

CEF Weekly Market Review: A Bit Off The Top

Jun. 27, 2021 7:15 AM ET | BKN, CIF, CIK... | 4 Comments | 11 Likes

Summary

- We review CEF market valuation and performance over the past week and highlight recent events.
- We highlight news and market action across a number of CEFs such as HFRO, FSLF, IGI, and a pair of Invesco loan funds.
- Valuation and distribution challenges remain two key risks for CEF investors in this market environment.
- This update covers the third week of June.
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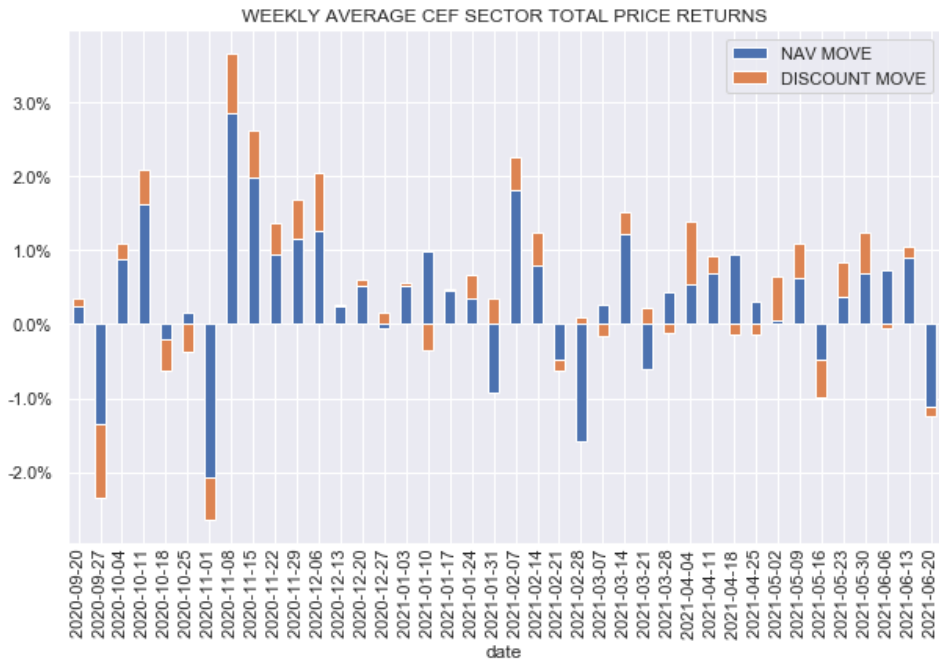
Witthaya Prasongsin/Moment via Getty Images

This article was first released to Systematic Income subscribers and free trials on 20-June.

Welcome to another installment of our CEF Market Weekly Review where we discuss CEF market activity from both the bottom-up - highlighting individual fund news and events - and top-down - providing an overview of the broader market. We also try to provide some historical context as well as the relevant themes that look to be driving markets or that investors ought to be mindful of. This update covers the third week of June.

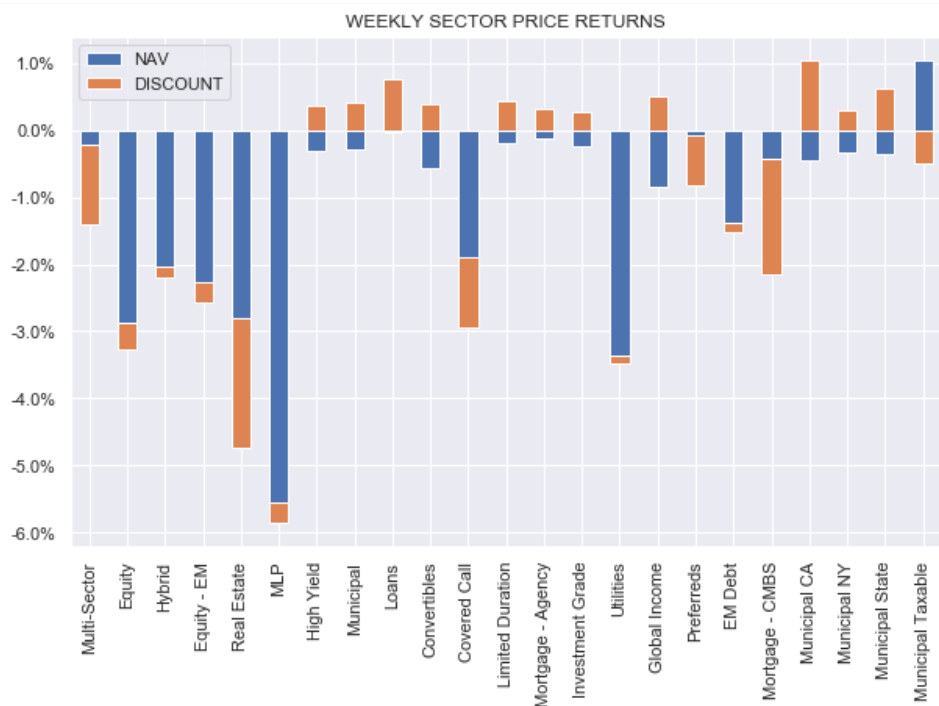
Market Overview

It felt like an unusually poor week for CEF returns even though the average sector lost just over 1%. However, even this tepid result was enough to make it the worst weekly showing since the end of February and the second worst week since last November.



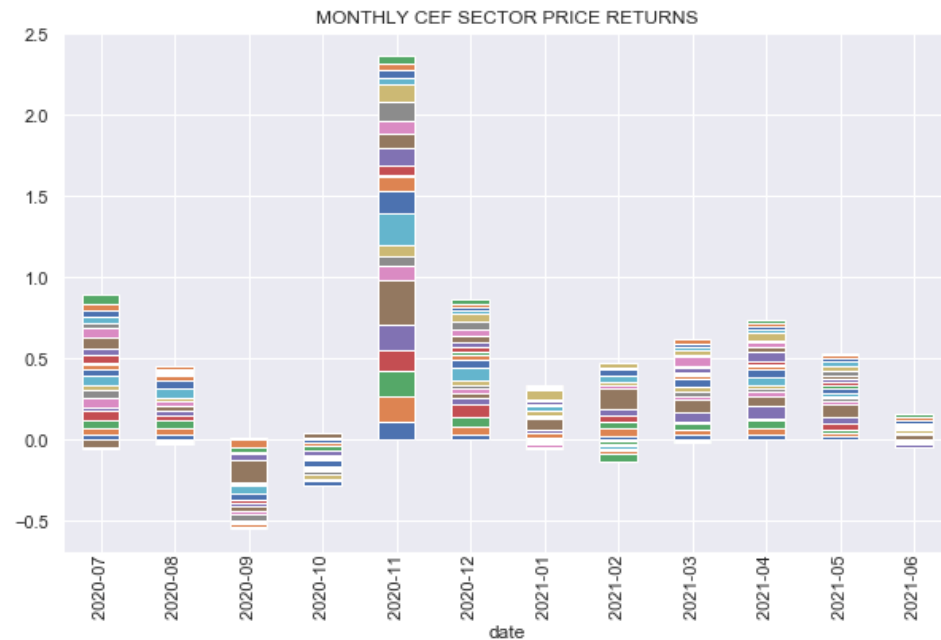
Source: Systematic Income

The average picture isn't quite fair to fixed-income sectors which did just fine due to the drop in Treasury yields with the bulk of the losses concentrated in higher-beta equity-linked sectors like MLPs and REITs.



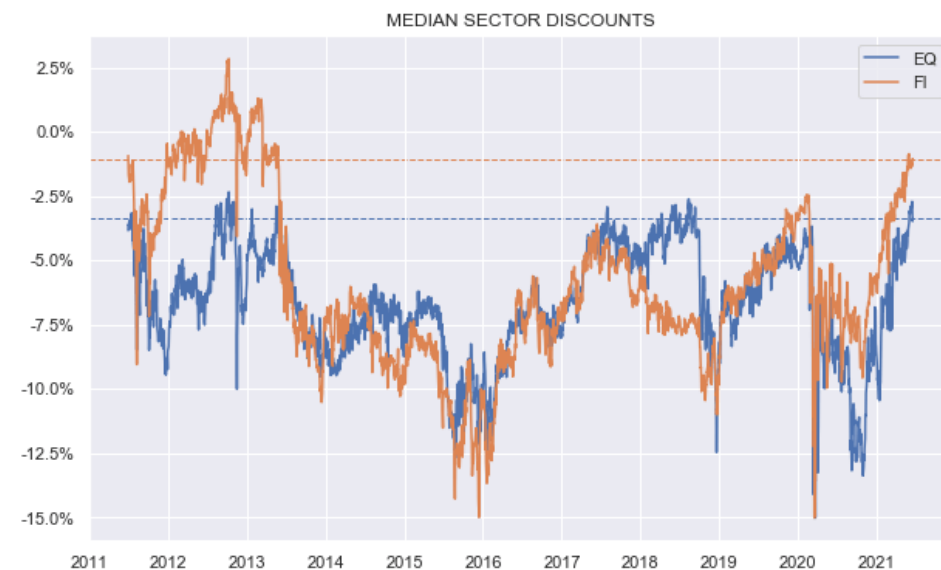
Source: Systematic Income

On a monthly basis, June is still very much in the green - the chart below shows that the number of sectors with positive price returns exceeds those with negative returns so far in the month.



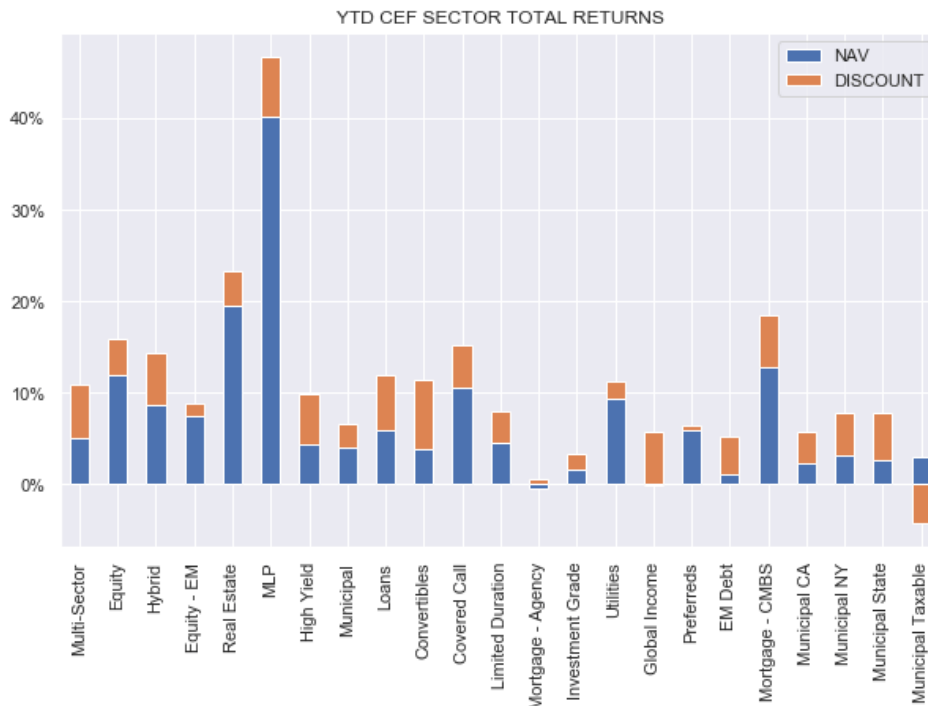
Source: *Systematic Income*

Fixed-income sector discounts remain elevated while equity-linked sector discounts have come off slightly their recent highs which nearly reached the tightest level since 2013.



Source: Systematic Income

On a year-to-date basis, all but the agency sector is showing positive NAV returns while only the Taxable Muni sector is in the red in price terms. The higher-quality, agency and taxable muni sectors are bringing up the rear due to the combination of their higher-quality and longer duration.

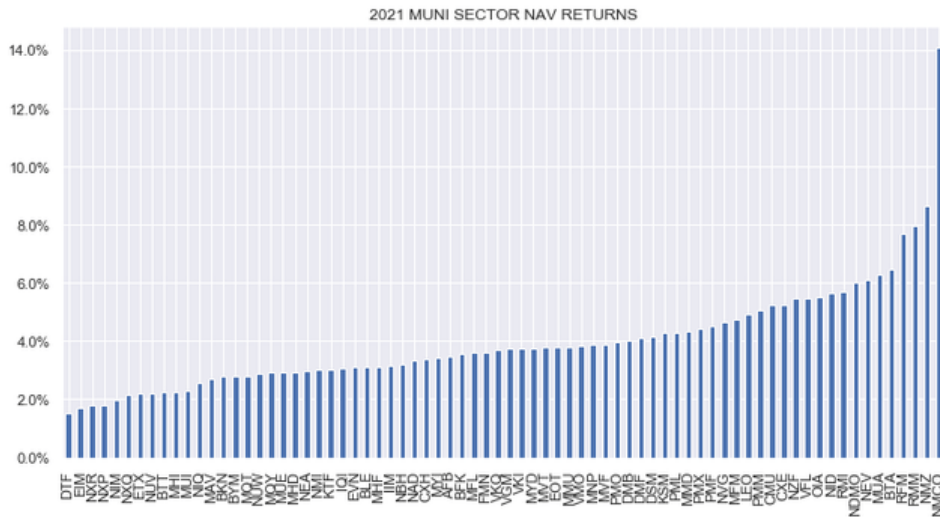


Source: Systematic Income

This dynamic highlights one of our refrains that at the start of the market cycle these types of sectors tend to struggle due to their tight credit spreads which are not able to tighten enough to offset the rise in risk-free rates. This feature prevents these sectors from participating in the rally and limits the growth in investor portfolio wealth. It is only once valuations richen substantially and risk-free rates rise that these sectors become more attractive.

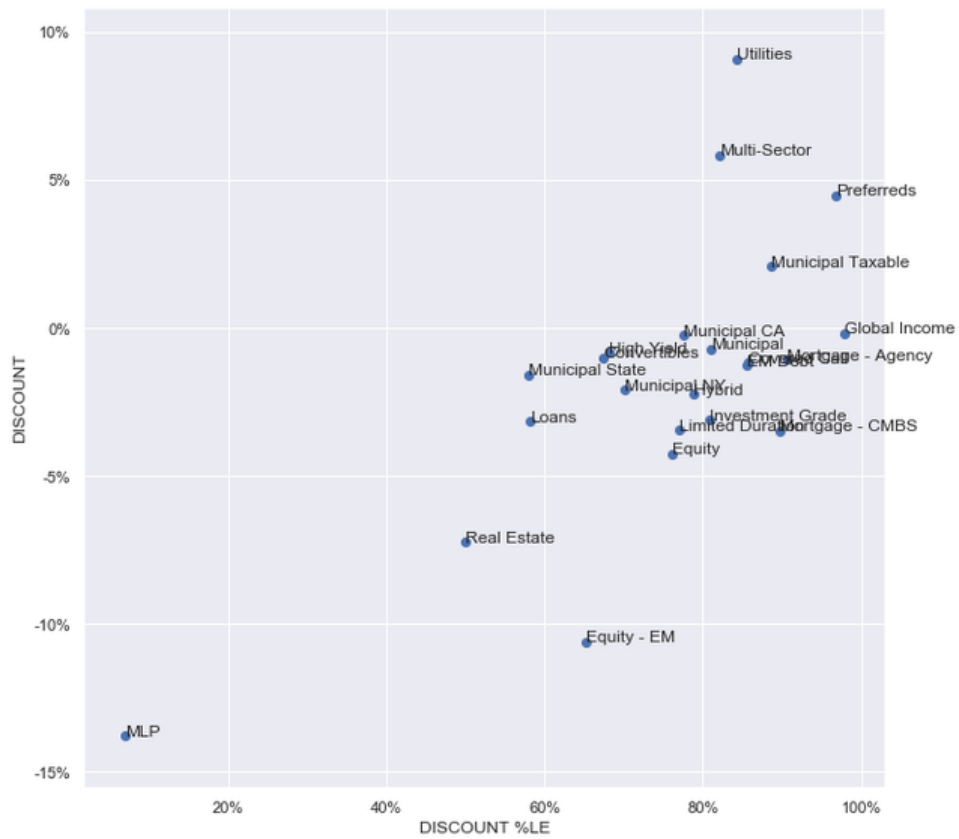
This is one reason we have turned more bullish on duration in April. First, risk-free rates rose enough to be more attractive from a carry perspective. Secondly, they rose high enough to be able to fall significantly in case of a macro disappointment or a market bump. Thirdly, the curve became sufficiently steep that yield curve rolldown returns became attractive. And fourthly, tighter valuations decreased the opportunity cost in being in higher-quality assets.

This dynamic highlights the (overly) simple rule-of-thumb that income investors often use in relation to duration, which is to avoid assets with duration exposure when interest rates are moving higher. This rule-of-thumb misses the point that duration is not the only driver of asset performance. For example, since the start of the year, 10-year Treasury yields are up by over 0.5% and yet all municipal CEFs have delivered positive total NAV returns. More importantly, the Nuveen Municipal Credit Opportunities Fund ([NMCO](#)) has the highest duration in the sector at a nearly massive 14, and yet it is by far the strongest NAV performer in the sector year-to-date. This fund and the broader high-yield focused tax-exempt sub-sector was our favorite pick in the space in the second half of last year due to its more cyclical exposure and much stronger valuation picture. This example shows that the "avoid duration" rule-of-thumb in a period of rising interest rates can easily deliver the opposite of investor expectations.



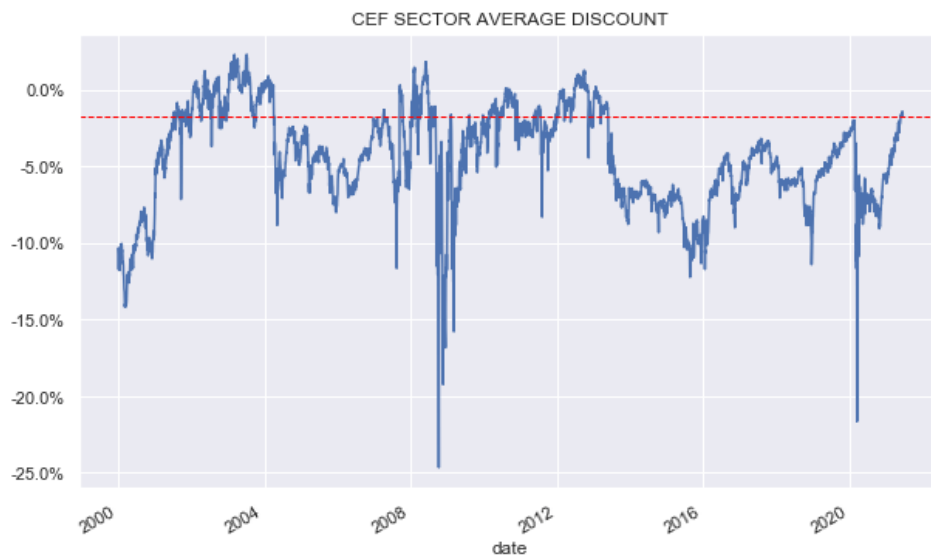
Source: Systematic Income

The CEF sector discount valuation picture shows that most sectors are clustered in the top right-hand quadrant of the chart reflecting both tight discounts and high discount percentiles. In fact only the MLP sector is trading at a below 50% discount percentile - indicating it is the only sector trading in the cheaper half of its 5-year discount history. And only two sectors - MLPs and EM Equity - are trading at a double-digit average discount.



Source: Systematic Income

The average CEF discount has pushed through its pre-COVID level and is trading at the tightest level since 2013.



Source: Systematic Income

CEF Commentary

The Highland Income Fund ([HFRO](#)) is proposing to convert from a CEF to a “diversified holding company”. The goal appears to be to allow the fund to loosen its investment mandate and to solve its discount problem. A couple of sweeteners are in place - a buyback program and an intention to maintain the distribution through Jan 2022. It’s not obvious that HFRO is facing real issues here. First, its allocation profile is already very unusual, to say the least – nearly half the fund is in 2 holdings: a 10.25% timber preferred and a NFRO REIT SUB – its own subsidiary. This is in strong contrast to other credit CEFs which tend to stay well diversified in publicly traded instruments.

And on the discount front, it’s true that the 14% discount (prior to the announcement) is wide as far as credit CEFs go but it’s probably not a million miles away from fair value given 1) the unobservability of the fund’s portfolio valuation and 2) its poor historic returns – the fund’s 3-year NAV returns are 4.1% per annum and its price return is negative. In fact, the fund's 3-year total price return appears to be the second worst in the CEF space outside of the MLP sector - the worst is the NexPoint Strategic Opportunities Fund ([NHF](#)) and is run by the same people.

CEFConnect puts HFRO in the loan sector and the fund's 3-year NAV return of 4.1% per annum is only slightly below the loan sector average. However, in our view, the fund doesn't belong in the loan sector since loans constitute only around a quarter of its portfolio and the loan allocation is below that of either preferred or common stocks. We keep the fund in the "Multi-Sector" sector where the average 7-year NAV return is 7.7%.

The HFRO valuation highlights two related issues about a naïve value strategy in CEFs which just seeks out the widest discounted funds on the view that you are getting a bargain in the process. First, wide discounts don't actually have to close or even move tighter – there is no iron law of markets that has to ensure this happens: “cheap” funds can remain “cheap”. And secondly, a sole focus on discounts ignores the moves in the NAV, which is what anchors discounts in the first place. HFRO is a good example how discounts can remain cheap and NAVs can perform poorly - a combination which delivers poor price returns to investors. The First Eagle Senior Loan Fund ([FSLF](#)) intends to liquidate. Very likely the scale of the fund (at something like \$180m total assets) and unimpressive returns didn't really make sense for the sponsor. Recall this used to be managed by THL (TSLF) which then moved to First Eagle. The fund will always have a warm spot in our hearts due to its “information alpha”. When the fund changed hands and tickers it disappeared from CEFConnect which pushed its discount out to a much wider level relative to its sector (because most investors had no idea what its discount was). And when it reappeared, the discount spread converged in short order. It's as good an example as any that the CEF market remains reasonably inefficient to allow (well-informed) investors to pick up some alpha along the way.

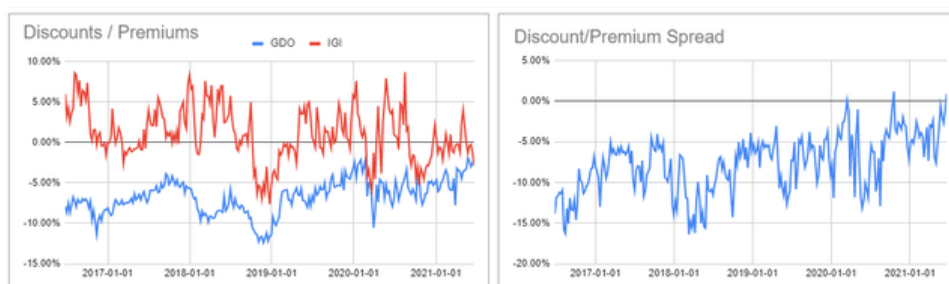
The excessive Nuveen Credit Opportunities 2022 Target Term Fund (JCO) premium has begun to deflate but is still too high. The math is very clear that the fund will deliver flat returns to investors over the next year into its June-2022 termination.



Source: [Systematic Income CEF Tool](#)

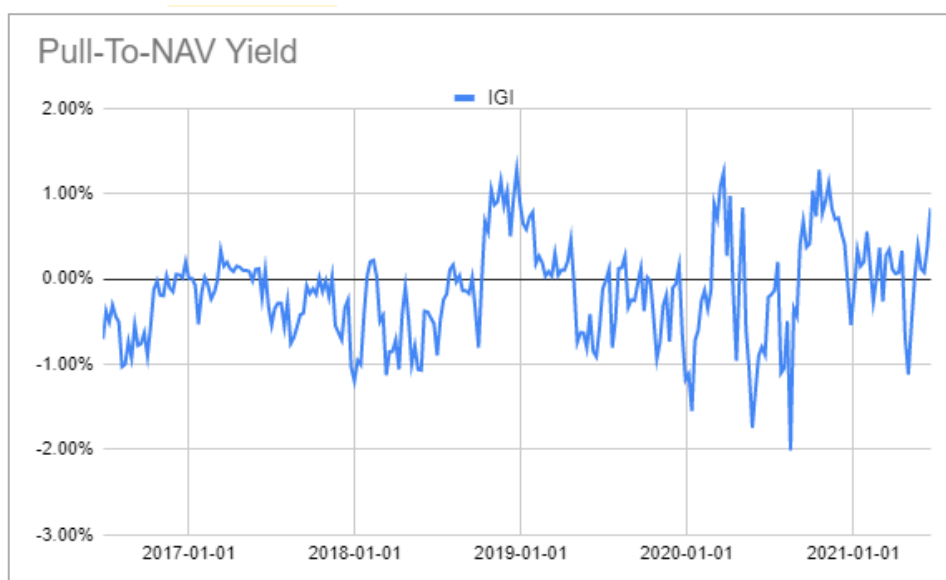
Term CEFs that still look reasonably attractive here are the Western Asset High Yield Defined Opportunity Fund (HYI) with a 1% PTN Yield, the Nuveen Intermediate Duration Municipal Term Fund (NID) also with a 1% PTN Yield, First Trust Senior Floating Rate 2022 Target Term Fund (FIV) at a 1.7% PTN Yield, and the Western Asset Investment Grade Defined Opportunity Trust (IGI) and a 0.7% PTN Yield. PTN Yield is defined as the annual tailwind return from the expected discount compression to zero on termination date.

Interestingly, IGI has moved to trade at a slightly wider discount than its other Western Asset investment-grade counterpart GDO which is very unusual.



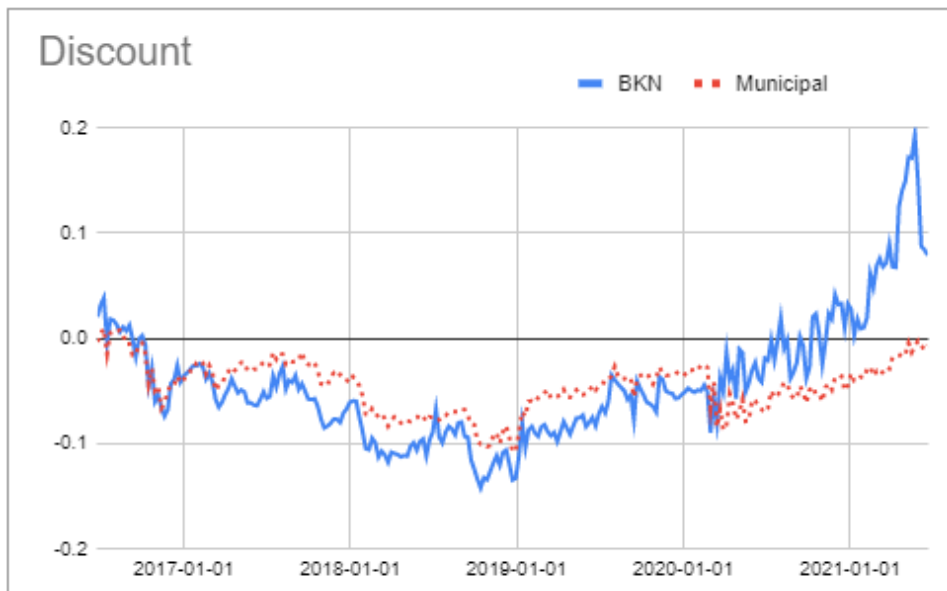
Source: [Systematic Income CEF Tool](#)

IGI has a lower fee than GDO, a higher-quality allocation, no leverage (GDO does carry leverage), and stronger distribution coverage though its current yield of 3.76% is quite a bit below the 6.63% of GDO. Its PTN Yield of nearly 1% is also unusually high for it. This makes it an attractive option for investors who really want to be in a no-leverage higher-quality credit CEF. For investors happy to take a bit more risk while keeping a foot in the investment-grade credit space, GDO remains attractive.



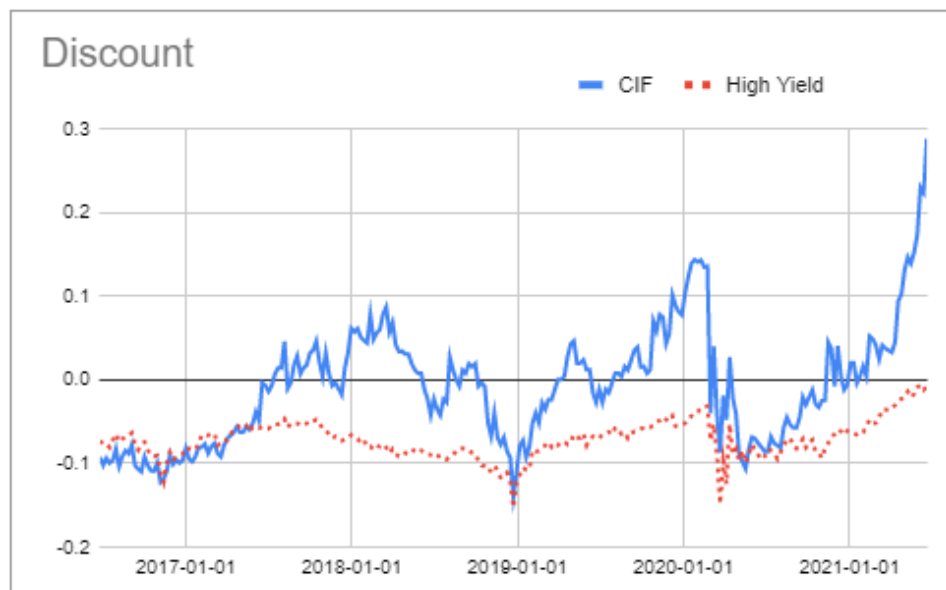
Source: [Systematic Income CEF Tool](#)

Like poorly stored fireworks, CEF premiums keep exploding occasionally. We saw this with the BlackRock Investment Quality Municipal Trust ([BKN](#)) recently whose premium rose to around 20% and has now come back down to 7% which is still too high.



Source: [Systematic Income CEF Tool](#)

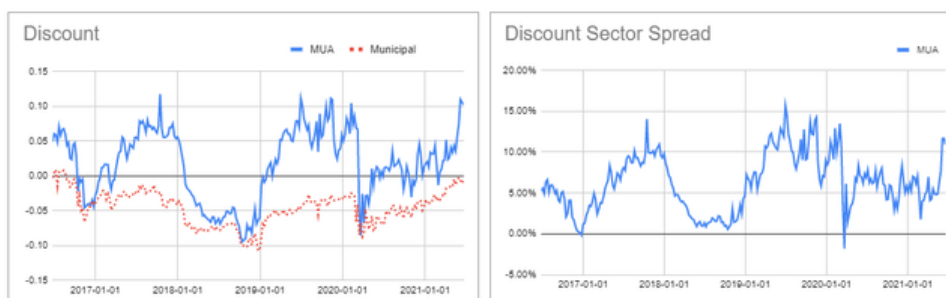
The MFS Intermediate High Income Fund (CIF) in the High Yield sector is another one with a 30% premium – up from single-digits in March.



Source: [Systematic Income CEF Tool](#)

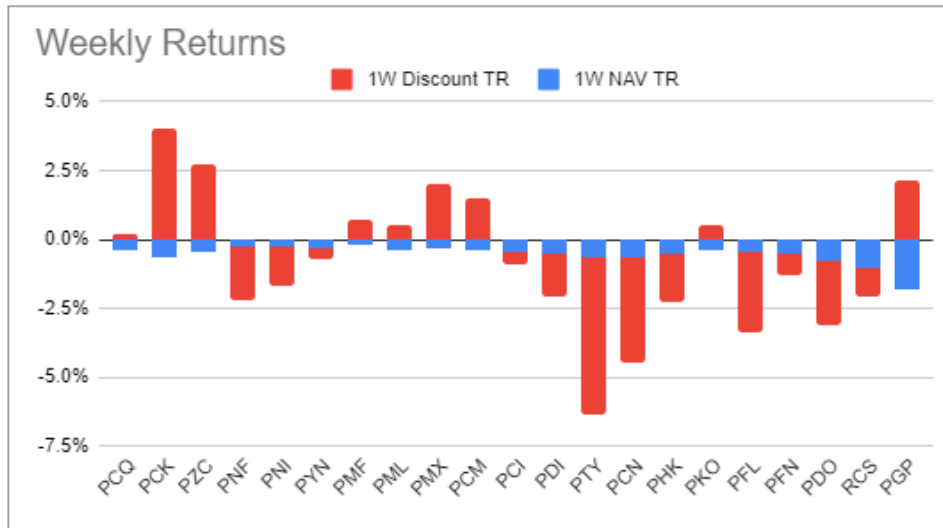
First Trust High Income Long/Short Fund ([FSD](#)) looks to be the closest fund by NAV return correlation to CIF and is a reasonable alternative. The BlackRock Corporate High Yield Fund ([HYT](#)) is another reasonable choice in the sector, as are the pair of Credit Suisse funds - CSAM Income Fund ([CIK](#)) (which deserves to trade at a richer valuation due to its low fee) and the CS HY Bond Fund ([DHY](#)).

In the tax-exempt sector, the BlackRock MuniAssets Fund ([MUA](#)) exploded with its premium rising to 16% which has now closed to around 10% - still too high. The fund is a bit unusual with a low leverage and a focus on unrated bonds but potential replacements are MHD and BTA.



Source: Systematic Income CEF Tool

PIMCO CEFs have seen a bit of premium weakness in the last few days – Corporate&Income Opportunity Fund ([PTY](#)) premium is off about 8% though it remains pretty high at 33%. Four of their other taxable CEFs are off about 3%. Typically, you see a bit of weakness going into the start-of-month distribution announcement or the ex-div date but the timing doesn't fit either story here. Maybe a 40% premium was too much for some people as it is for us.



Source: *Systematic Income CEF Tool*

The Calamos Long/Short Equity & Dynamic Income Trust Fund ([CPZ](#)) raised its distributions once again. The Calamos funds align their distributions with NAVs, something that was [highlighted](#) prior to the last two raises. So long as the NAV keeps rising, they will keep raising.

Two Invesco Loan CEFs - Credit Opportunities Fund ([VTA](#)) and Senior Income Trust ([VVR](#)) - approved changes to their investment policies to allocate up to 20% in equity securities. Before this, the funds could only hold equity obtained through debt restructurings (such as when the debt holders get common shares in a restructuring, rather than cash, which, presumably the company no longer has). This could end up being not particularly interesting since the funds could move into preferreds which, in aggregate, are not necessarily "lower quality" than loans despite being lower in the capital structure. This is because most issuers of preferreds are investment-grade rated (going by senior unsecured ratings) entities.

Alternatively, this move could mean something that HFRO indicated the other day which is that the underlying math of fixed-income CEFs is not particularly attractive given the combination of 1) longer-term yields that are no longer falling, 2) fund expenses that are high relative to underlying portfolio yields, and 3) the Fed looking to hike somewhere in 2023 which will raise fund leverage costs. At current yields, the average CEF is no longer adding marginal yield through its "leverage sausage factory" to its portfolio yield, which leaves investors simply taking on leverage for no additional yield benefit (though for the benefit of the CEF manager). It is possible, of course, that CEF managers can deliver alpha that does add additional return which could justify holding an "average" CEF over its passive counterpart – whether this will happen is arguably the most interesting dynamic to watch in CEFs. We will have a clearer picture towards the end of the year, especially if yields remain stable over that time. Without additional alpha, fixed-income CEF returns are going to be about half of their distribution rates which will probably be a disappointment to most investors.

PIMCO updated their leverage and coverage numbers for the month of May - something we discuss in more depth in a separate article. Suffice it to say that leverage increased marginally with the average taxable leverage running north of 40%, which is very high by CEF standards. And secondly, coverage dropped off sharply due to a negative earnings month for most taxable funds. Most investors will likely be disappointed and concerned about these numbers; however, these numbers are hard to get much excited about. First, coverage dips are a regular occurrence in the PIMCO taxable space, particularly around fiscal-year-end. Secondly, they are artificial to some extent unless you believe that a leveraged fixed-income fund can actually have negative earnings (leveraged equity funds, particularly, of the Gabelli variety have negative earnings all the time because the cost of their preferreds + fees exceeds their paltry equity dividend income). Thirdly, PIMCO don't react to one-off income drops by cutting distributions - rather, investors should [pay attention](#) to drops in borrowings, particularly for funds with high NAV distribution rates. We have more to say in a separate article on this topic.

Takeaways

High discount valuations and potential distribution cuts are two major persistent themes in the CEF market. On the valuation front, a few funds still flag as reasonably valued - examples are the Cohen & Steers Tax-Advantaged Preferred Securities & Income Fund ([PTA](#)) in preferreds (likely overlooked as it's a new fund), the Nuveen Mortgage and Income Fund ([JLS](#)) (a higher-quality ABS / non-agency RMBS fund), the Virtus / AllianzGI pair ([NCZ](#)) and ([NCV](#)) (for people comfortable with some higher-beta convertible debt exposure) and the pair of MFS tax-exempt funds Investment Grade Municipal Trust ([CXH](#)) and Municipal Income Trust ([MFM](#)) (unclear why these munis funds are ignored - maybe people are less familiar with MFS as a muni manager).

As far as distribution risk, it's fair to say that distributions are going to be challenged over the next few years, particularly in fixed-income sectors. Investors can, of course, ignore this dynamic and allocate based with a total return / portfolio yield perspective. Alternatively, they can follow a few strategies that [mitigate the risk](#) of sharp and unexpected cuts such as allocating to funds with managed distribution policies or strong coverage.

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Disclosure: I am/we are long NMCO, NCV. 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.

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