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IG CLOs: Strong Excess Return Potential, Lower Volatility

BARINGS INSIGHTS

Investment grade-rated tranches of collateralized loan obligations (IG CLOs) can offer a compelling opportunity for investors to earn excess returns above and beyond what they are currently earning by holding investment grade credit. Since 2014—with the inception of the J.P. Morgan CLO Index (CLOIE)—the excess returns generated by IG CLOs have been achieved with less volatility than corporate credit. As we believe this trend is likely to continue, investors with allocations to IG credit and U.S. corporates may benefit from diversifying some of their exposure into IG CLOs.

What is driving this trend? A variety of factors have contributed—including the spread pick-up that investors can earn from holding IG CLOs versus comparably rated asset classes, as well as the lower overall volatility—both of which result from the performance of the underlying collateral and the structural security offered by CLOs. However, it's not all market and structure related. Despite the common perception that manager differentiation is less important higher up in the capital structure, the ability to generate compelling risk-adjusted returns in the asset class is heavily influenced by manager selection decisions.

How IG CLOs Stack Up

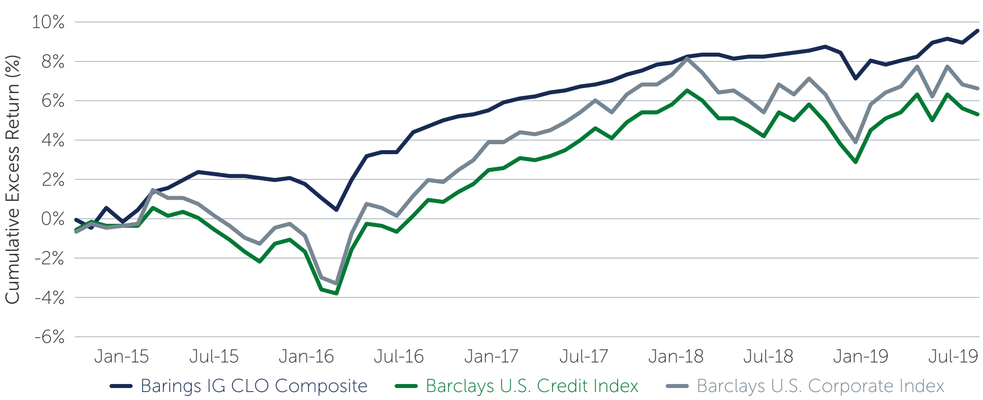
IG CLOs, as represented by the J.P. Morgan CLOIE, have historically offered similar absolute returns as U.S. IG corporates and U.S. credit.[1] However, comparing the absolute returns of IG CLOs to those of IG credit is not a commensurable assessment, primarily because of the difference in the rate duration of these asset classes.

To remove the interest rate duration component from returns and focus solely on the credit component of the asset classes, we look at the excess returns of the Bloomberg Barclays U.S. Credit and U.S. IG Corporate indexes, as well as those of the Barings IG CLO Composite.[2]

EXCESS RETURN = ABSOLUTE RETURN - RISK FREE RATE

When assessing excess returns from January 2015 through August 2019, Barings' IG CLO portfolios delivered cumulative excess returns of 9.50%, outperforming the Barclays U.S. Credit Index (5.90%) and Barclays U.S. Corporate Index (6.44%) by 360 bps and 306 bps, respectively (**FIGURE 1**).

FIGURE 1: Barings' IG CLO Portfolios Outperformed Indexes* (September 2014-August 2019)



*As of June 30, 2019, the Barings IG CLO Composite was allocated 94.5% to AAA—single-A rated tranches, with the remaining allocation to BBB rated tranches.
SOURCES: Barings, Barclays. From September 1, 2014 through August 31, 2019. We view late 2014 as the beginning of the oil sell-off. Performance is gross-of-fees. For complete performance information, please refer to the composite disclosure on page 4.

1. Sources: J.P. Morgan CLOIE, Bloomberg Barclays U.S. IG Corporate Index, Bloomberg Barclays U.S. Credit Index. As of August 31, 2019.
2. Bloomberg Barclays defines excess return as the index return minus the return on a set of duration-equivalent Treasuries. The Barings IG CLO Composite excess return is defined as the monthly gross-of-fees return, minus a 30-day rolling de-annualized 3-Month LIBOR.

FIGURE 2: Barings' IG CLO Portfolios Experienced Less Volatility Than Indexes

	Barings IG CLO Composite	Barclays U.S. Credit Index	Barclays U.S. Corporate Index
Excess Return (Cumulative)	9.50%	5.90%	6.44%
Excess Return (Annualized)	1.96%	1.24%	1.35%
Standard Deviation	1.40%	3.81%	4.00%
Sharpe Ratio	1.40	0.32	0.34

SOURCES: Barings, Barclays. From September 1, 2014 through August 31, 2019. We view late 2014 as the beginning of the oil sell-off. Performance is gross-of-fees, and does not reflect the deduction of investment advisory fees. The standard deviation and sharpe ratio are based off of the annualized return. **PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS.**

In addition to generating higher excess returns, the Barings IG CLO Composite also experienced less volatility, contributing to a higher Sharpe Ratio (1.40) than the U.S. Credit Index (0.32) and the U.S. Corporate Index (0.34) (**FIGURE 2**).

The Excess Returns Story

There are several reasons why we believe IG CLOs are well positioned to offer attractive excess returns with less volatility than comparable asset classes:

Spread pick-up: CLO spreads, particularly at the higher-rated AAA and AA tranches, tend to be wider than those of other comparably-rated corporated credit and securitized products. This is due largely to the complexity of the asset class—as well as its smaller market capitalization and perceived illiquidity—although liquidity in the CLO market has increased in recent years, as evident from the increase in trading volume.[3] As a result, CLOs can present an opportunity for investors to earn incremental yield relative to investment grade corporates, while still owning an investment grade-rated asset with seniority in the capital structure.

Structural protection: The structural protection of CLOs provides a reliable cash flow, leading to a resilient asset class with lower volatility. Higher-rated IG CLOs have proven to be resilient to losses from underlying loan defaults through multiple credit cycles. In fact, AAA and AA rated CLOs have never experienced a loss of principle—including during the financial crisis.[4] This can be attributed, in part, to the high quality of the underlying collateral—senior secured bank loans that rank first in priority of payment in the capital structure—in addition to enhanced structural protections.

Collateral credit quality: The credit quality of the underlying collateral is another contributor to the resilience of CLOs. The underlying collateral in CLOs is actively managed, meaning managers can trade in and out of individual loans over a specific time period based on performance. As a result, if certain sectors or credits experience weakness, managers can take steps to limit exposure and improve the quality of the names in their loan pools.

3. Source: City Velocity. As of August 31, 2019. The trailing 12-month average of BWIC volume in CLOs was $2.8 billion. Notably, June 2019 marked the highest volume in the last 36 months, at $4.5 billion.
4. For AA rated CLOs, there was one technical default, and it was repaid in full.

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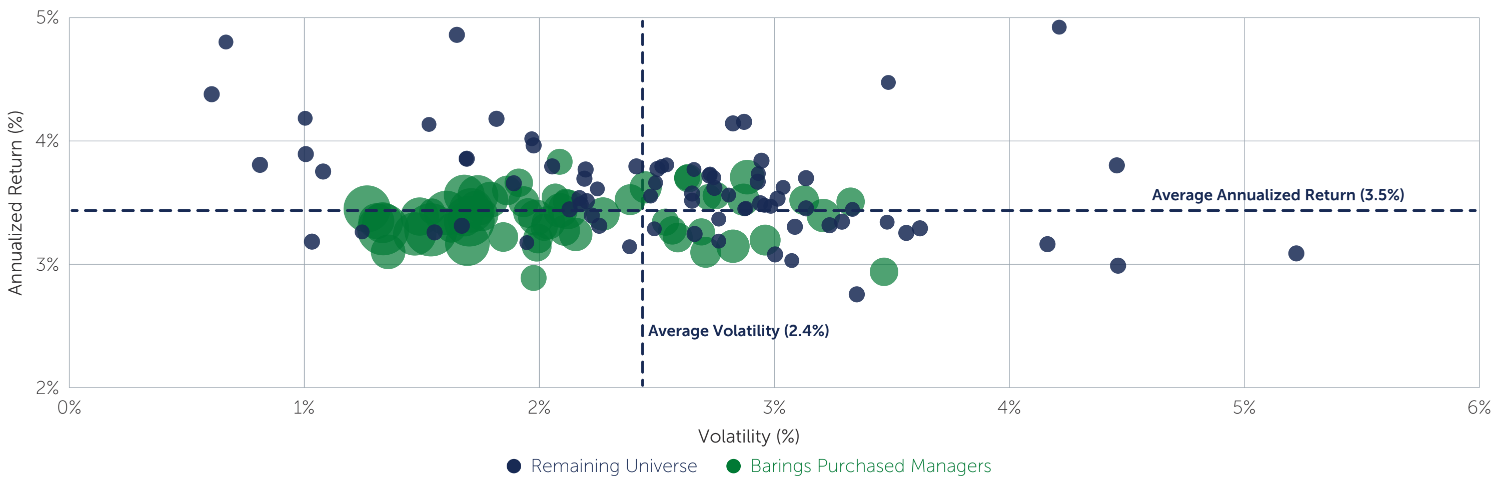
FIGURE 3: AA-Rated Barings Managers Outperformed on a Risk-Adjusted Basis (August 2016–August 2019)



SOURCES: Barings, Barclays. From August 1, 2016 through August 31, 2019. The chart represents the average annualized return and average volatility for Barings' managers, as well as the remaining CLO manager universe—represented by CLOIE, and assuming market weight—during the specified time period. Performance is gross-of-fees. PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS.

The Importance of Prudent Manager Selection

Prolonged periods of market volatility have produced a valuable track record through which to assess collateral managers, and offer insight into CLO manager performance, including how managers add value and manage risk in their bank loan portfolios. When evaluating managers, we continue to see dispersion in performance across the CLO capital structure, including in IG CLOs where manager selection is often undervalued. As such, we take a selective approach, choosing managers we believe will position us to deliver attractive annualized returns with lower volatility relative to a broader universe.

To highlight the impact of manager selection, we use the AA rated tranche as a proxy for IG CLOs. We use the time period from August 2016 to August 2019 to capture the volatility that permeated the market in late 2015, in pockets of 2016, and in late 2018. The green dots represent managers that Barings owns and the blue dots represent the remaining J.P. Morgan CLOIE universe of CLO managers. The blue dots are sized to a medium exposure i.e. market weight; a larger green dot signifies an overweight position and a smaller green dot signifies an underweight position. As evident from the graph above, Barings owns more exposure to managers that provide higher annualized returns with lower volatility than the market. Likewise, Barings is underweight managers that provide similar returns but exhibit higher volatility. Said another way, Barings-owned managers offer higher returns per unit of risk than the market, underscoring the potential benefit of manager selection in higher-rated tranches (**FIGURE 3**).

Conclusion

In the current economic environment, IG CLOs have the potential to offer attractive excess returns, as well as other benefits, including greater spread pick-up and lower overall volatility—both of which result from structural protection and strong collateral performance. Looking ahead, there are a number of macroeconomic uncertainties on the horizon—Brexit negotiations, U.S.-China trade tensions, and fluctuations in commodity prices, to name a few—that could introduce volatility into the markets. As such, we may see an increase in quality bias, which would be supportive of the asset class overall.

CLOs are complex, and the market is thus one in which size and experience with manager selection can have key benefits, even at the highest-rated tranches. At Barings, we prudently select CLO managers, focusing on those who we believe can ultimately add value to our IG CLO portfolio through a full market cycle. Given the potential benefits of the asset class, we see a compelling reason for investors currently allocating to IG credit and U.S. corporates to consider diversifying some of their exposure into IG CLOs.

RISK PROFILE While we see many benefits to investing in IG CLOs, it is also important to consider the potential risks. Despite the high quality of the underlying collateral, IG CLOs are subject to credit, liquidity and interest rate risk. Investors may also be exposed to price fluctuations and/or losses, which can result from changes in overall market conditions or issuer-specific fundamentals. At Barings, our primary goal is to deliver attractive risk-adjusted returns for our clients. To best manage risk, we conduct rigorous, bottom-up credit analysis in our initial underwriting process and regularly track key credit metrics to ensure the investment thesis for each credit that we invest in remains intact.

Investment Grade CLO Strategy Composite Performance Notes

Annual	Composite Annual Return (Gross)	Composite Annual Return (Net)	Composite Asset-Weighted Dispersion	3-Year Annualized Std Dev. (Composite)	Total Composite Assets (USD Millions)	Total Firm Assets (USD Millions)	Percentage of Firm Assets	# of Portfolios at End of Period (# of Entire Period)
06/30/2019^	3.19%	2.98%	0.96%	1.10%	3,538	307,362	1.15%	11 (8)
12/31/2018	1.52%	1.11%	0.93%	1.48%	2,261	286,629	0.79%	9 (8)
12/31/2017	3.59%	3.18%	0.94%	1.42%	1,962	284,798	0.69%	9 (6)
12/31/2016	4.50%	4.08%	0.46%	1.53%	1,248	178,724	0.70%	7 (6)
12/31/2015^	2.13%	1.72%	NM	0.97%	1,072	163,934	0.65%	7 (5)
12/31/2014^	1.15%	0.80%	NM	N/A	1,172	157,257	0.75%	5 (3)
12/31/2013^	1.28%	0.93%	NM	N/A	571	142,832	0.40%	4 (1)
12/31/2012**^	1.34%	1.25%	NM	N/A	51	116,633	0.04%	1 (1)

^ Information for the periods indicated has not been examined by independent accountants.
NM The asset-weighted dispersion of five or fewer portfolios for the entire year is not meaningful.
** Returns are from composite inception date of October 01, 2012 through December 31, 2012.

COMPLIANCE STATEMENT

Barings (the "Firm" fka Babson Capital Management LLC) claims compliance with the Global Investment Performance Standards® (GIPS®), and has prepared and presented this report in compliance with GIPS. The Firm has been independently verified for the period from 1993 through 2016 as Babson Capital Management LLC ("Babson"). See the "Definition of the Firm" section for further information.

Verification assesses whether (1) the Firm has complied with all the composite construction requirements of GIPS on an organization-wide basis, and (2) the Firm's policies and procedures are designed to calculate and present performance in compliance with GIPS. The Investment Grade CLO Strategy composite has been examined for the period 2016. The verification and performance examination reports are available upon request.

DEFINITION OF THE FIRM

The Firm provides investment management and advisory services to both institutional and individual clients. For purposes of compliance with GIPS, the Firm defines itself as consisting of the portfolios that it manages directly. In the third quarter of 2016, the previous subsidiaries of Babson were consolidated under the Barings name. Those entities included Babson Capital Management LLC, Cornerstone Real Estate Advisers LLC, Barings Asset Management Limited, and Wood Creek Capital Management LLC. For 2016, the Firm assets above represent Babson Capital Management LLC for GIPS purposes. In 2017, the Firm assets will represent the consolidated entity. A list of the Firm's composite descriptions is available upon request.

POLICIES

The Firm's policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request.

COMPOSITE DESCRIPTION

Portfolios included in the Investment Grade CLO Strategy composite seek to invest in U.S. CLO securities that carry original credit ratings from AAA to BBB. Some portfolios may also invest in European CLO tranches; however, all investments are hedged back to U.S. dollars (USD). The minimum portfolio value requirement for inclusion in the composite is USD $25,000,000. The name of the composite was changed from Senior CLO Strategy to Investment Grade CLO Strategy in September 2015. The composite was created in October 2012.

BENCHMARK

Due to the lack of market availability regarding benchmarks related to this strategy, and variation surrounding U.S. CLO tranches, no benchmark will be assigned. Therefore a benchmark value of zero will be applied.

FEES

Returns are presented gross of management fees, custodial fees, and withholding taxes, but net of all trading expenses. Net performance results are calculated by deducting fees from the gross monthly return, using the highest annual fee charged for a member portfolio dedicated to this strategy during the periods presented. Applicable fees for 2012–2014 were 35 basis points (bps), and for 2015–2016 were 40 bps. Actual fees may depend on the applicable fee schedule and portfolio size, among other things.

PERFORMANCE RESULTS

Results are calculated using a formula based on the time-weighted total rate of return, and are expressed in USD. The composite is asset-weighted; individual portfolios are valued daily on a trade date basis, and include accrued income. The composite and benchmark results assume the reinvestment of distributions. Performance results include all portfolios under the Firm's management that meet the composite definition. A portfolio is included in the composite when it is deemed that the investments made by the investment advisor fully reflect the intended investment strategy. **PAST PERFORMANCE IS NOT A GUARANTEE OF FUTURE PERFORMANCE.**

ASSETS, COMPOSITE DISPERSION, EX-POST STANDARD DEVIATION

The asset base used to calculate the composite's percentage of Firm assets includes both discretionary and non-discretionary portfolios managed by the Firm, and also includes non-fee paying portfolios. The asset-weighted dispersion calculation measures the deviation of individual portfolio returns around the aggregate composite return. Only portfolios that have been managed for a full annual period have been included in the dispersion calculation. No dispersion is reported for periods with five or fewer portfolios (shown as "NM"). The three-year annualized ex-post standard deviation of the composite and benchmark are displayed above.

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**As of June 30, 2019*

19-965281