Opening access

The popularity of CLO ETFs is set to increase, given the current rising interest rate environment. **Angela Sharda** investigates.

The advent of CLO ETFs opened up the CLO asset class to a broader set of investors. Against the backdrop of rising interest rates, demand for the product is set to continue apace.

"There has been strong demand in the US for CLO exposure through ETFs since these products were introduced less than two years ago. That demand is not surprising, given the current rising rate environment that we're in. The investment case is very strong and the ETF wrapper has opened up the asset class to a much broader set of investors," observes William Sokol, vp, director of product management at VanEck.

The VanEck CLO ETF – dubbed CLOI – is an actively managed ETF, sub-advised by PineBridge Investments, which seeks capital preservation and current income *(SCI 23 June 2022)*. It invests primarily in investment grade tranches of CLO obligations of any maturity.

Laila Kollmorgen, portfolio manager, CLO tranche at PineBridge Investments, notes that the CLO market has historically been an institutional market. Retail investors, smaller institutions, pension funds and investment companies were unable to access the CLO market because of the minimum account sizes that asset managers would accept. Therefore, ETFs have provided access to the CLO market that has previously been unavailable to these types of investors. ▶

Laila Kollmorgen, PineBridge Investments

Indeed, Sokol is seeing a diverse group of investors showing interest. For example, there is interest from advisors who haven't had access to CLOs, as well as larger institutional investors that are already investing heavily in CLOs.

He adds: "Many of our conversations with investors who are new to the asset class focus on the structure of CLOs and the benefits they provide, whereas those who are already familiar with CLOs are keen to learn about the ETF structure, trading of the ETF and how they can utilise it for their needs. This is an ETF that has broad appeal and multiple use cases."

Arguably the most well-known CLO ETF – Janus Henderson AAA CLO ETF (JAAA) – recently announced that it hit a record US$1.56bn of assets, after launching in October 2020 *(SCI 21 October 2020)*. The fund invests in triple-A rated CLOs and the current coupon on triple-A CLOs is 4.80%, with three-month Libor at 3.57% and the average portfolio margin at 1.20%. Combined, investors are achieving a close to 4% yield.

John Kerschner, head of US securitised products at Janus Henderson Investors, notes: "The demand has been incredibly strong. We have a great product in a macro market that almost no one has ever experienced. We have seen slower growth but higher inflation, which has negatively affected the major indexes – both equities and fixed income are down year-to-date."

However, he says that there have been hurdles along the way and it has been difficult for investors to find positive returns – although the saving grace for CLOs is that they are floating rate, and the ETF is exposed to triple-A securities, which are very high-quality.

Kerschner acknowledges that there are other funds in the market, but many of those rely on corporate credit for the majority of their allocation, and very few of them are floating rate. The yield of those portfolios will increase over time, while CLO yields reset every three months.

Janus Henderson launched its B-BBB CLO ETF (JBBB) – the first to focus on providing exposure to single-B to triple-B rated CLO securities – in January *(SCI 12 January)*.

Alternative Access Funds launched the other CLO ETF in the market, dubbed AAF First Priority CLO Bond ETF, in September 2020 *(SCI 7 August 2020)*. More recently, BlackRock disclosed in an SEC filing that it is prepping a CLO ETF, dubbed BlackRock AAA CLO ETF *(SCI 27 September)*.

At present, Kerschner believes that his firm has the best CLO ETF offering. He observes: "There are other products in this space. But honestly, they are neither growing, nor thriving."

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However, Sokol believes that there is probably room for multiple ETFs in the space, considering that the CLO market is over a trillion dollars in size. Also, given that CLOs themselves provide varying levels of risk and return – depending on where a position is in the capital stack – individual CLO ETFs will approach the market differently and appeal to a certain set of investors.

He claims: "If you compare this market to the loan market, for example, there are several loan funds from different managers and varied approaches to satisfy different investor needs. CLO ETFs are relatively new and we believe will continue to grow along with the CLO market."

Sokol suggests that given the liquidity in the space, there is also room for ABS ETFs as low-correlation, asset allocation tools for investors.

Nevertheless, Kollmorgen notes that the US is quite far behind Europe in this sense, so whether an ABS, CLO or other type of securitised products fund will be successful is yet to be seen. She also clarifies that the success of a specific product is dependent on a number of factors and whether one ETF or one fund is more popular than the other generally has to do with the management style, performance and accessibility.

She reveals: "There are different ETFs with different criteria. Whether an ETF focuses on triple-A, investment grade tranches or below investment grade exposure, investors need to recognise that these are different risk profiles. So, one ETF is not just a CLO ETF that is interchangeable, but that these are different investments with different risk profiles and will be managed accordingly."

However, in order for CLO ETFs to flourish, a number of hurdles still need to be overcome. Sokol acknowledges that retail investors and their advisors haven't had access to CLOs until now, so there is education needed on the asset class and how CLOs fit into a portfolio. Investors who are familiar with CLOs may need to better understand the ETF structures, if they haven't used ETFs before.

He adds: "We also get some questions on liquidity – similar to the types of questions that we used to get on high-yield bond ETFs. So, we need to explain how CLOs trade and how that could impact the trading of the ETF, and also some of the potential efficiencies that the ETF wrapper provides."

Kerschner notes that there are simpler marketing issues that could be problematic going forward. However, the more complicated issues lie around the knowledge of the actual product.

He concludes: "The challenges going forward are getting our message out – the product has great performance, makes sense for many investors, and has a lot of merit to it. Explaining what a CLO is and how it can help in portfolio construction will require a great deal of work, but we gladly accept that challenge. This is not a product that a lot of people know a great deal about – we encourage investors who don't have this product knowledge to reach out to us at Janus Henderson and have this discussion."