What Is a Collateralized Loan Obligation?

A Collateralized Loan Obligation ("CLO"), in simple terms, pools together a collection of leveraged loans that are generally senior secured but extended to companies that are rated below investment grade. These loans, which often pay a floating-rate coupon and generally mature in five to seven years (but not always), are packaged into a special purpose vehicle ("SPV") and the collective cash flows from the underlying loans are carved up into multiple tranches with varying degrees of risk.

The senior most tranche of a CLO, commonly referenced as the 'A' tranche, is rated AAA and has contractual, first payment priorities and represents the least risky class; but in exchange, this tranche receives the lowest margin or spread. At the other extreme, the equity tranche is entirely subordinated and considered to be the riskiest with its rate of return undetermined and subject to excess cash flows generated by the CLO. The equity tranche does not have a fixed payment schedule and its cash flows are the first to be compromised if certain set of provisions (called coverage tests) that regulates the CLO are not in compliance, such as overcollateralization and interest coverage. In market parlance, the equity experiences the 'first loss', if there are any. More stringent coverage tests and higher subordination can especially bolster the higher-rated tranches as the additional benefits will accrue from the highest-rated tranche downwards.

The Waterfall

In a typical CLO capital structure, the AAA-rated tranche sits atop the stack, with its cash flows having the most seniority; followed ordinarily by the AA-rated, A-rated, BBB-rated, BB-rated and lastly, the equity. What is important to understand is that the waterfall language will legally direct the stream of cash flows, meeting the interest payments of the AAA-rated tranche first followed by the AAs. Beginning with the single As and down to the BBs, which are labeled as the mezzanine and junior tranches, interest payments can usually be deferred.

Tranche	Rating		Commentary
A	AAA	>>	Senior tranche: with first priority, contractual interest margins
B	AA	>>	Senior tranche: with interest that is contractual as well and not deferrable
C	A	>>	Mezzanine tranche: with interest that is deferrable
D	BBB	>>	Mezzanine tranche: further subordinated than 'C' class with interest deferrable
E	BB	>>	Junior tranche: lowest subordination with interest payments that are deferrable
Equity	Non-rated	>>	Subordinated: claims on residual cash flows if CLO is in full compliance of coverage tests

A figurative way to think about risk impacting this CLO "totem pole" is rising flood waters. For example, in an environment where risk generally increases as the economy slows, operating conditions deteriorate and the prospects of corporate defaults grows, among other things, the lowest rung (the equity tranche) will be hit first by swelling flood waters. As flood waters creep up higher, there is the potential to inflict more damage up on the totem pole. In summary, any type of risk that leads to a breach of any coverage test or induces losses on the CLO will escalate from the bottom up with the equity absorbing the first loss.

An Illustration

Every CLO has particular nuances but the following is an illustration of what a typical CLO structure could look like.

Class	Rating	Issued Amount (US$mm)	Subordination	Spread (margin)[1]
A	AAA	130.00	35%	3-month LIBOR +1.25%
B	AA	20.00	25%	3-month LIBOR +1.65%
C (deferrable)	A	15.00	18%	3-month LIBOR +2.35%
D (deferrable)	BBB	10.00	13%	3-month LIBOR +3.50%
E (deferrable)	BB	10.00	8%	3-month LIBOR +7.25%
Subordinated (Equity)	Non-rated	15.00	0%	Residual cash flows

This is a hypothetical illustration for educational purposes only; and not representative of any actual product or security.

In this example, the total issuance is US$200 million with the underlying loans carrying an average spread of 3.25%. As we can calculate, the weighted-average spread ("WAS") on the CLO is 1.75%. The difference between the WAS and the average spread on the loans of 3.25% is called the "funding gap", which if large enough, can incentivize equity investors to participate and allow a CLO structure to be successfully formed. If the funding gap is not sufficient, equity investors may not be motivated to invest which would jeopardize the CLO issuance altogether.

The funding gap is equally important for the Class A tranche as this will help determine the final pricing of the CLO, the amount of subordination of each tranche and the strength of additional credit enhancements. In our example, the AAA-rated tranche has a subordination level of 35% while the equity has 0%, which is consistent with other CLO issuances. Another way of interpreting this is that the AAA-rated tranche, in exchange for a greater amount of subordination accepts a lower spread than the average spread on the loans. The higher subordination of the AAA-rated tranche that shelters the Class A is in effect possible because the equity tranche soaks up any initial losses.

ALTERNATIVE ACCESS

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The fund's investment objectives, risks, charges and expenses must be considered carefully before investing. The prospectus contains this and other important information about the investment company, and once available a copy may be obtained without charge, by calling the Fund at 1-800-617-0004. Read it carefully before investing.

Past performance is no guarantee of future results. The AAF First Priority CLO Bond ETF has no performance history. Once the fund has performance available, please call 800-617-0004 to receive fund performance.

Investing involves risk. Principal loss is possible. Shares of any ETF are bought and sold at market price (not NAV), may trade at a discount or premium to NAV, and are not individually redeemed from the funds. Brokerage commissions will reduce returns.

The Fund is also subject to the following risks: Collateralized Loan Obligations (CLOs) are generally backed by a pool of credit-related assets that serve as collateral. Accordingly, CLO securities present risks similar to those of other types of credit investments, including default (credit), interest rate and prepayment risks. In addition, CLOs are often governed by a complex series of legal documents and contracts, which increases the risk of dispute over the interpretation and enforceability of such documents relative to other types of investments. An increase in interest rates may cause the value of fixed-income securities held by the Fund to decline. The Fund may be subject to a greater risk of rising interest rates due to the current period of historically low rates and the effect of potential government fiscal policy initiatives and resulting market reaction to those initiatives. The Fund's income may decline if interest rates fall.

The Fund is a recently organized, diversified management investment company with no operating history. Additionally, the investment adviser has not previously managed a registered fund, which may increase the risks of investing in the Fund.

Credit ratings are provided by a nationally recognized statistical rating organization (NRSRO). Ratings are grades given to bonds that indicate their credit quality as determined by private independent rating services such as Standard & Poor's, Moody's and Fitch. These firms evaluate a bond issuer's financial strength, or its ability to pay a bond's principal and interest in a timely fashion. Ratings are expressed as letters ranging from 'AAA', which is the highest grade, to 'D', which is the lowest grade.

Investment grade- a rating that signifies a municipal or corporate bond presents a relatively low risk of default.
LIBOR (London InterBank Offered Rate)- a benchmark interest rate at which major global banks lend to one another in the international interbank market for short-term loans.
Spread- the difference in yield between a US Treasury bond and another debt security.
Subordination- priority of collateralized debts, ranking one behind another for purposes of collecting repayment form a debtor
Tranches- segments from a pool of securities that are divvied up by risk in order to be marketable to different investors.

The AAF First Priority CLO Bond ETF is distributed by Quasar Distributors, LLC.

[1] We used prevailing market spreads as of September 11, 2020 as an estimate for this illustration.