Seeking Alpha α

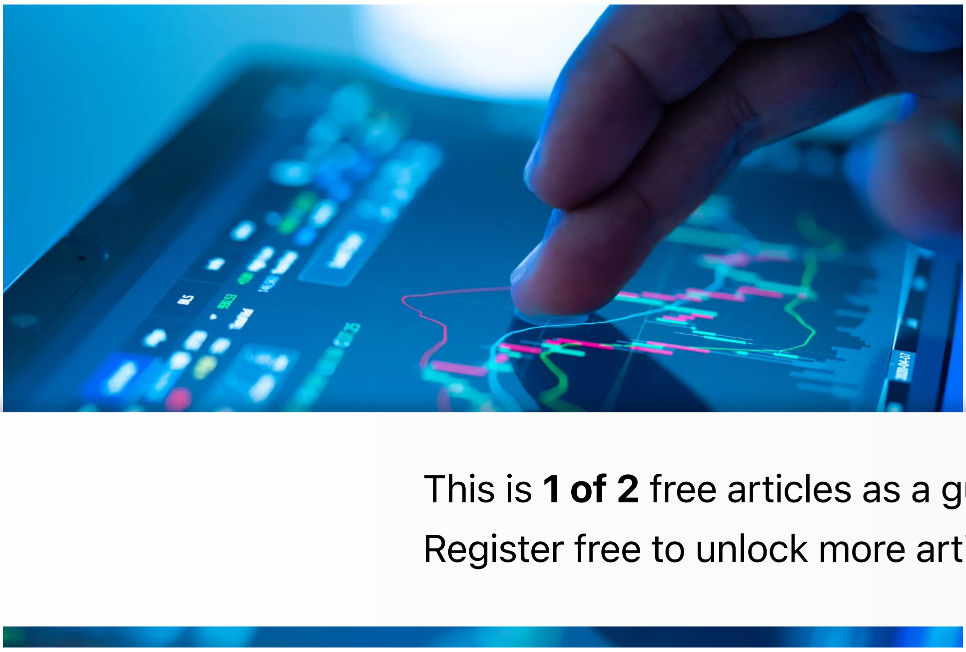
Closed End Funds

Remaining High Single-Digit Yield Opportunities In CEFs

Jun. 26, 2021 4:10 AM ET | BGH, EIC, HYT... | 12 Comments

Summary

- Yields have been trending lower over the past year across all types of income assets.
- We take a look at CEFs which feature high single-digit portfolio yields rather than just high distribution rates.
- We highlight different strategies investors can pursue in their search for these opportunities.
- We highlight EIC, BGH, FIV and TEI.



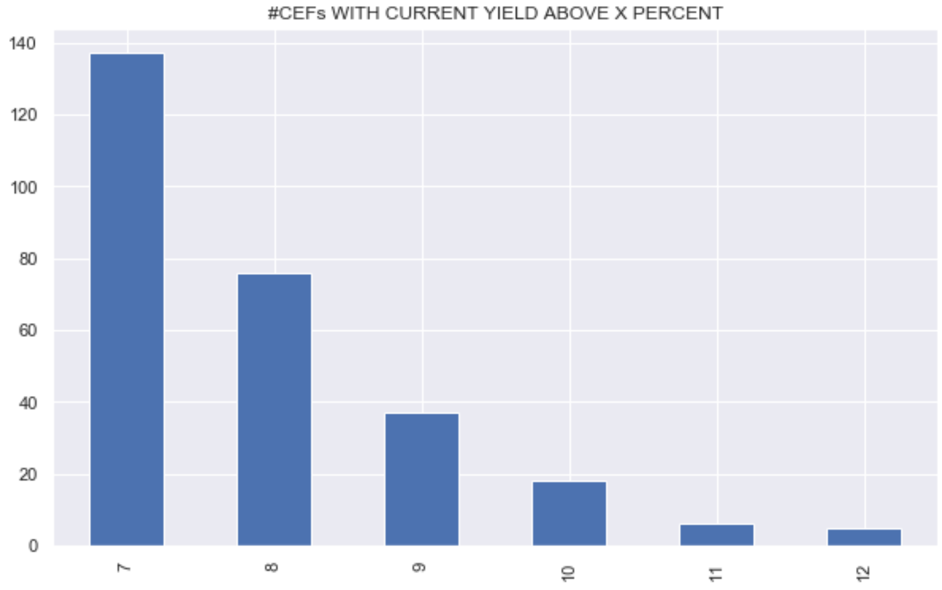
Witthaya Prasongsin/Moment via Getty Images

This article was first released to Systematic Income subscribers and free trials on 6-June.

That yields have been coming lower across a broad swathe of assets won't come as a surprise to income investors. Despite this downtrend in yields, there are many CEFs that continue to offer high single-digit distribution rates. In this article, however, we focus less on distribution rates (which are often arbitrary) and more on portfolio yields and highlight a number of funds that still feature high single-digit portfolio yields.

An Important Distinction

It may seem odd to discuss the "remaining" high single-digit yield opportunities in CEFs. A quick look at the chart below shows that there are literally hundreds of funds with current yields (i.e. distribution rates on price) above 7%, over 100 with current yields above 8%, and dozens above 9%.



Source: Systematic Income

In this article, however, we focus less on fund distribution rates and more on portfolio yields - an important distinction we discuss in this section.

It's probably fair to say that income investors are divided roughly into two camps - let's call them, *yield investors* and *distribution investors.* Distribution investors care much more about "what goes in their pocket" or the actual distribution amounts they receive from their holdings. These investors are less focused on how these distributions are manufactured - whether they come out of coupons, dividends, return of capital or capital gains. These investors take the view that as long as a given fund just keeps making attractive distributions the rest will take care of itself.

Yield investors, in our definition here, are the neurotic type who worry a great deal about how their distributions are put together. They are less likely to feel satisfied with ample distributions that are not backed up by similar asset yields. Recall, that we like to make a distinction between three types of CEF yields: current yield (also called distribution rate or what the fund chooses to distribute), net investment income or NII yield (what the fund receives in coupons and dividends) and portfolio yield (which is based on the portfolio asset yield-to-worst that takes into account any optionality of the fund's holdings - something that NII yield above doesn't do).

As an example, consider the BlackRock Corporate High Yield Fund (HYT) which has a NAV current yield of 7.68% (what the fund pays out relative to its NAV), a net investment income yield of 6.50% (what the fund receives in coupons from its assets net of fees on its NAV) and an estimated net portfolio yield of 4.55% (what the funds' underlying assets yield when adjusted for optionality, net of fees, on its NAV). The reason this distinction is important to *yield-investors* is that, all else equal, it is this last net portfolio yield number that is the actual driver of investor wealth. Coincidentally, the reason we pick HYT is because BlackRock shows the gross portfolio yield on net assets of its fixed-income funds - the only one of the major CEF managers to do so.

In the sections below we highlight the different strategies investors can pursue in order to find funds with high single-digit portfolio yields.

Find More Esoteric Securities

The **Eagle Point Income Company** (EIC) is the only exchange-traded CEF that allocates almost entirely to CLO Debt or the rated tranches of collateralized loan obligations. The fund discloses its portfolio yield in its monthly portfolio updates with the latest figure being 9.16% (CLO Debt itself having a yield of 8.2%). There is a bit of a disconnect between the fund's CLO Debt 8.20% average effective yield and the average coupon on its CLO Debt securities of 3-month Libor + 6.31% given Libor is trading at 0.13%. In other words, the 8.20% figure is not the same as the 6.44% one (0.13% + 6.31%). The discrepancy may have to do with a few things such as the fact that the yield is quoted on the fair value of CLO Debt securities whereas the coupon assumes the par convention. This should make the differential converge by about 0.20% given the 96.9% weighted average price of CLO Debt securities.

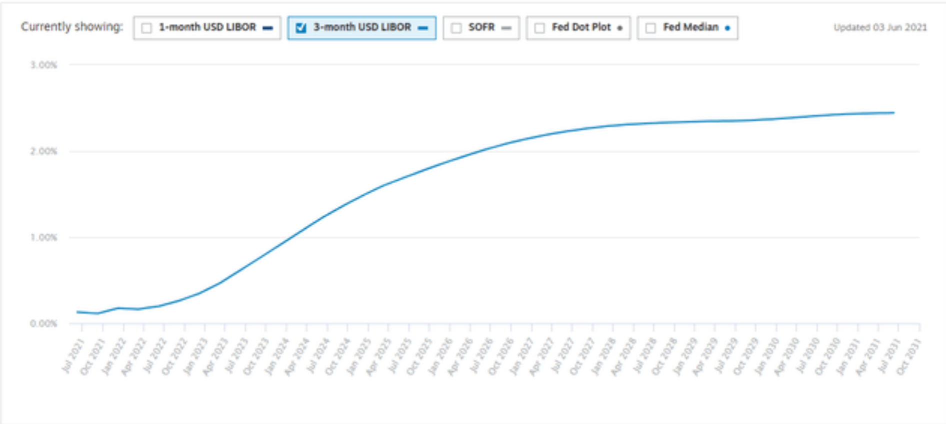
Summary of Portfolio of Investments and Cash[1]

Weighted Average Effective Yield on the Portfolio[5]	9.16%
Weighted Average Effective Yield on CLO Debt[5]	8.20%
Weighted Average Coupon on CLO Debt	L + 6.31%
Weighted Average Mark on CLO Debt	96.86%
Weighted Average Effective Yield on CLO Equity[5]	13.47%

Notes: Calculations above for CLO debt are based on par value.

Source: Eagle Point Income Co

Another 1% of the discrepancy likely comes from taking Libor forwards into account, or Libor rates implied by the shape of the current interest rate curve. Since Libor is expected to grow over the next few years as Fed begins its hiking cycle, the CLO Debt coupons are expected to grow as well and this is why effective yield is higher than the CLO Debt current coupon.



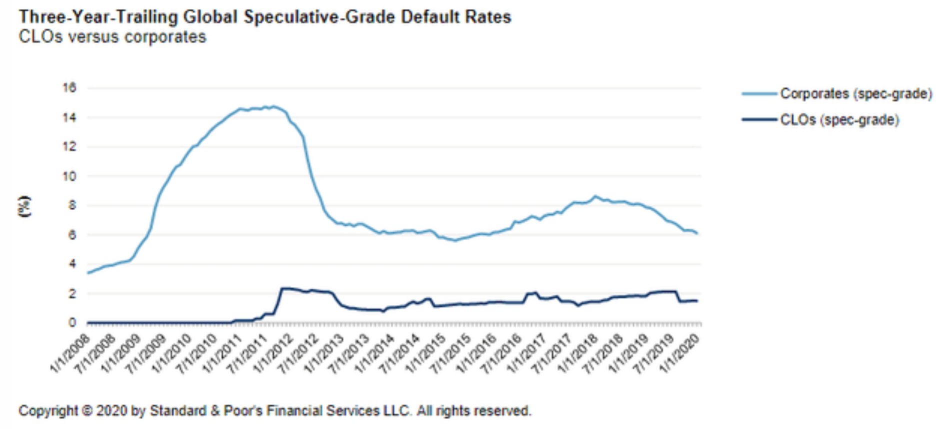
Source: Chatham Financial

It's not clear where the remaining 0.7% differential comes from - perhaps there are some compositional effects that end up distorting the weighted-average calculations.

In any case, it's fair to say that once we factor in the fund's CLO Equity position as well as additional leverage and expected rise in Libor forwards (useful when turning floating-rate cashflows into fixed-rate equivalents) EIC features a portfolio yield in the high single-digits which fits our criteria here.

The fact that EIC can generate a higher overall yield for investors than "normal" loan funds (which boast net portfolio yields closer to 6%) is not due to any magic. BB-rated CLO Debt, which is what EIC primarily holds, is trading at a discount margin of around 6.4% according to Palmer Square whereas loans trade at a margin of 4.4%, according to Nuveen. So long as this differential persists, EIC will be able to drive a higher portfolio yield for investors.

Apart from reaching our high single-digit portfolio yield level, EIC has a number of additional attractive features. It is tempting to compare EIC to a loan fund but a portfolio of CLO Debt has quite different dynamics from a portfolio of loans which are worth highlighting. First, the historic default rate of junk-rated CLO tranches has been well below their similarly-rated loan counterparts.



Source: S&P

Secondly, CLO Debt features a level of subordination which should allow CLO debt to outperform a portfolio of loans in a "normal" recession. This is because the CLO Equity tranche eats the first losses in the portfolio before they spread to more senior (i.e. Debt) tranches in the CLO structure.

The downside is that in a truly cataclysmic scenario, CLO Debt will likely underperform a portfolio of loans because loan portfolio defaults can burn through the entire CLO Debt tranche, leaving it essentially worthless whereas a portfolio of loans will accumulate recoveries along the way.

There are two additional attractive features of EIC itself: its discount valuation as well as its room to add additional leverage. While the loan CEF sector is trading at an average discount of 4%, EIC is trading around a discount of 10-11%, depending on if you use the official figures (not quite apples-to-apples as the last available NAV is from April) or our daily-calculated estimate.

		NAV			Discount / Premium	
Fund	Price	Official	Official Date	Estimated	Last Official	Estimated
EIC	$15.70	$17.38	2021-04-30	$17.73	-9.67%	-11.26%

Source: Systematic Income CEF Tool

The fund also runs at a fairly low leverage of around 15%, according to its Q1 numbers and so has a lot of room to add assets which would generate additional yield for investors. This is in contrast to an average loan CEF which runs at 31% leverage and has much less room to add borrowings.

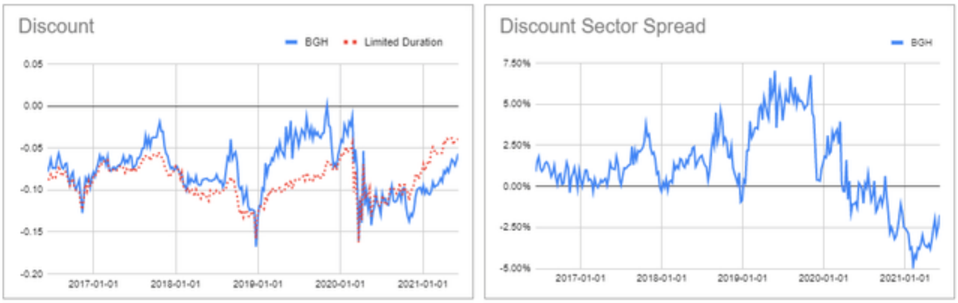
Move Lower in Credit Quality

Another strategy to achieve high single-digit portfolio yields is to move way lower down the credit quality spectrum. A fund that does exactly this is the **Barings Global Short Duration High Yield Fund** (BGH) which has one of the lowest credit quality allocations in the listed fixed-income CEF space with nearly 40% of the portfolio in assets rated CCC or below.

Unfortunately, the fund does not disclose its portfolio yield but we can estimate it in a couple of ways. One way is to simply use its rating profile and compare it against the BofA corporate bond index yields. Using this method we get a gross portfolio yield number of 5.24% and a net portfolio yield (after fees and leverage on net assets) of 5.84%. In our view, this is a low-ball estimate of the fund's actual portfolio net yield for two reasons.

First, the fund's 25% portfolio allocation to Oil & Gas as well as mining sectors suggests that its yield is significantly higher since these sectors tend to trade at higher yields than similarly-rated securities in other sectors. And secondly, the fund shows that its weighted-average market price is $93.83 as of April and its income yield for the last reported six months was 8.99%. If we put the two together we can estimate that the fund's net portfolio yield is north of 10% due to the additional positive pull-to-par in the portfolio. We don't know for sure because there may be some defaulted securities in the portfolio which are unlikely to recover fully back to par but it's a reasonable estimate.

Since we first highlighted this fund its valuation has bounced back somewhat but its discount still trades a bit wider of the Limited Duration sector.

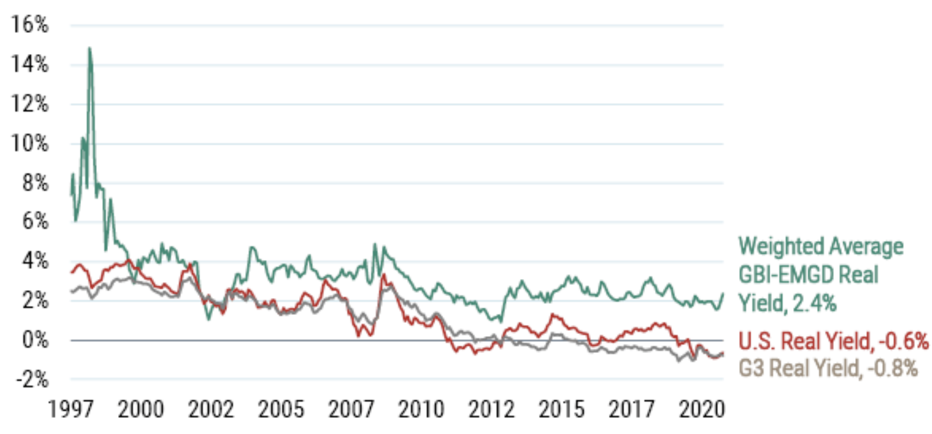


Source: Systematic Income CEF Tool

Take Local Currency Exposure

A third strategy to get high single-digit portfolio yields is to avoid the struggle in the USD (or even G10) denominated market entirely and to allocate to local-currency, particularly Emerging Market currency, assets. Not only do EM assets offer higher absolute yields, but they also offer higher real yields as the following chart shows.

EXHIBIT 6: INFLATION-ADJUSTED BOND YIELDS



Source: GMO

The key risk to local-currency EM credit is that local currencies underperform relative to the dollar, offsetting their higher yields. However, a period of negative US real yields tend to support local EM assets historically. Plus, as we are early in the global macro cycle we should expect acceleration in global growth with rising exports and commodity prices favoring EM economies.

One fund that allocates to local-currency EM debt is the Templeton Emerging Markets Income Fund (TEI). The fund is trading at a 6.9% discount and an 8.82% current yield (CEFConnect has not yet updated its numbers as of this writing and so its current yield number is incorrect). The fund recently switched to a managed distribution plan of 8.5% of the average monthly NAV.

TEI discloses its portfolio yield which is 9.93% which derives from its local currency positions in Indonesian, Egyptian, Colombian and other primarily local-currency government debt. TEI has very uninspiring long-term returns though this is largely driven by poor historic performance of EM FX relative to the USD.

Takeaways

Although there is a boatload of funds with high single-digit current yields, the number of funds that offer high single-digit portfolio yields is quite small. The distinction between the two types of yield is not one that matters to all investors. In our view, however, it is an important one to highlight because in a market environment of fairly expensive asset and discount valuations, CEF returns in the medium term are much more likely to resemble their portfolio rather than current yields.

As the article makes clear - there is no free lunch. In almost all cases, funds with high portfolio yields will have to take more market risk than funds that boast the same current yield. In other words, funds with high current yields, more often than not, tend to feature portfolio yields that are a fraction of their current yields. This means that funds with high portfolio yields are not appropriate to investors who are worried about a significant downturn in markets but can be quite attractive to investors who have a constructive stance and want to ensure that their CEF returns deliver on the apparent promise of their high distribution rates.

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This article was written by

ADS Analytics
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Author of **Systematic Income**
Income investing across CEFs, ETFs, preferreds, baby bonds and more.

Disclosure: I am/we are long EIC, TEI. I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it (other than from Seeking Alpha). I have no business relationship with any company whose stock is mentioned in this article.

12 Comments

Comments (12)

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Arctic Investor 26 Jun. 2021, 9:47 PM

Comments (89) | + Follow

Thought provoking article. Here are a few of my thoughts:

"in a market environment of fairly expensive asset and discount valuations, CEF returns in the medium term are much more likely to resemble their portfolio rather than current yields."

The quote above wasn't demonstrated in the article. It is stated without data to back it up. Other than that, going lower on the quality spectrum as these funds do isn't inherently less risky or better performing than higher quality assets that are boosted with higher leverage. They have different risk profiles but claiming one is less risky or more likely to have better returns deserves to be backed up with evidence.

Cheers!

Reply Like (1)

ADS Analytics Yesterday, 1:56 AM

Marketplace Contributor

Premium

Comments (1.38K) | Following

Author's Reply @Arctic Investor It's self-evident. The fact that yields have trended lower over the last decade has boosted CEF returns. If yields continue trending lower at the same pace they will turn negative soon enough. So if you don't think yields will turn negative you must also think that CEFs will miss the kind of tailwind they received over the past decade.
ADS

Reply Like (1)

takinstocknsichuashun 26 Jun. 2021, 9:46 PM

Comments (141) | + Follow

Yeah, TEI seems like a good play for Dollar bears.

Reply Like (1)

BeaJawa 26 Jun. 2021, 10:42 AM

Comments (6.88K) | + Follow

negative real-yields on recent SEC 30day junk bond etf yields is an eye opener to me as well.. HYG and JNK yield less than the recent CPI print! omg!

Reply Like (1)

ADS Analytics 26 Jun. 2021, 8:51 PM

Marketplace Contributor

Premium

Comments (1.38K) | Following

Author's Reply @BeaJawa yes i've seen that meme. it's an apples to oranges number since cpi is 12-month backward looking and the yield of hy corp bonds is a multi-year forward-looking measure. if you do more of an apples-to-apples comparison of 5y breakevens vs hy corp yields, real yields are comfortably above zero
ADS

Reply Like

BeaJawa Yesterday, 1:31 PM

Comments (6.88K) | + Follow

@ADS Analytics h/y bond yield is what it is..low..driven by the comfort level the FED has given markets ..and 'inflation expectations' are high.. a FORWARD looking number.. anyway you slice it, the yield is not enough to compensate for the risk in the FCF draught many of these companies are facing

Reply Like

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movetohawaii 26 Jun. 2021, 10:32 AM

Comments (522) | + Follow

🤙

Reply Like

BeaJawa 26 Jun. 2021, 10:26 AM

Comments (6.88K) | + Follow

key word here 'remaining.'... CEF's are either overvalued or priced to perfection. Bloomberg's high yield-total index actually shows a negative real yield now.. so to buy junk you get less return than inflation.

I have $TEI on watch and see you own it..it is interesting as a hedge but the lack of vaccinations in EM's-while the Indian Covid variant spreads- gives me pause on the potential recovery and strength of these economies and their bonds. Many are seeing inflation and raising rates as well- so holders could be in for principal/capital loss adjustments. Bea

Reply Like (1)

jasonjones

Yesterday, 9:47 AM

Comments (5.85K) | + Follow

@BeaJawa Excellent comment. Remaining is the key word. Last year was buying time. Not now.

Reply Like (1)

Monthly Income Investor

26 Jun. 2021, 9:51 AM

Comments (269) | + Follow

Great read. Learned some things I didn't know and now I want to research things you mentioned. I love learning new things about cefs I didn't know!

Reply Like

EdT.cpa_Retired

26 Jun. 2021, 8:52 AM

Marketplace Comments (1.4K) | + Follow

I can ask no more than that an author stimulate my thinking.....and you have done so. Thanks.

Reply Like (2)

Banneker

26 Jun. 2021, 8:31 AM

Marketplace Comments (38) | + Follow

Lots of logic, delivered in a pleasantly readable way. Thank you for the article. I will take a look at these CEFs.

Reply Like (2)