

US Insight: CLO Q&A with Flat Rock Global's Shiloh Bates on why 2025 was such a bad year for CLO equity, and why 2026 will likely be better

News 12 Jan 26, 03:36 PM Analysts: Tom Davidson Senior Managing Editor

Shiloh Bates is chief investment officer of Flat Rock Global and a veteran investor who literally wrote the book on CLO equity. *LFI* recently caught up with Bates to hear his views on exactly why CLO equity performed so poorly last year, clearing up some common misconceptions in the process, and why he's feeling more confident about the year ahead.

LFI: How did the broader CLO market perform in 2025?

Bates: 2025 was a record year for CLO issuance. New-issue volumes reached a record of \$205bn, while CLO refinancing and reset volumes also set records of \$321bn. CLO BBs, usually the junior-most debt tranche issued by CLOs, returned 9%, and only 0.35% of CLO BBs defaulted during the year. It follows that more senior CLO securities also performed well.

LFI: What about CLO equity?

Bates: In contrast to the strong performance of CLO debt, 2025 was a difficult year for CLO equity investors. According to BofA Research, CLO equity total return was -5% year to date through November 30, 2025. Elevated loan defaults, declining asset spreads, and higher required equity returns combined to produce poor CLO equity returns, despite strong performance in the broader credit markets. I believe these headwinds are cyclical rather than structural, and that conditions in 2026 are likely to improve across all three dimensions.

LFI: Which of those factors do you think was most damaging?

Bates: While numerous factors affect CLO equity returns, the loss rate on the CLO's loan portfolio is usually the most important. I believe many CLO equity investors reserve for loan losses using a 60bps annual loss rate. At the end of 2025, the leveraged loan default rate in CLOs was 2.8% and the average recovery rate was approximately 50%. That implies loan losses of roughly 140bps, or about 2.3 times higher than base-case expectations.

Defaulting loans were not concentrated in any single industry. Rather, many defaults reflected capital structures formed during the zero-interest-rate period. As rates rose beginning in 2022, borrowers' interest burdens increased meaningfully. Borrowers with operational setbacks such as customer losses, regulatory challenges, or technological disruption were disproportionately impacted. This resulted in higher default rates and pressure on CLO equity returns.

A common misconception in 2025 was that default activity remained benign and that a few high-profile bankruptcies made for salacious headlines. While in-court business restructurings were not elevated, out-of-court restructurings accounted for 60% of total defaults in 2025. Any process that reduces contractual interest or principal payments to the lender represents an economic hit to CLO equity.

LFI: Is the picture different for private credit?

Bates: The Cliffwater Direct Lending Index ("CDLI") reported losses of 60bps for the twelve months ended September 30, 2025, implying only 43% of the loan losses in CLOs. However, the CDLI benefits from what I refer to as a "growing denominator problem." Assets under management are expanding rapidly in private credit, while newly originated loans are unlikely to exhibit credit stress for several years. CLOs are largely fixed in size, so growing assets under management does not mask credit deterioration in its loan portfolio.

LFI: What else impacted CLO returns beyond defaults?

Bates: In addition to elevated defaults, CLO equity cash flows declined. One of the most attractive characteristics of CLO equity is what I call the "self-healing mechanism." During periods of elevated defaults, leveraged loans typically trade at discounts to par, allowing CLOs to reinvest repayments into discounted assets that later repay at par. In 2025, this mechanism was largely absent.

Aside from a brief period of volatility in April 2025 around the so-called “Liberation Day,” quality loans traded near par for most of the year. Healthy demand for leveraged loans, combined with sparse LBO activity, kept loan prices elevated. As a result, CLOs had limited opportunity to buy discounted loans and — even worse — borrowers were able to renegotiate loan spreads lower, reducing interest income flowing into CLOs.

Declining loan spreads are not a problem for CLO equity investors if the CLO can proportionately reduce its financing costs. 2025 was a busy year for CLO refinancings and resets, and many were highly accretive to CLO equity returns. Unfortunately, CLOs begin their lives with 2-year non-call periods on their financing. Leveraged loans, by contrast, often have non-call periods of six months or less. As a result, asset spreads declined faster than CLO financing costs.

Finally, in 2025 CLO equity valuations moved lower. While the S&P 500 hit record highs and most credit spreads are near record lows, CLO equity trades at a discount, in my opinion. Although CLO equity has historically exhibited low correlation to the S&P 500, this diversification benefit can be difficult to appreciate when public equity markets are at record highs. In 2018, when I joined Flat Rock, I was buying CLO equity with targeted returns of approximately 12% in my base case model. At the end of 2025, CLO equity investments were available with approximately 16% return opportunities, a substantial increase that resulted in mark-to-market losses.

LFI: What are your expectations for CLO equity in 2026?

Bates: Each year, any one of these factors can present a manageable challenge to CLO equity returns. However, having all three occur simultaneously has made it a particularly difficult environment for the asset class. I believe relief is coming for all three factors in 2026.

During 2025, the Secured Overnight Financing Rate (SOFR) declined from 4.3% to 3.7%, and further declines are expected in 2026. Lower SOFR reduces borrowers' interest burdens and could lower leveraged loan default rates, all else equal.

Lower SOFR may also contribute to increased LBO activity by enabling private equity firms to finance acquisitions at more favorable rates. Other factors supporting increased LBO activity include more permissive regulation from Washington, D.C., and greater clarity around tariff rates. Increased leveraged loan issuance has the potential to push loan spreads wider, while CLO financing rates are not expected to increase.

Furthermore, a lower SOFR may make the high returns offered by CLO equity all the more compelling, potentially offsetting the reduction in CLO equity prices experienced in 2025.

CLO equity pays substantial quarterly distributions over the 8+ year projected life of a typical CLO before it is ultimately liquidated. The market currently discounts those future cash flows at high rates. As time passes, discounted future cash flows become realized cash flows. If realized cash flows match projections, CLO equity market values should increase. Additionally, those cash flows can be reinvested in today's higher-return opportunity set.