XAI KNOWLEDGE BANK

INVESTMENT THEMES:

Navigating a Rising Interest Rate Environment

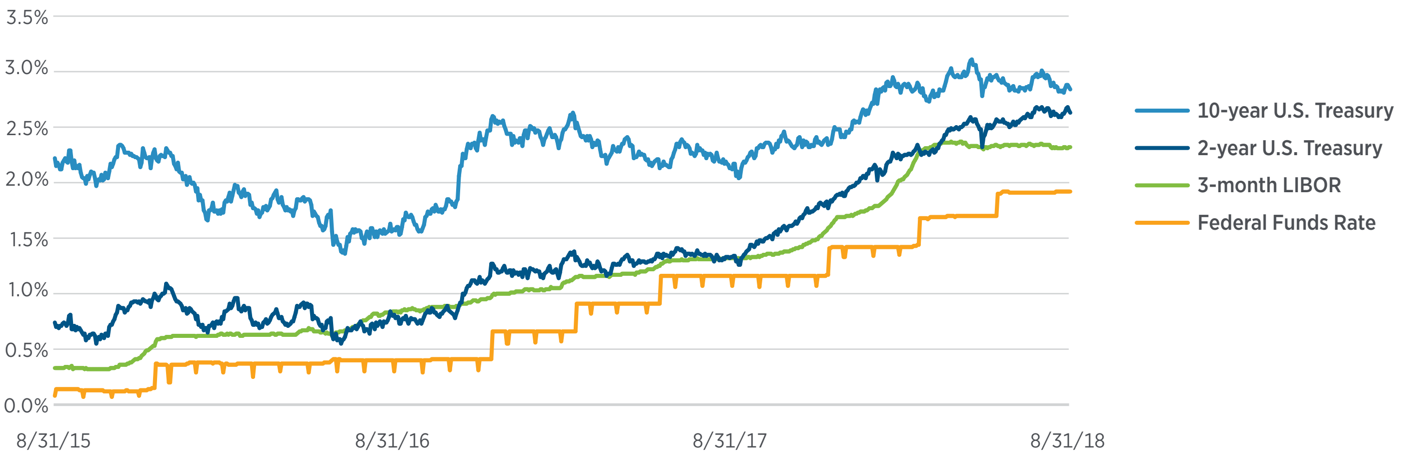
September 2018

XAI Octagon Floating Rate & Alternative Income Term Trust (XFLT)

After years of uncharacteristically low interest rates, the Federal Reserve (the "Fed") began to raise rates in December 2015. Since then, rates have steadily increased, as shown in the chart below, and on June 13, 2018, they were raised for the seventh time in the past two years. According to JP Morgan, the Fed is expected to raise rates a total of four times in 2018.[1]

The 10-year U.S. Treasury reached a seven-year high of 3.11% on May 17, 2018. During rising rate periods, traditional fixed income generally decreases in value.

Fed Rate Hikes Drive LIBOR and U.S. Treasuries Higher (Performance shown from 8/31/15–8/31/18)



Source: 10-year U.S. Treasury represented by Bloomberg US Generic Govt 10 Year Yield Index, 2-year U.S. Treasury represented by Bloomberg US Generic Govt 2 Year Yield Index, 3-month LIBOR represented by ICE LIBOR USD 3 Month, Federal Funds Rate represented by US Federal Funds Effective Rate (continuous series).

Past performance is not indicative of future results.

XA INVESTMENTS

The Case for CLOs in a Rising Rate Environment

XA Investments LLC (“XAI”) and Octagon Credit Investors, LLC (“Octagon”) believe that floating-rate loans and collateralized loan obligations (CLOs) are compelling investment options in today’s rising rate environment. The XAI Octagon Floating Rate & Alternative Income Term Trust (“XFLT” or the “Trust”) is a listed closed-end fund[2] which invests in a portfolio of floating-rate loans, CLO debt and CLO equity. The Trust’s portfolio as of June 30, 2018 was invested in CLO debt and equity (47%), first lien and second lien loans (48%) and other investments (5%). CLO investing introduces a new set of opportunities and risks for investors. During a Fed hike cycle, XAI and Octagon expect the Trust to benefit from its investment in floating-rate securities and low average effective duration of less than 6 months. The Trust also benefits from Octagon’s active management and ability to scour credit markets in search of relative value opportunities.

For some time, floating-rate loans have been accessible through an array of mutual funds and ETFs. Advisors and investors have therefore developed a familiarity with loans and their benefits. Conversely, CLOs are less familiar and far more difficult to access. This paper will focus on the benefits of CLOs and how they can serve as a less explored alternative to other types of credit.* With interest rates rising from unprecedented levels and corporate credit spreads tight, many high yield bond buyers, for instance, are viewing the CLO market’s wider spreads and floating-rate coupons as attractive.

Because CLOs invest mostly in floating rate loans, the structure of CLOs is designed to pass-through additional income to CLO investors in environments of rising short term interest rates.[3] CLOs securities thereby offer the potential to mitigate income and duration risk compared with fixed rate investments, particularly those with intermediate and longer term maturities. As LIBOR increases, CLO debt increases its distributions. CLO equity is more nuanced; “the spread” paid to equity holders increases as interest rates rise. In contrast, interest rates on traditional fixed income investments are locked or “fixed” and therefore adversely impacted by rising rates.

CLO debt tranches typically offer higher yields relative to similarly rated corporate credits and other structured products. They also provide strong potential for capital preservation through structural protections and investor-centric covenants. Historically, the CLO structure has proven to be extremely resilient through multiple market cycles. In fact, there has never been a default in the AAA and AA CLO debt tranches.[4] The Trust does not expect to invest in AAA and AA CLO debt tranches due to lower current yields. Negative correlations to U.S. Treasury bonds and low correlations to investment grade corporate credit and equities present valuable diversification benefits as well. Lastly, CLOs offer access to a broader range of debt issuers, most of whom do not participate in high yield bond markets.

In a CLO, the collateral manager purchases a portfolio of floating-rate loans (typically 150–300 issuers) with proceeds from the CLO debt and CLO equity issuance. Interest earned from the floating rate loans or “loan collateral pool” is used to pay the coupon interest on the CLO liabilities. Once interest payments are made and expenses paid, any remainder or residual cash flow, is distributed to the CLO equity or “residual” holders. Notably, these equity investors are first to absorb any loan portfolio losses, reducing such residuals.

CLOs can be attractive to those investors who are concerned with the impact of rising rates on credit instruments. As mentioned previously, the bank loans purchased by a CLO collateral manager are floating-rate and may be particularly favorable to investors anticipating a rate hike. When interest rates rise, the interest paid increases, and ultimately benefits the CLO.

Since securities with floating-rate coupons have little to no duration, their prices are minimally impacted by rising rates. In many cases, these securities actually benefit from higher rates, as their total yields adjust upward. Historically, floating-rate loans have been one of the best-performing asset classes during Fed tightening cycles.

The table on the top of the following page summarizes the performance of various asset classes during the last five cycles of Fed tightening, including the current cycle. Even though accurately predicting interest rate moves is a challenge, history may serve as a guide. If interest rates rise, floating-rate loans have the potential to outperform longer-duration fixed income such as investment grade bonds, municipal bonds and high yield bonds.

*CLOs often involve risks that are different from or more acute than risks associated with other types of credit instruments. See “Key Risks” on page 4 for a discussion of risks associated with CLO investing.

Floating-Rate Loans Outperform as Fed Raises Rates

		Asset class performance during past periods of Fed tightening				
Date range	**Rate hike (bps)**	**U.S. Treasuries**	**Investment Grade Credit**	**Municipal Bonds**	**High Yield**	**Floating-Rate Loans**
3/29/88 to 2/24/89	325	5.02%	5.21%	7.44%	n/a	n/a
2/4/94 to 2/1/95	300	-7.65%	-3.93%	-3.56%	-1.74%	9.33%
6/30/99 to 5/16/00	175	2.99%	0.10%	-0.16%	-2.27%	3.06%
6/30/04 to 6/29/06	425	8.59%	5.85%	9.30%	14.88%	5.92%
12/16/15 to 8/31/18	175	6.75%	9.30%	6.72%	25.20%	17.60%
	XFLT*	**Asset class performance since XFLT inception**				
9/27/17 to 8/31/18	5.82%	-0.62%	-0.76%	1.00%	2.48%	4.86%

Source: U.S. Treasuries represented by Bloomberg Barclays US Long Treasury Total Return Index, Investment Grade Credit represented by Bloomberg Barclays US Credit Index, Municipal Bonds represented by Bloomberg Barclays US Municipal Index, High Yield represented by Bloomberg Barclays US High Yield 1% Issuer Cap Index, Floating-Rate Loans represented by Credit Suisse Leveraged Loan Index. Data for indices are through the nearest month end.

Past performance is no guarantee of future results. Performance during other time periods may have been different or negative. Other indices may not have performed in the same manner under similar conditions. Indicies are unmanaged, do not reflect the deduction of fees and expenses, and are not available for direct investment. This is for illustrative purposes only and does not represent the performance of any specific portfolio or fund managed by XAI and Octagon.

Investing in the bond market is subject to risks related to the market, interest rates, issuers, credits, inflation and liquidity. The value of most bonds is impacted by changes in interest rates. Bonds with longer duration tend to be more sensitive and volatile than those with shorter durations; bond prices generally fall as interest rates rise, a risk which may increase in the current low interest rate environment.

Benefits of Investing in CLOs

CLO investing involves important risk considerations including risk of loss, accounting and valuation risk, leverage risk and market volatility risk. See page 4 for a discussion of risks associated with CLO investing.

Attractive yields	CLO debt provides opportunity for incremental yield pick-up relative to similarly rated bonds and other structured securities[5]
Low historical defaults	CLO debt tranches have demonstrated long-term historical default rates lower than similarly rated U.S. corporate credit instruments[4]
Floating rate income	Coupon floats over LIBOR, which may benefit investors in periods of rising short-term interest rates[6]
Portfolio diversification	CLO debt has low correlations to equites and investment grade corporate credit and negative correlation to U.S. Treasury bonds[7]

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*XFLT price performance was 5.82% and XFLT NAV performance was 4.40%.

Index Definitions

Bloomberg Barclays US Credit Index measures the investment grade, U.S. dollar-denominated, fixed-rate, taxable corporate and government related bond markets. It is composed of the U.S. Corporate Index and a non-corporate component that includes foreign agencies, sovereigns, supranationals, and local authorities.

Bloomberg US Generic Govt 2 Year Yield Index measures the 2-year yield of generic U.S. on-the-run government 2-year bonds. Yields are yield to maturity and pre-tax.

Bloomberg US Generic Govt 10 Year Yield Index measures the 10-year yield of generic U.S. on-the-run government 10-year bonds. Yields are yield to maturity and pre-tax.

Bloomberg Barclays US High Yield 1% Issuer Cap Index measures the U.S. dollar-denominated, high yield, fixed-rate corporate bond markets. Securities are classified as high yield if the middle rating of the Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below. Issuers are capped at 1% of the index.

Bloomberg Barclays US Long Treasury Total Return Index measures U.S. dollar-denominated, fixed-rate, nominal debt issued by the U.S. Treasury. Treasury bills are excluded by the maturity constraint, but are part of a separate Short Treasury Index.

Bloomberg Barclays Municipal Index measures the U.S. dollar-denominated long-term tax-exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds, and pre-refunded bonds.

Credit Suisse Leveraged Loan Index tracks the investable market of the U.S. dollar-denominated leveraged loan market. It consists of issues rated "5B" or lower, meaning that the highest-rated issues included in this index are Moody's/S&P ratings of Baa1/BB+ or Ba1/BBB+. All loans are funded term loans with a tenor of at least one year and are made by issuers domiciled in developed countries.

ICE LIBOR USD 3 Month Index represents the 3-Month London Interbank Offered Rate.

U.S. Treasuries are debt securities issued by the U.S. government and secured by its full faith and credit. Income from Treasury securities is exempt from state and local taxes. Although U.S. government securities are guaranteed as to payments of interest and principal, their market prices are not guaranteed and will fluctuate in response to market movements.

Glossary

Basis point is one one-hundredth of a percentage point.

CLO (collateralized loan obligation) is a type of structured credit. CLOs typically invest in a diverse portfolio of broadly syndicated senior secured loans. CLOs finance this pool of loans with a capital structure that consists of debt and equity.

CLO debt represents senior and mezzanine debt or liabilities of a CLO structure with tranches from AAA down to BB. Interest earned from the underlying loan collateral pool of a CLO is used to pay the coupon interest on the CLO liabilities. CLO debt investors earn returns based on spreads above 3-month LIBOR.

CLO equity represents a residual stake in the CLO structure and first loss position in the event of defaults and credit losses. CLO equity investors receive the excess spread between the CLO assets and liabilities and expenses.

Collateral is a property or other asset that a borrower offers as security for a loan. If the borrower stops making the promised loan payments, the lender can seize the collateral to attempt to recoup its losses.

Correlation A statistical measure of how two securities move in relation to one another. The correlation coefficient, or indicator of related movement, ranges from 1 to -1.

Duration is the measure of a bond's price sensitivity to interest rates and is expressed in years. It is the change in the value of a bond that will result from a 1% change in market interest rates.

Federal funds are overnight borrowings between banks and other entities to maintain their bank reserves at the U.S. Federal Reserve. Banks keep reserves at the Federal Reserve Bank to meet requirements and to clear financial transactions.

LIBOR is the London interbank offered rate and it is an interest rate at which banks can borrow funds, in marketable size, from other banks in the London interbank market. The LIBOR is fixed on a daily basis by the British Bankers' Association. LIBOR is derived from a filtered average of the world's most creditworthy banks' interbank deposit rates for larger loans with maturities between overnight and one year.

Senior Secured Loans are debt obligations (also commonly referred to as "senior loans" or "floating rate loans"), issued by a bank to a corporation that holds legal claim to the borrower's assets above all other debt obligations. Senior secured loans have floating rates that typically fluctuate according to LIBOR.

Tranches are pieces, portions or slices of debt or structured financing. Each portion, or tranche, is one of several related securities offered at the same time but with different risks, rewards and maturities. CLOs are typically structured with debt tranches from AAA down to BB.

Disclosures

Key Risks

An investment in the Trust is subject to investment risk, including the possible loss of your entire investment. There can be no assurance that the Trust's objectives will be achieved. The Trust is a recently-organized, diversified, closed-end management investment company with a limited history of operations. As a result, investors have a limited track record and operational history on which to base their investment decision. Shares of closed-end funds frequently trade at a discount from their net asset value, which is a risk separate and distinct from the risk that the fund's net asset value could decrease as a result of its investment activities.

Investors should consider the investment objective, risks, charges and expenses of the Trust carefully before investing. An investment in the Trust involves risks and is not appropriate for all investors and is not intended to be a complete investment program. **Investors should read XFLT's prospectus and SEC filings (which are publicly available on the EDGAR Database on the SEC website at http://www.sec.gov) carefully before investing in XFLT.**

Below Investment Grade Securities Risk. The Trust invests primarily in below investment grade credit instruments, which are commonly referred to as "junk" bonds and involve substantial risk of loss. Securities of below investment grade quality are considered predominantly speculative with respect to the issuer's capacity to pay interest and repay principal when due and therefore involve a greater risk of default or decline in market value due to adverse economic and issuer-specific developments. Issuers of below investment grade securities are not perceived to be as strong financially as those with higher credit ratings. Securities of below investment grade quality display increased price sensitivity to changing interest rates and to a deteriorating economic environment. The market values for securities of below investment grade quality tend to be more volatile and such securities tend to be less liquid than investment grade debt securities.

CLO Risk. CLO investing poses new and different risks than stock or bond investing. CLOs often involve risks that are different from or more acute than risks associated with other types of credit instruments. CLOs are leveraged investments that may be volatile and may be illiquid in certain market environments. Additionally, the underlying loans of a CLO are senior secured, below investment grade credit and they carry the possibility of default, a risk that increases as the credit cycle progresses. Generally, there may be less information available to investors regarding the underlying investments held by CLOs than if investors had invested directly in credit securities of the underlying issuers. The market value of CLO securities may be affected by changes in the underlying collateral, including shifts in market value or changes in distributions, defaults and recoveries, capital gains and losses, prepayments and the availability of new investment opportunities, prices and interest rates. CLOs are a type of structured credit instrument. Holders of structured credit instruments bear risks of the underlying investments, index or reference obligation as well as risks associated with the issuer of the instrument, which is often a special purpose vehicle, and may also be subject to counterparty risk.

CLO equity is subject to a higher risk of total loss. There can be no assurance that distributions on the assets held by the CLO will be sufficient to make any distributions to CLO equity. CLO equity are illiquid investments and subject to extensive transfer restrictions, and no party is under any obligation to make a market for subordinated notes. Investments in CLO equity may have complicated accounting and tax implications.

Footnotes

1 Reuters, "LPC: US CLOs may see record year as investors seek interest rate hedge," January 10, 2018

2 Closed-end funds (CEFs) are actively managed portfolios and are subject to active management risk. Shares of CEFs frequently trade at a discount from their net asset value. An investment in a CEF is subject to investment risk, including possible loss of the entire principal amount that you invest.

3 Senior secured loans have LIBOR floors, most commonly the LIBOR floor is 1%. Investors in senior secured loans benefit from higher interest payments once LIBOR is above the 1% floor.

4 ©1993–2015 Moody's Investors Services, Inc., Moody's Analytics, Inc. and/or their licensors and affiliates–used with limited permission, Moody's Investors Services, Special Comment: Default and Loss Rates of Structured Finance Securities: 1993–2015. June 1, 2016. Please note this is the latest information available from Moody's.

5 J.P. Morgan, Credit Strategy Weekly Update: High Yield and Leveraged Loan Research, June 30, 2018

6 Citi Research

7 Bloomberg, XAI

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