investors only

Floating Above the Rest

The compelling case for European AAA-rated CLOs

In the current financial landscape, investors are constantly seeking assets that offer an optimal balance of yield, safety, and stability. European AAA-rated CLOs can offer unique combination of benefits that set them apart from other fixed-income assets, with a current yield of 4.3% and a historical volatility marginally higher than short-term (2yr) German government bonds.¹ Therefore, against this backdrop, European AAA-rated CLOs (Collateralised Loan Obligations) emerge as an increasingly attractive option.

Unparalleled safety record

One of the most striking features of EUR AAA CLOs is their perfect safety record. Since data collection began in 1997, there have been no defaults in AAA CLOs. This track record spans multiple economic cycles, including the 2008 financial crisis, highlighting the resilience of these instruments. This resilience reflects the position of AAA CLOs at the top of the capital structure, meaning that the weight of default risk is faced by investors in the unrated CLO tranche.

Rarity of AAA-rated floating-rate investments

EUR AAA CLOs represent one of the few AAA-rated floating rate assets available to investors. This scarcity is underscored by the absence of an AAA industrial index, reflecting the limited number of AAA-rated industrial corporate bond issuers. For investors seeking top-rated floating rate exposure, CLOs offer a unique opportunity.

Attractive spread and yield comparison

The following tables illustrate the compelling spread and yield offered by EUR AAA CLOs compared to other assets. See footnote 1 for a discussion on the calculation of “discount margin” (equivalent spread over floating rate Euribor) for fixed rate assets.

Table 1: Discount margin comparison (as at 31-Dec-24)¹

	EUR CLO AAA	Gov (2yr) Germany	Industrials			Financials		Sr Banks			
			AA	A	BBB	AAA	AA	AAA	AA	A	BBB
Volatility	2.5%	1.7%	2.8%	3.1%	3.3%	3.3%	3.2%	3.4%	3.2%	3.4%	3.7%
Discount margin	1.3%	-0.1%	0.4%	0.6%	0.8%	0.4%	0.6%	0.3%	0.6%	0.8%	1.0%
Yield to maturity	3.7%	2.1%	2.5%	2.8%	3.0%	2.6%	2.8%	2.5%	2.8%	3.0%	3.2%

Source: Fair Oaks Capital and JP Morgan as at 31-Dec-24.

As evident from Table 1, EUR AAA CLOs offer a significant pick-up in spread compared to other assets, even those rated well below AAA. This spread advantage extends across various sectors, including government bonds, industrials, financials, and banks.

Understanding terms such as *Discount Margin*, *Asset-Swap Spread* and *Yield to Maturity*

Discount Margin

For floating-rate securities like CLOs, discount margin represents the additional spread over the reference rate (e.g., EURIBOR) that would make the security's price equal to its face value. For CLOs, it's the spread over the reference rate that equates the present value of expected cash flows to the current market price.

Asset-Swap Spread

For fixed-rate bonds, asset-swap spread is calculated by determining the spread over a reference floating rate (typically EURIBOR) that would make the present value of the floating-rate cash flows equal to the bond's market price. This allows for a direct comparison with floating-rate instruments like CLOs on a similar basis.

Yield to Maturity

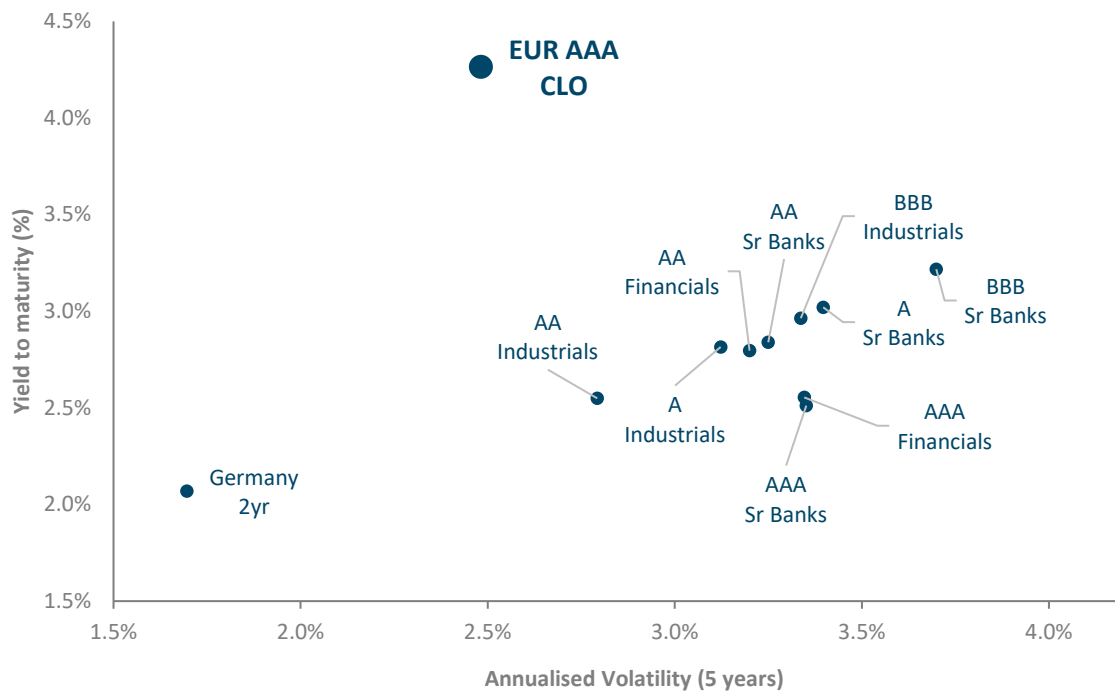
For floating rate CLOs, yield to maturity is calculated using the fixed rate curve for the expected life of the CLO – in this case 3.3 years (source: JP Morgan).

These measures enable a consistent comparison between floating-rate CLOs and fixed-rate assets, accounting for the term structure of interest rates and market pricing.

Volatility profile

Despite offering higher yields, EUR AAA CLOs have demonstrated remarkably low volatility. With a 5-year historical volatility of 2.5%, they are marginally higher than short-term (2yr) German government bonds (1.7%) and are significantly less volatile than other assets in the study, including those with lower credit ratings.

Chart 1: Yield to maturity and volatility comparison (as at 31-Dec-24)¹



Source: Fair Oaks Capital and JP Morgan as at 31-Dec-24.

Resilience to interest rate fluctuations

We believe that today's yields on fixed rate corporate bonds (for example German 2-year government bond at 2.1%) fully price in future rate cuts from the European Central Bank's current 3.15% reference rate (as at Dec-24). In contrast, European AAA-rated CLOs offer a gross "current yield" of approximately 4.3% (Euribor 3M + 1.3% spread). This structure provides a buffer against potential rate cuts, likely ensuring higher yields for CLO investors over a two-year period compared to government bond investors.

Moreover, the floating rate nature of CLOs helps mitigate the volatility often associated with fixed-rate instruments during periods of interest rate uncertainty.

Recognizing the value proposition of EUR AAA CLOs, Fair Oaks Capital has recently launched the first European AAA CLO ETF. The **Fair Oaks AAA CLO ETF** (LSE ticker: FAAA, Xetra ticker: LAAA) began trading on Xetra and the Frankfurt Stock Exchange on September 11th and the London Stock Exchange on September 26th, 2024. With a total expense ratio of 0.35%, it offers investors an accessible way to gain exposure to this asset class.

Conclusion

For sophisticated and institutional investors, exposure to European AAA CLOs can be a valuable addition to an income-generating portfolio thanks to the asset class's key features:

1. A proven track record of zero defaults
2. Attractive yields compared to similarly or lower-rated assets
3. Low historical volatility
4. Resilience against interest rate fluctuations

The **Fair Oaks AAA CLO ETF** provides liquid and transparent access to this institutional-quality asset class. As market volatility persists and yield opportunities remain scarce, EUR AAA CLOs stand out as an attractive option for investors seeking a balance of safety, yield, and stability in their fixed-income allocations

Endnotes

1. Fair Oaks Capital analysis and JP Morgan indices as at 31-Dec-24. The specific indices used for each asset class are as follows:
 - **CLOs:**
 - Euro CLOIE AAA-rated Index
 - **Government Bonds:**
 - Germany 2-year government bond
 - Italy 2-year government bond
 - **Industrials:**
 - AA Industrials: Industrial AA-rated bonds, 3-5 maturity Index
 - A Industrials: Industrial A-rated bonds, 3-5 maturity Index
 - BBB Industrials: Industrial BBB-rated bonds, 3-5 maturity Index
 - **Financials:**
 - AAA Financials: Financials AAA-rated bonds, 3-5 maturity Index
 - AA Financials: Financials AA-rated bonds, 3-5 maturity Index
 - **Banks:**
 - AAA Sr Banks: Banks Senior AAA-rated bonds, 3-5 maturity Index
 - AA Sr Banks: Banks Senior AA-rated bonds, 3-5 maturity Index
 - A Sr Banks: Banks Senior A-rated bonds, 3-5 maturity Index
 - BBB Sr Banks: Banks Senior BBB-rated bonds, 3-5 maturity Index

Disclaimer

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ADDITIONAL INFORMATION

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