XA’s Flynn: Healthy Borrowers Should Keep CLO Space Humming

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Chuck Jaffe, in this episode of The NAVigator podcast interviews Kimberly Flynn, President of XA Investments, which runs the XAI Octagon Floating Rate & Alternative Income Trust. Kimberly and Chuck discuss the development, growth, and heightened demand in alternative investments, as well as how current market conditions around rates, tariffs, and uncertainty are hitting the loan markets. She notes that the current picture for leveraged loans involves healthy borrowers and muted defaults, making for good fundamentals and a solid outlook. She notes that the uncertainty surrounding tariffs and Federal Reserve moves will lead to more volatility but also should create new opportunities for active managers.

The podcast can be found on AICA’s website by clicking here: https://aicalliance.org/alliance-content/pod-cast/

CHUCK JAFFE: We’re talking alternative investments and opportunities in the loan markets with Kimberly Flynn from XA Investments, this is The NAVigator. Welcome to The NAVigator, where we talk about all-weather active investing and plotting a course to financial success with the help of closed-end funds. The NAVigator is brought to you by the Active Investment Company Alliance, a unique industry organization representing the full spectrum of the closed-end fund business from investors and users to fund sponsors and creators. If you’re looking for excellence beyond indexing, The NAVigator will point you in the right direction. Today we’re looking in the direction of alternatives and alternative directions with Kimberly Flynn, she’s president at XA Investments, a leading provider of research for listed closed-end funds and interval funds, but a firm that also partners with other portfolio managers in creating ETFs built around its research. You can learn more about everything they're doing at XAInvestments.com. And if you want to learn about closed-end funds, interval funds, and business-development companies generally, check out AICAlliance.org, it's the website for the Active Investment Company Alliance. Kimberly Flynn, it's great to have you back on The NAVigator.

KIMBERLY FLYNN: Thanks, Chuck. Always great to be back talking with you.

CHUCK JAFFE: Let's start with, I mean, they're called alternatives because of what they do, but they're no longer alternatives, everyone talks to me about alternatives. They're clearly mainstream, they're clearly a big part of what people are doing, but there's a lot of flavors and a lot of demand out there for new and different things, so help us understand a little bit about what is driving all this demand and how far afield alternative is getting.

KIMBERLY FLYNN: Well, I think you're right, alternatives really, it's not a great word for investments in private markets which really open up new income and total return opportunities. So if you're looking for portfolio diversification away from stocks and bonds, the private market arena, which alternatives encompass, really gives you access to a lot of interesting things. We're talking private credit, specifically structured credit today, but there's a whole opportunity set in private equity, venture capital, infrastructure, you name it, private market strategies that individual investors in the past really haven't had much access to in a registered fund where you get a 1099.

CHUCK JAFFE: It's an interesting role that you guys play in the space, because you do industry-wide research but you also are managing money, you're managing assets, or at least you're doing that in partnership with other firms. How does that come about? Which comes first, the research or the money management?

KIMBERLY FLYNN: We've been in business now for about nine years and I started the firm when I left Nuveen Investments, so I've got a rich history in the listed closed-end fund marketplace, loving that structure for income production and I wanted to do more in private markets, and so the asset management business definitely came first. We launched our first registered listed closed-end fund in September of 2017, which is XFLT, but the relationship we have with the portfolio manager, Octagon Credit, they're a subadvisor to the fund. We have no affiliation with Octagon, but we have a great partnership in managing and growing

XFLT for shareholders. And so that definitely came first, but what we found out was that a lot of people were really interested in XFLT because it was so different than any other traditional listed closed-end fund on the market. There's plenty of senior loan listed closed-end funds or muni bonds, but this was different and it brought more attention to what we were doing, or trying to do at the time, and now there's so many firms that are trying to get in front of investors. You have Blackstone and Apollo and KKR making headlines every day about trying to democratize alternatives, bring alternatives to retail investors, and so there's been a focus in the last three or four years, this has led to a lot of other alternative managers who aren't as big as Blackstone, they too want to launch registered closed-end funds. And so that's what led to our consulting and our research practice, because we had followed this space so closely, and in working with John Cole Scott at Closed-End Fund Data, it really just led us to be at that intersection of what people were trying to learn more about; which is why we in partnership with Closed-End Fund Data, we publish this really rich research on interval funds and on listed closed-end funds.

CHUCK JAFFE: I should point out in case anybody missed it, that the XFLT is the XAI, that's for XA Investments, Octagon Floating Rate & Alternative Income Trust. We have seen other firms and other funds come into the CLO, collateralized loan obligation debt, and so let's talk about that market. Because when you get a new market, which you guys were basically the first ones into back 2017, when you get a new market, you're not worried about the size of the market, can it sustain it, is it good for investors to have a lot of competition and whatever, but once you get others coming in, there are some markets that, hey, they got no problem swallowing up all the action, there are others where you're going, wow, it really makes a difference when a couple are in it. So is it good for the XFLT shareholders that the other companies are invading their space? Is competition or what have you, the ability to differentiate?

KIMBERLY FLYNN: Yeah, differentiation does become more important, but the benefit we have in the CLO product set that's out there definitely has expanded, you see CLO debt ETFs, JAAA is probably the largest and most successful in that space. I point to that product because it's gained such size and scale that it's brought a lot of other advisors and investors into the world of CLOs. And you know, in the beginning when you're venturing into CLO debt and equity, it takes a little bit to get comfortable with the CLO structure itself, understanding the waterfall of the cash flows; and so we like it, JAAA, and there are other CLO debt ETFs that are up in quality in the CLO debt stack, that's really helped a whole new base of buyers, educate them on CLOs. We also see new entrants to the listed closed-end fund space, now those are predominantly CLO equity-focused type products, so I agree with you, definitely more need for differentiation and helping investors understand the benefits and the risks of the debt versus the equity, absolutely mission critical. Because I think our fund, for example, XFLT invests in a mix of senior loans, CLO debt, and CLO equity, and that is done by design, so we think we're uniquely positioned even though we've seen a lot of growth in the market, and I think we leave it to advisors and investors to think about what's more appropriate for them. Do they want to go full tilt into CLO equity? CLO equity obviously very attractive, high-yields, very high distributions, and so that can be appealing to some investors, but they might be worried about the risk of loss investing in CLO equity. So a lot of choice, the spectrum has definitely opened up, it's a little bit like the candy bar aisle, if you will, there's a lot of choice now that wasn't available five years ago.

CHUCK JAFFE: Speaking of that choice, there's a bunch of positive news, at least for the borrowers, we've also seen no significant increase in default activity. So what's your outlook on the markets performance for the rest of this year in terms of we've got a pretty benign interest rate environment, where if anything we're going to see a rate cut or two maybe, and nobody's worried about great default risk, so how does that play out for the space?

KIMBERLY FLYNN: Yeah. We agree that things are fairly healthy, we're still early in earnings season for fourth quarter, but I think all evidence right now is pointing to robust earnings and a very healthy picture for the leveraged loan space, and so if borrowers are healthy, that bodes well for CLO debt and equity. You're right, Chuck, defaults have definitely been more muted in recent months, and I think that expectation is that defaults will remain fairly muted. It's really the lowest level of defaults that we've seen since December of '22, so it's been a bit of reprieve in the market for investors, so it's a good time, if you're already invested in loans or CLOs, the good news on the fundamentals is that things are looking very constructive.

CHUCK JAFFE: How are things looking with regard to some of the things that are weighing on everybody's mind with this market, like tariffs?

KIMBERLY FLYNN: The challenge with tariffs is that it brings uncertainty, and it does bring increased volatility for risk assets like loans, like CLOs, and so I think that the concern is when you have uncertainty about the impact, maybe on price increases due to tariffs and how they're going to be implemented, it does lead to more volatility, but an active manager like Octagon has opportunities to take advantage of some of that volatility. So I think that the market is probably looking for a little bit more clarity, we think that the Fed is going to be very data-driven with respect to rate cuts. Now the market does look like they're factoring in, if you look at the futures market, anywhere from two to three cuts in 2025, but I think the Fed is going to need to see positive signs that the tariffs either aren't implemented or are not having an impact for them to act. Obviously we saw them pause in January, that is still developing, right? We're all watching and waiting to see. We've seen some equity market volatility as a result of that, but that also carries over into the loan market.

CHUCK JAFFE: If we wind up seeing a significant change in the rate cut environment, is there an anticipation of how that plays out in a CLO-driven fund?

KIMBERLY FLYNN: CLO loan products, they're all floating-rate assets, and so they are going to have income generation that's higher in a rising rate environment and that's lower or declining when rates are declining, and so the benefit of the last two years of rising rates has increased income production for CLO products. So with declining rates, you're going to see a commensurate decline in the income production, one of the benefits for CLOs is that if we do see declines in rates, that is going to reduce the cost of the leverage used, so it could actually enhance total return for CLO equity over time. It does have to bear out in terms of it has a negative effect on one hand to income production on the loans in the portfolio, but it might have a positive total return impact to the CLO equity because the debt is what's driving the leverage for the CLO equity. So a little bit tricky, but we talk with investors all the time about how if they're looking to be invested in CLOs, they should be invested through a market cycle, partly because you're buying a CLO because it's producing cash flows in a variety of different environments, and so there may be NAV volatility through that market cycle, but what you can count on is the high level of cash flow production. And so it's helpful having an active manager to navigate volatility, I think that's where we as a firm at XAI get concerned about some of the ETF products in the marketplace, because those haven't really been cycle tested just yet.

CHUCK JAFFE: Kim, great stuff. Thanks so much for joining me on The NAVigator to talk about, look forward to doing this with you again down the line.

KIMBERLY FLYNN: Thanks, Chuck. Appreciate it.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe, and I am Chuck Jaffe, it'd be great if you could check out my hour-long weekday show on your favorite podcast app or by going to MoneyLifeShow.com. To learn more about interval funds, closed-end funds, and business-development companies go to AICAlliance.org, that's the website for the Active Investment Company Alliance. Thanks to my guest Kimberly Flynn, she's president at XA Investments, a leading provider of research for listed closed-end funds, but also partners with other portfolio managers to create ETFs that are built around its research. You can learn more about it all at XAInvestments.com. The NAVigator podcast is new every Friday, make sure you never miss an episode by subscribing or following on your favorite podcast app. We'll be back next week with more closed-end fund talk, and until then, happy investing, everybody.

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