



Liquidity Commentary

There is a perception across some segments of the investment community that liquidity in a ‘AAA’ CLO Bond ETF could pose potential challenges. This contention would in practice apply to many other credit products offered via an ETF and already trade successfully in the marketplace. Still, concerns of liquidity warrant attention and should be addressed.

Often, there is a proclivity to group volatility and liquidity in the same category of risk. In our opinion, it is important to distinguish liquidity from volatility. Volatility is often viewed as a sudden and unpredictable rate of change, typically for the worse. However, volatility is not necessarily a negative feature especially if the underlying asset is inherently volatile; or becomes temporarily volatile due to some exogenous stress, like evidenced earlier this year in March-April. Short-term volatility can in fact be a source of important market signals and we believe should not be misconstrued as a barometer of illiquidity per se.

Liquidity can be defined by several measures. In the marketplace, liquidity is often characterized by the collective breadth and scope of buyers and sellers, that drive transactions as it intersects with the crosscurrents of bids and offers, which in turn generates volume. For an ETF to be considered liquid, from one perspective, the execution price of the ETF should in practice closely mirror the aggregate values of the underlying assets, which is measured by the net asset value (“NAV”). Another way of expressing this is if the premium/discount to NAV of an ETF is de minimis or ‘zero’, the price of the ETF, in theory, should fairly reflect the value of the underlying assets. If the market price is grossly inconsistent with the NAV, for example, it could dissuade investors from executing on a regular basis. This could be one important factor in depressing liquidity.

In this vein, for an ETF investor, it is critical that the NAV accurately and consistently reflects prices of the underlying assets. For this to happen, the pool of underlying CLOs should not only be able to be justifiably modeled and measured but also regularly valued from a transactional, market standpoint. One clear way to determine the veracity of valuations is via secondary market activity, which can serve as one of the most critical pillars in calculating the NAV.

Secondary Trading Activity

Over the past decade, the CLO market has grown substantially, in both size and importance to corporate funding markets. A broadly diversified buyer base has emerged increasing participation and growth in the CLO market, which has fueled an active secondary market for AAA CLOs.

There are multiple avenues to trade CLOs, which include bilateral transactions and broad market auctions. In bilateral transactions, broker-dealers making active two-way markets facilitate customer trades (crosses) or buy/sell using their balance sheet and inventory. In an auction, also known as a Bid Wanted in Competition (“BWIC”) or an Offer Wanted in Competition (“OWIC”), a customer solicits bids (or offers) from multiple dealers who in turn work with their CLO network to provide best execution to the seller (or buyer). This dynamic process occurs throughout each trading day.

Trading volumes for CLOs can be observed and estimated in multiple ways. FINRA-reported trade volumes, aggregated BWIC/OWIC volumes and observable dealer prints shed light on total volumes



in various areas of the market. An analysis of FINRA’s TRACE-reported volumes reveals that in 2019, approximately US\$300 million of investment grade CLO/CBO/CDOs traded daily, of which the vast majority constituted AAA-rated CLOs. More recent trade statistics show that an average of greater than US\$500 million of investment grade bonds trade per day¹. BWIC volumes aggregated by Citibank for the period 2011-2018 show a robust range between US\$17.6 billion and US\$32 billion in annual BWIC auctions².

The NAV

With active secondary market trading and broker reported volumes as points of reference, an ETF like the AAF First Priority CLO Bond ETF (“Fund”) should be able to accurately gauge the value of each of its holdings on a daily basis to produce a reliable and consistent NAV calculation. Moreover, like other credit-focused assets, CLOs are priced on a variety of market factors that impact the final valuation. Many of the same factors that the Fund will use to make trading and allocation decisions will be inputs that are included in the pricing models offered by third party pricing sources. According to the Bank of England, approximately 4% of the CLO market (about US\$32 billion) is already held in various open-ended funds that mark their positions regularly³, if not daily, which may create a positive feedback loop with respect to valuations and marked to market protocols. Similar to other open-ended funds with CLO exposure, per the Fund’s valuation policy, it will use one (or more) of the following pricing services to determine a daily NAV: JP Morgan, Pricing Direct; Bank of America Merrill Lynch, PriceServe (distributed by Intercontinental Exchange (ICE)); Thompson Reuters Pricing Service; Bloomberg BVAL, Kanerai; IHS Markit; Moody’s Analytics.

Some Contributors to Highly Liquid Classification		AAA Rated CLO Bond / Market Attributes
AAA CLO Structure	Restriction on Trading/Transferring Investment	DTC transferred bonds; T+2 settlement
	Credit / Default History	Zero principal losses since inception in 1994 ⁴
	Duration	May offer shorter interest rate duration due to floating rate note structure, i.e., coupon resets quarterly ⁵
	Availability of Information	Publicly made available by a variety of trustees and vendors
AAA CLO Market	Market Size	CLO market totals almost US\$700B, of which more than US\$400B is AAA Rated CLOs ⁶
	Active Market Makers	More than 24 Broker Dealers who regularly make prices and trade CLOs ⁷
	Diversity of Market Participants	Domestic and Global Banks, Insurance Companies, Pensions, Endowments & Institutional Money Managers ⁸
	Frequency of Trades / Quotes	Daily markets made by multiple broker dealers across a multitude of CUSIPs ⁹
AAA CLO Market Data	Daily Trading Volume	Typically greater than US\$300MM per day; US\$200MM to 1000MM range per day ¹⁰
	Primary Market	In recent years, greater than US\$100B per year; which provides context for the depth of the bid ¹¹
	Investment Valuation	Multiple providers of valuation on daily basis ¹²

According to SEC rule 22e-4, which presents another classification of liquidity (see Table), a highly liquid is one defined as convertible to cash in 3 or fewer business days. The Fund will be an actively managed diversified portfolio of the most senior and liquid bonds in the CLO capital structure, seeking to invest in AAA-rated CLOs that rigorously reflect pre-determined portfolio construction criteria, that includes important liquidity considerations (per the Prospectus).



Contact Information:

Todd Themistocles

Email: tthemistocles@altacfunds.com

Phone: 917-535-5737

Disclaimer:

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.

The fund is currently not available for investment.

Diversification does not assure a profit nor protect against loss in a declining market.

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.

The AAF First Priority CLO Bond ETF is distributed by Quasar Distributors, LLC. Quasar Distributors, LLC is not affiliated with other broker dealers referenced herein.

¹ FINRA-ICE Data Services, Structured Trading Activity Reports.

² "Citigroup Is Trying to Take CLO Trading Out of the 1990s", Bloomberg, June 20, 2019.

³ Bank of England, Financial Stability Report, July 2019.

⁴ "Understanding Collateralized Loan Obligations", Guggenheim Partners, May 1, 2019; "Seeing Beyond the Complexity: An Introduction to Collateralized Loan Obligations", Pine Bridge Investments, September 19, 2019; The CLO asset class was created in the late 1980s as a framework for banks to tranche different pools of risk and securitize the cashflows. The CLO officially debuted in 1994, which is often referred generically to "CLO Vintage 1.0". To date, AAA-tranches have never experienced a default since the asset class was created.

⁵ "Debt Instruments and Markets: Floaters and Inverse Floaters", Professor Carpenter, New York University, Stern School of Business.

⁶ "CLO issuance rises slightly in second quarter amid loan downgrades", www.reuters.com, July 13, 2020.

⁷ The list includes: Amherst, Baird, Bank of America, Barclays, BNP, Brean, Brownstone, Cantor, Citigroup, Credit Suisse, Deutsche Bank, Goldman Sachs, Greensledge, Guggenheim, JP Morgan, Janney, Jefferies, Marv, Mizuho, Morgan Stanley, MUFG, Nat Alliance, Natixis, Nomura, RBC, SMBC, Societe Generale, Stifel, Wells Fargo.

⁸ Bank of England, Financial Stability Report, July 2019.

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¹⁰ As calculated per FINRA data, FINRA-ICE Data Services, Structured Trading Activity Reports.

¹¹ Per CreditFlux: 2017: \$110.25, 2018: \$169.18; 2019: \$124.21.

¹² JP Morgan, Pricing Direct; Bank of America Merrill Lynch, PriceServe (distributed by Intercontinental Exchange (ICE)); Thompson Reuters Pricing Service; Bloomberg BVAL, Kanerai; IHS Markit; Moody's Analytics.