

# CLOs For Dummies

Jan. 20, 2021 12:40 PM ET | ARDC, ECC, EIC... | 106 Comments | 53 Likes

## Summary

- Forgive my cheeky title, which applies to the author as much as to many readers. We're all on a learning curve here with more exotic asset classes like CLOs.
- Collateralized Loan Obligations (CLOs) can seem pretty complex, but stripped down to their essentials they are "virtual banks".
- Traditionally CLOs were limited to institutional investors, who viewed them as a way to make "equity returns" from credit-based investments, which are essentially more stable and predictable than stocks.
- Closed-end funds have now made CLOs available to retail investors, but the industry is playing catch-up in making itself as transparent as it needs to be to attract more investors.
- This article won't make anyone an expert, but it's a start in the right direction.

- This idea was discussed in more depth with members of my private investing community, Inside the Income Factory.

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## **Background: "Equity Returns" With Credit Investments**

I published a version of this article earlier this month for my "Inside the Income Factory" members. Collateralized Loan Obligations ("CLOs") are an ideal way to earn an equity return by making more predictable "credit bets" rather than more potentially volatile "equity bets," a concept [explained here](#) in more detail. (Hint: Think of betting on a horse to merely finish the race as opposed to betting on a horse to win, place or show. Which bet do you think is easier to win? That's the difference between credit and equity.)

For the past 30 years or so, CLOs have been available to institutional investors, but only in recent years have become accessible to retail investors, through a number of closed-end funds, including Eagle Point Credit ([ECC](#)), Oxford Lane Capital ([OXLC](#)), XAI Octagon Floating Rate & Alternative Income Term Trust ([XFLT](#)), OFS Credit Company ([OCCI](#)), Eagle Point Income ([EIC](#)) (for CLO debt only, not equity), and Ares Dynamic Credit Allocation ([ARDC](#)) (which owns CLO debt and equity for about 30% of its portfolio).

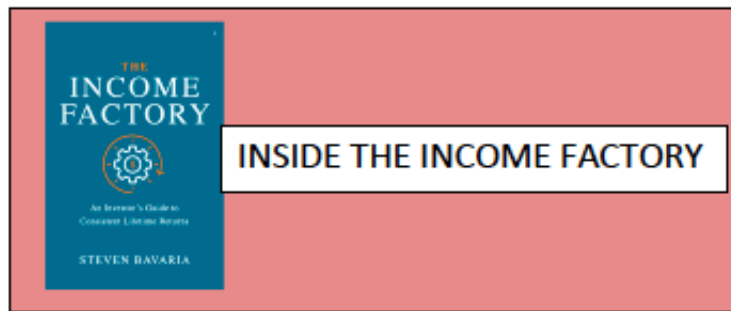
Many of these funds have made efforts to get up the curve in explaining the CLO asset class in a transparent way to retail investors. The goal is to help investors understand what they are buying and how to anticipate or project potential results under various economic and financial market scenarios. Nobody expects to be able to **predict** actual future results, but most investors would like to be able to understand the factors that influence those results, both positively and negatively.

This article is intended to be an introduction to CLOs. It won't make anybody an expert, but is intended to give readers a basic framework on which to build a greater understanding going forward.

In a [recent article](#) I complimented XFLT for presenting its results so transparently in a recent report. Since then XFLT's management has announced they are planning a webinar on the basics of CLOs aimed at retail investors on February 2. Seeking Alpha readers are invited to register. *(Leave me a comment below if you wish to do so, and I will send you the registration link, which for editorial policy reasons I am not allowed to post in the article.)* If readers have specific questions about CLOs they wish me to pass on to XFLT prior to the webinar, please add them as comments below.

*If parts of this article seem familiar, it may be because it covers some of the same ground as Chapter 13 in my book, [The Income Factory: An Investor's Guide to Consistent Lifetime Returns](#) (McGraw-Hill, 2020).*

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## CLOs - Virtual Banks

Many years ago there was an adage about bankers that they lived and worked according to the "3-6-3 rule." They paid their customers 3% on their deposits, loaned the money out at 6%, and were on the golf course by 3:00 pm. Nice work if you could get it.

Mythical and overly simplistic as that maxim may be, there's a germ of truth in it and anyone who truly "gets it" will understand immediately how Collateralized Loan Obligations (CLOs) work. For those who don't, we have this article.

CLOs are virtual banks. Buying the equity in a CLO is like buying the stock of a bank, where the CLO/bank acquires a portfolio of loans that pay an interest rate (perhaps 5% or so), using funds that include (1) its own equity capital, and (2) money borrowed from investors (in the case of a CLO), or taken as deposits (in the case of a bank). The key to making money, for both banks and CLOs, is (1) to have as big a spread as possible between the interest rate you collect on your loan portfolio, and the rate you pay on your bank deposits or CLO borrowings, and (2) to leverage that borrowing as much as you prudently can, so you can collect the spread multiple times.

Whether a bank or a CLO, the equity owners at the bottom of the balance sheet get all the excess spread between (1) the interest received on the loan assets, and (2) the interest, at a lower rate, paid out to depositors or creditors. But equity owners also absorb all the losses from borrowers who default and fail to pay, which is where things get interesting.

## **CLOs - A Little Background**

The assets that are the "raw material" from which CLOs are constructed are senior, secured floating-rate term loans to non-investment grade corporations. These loans are secured by collateral and have a long, well-documented history of protecting lenders when they default, with recoveries averaging 70-75%. To be conservative, we will use 70% recovery assumptions in our examples (i.e. losses on defaulted loans of 30%). As a result, loans typically have about half the credit losses of high-yield bonds, which are ***unsecured*** and whose recovery rates are only 40 to 50% (i.e. losses of 50 to 60%). Loans also carry no interest rate risk because their coupons are re-set every 1 to 3 months at a spread above the LIBOR rate.

An ordinary investment in a portfolio of high-yield corporate loans (also known as "leveraged loans") in today's market might generate coupon income of about 5%, depending on current interest rate levels and the credit ratings of the borrowers in the portfolio. If you want to earn more than that, you could leverage your investment by borrowing additional money at a lower rate, say 3%, and investing in more loans at 5%. You won't make as much on that second batch of loans as you do on the first batch because you used your own money on the first batch and don't have to share the income with anyone, while the first 3% of income received on the second batch is owed to the lenders who provided you with the additional funds.

So your naked investment in the loans, using just your own capital, earns you 5%. If you borrow an equal amount to your capital at 3% and invest it in additional loans at 5%, you would net 2% on that second batch. So your total earnings - so far - would be the 5% earned on your equity, plus 2% on the borrowed funds, for a total of 7%. If you leveraged your capital a second time and borrowed more money to buy loans at 5%, you'd make another 2%, for a total return on your capital of  $5\% + 2\% + 2\% = 9\%$ . With every turn of leverage you'd earn another 2% of "spread" income.

That's how the math works, whether it's a bricks-and-mortar commercial bank or a CLO, which is essentially a virtual bank, without the retail branches, loan officers and tellers, etc. In reality, banks and CLOs often leverage their capital by about 10 times (i.e. support an asset base of 10 times their equity). Using our simple example, that would mean the equity owners' total return would be 5% on their original capital, plus the 2% spread earned another 9 times, for a total of  $5\% + 18\% = 23\%$ . Of course, if that's all there was to it, we'd all invest all our money in banks and CLOs.

In reality, that 23% is our "gross" income on the portfolio, since we haven't deducted expenses. For a CLO, as in a bank, there are administrative expenses (salaries, rent, other overheads) plus the most important of all - credit loss. Just as the equity absorbs all the profits on the entire portfolio, it also has to absorb any losses. With leverage of 10 times the equity, a 1% credit loss, across the entire portfolio, represents a 10% loss to the equity.

Note that basic "CLO math" is pretty simple and straight forward. You lend at a higher rate, borrow at a lower rate, and collect the difference (i.e. the spread). The hard part, and what CLO managers get paid to do, is to **keep the difference** and not lose it to credit loss or other sorts of "margin erosion" that can occur over the course of the six to eight years of a typical CLO's life. Before we discuss the margin erosion challenges facing CLO managers, let us look at a simplified CLO structure and see what the gross cash flows are anticipated to be.

## CLO Structure

This table provides a model of a typical CLO, in which we assume the organizers raise \$50 million of equity and then leverage it by borrowing an additional \$450 million of debt. That adds up to \$500 million (i.e. 10 times \$50,000), but notice that only about \$490 million of it actually gets to be invested in earning assets (i.e. corporate loans). That's because (1) a portion of the \$500 million is used to pay the bankers who underwrote the deal, and (2) the equity, being the riskiest part of the structure, is often initially placed at a discount in order to induce investors to purchase it.

So we will assume the net capital raised (debt and equity) is used to acquire \$490 million of senior secured corporate loans estimated to earn an average coupon of 4.6%, which is a 3.85% spread above a LIBOR "floor" of 0.75%. That generates an annual income of 4.6% times \$490 million, or \$22,540,000.

Note that most loans are written at a spread above LIBOR, but if LIBOR goes below a certain point, called a "LIBOR floor," the lenders collect the spread plus the floor, rather than the actual LIBOR rate. That can add an additional 50 basis points or more to the loan coupon. CLO debt generally does NOT include a LIBOR floor, so that when rates fall, CLO equity gets the full benefit of the drop in rates in the cost of its liabilities. So CLO equity gets to "have it both ways," to a certain extent, when rates drop.

TYPICAL CLO STRUCTURE						
ASSETS			(US Dollars)			
Senior Secured Loans		490,000,000		Libor	0.25%	
Average Coupon		4.6%		Libor Spread Loans	3.85%	4.6%
Gross Annual Interest Income		22,540,000		Libor Floor	0.75%	
LIABILITIES						
	% of Total	% of Rated Notes		Spread Over LIBOR	Total Coupon	Interest Payment
AAA - Rated Tranche	64%	71%	320,000,000	1.40%	1.65%	5,280,000
AA - Rated Tranche	10%	11%	50,000,000	2.00%	2.25%	1,125,000
A - Rated Tranche	6%	7%	30,000,000	2.75%	3.00%	900,000
BBB - Rated Tranche	6%	7%	30,000,000	4.35%	4.60%	1,380,000
BB - Rated Tranche	4%	4%	20,000,000	8.00%	8.25%	1,650,000
Equity	10%		50,000,000			
Rated Notes			450,000,000			
TOTAL	100%		500,000,000		Total Interest Cost of Leveraged Debt	10,335,000
					Weighted Average % Cost of Debt	2.3%
					Spread/Margin	2.3%
Gross Annual Interest Income					22,540,000	
Interest Income After Cost of Leverage					12,205,000	
Collateral Management Fees and Other Expenses				0.65%	3,185,000	
Net Income After Interest Cost and Mgmt Fees					9,020,000	
Net Income As % of Equity Investment					18.0%	

*NOTE: We have attempted to use realistic assumptions about loan yields and the cost of the various CLO debt tranches but caution readers this is just a model, intended to demonstrate the structure and dynamics of a CLO, especially how its earnings and cashflow are so dependent on critical variables like (1) the coupon rates on the loans it owns, (2) the cost of its various debt tranches, (3) the default and loss rates on its loan portfolio, and (4) other factors we will mention later. Actual CLOs vary considerably in their structure, complexity and performance.*

## **CLO Liabilities**

Where CLOs get complicated is on the liability side. Just as a bank has a lot of different types of liabilities (checking and savings accounts, CDs, subordinated debt, preferred stock, bonds and notes), so does a CLO. Banks and CLOs maximize their profits by having as many cheap liabilities as possible. The lower your overall cost of funds, the greater the spread between what you earn on your loan portfolio and what you pay to fund it. In place of low-interest or no-interest checking and savings accounts, a CLO issues as much as it can of highly-rated, low-risk, low-cost debt. The reason it's low-risk and low-cost is because investors who buy it are relying on a cushion of higher-risk and higher-cost debt junior to it in the capital structure, to absorb any credit or other losses along with the equity.

Our model CLO has \$400 million in triple-A, double-A or single-A-rated debt, at coupon rates between 1.65% and 3%. Ironically, these are much higher rates than those paid by similarly rated paper in "normal" corporate credit markets. It's doubly ironic because default rates for highly-rated CLO debt have been historically much lower (virtually non-existent) than default rates for ordinary corporate debt with similar ratings.

There's a similar disparity in the default rates for triple-B and double-B tranches of debt that are below the AAA, AA and A-rated tranches. The triple-B and double-B debt provides the cushion of credit protection between the CLO's equity and its highly-rated debt. There have been some, albeit relatively few- and far-between, defaults in the CLO world where the equity was wiped out and the losses reached up into BBB and BB-rated territory. But here too, just like the more highly-rated CLO debt, the rate of defaults historically has been substantially below the default levels of similarly rated corporate debt. Meanwhile, coupons on this lower-in-the capital-stack CLO debt have always been much higher than typical corporate debt at the same rating level.

This means **CLO debt - whether AAA-rated, BB-rated or in-between - is a bargain for investors in that they are paid a premium return for taking less risk than the credit ratings would suggest.** I believe the additional spread represents complexity and liquidity risk, rather than actual risk of loss, which makes CLO debt attractive for long-term investors willing to get up the learning curve required to understand the asset class. I think the same applies to CLO equity, although the complexity is somewhat greater and the learning curve a bit steeper.

## **Impact of Credit Losses**

The goal of a CLO manager is to keep as much of their gross income (the "spread") from the loan portfolio as possible after paying off the note holders and other expenses, and to pass it down to the CLO's equity owners. That means keeping loan losses to a minimum, through (1) good due diligence upfront (i.e. buying the right loans) and (2) careful monitoring and management of the portfolio throughout the CLO's life.

This chart shows the impact on CLO equity returns of various levels of loan loss. Case 1 is called the "optimistic" case, which represents the pre-pandemic reality of recent years, when defaults have been rather low. Secured corporate loans, over many years, have recovered on average about 70% of their principal when they default, meaning the loss on each defaulted deal is about 30%. That means a portfolio of loans with a default rate of 1% would lose 30% of 1%, or 0.3% of the portfolio. In a leveraged CLO, that would mean a 10 times hit to equity, or 10 times 0.3%, which equals 3%. The 3% credit loss would reduce the equity return from 18% down to 15%.

Net Income As % of Equity Investment (Before Credit Losses)						18.0%
Net Income AFTER Credit Losses:						
	Default Rate	Recovery Rate on Defaulted Loans	Loss Rate on Defaulted Loans	Portfolio Loss Rate (Loss Rate Times Default Rate)	Loss Rate to Leveraged Equity (10X)	Equity Income After Losses
Case 1: Optimistic	1%	70%	30%	0.3%	3%	15%
Case 2: Historical	2%	70%	30%	0.6%	6%	12%
Case 3: Current (11/2020)	4%	70%	30%	1.2%	12%	6%
Case 4: More Severe	6%	70%	30%	1.8%	18%	0%
Case 5: Draconian	8%	70%	30%	2.4%	24%	-6%

You can see from this chart that increasing the rate of credit default and loss has a serious impact on CLO earnings. At the current rate of defaults in the leveraged loan market (about 4%, per S&P, much lower than originally projected earlier last year), our CLO model would generate an equity return of about 6%. Not too exciting. If defaults and losses spike higher (as some researchers, like Fitch Ratings, think they might) it would be even worse.

Here's recent loan market default experience. You can see that while it has most recently hit the 4% mark, 1% to 2% has been more typical.

## US leveraged loan default rate



Data through Nov. 30, 2020.

Sources: LCD, an offering of S&P Global Market Intelligence; S&P/LSTA Leveraged Loan Index

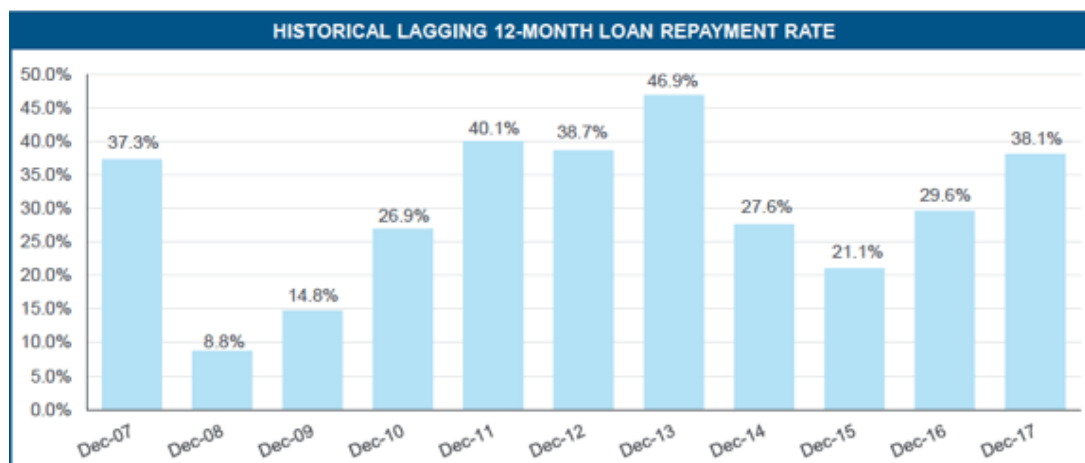
## CLO Management - Playing Offense As Well As Defense

If the above tables told the whole story, and CLO equity return potential topped out in the mid to high teens but ran down toward zero and below whenever credit defaults increased even marginally above their historical averages, I don't think we'd be too interested.

Fortunately, CLO managers get to play offense as well as defense. I think of avoiding or minimizing credit defaults and losses as essentially playing defense. You're trying to protect and defend the basic cash flow that the portfolio generates.

But CLO managers have offensive strategies as well, that they use to increase the spread on their portfolios. The first is their ability to actively trade and reinvest payment proceeds from their existing loan portfolios during the "reinvestment period" (generally about the first four years of a CLO's life - see CLO life-cycle chart down below). This can be a powerful way to build cash flow.

Although it may vary considerably from one year to the next, leveraged loans repay at an average rate of about 25% per year. During the re-investment period CLO managers can use the repayment proceeds from healthy loans repaying at par, to buy new loans in the secondary market at discounts to par. These discounts may be 2% or 3%, as they currently are, or they may be 10% or more, as they were at times in 2020. The more volatile the economy and the financial markets, the greater the discount often is on healthy, performing loans. In 2008-2009, for instance, healthy performing loans were trading at 70 to 75 cents on the dollar.



1. Source: S&P Capital IQ/S&I, Financial LCD Research, LCD Quarterly Leveraged Lending Review: 1Q18 (April 2, 2018). Past performance is not a guarantee, predictor or indicator of future results.

This ability to continually roll a portion of your portfolio over into new loans, purchased at discount prices, is a powerful tool for CLO managers to boost their cash flow and their income. Just like closed-end fund investors buying funds at discounts, the CLOs end up with more assets working for them than they actually had to pay for. That translates into a higher yield on the investment than what the yield would be if purchased at par. Suppose a CLO's loan assets have an average coupon of 4.6%, as we assumed in our example up above. If one of the loans repays at par and the CLO re-invests the proceeds into a similar yielding loan but manages to purchase it for 96 cents on the dollar (a 4% discount), the same interest payment that represented a 4.6% yield on the investment at par now represents a 4.8% yield on the discounted price. Not a big jump, obviously, but it accumulates as you do it on dozens or hundreds of loans over the course of a CLO's lifecycle, especially with the 10-times leverage.

It gets even better as markets become more volatile. If the discount were 10%, a 4.6% yield on par becomes a 5.1% yield. And if markets were extremely volatile, like 2008/2009 or more recently in 2020, and CLOs could re-invest principal repayments at a discount of, say, 20%, then a 4.6% yield on par becomes a 5.75% yield on the discounted amount of the investment.

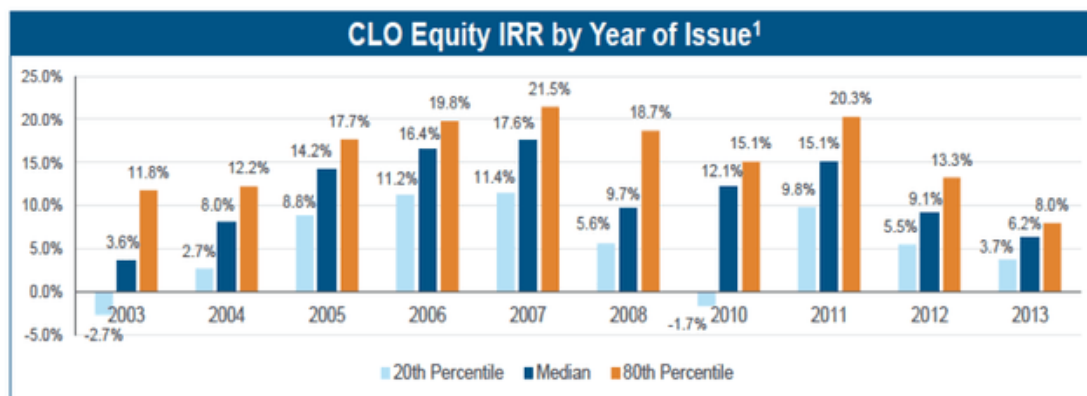
But that's not all. Besides the increased yield spread from having more assets working for it than it previously did, the CLO also can look forward to substantial capital gains later on when it gets its principal paid back at par for loan assets it bought at a discount.

## **Lots of Moving Parts**

So far, we have noted how CLO managers have to:

- Be defensive about avoiding and minimizing credit risk,
- While also going on offense when it comes to managing their loan portfolio, using repayments from existing loans to fund new loan investments at discounted prices and higher yields,
- Which also generates capital gains when the discounted loans pay off at par

These two activities - (1) avoiding credit risk and (2) boosting returns by re-investing at discounted loan prices - tend to be related. As you might imagine, loan defaults tend to go up during periods of economic turmoil and volatility. Those are the same conditions that often see spikes downward in the market prices of loans (and other asset classes), allowing opportunistic managers to load up on healthy assets at bargain prices. That's why CLO experts and practitioners point out how well their asset class has performed during turbulent periods, as this chart demonstrates.



It also helps explain an anomaly that seems to arise in the net asset value ("NAV") calculation of closed-end funds that buy CLOs. A CLO's equity, like any other entity's, should generally equal the value of its assets minus the value of its liabilities. Since the amount of the liabilities is fixed, we would expect increases and decreases in loan market prices to directly affect the net asset value of CLO equity and the funds that hold it. While I'm not privy to the formulas that are used to determine the net asset values of closed-end funds that hold CLOs, it seems to me that they tend to rise and fall, at least in part, with movements in the secondary loan market.

However, it's not that simple. Falling loan prices may reduce the mark-to-market value of a CLO's loan holdings. But for the 95% or more of those loans that are healthy and performing, there has been no diminution of value, since the CLO can hold them to maturity and collect them at par, regardless of how low their prices fall in the secondary market. Think of it as the owner of a loan essentially can "put" that loan back to the issuer/borrower at par when it matures, regardless of what its price in the secondary loan market may be.

But the story gets even better when you consider that the lender (the CLO) can often take the repaid loan's proceeds and purchase a replacement loan at a discount. So the CLO's income generating capacity has actually increased as the secondary market price of its assets has decreased. The equity value on its balance sheet, measured in a static way as "assets minus liabilities" may have dropped, but the CLO's income generating ability, which is its value as a business, has arguably increased.

In our "mark-to-market" investing world, it may be hard to accept the idea that the secondary market price of an asset is pretty irrelevant to the owner of that asset if they are confident they can redeem the asset at par (i.e. collect a loan at maturity at its face value). As long as a CLO knows it can hold the loan and be paid at par at maturity, then the CLO's own value is not really impaired by the drop in market value of its loan assets, and indeed may be greater than it was before loan prices dropped.

## **But Wait, It's Not Quite That Simple!**

A CLO's ability to wait for its healthy, performing loans to mature at par and re-invest the proceeds only lasts until the end of its reinvestment period.

Here is the "life-cycle" of a typical CLO. Notice that at the end of year 4, the reinvestment period ends and the amortization period begins. This has substantial implications for a CLO manager trying to maximize the earnings margin on their portfolio. In our model up above, we assumed a weighted average interest cost of debt of 2.3%. That reflected a blend of low-risk, highly-rated debt priced at 1.65%, lower-rated riskier debt priced at 8.25%, and a range of other debt in between. Once the reinvestment period ends, the CLO begins its "unwinding" period. That means loan principal repayments can no longer be used to buy replacement loans, and must be used to begin paying down the CLO debt. (Good news, some recent CLOs are reportedly structured with five-year re-investment periods, which extends the period during which managers can reinvest repayments at maximum spreads.)

## Life of the Typical CLO<sup>1</sup>

Pre-closing	
Month 1 to Month 6	<b>Warehouse Period</b> Underwriting bank provides CLO manager with financing to begin acquiring assets in advance of CLO closing. Equity investors provide first loss capital during the warehouse period
Closing	
CLO comes into legal existence	
Post-closing	
Month 1 to Month 3	<b>Ramp-Up Period</b> Post-closing, proceeds from CLO debt issuance used to repay warehouse and purchase additional assets
Month 4 to Year 4	<b>Non-Call Period</b> Post Year 2, the equity investor(s) may direct original CLO liabilities to be refinanced (prepaid at par) and replaced with new liabilities in order to reduce interest expense
	<b>Reinvestment Period</b> <ul style="list-style-type: none"><li>■ Collateral Manager permitted to actively trade underlying assets to maximize value and ensure portfolio remains in compliance with collateral quality tests</li><li>■ Principal cash flows from underlying loan/bond assets used by the Collateral Manager to purchase new assets</li></ul>
Year 5 to Maturity	<b>Amortization Period</b> <ul style="list-style-type: none"><li>■ A portion of cash flows from asset amortization, prepayments/repayments, and sales are used to pay down outstanding CLO debt in order of seniority</li></ul>

When a CLO begins to amortize its debt, it has to start with its most senior, and therefore cheapest, liabilities. That means paying off its triple-A debt, then its double-A, single-A and so on down the line. With every dollar of senior debt it pays off, the CLO's weighted average interest cost increases, reducing its asset-liability spread and therefore its income. For example, if a CLO wound down to the point that its AAA through A-rated debt were all paid off, and all it had left was BBB and BB-rated debt, its average cost of funds would then be somewhere in the 5%-6% range, which might be as much or more than it was earning on its loan portfolio, and its profit margin would turn negative.

So CLO managers, long before they reach that point, have an incentive to step in and liquidate their portfolios and wind up the CLO prematurely. Of course, that means they cannot wait for their remaining loan portfolio to pay off at maturity and collect par, but have to sell it on the secondary market at whatever discount currently applies.

This often means CLO managers don't know for sure (1) what their portfolios are really worth, and (2) how accurate their earnings accrual over the life of the CLO has been, until they liquidate the portfolio at the end of the CLO's life. They have models and algorithms with various assumptions that they monitor and tweak continually, but the ultimate CLO equity return is not known until the portfolio assets finally wind down and are repaid and/or liquidated. This is why CLO management quality is so important, as is indicated by the range of returns shown on the CLO equity IRR chart above.

CLO managers can effectively extend the reinvestment period and postpone the beginning of the amortization period by doing a "re-set" which is essentially a re-issuance of the CLO with new terms and an extended maturity. It pushes out the reinvestment window, providing additional opportunity for the CLO to collect payments at par from its existing portfolio and re-invest on more attractive terms or at a discount. At the same time, it may allow the CLO managers to negotiate cheaper funding. These improvements, on both sides of the CLO balance sheet, increase the spread (margin) available to the equity.

Short of a total "re-set," managers also have the option, after the end of the first two year "non-call" period, to pre-pay and refinance the CLO's liabilities at lower rates, if market conditions allow. That too, can improve the earnings margin.

## Summary

CLOs are simple in theory, but execution is complicated, and makes all the difference.

- Obviously, CLO equity returns depend heavily on the spread (margin) between the loan assets and the debt incurred to fund them, especially with the 10 to 1 leverage magnifying everything that affects it.
- The main negative threat to that spread is credit loss, which managers try to minimize by smart loan underwriting and selection, and adroit portfolio review and pruning throughout the life of the CLO.
- Potentially offsetting the cost of credit loss are steps CLO managers can take to (1) trade their loan portfolios opportunistically, (2) reinvest principal payments at discounted loan prices, (3) renegotiate existing debt to lower rates, and (4) occasionally re-set the entire CLO agreement, extending its re-investment period and reducing funding costs.

These are a lot of moving parts for investors to try to follow. The more investors know about how CLOs are structured and what the various dynamics are that influence their earnings, the more we can ask questions and encourage CLO fund managers to be transparent in how they present their funds' activities and results.

In future articles we will explore other topics, including CLO cash flows as well as the distributions from funds that hold CLOs, to try to understand and manage our own expectations about what sort of returns we might reasonably anticipate, and how to regard distributions from a return-of-capital perspective (how much constructive vs. destructive ROC, etc.). A complex issue not raised in this article but deserving discussion in future is the difference between a CLO investor's tax treatment and GAAP accounting treatment of the cash distributions received from its CLO equity investments.

But I think this is a good start and hopefully provides a basic framework for investors who are new to CLOs to begin to understand what's potentially a valuable asset class for Income Factory investors and others looking for credit-based equity returns.

As always, I look forward to your questions, comments and discussion.

Steve

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*I launched **Inside the Income Factory** because many of my 11,000+ Seeking Alpha followers and readers of my book **The Income Factory**® (McGraw-Hill, 2020) said they wanted more ongoing and interactive dialogue than I could provide through less frequent public articles. It allows me to answer more member questions about how to apply our **Income Factory**® philosophy to earning "equity returns" from alternative, more predictable "non-equity" asset classes.*

So if you want to take your *Income Factory* investing up a notch, please [click here](#) to learn more.

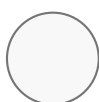
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Thanks,

Steve Bavaria

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**Disclosure:** I am/we are long XFLT, ECC, OXLC, ARDC, OCCI, EIC. I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it (other than from Seeking Alpha). I have no business relationship with any company whose stock is mentioned in this article.

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