In CLO BBs Active Management Matters

December 2025

Big Idea: CLO BB bonds will likely remain a compelling risk-adjusted return opportunity in fixed income as we move into 2026, and many investors understand the impacts on risk moving down in credit rating, but most may not realize the amount of variance in risk within a pool of similarly rated debt securities. Palmer Square actively invests in CLO BBs with a focus on avoiding tail risk.

Executive Summary

- In 2025 CLO BB bonds represented one of the more compelling risk-adjusted opportunities across fixed income, returning 8.90% YTD* as measured by BB portion of the Palmer Square CLO Debt Index, and we believe 2026 will paint a similar story for this segment.
- Spread and Price Dispersion among CLO BB debt tranches is vast.
- An experienced manager with a focus on quality seeks to limit exposure to right-tail risk while understanding the uniqueness within each CLO debt tranche.
- As risk premiums have compressed, the downside risk is substantial, and the market tends to underprice the risk associated with newer managers, weaker portfolios and poor CLO structures.

Introduction

Through its various strategies, Palmer Square has actively invested in CLO BBs through multiple cycles, with a focus on avoiding tail risk. As we move into 2026, the current state of credit markets indicates an elevated level of tail risk broadly and suggests a widening gap in quality among CLO managers, particularly as we focus on the BB tranches. For CLOs generally, this risk can be present in multiple ways: manager tiering, collateral, spread duration, and structure. Through a combination of propriety analysis and third-party systems, the Palmer Square team manages these risks with the goal of providing superior returns over a full market cycle.

CLO Refresher

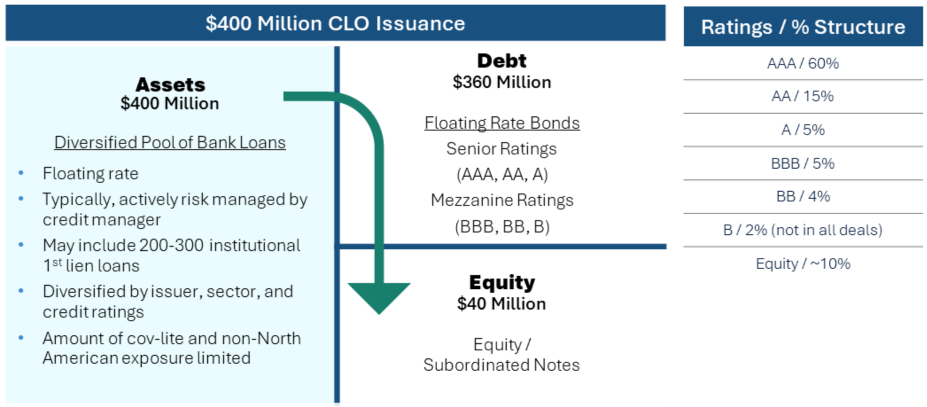
As a refresher, a typical CLO has a structure quite similar to a typical corporation where there are assets, liabilities and equity. The assets of the CLO are represented by a diversified pool of interest-generating, institutional, large bank loans actively managed by an institutional credit manager. While individual loans vary in size, managers like Palmer Square typically focus on corporate 1st lien loans (200-300), which are Fortune 1000-type and $1 billion or more in size (i.e., broadly-syndicated).

The loans held by the CLO are segmented across different ratings categories (AAA, AA, A, BBB, BB, B) which represent the priority waterfall of interest and principal payments that are made across the pool of loans.

*As of 12/19/2025. It is not possible to invest directly in an index. Past performance is no guarantee of future results. Please see notes and disclosures for definitions.

As the various tranches across the CLO are paid off, the incremental cash flow in excess of what is needed to pay liabilities, is allocated to equity, creating potential upside for CLO managers and equity holders in the structure, similar to the illustration in Exhibit 1below:

Exhibit 1: CLO Structure



An important distinction to note regarding CLO debt relative to corporate bonds, is that CLO debt tranche ratings are a function of subordination, as opposed to corporate bonds where ratings reflect the creditworthiness of the borrower. This is an important nuance that distinguishes the structural protections CLOs provide across various tranches and one of the primary reasons, along with the experience of top tier CLO managers like Palmer Square, why the senior tranches of these instruments have experienced very few defaults historically (zero within AAAs) and institutional allocators are increasingly using senior and mezzanine CLO debt as core holdings within fixed income portfolios.

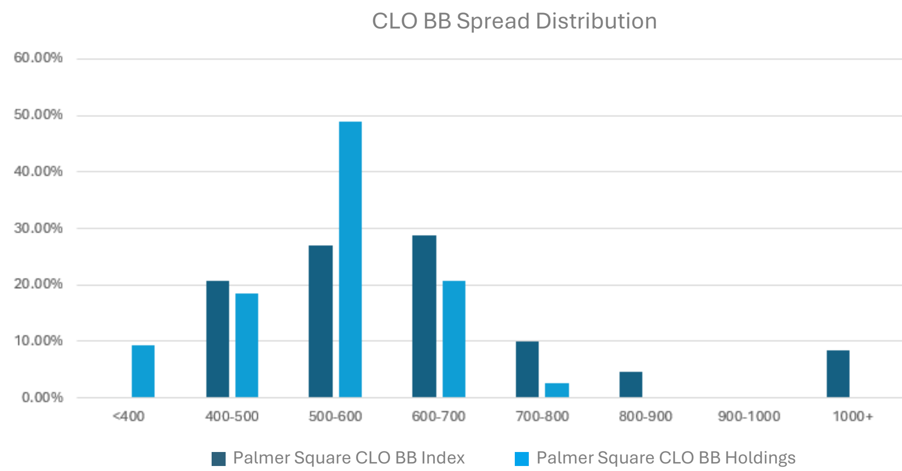
All CLO BBs Are Not Created Equal

As with actively managed investment funds, the quality, history and track record of CLO managers can vary substantially. CLOs are actively managed instruments that require ongoing manager participation across collateral pools (assets) and financings (liabilities), and the quality of that ongoing management is directly correlated to the risk-adjusted performance that investors experience across those tranches. As we'll discuss in the remainder of this paper, the importance of the CLO manager becomes increasingly important for investors to consider as they move beyond senior CLO debt tranches to the BBs, where dispersion in quality can be quite meaningful. In an environment where tail risk can be elevated, quality in this context takes on an even more multi-dimensional meaning and is when active management from an experienced manager like Palmer Square becomes even more critical for investors looking to benefit from this asset class.

Dispersion in Spread

Investors who only consider the aggregate discount margin/spread for CLO BB debt may not realize the significant dispersion among the underlying constituents. Exhibit 2 below provides a comparison of the dispersion of spread between CLO BB holdings with Palmer Square portfolios and the constituents within the Palmer Square CLO Debt BB Index. As indicated, Palmer Square's focus on higher-quality results in an exposure tilted to the left and mitigating the right-tail risk.

Exhibit 2: CLO BB Spread Distribution



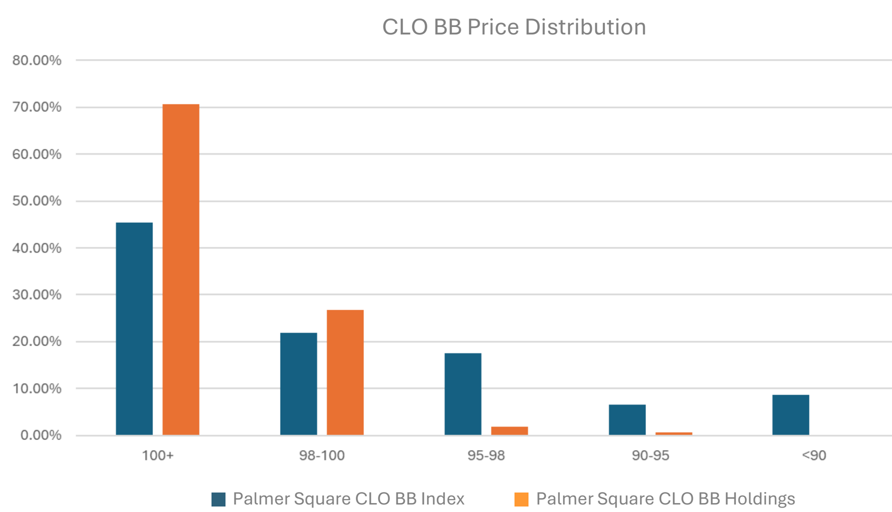
Source: Bloomberg and Palmer Square, as of November 20, 2025

Dispersion in Price

Similar to discount margin/spread, there is a wide dispersion in price among constituents within the CLO BB index (see Exhibit 3 below). Important to note, 70% of Palmer Square holdings are above par compared to under 50% for the index, and more than 97% of holdings are above 98 price compared to ~67% of the index. Similarly, approximately 15% of index holdings are priced below 95 while Palmer Square holdings below 95 are less than 1% of portfolios, with no holdings under 90.

When considering the market more broadly, the discrepancy between Palmer Square and the index is even more pronounced as the index excludes smaller fringe managers that are overrepresented in low dollar price BBs.

Exhibit 3: CLO BB Price Distribution



Source: Bloomberg, Palmer Square, as of November 20, 2025

Summary

Palmer Square's focus on quality is particularly important during markets similar to what investors have experienced in 2025, and will likely experience in 2026, where risk premiums have compressed. Through these times, downside risk is substantial, and the market tends to underprice the risk associated with newer CLO managers, weaker portfolios and poor structures.

Palmer Square's current positioning and deep experience within these markets, in our estimation, can maximize risk-adjusted performance during periods of volatility while also offering increased flexibility to take additional risk if opportunities arise in the medium/near term.

Notes and Disclosures

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Tail risk refers to the risk of rare, extreme investment outcomes that lie far outside what traditional risk models, often built on normal distribution assumptions, would predict. Left tail risk refers to extreme negative returns (i.e. large losses) while right tail risk refers to extreme positive returns or large, unexpected gains.

The Palmer Square CLO Debt Index (ticker: CLODI) seeks to reflect the investable universe for U.S. dollar denominated collateralized loan obligations ("CLOs"), and is comprised of original rated A, BBB, and BB debt issued after January 1, 2009, subject to certain inclusion criteria. The addition, removal or inclusion of a security in the Palmer Square CLO Debt Index (the "Index") is not a recommendation to buy, sell, or hold that security, nor is it investment advice. It is not possible to invest directly in an index. Index performance does not reflect the deduction of any fees and expenses. Past performance is not a guarantee of future returns. There are risks involved with investing, including the possible loss of principal, that investors should be prepared to bear. The information contained herein should not be construed as personalized investment advice and should not be considered a solicitation to buy or sell any security or engage in a particular investment strategy.

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