‘AAA’ CLOs

Summary

The Collateralized Loan Obligation (“CLO”) market is now the largest source of levered lending for U.S. corporates, with the overall market growing to over US$700 billion and the AAA segment representing US$400 billion.[1] As a point of reference, the total leverage loan market exceeds US$1.4 trillion.[1]

The AAA-rated tranche of CLOs offers numerous potential benefits to any diversified portfolio: i) floating interest rates that typically reset quarterly (which shortens duration and shelters it from interest rate exposure) ii) higher current relative yield to other similarly rated investment grade assets [see table below] iii) historically better long-term Sharpe ratios[2] and iv) first priority claims. Since the inception of the asset class through June 2019(the most recent data available), AAA-rated CLOs have never experienced a default.[3] Despite this, retail investors have not been able to access this important area of the credit market.

VARIOUS INVESTMENT GRADE BOND INDICES METRICS (a) as of 9/17/2020				
Index	**Index Rating Category**	**Index Coupon Types**	**Yield to Maturity**	**Discount Margin (y) / OAS(z) (bps)**
Palmer Square CLO AAA Index	IG	Floating	1.59%	130(y)
Bloomberg Barclays US Floating Rate Note < 5 Years Index	IG	Floating	0.65%	45(z)
Bloomberg Barclays U.S. Aggregate Bond Index	IG	Fixed	1.18%	59(z)
Bloomberg Barclays US MBS Index	IG	Fixed	1.30%	63(z)
Bloomberg Barclays CMBS Index	IG	Fixed/Floating	1.60%	122(z)

Debunking Some Misconceptions

Some market practitioners still group CLOs with high-risk products that are considered opaque, difficult to quantify and assess systematically. Some of this can be attributed to a misunderstanding of how a CLO is structured and the benefits that accrue to the senior most issues, specifically the AAA tranches; and some of this can be attributed to the legacy of 2008-09 when Collateralized Debt Obligations (“CDO”) wreaked havoc on the global financial system.

Investors should understand that there is a fundamental difference between CLOs and CDOs. In fact, CLOs share very little in common with its CDO counterpart that were issued prior to the Global Financial Crisis (2008-2010). Back then, CDOs were largely composed of arcane sub-prime mortgages; in contrast CLOs today are almost exclusively supported by secured, first lien loans issued by middle market corporations, which have led to higher recoveries relative to high yield bonds.[4]

Although the trend evidenced since the creation of the asset class cannot be guaranteed for future market cycles, it is important to recognize that AAA and AA-rated CLOs have, collectively, only experienced a single default.[5] Furthermore, only 0.3% of *all* CLO tranches have defaulted since 1994, which includes the period through the Global Financial Crisis.[6] A recent Moody’s article concluded that even if we entered a Great Depression-like operating environment, which caused recovery rates on defaulted loans to drop toward 50%, from a historic average of 77%, a AAA tranche of a recent CLO issue would in all likelihood remain unaffected.[7] Another way of interpreting this is to understand that in a typical CLO, there is approximately 40% of subordinated capital that bolsters the

AAA tranche before any impairment. It is also noteworthy that rating agencies have pushed for greater protective provisions within CLOs structures after the Global Financial Crisis.

The Opportunity

In recent years, the leverage loan market has evidenced strong growth, with loans outstripping the high yield bond market as the primary source of capital for levered companies. As a consequence, the demand for CLOs have ballooned. Despite the recent trajectory, many AAA-rated CLOs have been "tucked away" by banks, insurance companies and pension funds, rarely traded. As such, additional demand has been unnaturally checked.

The potential benefits of a 'AAA' ETF product, while not suitable for everyone, are manifold for various investors, not least of which is the opportunity to access an investment-grade product that can potentially deliver higher relative yields with a focus on principal preservation. In fact, a AAA ETF product could expand interest in the asset class offering direct access to the first priority CLO bond market for a host of new participants. With the introduction of a new floating-rate investment grade bond product, many investors could potentially enhance their return profiles while diversifying their portfolios. For existing AAA CLO investors, an ETF could add enhancements to the marketplace with a broadening of the investor base, which could improve transparency while adding greater depth and liquidity. The ETF can also give existing players a new exchange-listed distribution channel, away from the over the counter markets. In summary, all participants could further benefit from increased lucidity into the CLO market, its workings, pricing and risks.

DESCRIPTION OF THE INVESTMENT VEHICLE (b)	
Fund Name	AAF First Priority CLO Bond ETF
Manager	Alternative Access Funds LLC
Ticker	"AAA"
Fund Type	ETF
Targeted Investment	AAA-rated first priority USD-dominated CLO bonds
Management Fee	25 bps
Passive / Active	Active
Distribution Frequency	Monthly

INVESTMENT CRITERIA (b)	
Bond Rating	AAA or equivalent by an NRSRO
CLO Type	Broadly Syndicated Loan CLOs
Tranche Priority	First Priority
Minimum Initial Deal Size	$300MM
Minimum Initial Tranche Size	$150MM
Maximum Position Size	5.00%
Maximum CLO Manager Exposure	7.50%
Maximum WARF	Less than the greater of (a) [3000] or (b) the median of WARF value of all outstanding BSL CLOs

Contact Information:

Todd Themistocles
Email: tthemistocles@altacfunds.com
Phone: 917-535-5737

Disclaimer

Sources:

[1] Bank for International Settlement, Quarterly Review, September 23, 2019
[2] Bank of America Merrill Lynch Global Research, 8 August 2019; 5-year AAA rated CLO Sharpe Ratio, 0.73; 5-year IG Corporates Sharpe Ratio, 0.25; 5-year High Yield Bond Sharpe Ratio, 0.22
[3] S&P 2018 Annual Global Leveraged Loan CLO Default And Rating Transition Study, June 19, 2019
[4] S&P S&P: Leveraged Loan Recoveries Have Dipped While High Yield Increases, January 18, 2019
[5] S&P 2018 Annual Global Leveraged Loan CLO Default And Rating Transition Study, June 19, 2019
[6] S&P 2018 Annual Global Leveraged Loan CLO Default And Rating Transition Study, June 19, 2019
[7] Moodys Analytics, "CLO Stress in the Time of COVID-19", June 23, 2020;

[a] Bloomberg as of 9/17/2020
[b] AAF First Priority Bond ETF Form N-1A, 12/23/2019

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.

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

Past performance is no guarantee of future results. Index performance is not representative of fund performance. The fund is new and 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.

The AAF First Priority CLO Bond ETF is distributed by Quasar Distributors, LLC.
For registered investment use only – not for public distribution.