XAI KNOWLEDGE BANK

INVESTMENT THEMES:

Navigating a Rising Interest Rate Environment

Anticipated Interest Rate Increases

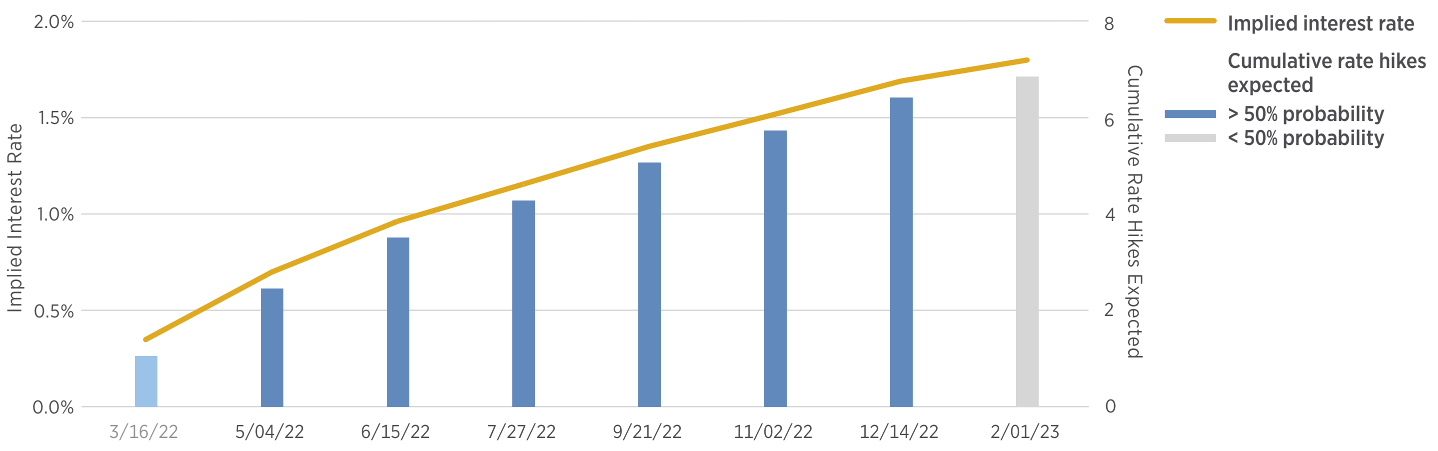
April 2022

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

Due to inflationary concerns, the Federal Reserve (the "Fed") announced in late 2021 an end to their bond buying program, and at the Fed's meeting on March 16, 2022, it raised interest rates for the first time in three years by 0.25%. The current rate of inflation in the U.S. is around 8.0%.[1] After years of uncharacteristically low interest rates, the market has expected the Fed to raise rates and this month's rate hike matched those expectations.

With the market anticipating multiple rate hikes, and indeed, on March 16 Fed Chairman Jerome Powell hinted at possibly six more increases over the rest of the year to fight inflation, it is possible we may see a cumulative interest rate increase of 1.50% during 2022.[2] This paper focuses on access to CLOs and how they can serve as an attractive alternative to other types of credit during periods of rising interest rates.

Fed Funds Overnight Rate Expected to Increase at Upcoming Central Bank Meetings



Source: Bloomberg

Note: As of pricing date 3/9/2022. Cumulative Rate Hikes Expected represents the number of cumulative hikes (+) or cuts (-) estimated by the associated meeting. This is calculated as the implied rate change divided by the assumed rate move. Implied Interest Rate represents the overnight rate expected after the corresponding Central Bank meeting that is implied by the chosen instrument. Past meeting shown on 03/16/2022. Future meetings shown from 05/04/2022 to 02/01/2023.

Performance data quoted represents past performance. Past performance does not guarantee future results. Current performance may be lower or higher than the performance data quoted.

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

CLOs and Investment Access

XA Investments LLC ("XAI") believes 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[3] that invests in a portfolio of floating-rate loans, CLO debt and equity. The Trust's portfolio, as of December 31, 2021, was invested in CLO debt and equity (50%), first lien and second lien loans (46%) and other investments (4%). CLO investing introduces a new set of opportunities and risks for investors. During a Fed hike cycle, XAI believes the Trust may benefit from its investment in floating-rate securities and low average effective duration of less than six months. The Trust may also benefit from its active management during such a rising rate period.

For some time, exposure to floating-rate loans has been accessible through an array of mutual funds, ETFs, and closed-end funds. Therefore, advisors and investors have developed a familiarity with loans, their risks, and benefits. Conversely, CLOs are less familiar and far more difficult to access. With interest rates expected to rise from historically low levels, many investors may find the CLO market's floating-rate coupons attractive.

CLOs may present a natural hedge to rising interest rates because of their floating rate income and low duration risk.[4] As rates increase, CLO debt securities pay higher coupons. CLO equity securities are more nuanced; in the long term, "the spread" paid to equity holders often increases as interest rates rise. By contrast, interest rates on traditional fixed income investments are locked or "fixed" and therefore adversely impacted by rising rates.

CLOs and their Response to Interest Rate Changes

CLO debt tranches typically offer higher yields relative to similarly rated corporate credits and other structured products. They may also provide 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 documented default in the AAA and AA CLO debt tranches.[5] Negative correlations to U.S. Treasury bonds and low correlations to investment grade corporate credit and equities also present valuable diversification benefits. 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 debt securities. Once interest payments are made and the CLO's operating expenses are 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 investors 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 on underlying loans can increase and ultimately benefit the CLO—in particular, the CLO equity holders.

Rate Hikes and the Implications of LIBOR/SOFR Floors

Most loans in the marketplace have LIBOR (or SOFR) floors (i.e., 50 to 75 bps),[4] which means that when rates rise there can be a delay in the increase in loan yields if the loans are already paying out the minimum or the floor rate. Rates must rise above the floors for floating-rate loan investors to see the benefit of the rate hikes. If we observe multiple rate hikes, which result in the loan market moving above the floors, loan interest will adjust with changes in rates going forward.

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

Floating-Rate Loans and CLO Debt Outperform as Fed Raises Rates

		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**	**CLO Debt (BB-rated tranches)**
2/4/94 to 2/1/95	300	-7.65%	-3.93%	-3.56%	-1.74%	9.33%	n/a
6/30/99 to 5/16/00	175	2.99%	0.10%	-0.16%	-2.27%	3.06%	n/a
6/30/04 to 6/29/06	425	8.59%	5.85%	9.30%	14.88%	5.92%	n/a
12/16/15 to 12/31/18	225	7.93%	8.95%	7.82%	20.02%	14.75%	36.63%

Source: U.S. Treasuries represented by Bloomberg US Long Treasury Total Return Index, Investment Grade Credit represented by Bloomberg US Credit Index, Municipal Bonds represented by Bloomberg US Municipal Index, High Yield represented by Bloomberg US High Yield 1% Issuer Cap Index, Floating-Rate Loans represented by Credit Suisse Leveraged Loan Index. CLO Debt is represented by the J.P. Morgan Collateralized Loan Obligation Post Crisis BB Index ("CLOIE"). Data for indices are through the nearest month end. CLOIE index incepted on 12/30/2011.

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 the Trust's adviser or sub-adviser.

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

The following table summarizes many key attributes of CLO securities, as compared with various other credit and structured securities. CLO investing involves important risk considerations, however, 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[6]
Low historical defaults	CLO debt tranches have demonstrated long-term historical default rates lower than similarly rated U.S. corporate credit instruments[5]
Floating rate income	Coupon floats based on LIBOR (or the new market standard SOFR), which may benefit investors in periods of rising short-term interest rates[7]
Portfolio diversification	CLO debt has low correlations to equities and investment grade corporate credit and negative correlation to U.S. Treasury bonds
Inflation hedge	Floating-rate loans and CLO securities can serve as an inflation hedge in the portfolio. These floating-rate investments demonstrate higher correlation to inflation than other inflation hedges such as commodities or infrastructure

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Index Definitions

Bloomberg 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 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 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 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. **JP Morgan Collateralized Loan Obligation Post Crisis BB Index ("CLOIE")** measures the market for U.S. dollar-denominated broadly syndicated, arbitrage CLOs. The CLOIE is divided by origination (pre- versus post-crisis) and is broken out further into six original rating classes (AAA, AA, A, BBB, BB, B). The sub-index we reference here tracks BB-rated CLO debt.

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. **Inflation** is a general increase in the prices of goods and services in an economy resulting in a decrease in the purchasing power of money. **LIBOR (London interbank offered rate)** 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. **SOFR (Secured Overnight Financing Rate)** is a broad measure of the cost of borrowing cash overnight collateralized by Treasury securities. SOFR is the benchmark reference rate for loans that will replace 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

The information in this material is provided as a summary of complicated topics for informational and educational purposes and is not intended to be relied upon as a forecast or research, and does not constitute legal, tax, investment or other professional advice on any subject matter. Further, the information is not all-inclusive and should not be relied upon as such.

Illiquid investments are designed for long-term investors who can accept the special risks associated with such investments. An investment in illiquid investments involves risks, including loss of principal. Investors considering an allocation to alternatives should evaluate the associated risks, including greater complexity and higher fees relative to traditional investments. Investors should carefully weigh the diversification benefits, expected returns and volatility of alternatives relative to traditional investments. Investments in alternatives involve risks, including loss of principal. **Performance data quoted represents past performance. Past performance does not guarantee future results. Current performance may be lower or higher than performance data quoted.** Diversification does not eliminate the risk of experiencing investment losses. You should not use this material as a substitute for your own judgment, and you should consult professional advisors before making any investment decisions. This material may contain "forward looking" information that is not purely historical in nature, including projections, forecasts, estimates of market returns, and proposed portfolio compositions. There is no guarantee that any forecasts will come to pass. This information does not constitute a solicitation of an offer to sell and buy any specific security offering. Such an offering is made by the applicable prospectus only. A prospectus should be read carefully by an investor before investing. Investors are advised to consider investment objectives, risks, charges and expenses carefully before investing. Financial advisors should determine if the risks associated with an investment are consistent with their client's investment objective.

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. 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. The Trust invests primarily in below investment grade credit instruments, which are commonly referred to as "high yield" securities or "junk" bonds. Investments in below investment grade securities are considered predominantly speculative with respect to the issuer's capacity to pay interest and repay principal when due and such issuers are not perceived as strong financially as those with higher credit ratings. Investments in below investment grade credit instruments involve substantial risk of loss. The Trust invests a significant portion of its assets in CLO debt and subordinated notes (commonly referred to as CLO "equity") which often involve risks that are different from or more acute than risks associated with other types of credit instruments. 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. Senior loans may not be fully secured by collateral, generally do not trade on exchanges, and are typically issued by unrated or below-investment grade companies, and therefore are subject to greater liquidity and credit risk. **For more information on risks associated with the Trust, please see the Trust's web page at xainvestments.com or the Trust's SEC filings (which are publicly available on the EDGAR Database on the SEC website at http://www.sec.gov).**

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.

CLO Interest Rate Risk. Although senior secured loans are generally floating rate instruments, the Trust's investments in senior secured loans through CLOs are sensitive to interest rate levels and volatility. Although CLOs are generally structured to mitigate the risk of interest rate mismatch, there may be some difference between the timing of interest rate resets on the assets and liabilities of a CLO. Such a mismatch in timing could have a negative effect on the amount of funds distributed to CLO subordinated notes. In addition, CLOs may not be able to enter into hedge agreements, even if it may otherwise be in the best interests of the CLO to hedge such interest rate risk. Furthermore, in the event of a significant rising interest rate environment and/or economic downturn, loan defaults may increase and result in credit losses.

Because CLOs generally issue debt on a floating rate basis, an increase in reference rates will increase the financing costs of CLOs. Many of the senior secured loans held by CLOs have rate floors such that, when the rate is below the stated floor, the floor (rather than the reference rate itself) is used to determine the interest payable under the loans. Therefore, if LIBOR or SOFR increases but stays below the average stated floor rate of the senior secured loans held by a CLO, there would not be a corresponding increase in the investment income of such CLOs. The combination of increased financing costs without a corresponding increase in investment income in such a scenario would result in smaller distributions to holders of the CLO subordinated notes.

CLOs and bank syndicated loans have traditionally used LIBOR as an interest rate benchmark, which is being phased out, with new instruments typically being issued with SOFR as the alternative rate and existing instruments required to transition by June 30, 2023. Replacement of LIBOR may adversely affect the market value or liquidity of CLO securities and/or loans, and pose tangential risk for markets and assets that do not rely directly on LIBOR. It is possible that different markets might adopt different rates, resulting in multiple rates at the same time and a potential mismatch between CLO securities and underlying collateral, the effects of which are uncertain at this time, and could include increased volatility or illiquidity.

Closed-end Fund Risk. Shares of closed-end funds are subject to investment risks, including the possible loss of principal. Closed-end funds differ from open-end funds (commonly known as mutual funds) because investors in a listed closed-end fund do not have the right to redeem their shares on a daily basis but may sell their shares on the exchange in the secondary market. Closed-end fund shares frequently trade at a discount to their net asset value.

Footnotes

1 According to the U.S. Bureau of Labor Statistics Consumer Price Index 12-Month percentage change for the year ended January 2022. 2 Bloomberg. 3 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. 4 Senior secured loans have reference rate floors (typically tied to LIBOR or increasingly, SOFR); most commonly the LIBOR floor has been 0.50%. Investors in senior secured loans benefit from higher interest payments once LIBOR is above the 0.50% floor. Similar levels are expected to persist as reference rates shift to SOFR. 5 ©1993–2017 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: 1993–2017. November 6, 2018. Please note this is the latest information available from Moody's. 6 J.P. Morgan, Credit Strategy Weekly Update: High Yield and Leveraged Loan Research, February 11, 2022. 7 Citi Research, "2022 Global CLO Outlook" (December 14, 2021).

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