ZAIS Insights

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Not paid to take risk in leveraged loans

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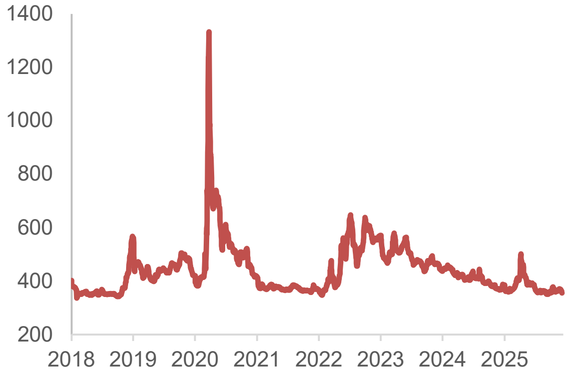
Summary

- Leveraged loan spreads have tightened to the pre-COVID lows …
- … making it difficult to distinguish between good and bad credits …
- … while default risks are elevated
- New ZAIS CLOs positioned at low-risk end of the CLO manager universe

Despite blows from COVID, Fed tightening and, most recently, uncertainty around US tariff policy, leveraged loan spreads have returned to the pre-COVID lows (see Chart 1). In this report, we ask whether the fundamentals support the tight spreads, discuss potential risks and outline how ZAIS CLOs are positioned in this environment.

Chart 1: US leveraged loan credit spreads

Basis points



Source: JPMorgan[1]

In our view, credit fundamentals remain solid but the share of borrowers with weaker fundamentals has risen, idiosyncratic risks have increased and the tight spreads make it more difficult to identify value opportunities.

This difficulty though, is less of a challenge to ZAIS because we have shifted our focus to defensive strategies.

Diverging credit fundamentals ...

Table 1 shows credit fundamentals for public and private issuers for the last quarter of 2019, just before the outbreak of COVID, and the most recent available data. Structurally, the debt share of private issuers has increased strongly over the last six years. We attribute that to increased borrowing by private equity firms as well as the rise of private credit.

Table 1: Leverage loan credit fundamentals*

		All issuers	Public issuers	Private issuers
Debt share	2019-Q4 2025-Q2	100.0% 100.0%	87.9% 56.9%	12.1% 43.1%
Profit margin	2019-Q4 2025-Q2	16.0% 16.1%	16.1% 16.9%	15.3% 14.7%
Leverage ratio	2019-Q4 2025-Q2	4.9x 5.0x	4.8x 4.6x	6.2x 5.7x
Interest coverage	2019-Q4 2025-Q2	4.0x 3.0x	4.2x 4.0x	2.3x 2.1x
Effective interest rate	2019-Q4 2025-Q2	5.1% 6.7%	5.0% 5.4%	7.0% 8.4%

* The credit fundamentals include all debt instruments issued by firms with leveraged loan liabilities including bonds and private credit.

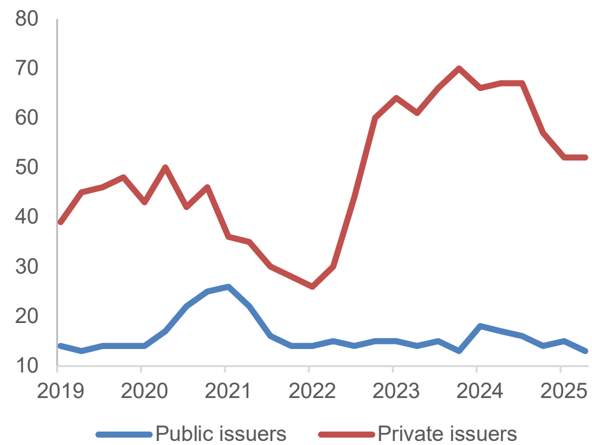
Source: JPMorgan [2]

Profitability has in general remained high, but improved somewhat with public issuers and declined a bit with private issuers. Public and private issuers have reduced leverage but that was not enough to offset the rise in effective interest rates, resulting in somewhat lower interest coverage ratios for both issuer types.

In our view, the slippage in interest coverage ratios appears modest, given that interest rates across the curve are 250bps higher now than before COVID.[3] More concerning to us is the much lower interest rate coverage ratio for private issuers given their increased share in total debt. This relative weakness of private issuers is also reflected in the much higher share of private issuers with interest rate coverage ratios of less than 2 (see Chart 2).

Chart 2: Issuers with interest coverage ratios of less than 2

% of total



Source: JPMorgan [4]

Summarizing, we do not see an across the board deterioration in credit fundamentals: profit margins remain high, leverage ratios have declined and the slippage in interest rate coverage ratios is modest, given the overall rise in interest rates.

However, our concern is that the share of fundamentally weaker credits, especially in the private issuer domain, has increased substantially.

... but less spread dispersion

All else equal, we would expect that the rising share of weaker credits should be reflected in overall wider credit spreads and more spread dispersion along the credit curve. The fact is, spreads have tightened over the last six years with less dispersion across the credit curve (see Table 2 below).

This is most evident in the B-rated sector, where roughly two-thirds of new loans are issued.[5] B2 credits are currently priced 112 basis points lower than at the end of 2019. Moving one notch up the credit curve, spreads currently tighten by just 52 basis points versus 98 basis points at the end of 2019.

Moving one notch down the credit curve, spreads currently widen by just 126 basis points versus 249 basis points at the end of 2019.

Table 2: Leverage loan spreads by rating

Basis points 1-month averages

Moody's rating	Dec-2019	Nov-2025
Baa2	168	170
Baa3	175	167
Ba1	192	207
Ba2	254	234
Ba3	305	276
B1	402	338
B2	501	389
B3	750	515
Caa1	1573	1061
Caa2	2523	2169
Caa3	3395	3242
Ca	6155	4110
C	13127	6812
All	434	366

Source: JPMorgan [6]

The spread tightening is not the result of low supply. New issuance in 2024/25 is more than double compared to 2018/19 (see Table 3). However, the use of new issuance has shifted from acquisition to repricing, which suggests to us that private equity is struggling to exit deals and forced to extend existing loans.[7]

In our view, spread tightening amid strong supply is a sign of flush demand, which we observe not just in the leveraged loan market but across all risky asset classes. We do not expect a systemic crisis but we think the leverage loan market has become increasingly vulnerable to idiosyncratic risks given more issuers with weaker credit fundamentals and overall tight spreads.

Table 3: Leverage loan issuance

	2018/19	2024/25YTD
Issuance (USD bn)	1,095.3	2,257.8
Of which (%)		
Refinancing	26.2	29.9
Repricing	28.7	54.3
Acquisition	37.7	10.2
Corporate & dividend	7.4	5.6

Source: JPMorgan [8]

In this environment, we find it difficult to identify attractive relative value opportunities that offer an additional spread to compensate adequately for the additional risk. As a result, we have strengthened our defensive positions in the ZAIS CLO leveraged loan portfolios.

Building a low risk loan portfolio

Our defensive portfolio strategy is not just a response to the current market environment but a strategic shift that we have implemented step-by-step over the last four years. The main criteria for our portfolio construction are:

- Credit quality; avoiding credits with high loss probability over the long term;
- Diversification; low beta issuers (low correlations);
- Liquidity; issuers with trading debt of at least USD 2 billion;
- Sectors; maintaining broad balance and avoiding large overweights, especially in hype sectors; and
- Transparency; regular reporting and guidance.

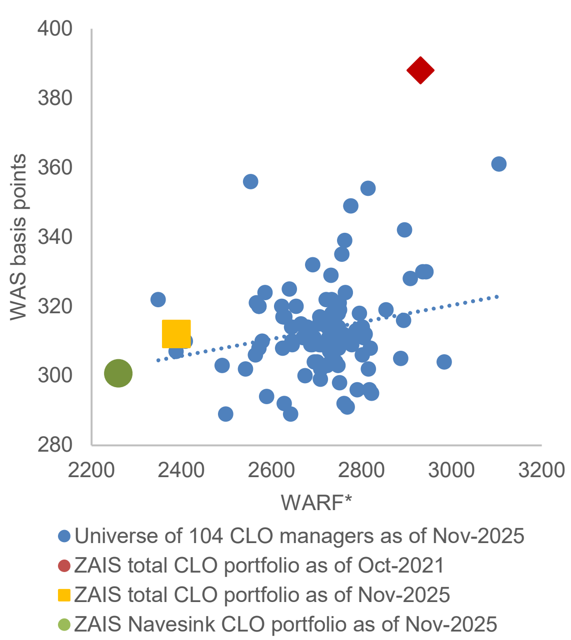
Given increased idiosyncratic risks and less reliable market pricing, full transparency is critical for our assessment of individual issuer's credit quality. Unfortunately, we find that transparency does not appear to be a top priority for all issuers. We observe that more issuers provide only the bare minimum information and seem to try to avoid the direct dialog with loan investors to provide background information and guidance.

Charts 3 and 4 outline the evolution of the ZAIS CLO portfolio from 2021 until now versus the current universe of CLO managers in terms of:

- Weighted average risk factor (WARF)
- Weighted average spread (WAS)
- Weighted average price (WAP)

The two charts show that portfolio strategies and styles vary significantly within the universe of CLO managers. Still, portfolios with lower credit risk scores tend to have lower spreads and higher prices.

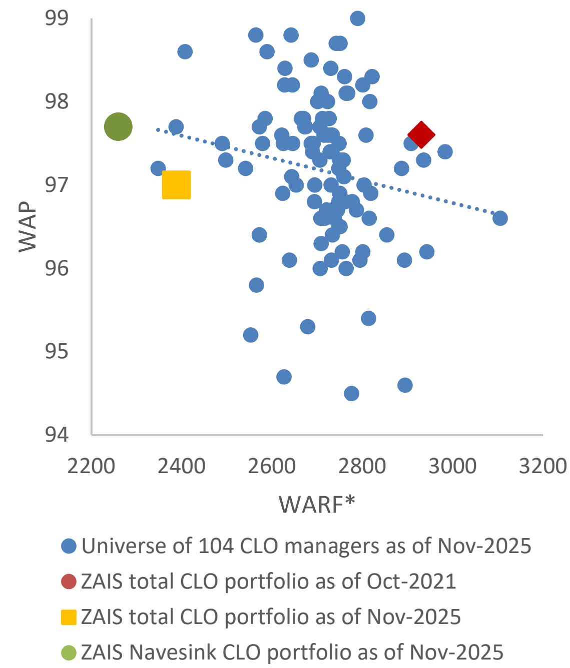
Chart 3: CLO manager WARF versus WAS



*Based on Moody's credit rating, a lower score means higher rating.

Source: Wells Fargo and ZAIS [9]

Chart 4: CLO manager WARF versus WAP



*Based on Moody's credit rating, a lower score means a higher rating.
Source: Wells Fargo and ZAIS [10]

As part of our strategy overhaul, we have launched a new series of CLOs, called Navesink, which are defensive by design.

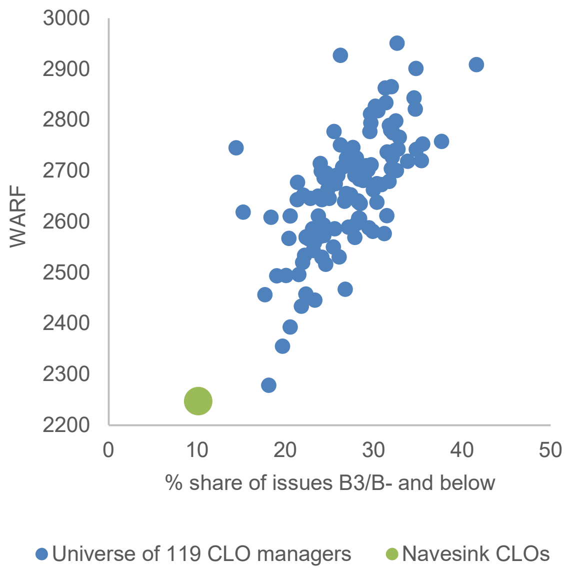
The main aim is to minimize losses in the event of credit tests misses and defaults. Since July 2023, we have launched four Navesink CLOs.

Charts 3 and 4 show the positioning of the three existing Navesink funds (green dot) versus the CLO manager universe.

Our aim to build portfolios with low loss probabilities over the long term is reflected in a very low credit risk score (WARF), and appropriate spreads and prices (WAS and WAP).

As a result, we end up passing on more loans rated B3/B- and lower than other CLO managers (see Chart 5 on the next page).

Chart 5: CLO manager exposure to loans rated B3/B- and lower and WARF as of November 2025



Source: Intex Kanerei and ZAIS [11]

With most CLO managers positioned in the middle of the credit score spectrum, we believe that our structurally defensive approach of the Navesink CLOs offers value for investors who are looking to buy CLOs for a modest pickup in spread at very low additional risk. We think that the ZAIS Navesink CLOs standout in offering that investment proposition.

More information

As always, we are available to discuss our views with you. Please contact your Client Relations representative at +1 732 978 9722 or zais.clientrelations@zaisgroup.com

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[1] JPMorgan; Leveraged Loan Index; Liquid; Summary Spreads – Forwards to 3 years; December 3, 2025.

https://markets.jpmorgan.com/#dataquery

[2] JPMorgan; North America Credit Research; 2Q25 Leveraged Loan Credit Fundamentals; September 22, 2025.

https://markets.jpmorgan.com/jpmm/research.article_page?action=open&doc=GPS-5086035-0

[3] Board of Governors of the Federal Reserve System (US), Federal Funds Effective Rate [FEDFUNDS], retrieved from FRED, Federal Reserve Bank of St. Louis; December 3, 2025.

https://fred.stlouisfed.org/series/FEDFUNDS

Board of Governors of the Federal Reserve System (US), Market Yield on U.S. Treasury Securities at 10-Year Constant Maturity, Quoted on an Investment Basis [GS10], retrieved from FRED, Federal Reserve Bank of St. Louis; December 3, 2025.

https://fred.stlouisfed.org/series/GS10

[4] Same as footnote 2.

[5] JPMorgan; Credit Strategy Weekly Update; High Yield and Leveraged Loan Research; December 5, 2025.

https://markets.jpmorgan.com/jpmm/research.article_page?action=open&doc=GPS-5149306-0

[6] JPMorgan; Leveraged Loan Index; Moody's Rating; Summary Spreads – Forwards to 3 years; December 3, 2025.

https://markets.jpmorgan.com/#dataquery

[7] Same as footnote 5.

[8] Same as footnote 5.

[9] Wells Fargo Securities; The U.S. CLO Manager Style Guide: October; October 29, 2021. Used for the ZAIS position as of October 2021.

Wells Fargo Securities; The U.S. CLO Manager Style Guide: November; December 1, 2025. Used for the CLO manager universe and the ZAIS position as of November 2025.

https://www.wellsfargo.com/cib/

The ZAIS Navesink portfolio from November 2025 is the average of the ZAIS Navesink 1 to 3 CLOs; Data from ZAIS Group LLC; December 3, 2025.

[10] Same as footnote 9.

[11] Kanerai CLO Insight; Intex Data sourced from trustee reports; November 11, 2025.

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