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Closed End Funds

HYI: High Yield, No Leverage, Term Structure Fund Worth A Look

Jul. 01, 2021 3:29 AM ET | **Western Asset High Yield Defined Opportunity Fund (HYI)** | COMM, DISH, EHT... | 3 Likes

Summary

- We regularly cover HYI as it is one of the solid choices in the high yield space that also don't utilize leverage.
- For CEFs, funds that don't operate with leverage can be seen as relatively more attractive for more conservative investors.
- However, keep in mind that it is still a high yield fund - so that does entail risks on its own.
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Written by Nick Ackerman, co-produced by Stanford Chemist

Western Asset High Yield Defined Opportunity Fund (HYI) is one of those rare closed-end funds that doesn't utilize leverage. At the end of 2019, 71% of CEFs utilized leverage in one form or another. While another 29% did not. Of that 29%, it is oftentimes an options-based strategy that is employed on the fund. However, for HYI, that isn't the case either. It is just a straightforward high-yield fund that operates with no other complexities. Well, except for one wrinkle. It is a term-dated fund that is set to liquidate around September 30th, 2025.

We still have several years before this termination. However, what we have seen so far is a tightening of the discount. That is after last year's significant widening. It touched, very briefly, double-digit discounts before snapping back up. This is exactly what the term structure is designed to do. This is because heading into termination the discount should become more and more narrow. As investors will receive NAV back from the fund, this makes sense. Here is an example of Eaton Vance Target Term Trust (EHT) - terminating on July 1st.

Data by YCharts

As we can see, there were times of volatility that opened up a lot of opportunities. Ultimately though, we had been cruising into par right before it winds up.

HYI has an investment objective of "high income, with capital appreciation as a secondary objective." They "emphasize team management and extensive credit research expertise to identify attractively priced securities."

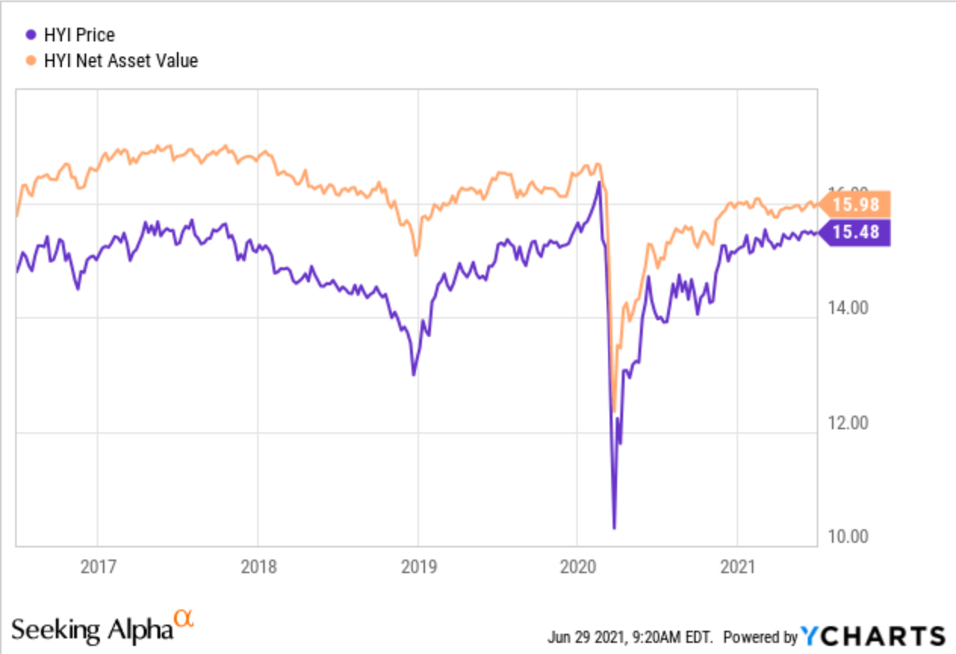
They invest in a portfolio of several different types of fixed-income investments. However, they are primarily invested in high yield. The fund has around $357.75 million in total managed assets. They have an expense ratio of 0.91%. This makes the fund a bit on the cheaper side in terms of expenses on CEFs. Since they don't utilize leverage, we don't have to worry about including leverage expenses here.

WESTERN ASSET
HIGH YIELD DEFINED OPPORTUNITY FUND INC. (HYI)

(Source)

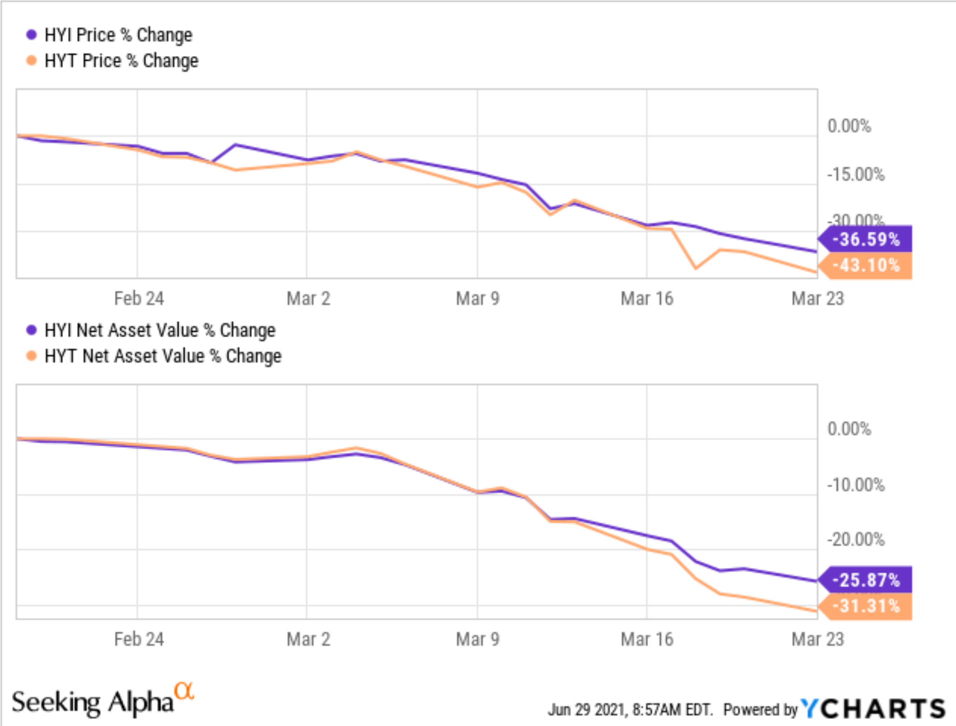
Performance - Rebounding Accomplished

The fund has largely rebounded from its lows in 2020 where it too felt the hit of the COVID-induced sell-off. The fund finished up in 2020 on a total return basis as well. This largely came as a lot of debt came rebounding strongly once the Fed stepped in.



Data by YCharts

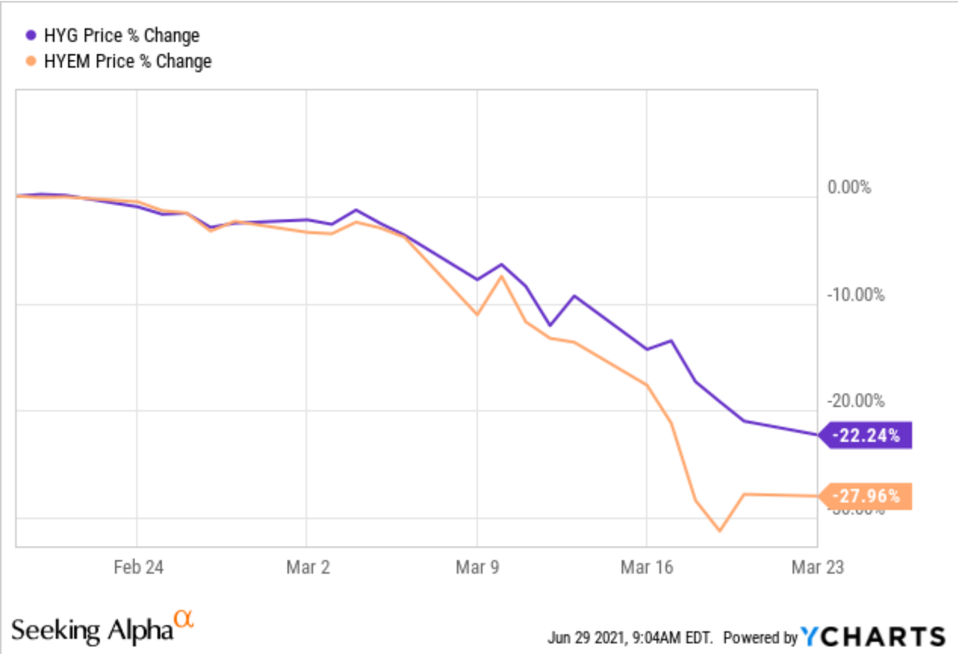
One thing that I believe is interesting to note is comparing the fund to a leveraged high yield fund. During that panic selling between February 19th, 2020 to March 23rd, 2020, I would have anticipated even less downside than we see below. Below is a comparison between HYI and BlackRock Corporate High Yield Fund (HYT).



Data by YCharts

There could be a couple of reasons for seeing a different outcome than initially expected. I believe that HYT is better diversified with many more holdings. Though nothing was really truly safe as everything got sold off similarly during the lows. Not only does HYT have a lot more holdings than HYI, but their portfolios aren't exactly the same either. HYI is heavily invested in high yield. However, it also has a material amount of exposure to emerging market debt as well.

Below we will look at another chart to compare emerging market debt with high yield debt during the 2020 market collapse. The chart shows us the performance between; VanEck Vectors EM High Yield Bond ETF (HYEM) and iShares iBoxx $ High Yield Corporate Bond ETF (HYG). The timeframe is the same as compared above - February 19th, 2020 to March 23rd, 2020. What we see is that HYEM led to the downside.

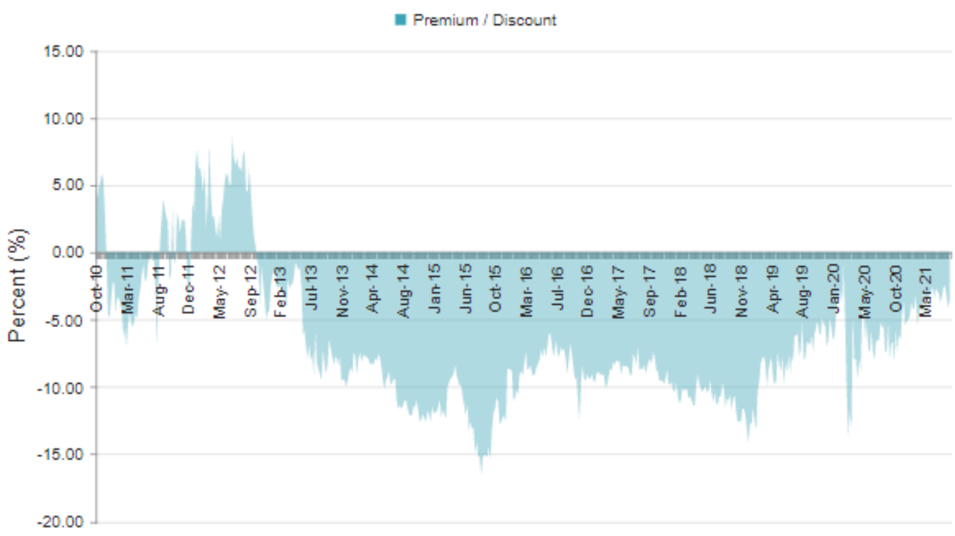


Data by YCharts

This is typically seen as emerging markets are going to be viewed as even more fragile than high-yield U.S. corporate debt.

In terms of HYI's discount at this time for its valuation. We see that it has been trending towards a more narrow range since around 2018. It only briefly widened in March 2020 before contracting once again. The overall CEF space is historically highly valued - along with the rest of the market if we are being honest.

Therefore, HYI at its current 3.13% discount is attractive but not excessively so. Part of its charm is we know that over the next few years investors will be able to cash out at NAV. The problem with that, we won't know what NAV is at that time. We could have another couple of corrections and recoveries from now until then.



(Source - CEFConnect)

Distribution - Attractive Yield

HYI certainly has an appealing yield when you consider it isn't leveraged. The current distribution rate works out to 7.33%. For a while, the fund was covering its distribution as well. However, due to last year's action to stave off a deeper recession. The Fed slashed rates to 0% last year and this saw debt yields subsequently drop. We explored this sinking coverage a bit more in our last update of HYI.

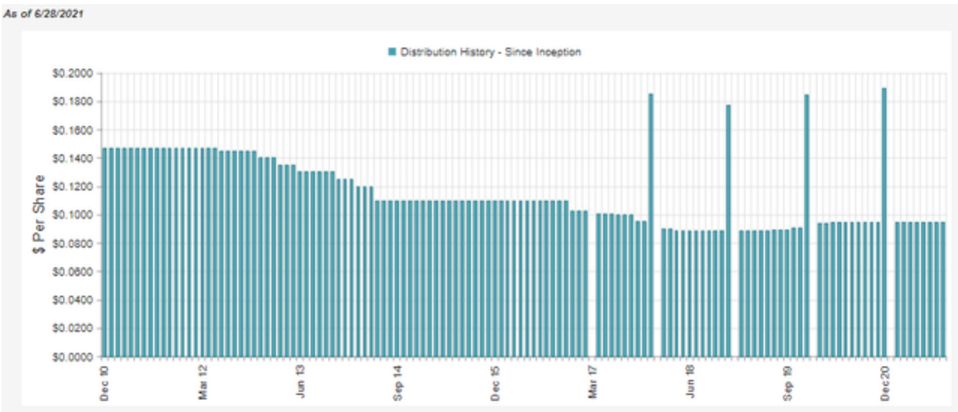
For the Six Months Ended November 30, 2020 (unaudited) and the Year Ended May 31, 2020	November 30	May 31
Operations:		
Net investment income	$ 11,397,932	$ 25,666,028
Net realized loss	(4,822,663)	(26,024,236)
Change in net unrealized appreciation (depreciation)	30,754,239	(4,234,714)
Increase (Decrease) in Net Assets From Operations	***37,329,508***	***(4,592,922)***
Distributions to Shareholders From (Note 1):		
Total distributable earnings	(12,843,369)	(23,306,741)
Return of capital	—	(1,785,000)
Decrease in Net Assets From Distributions to Shareholders	***(12,843,369)***	***(25,091,741)***
Fund Share Transactions:		
Cost of shares repurchased (0 and 98,024 shares repurchased, respectively) (Note 6)	—	(1,040,253)
Decrease in Net Assets From Fund Share Transactions	***—***	***(1,040,253)***
Increase (Decrease) in Net Assets	***24,486,139***	***(30,724,916)***

(Source - Semi-Annual Report)

> NII coverage had been one of the other qualities of the fund - it regularly covered its distribution through income. This is an important metric for sustainability in fixed-income funds as capital gains are less of a reliable source. The latest NII coverage comes to ~89%.

While I suggested a small trim could bring the fund back in line with 100% coverage. They have continued to pay out the same amount of $0.0945. This is announced quarterly and so investors can expect this rate through at least September. After that, they will have to once again revisit this situation to see if maintaining the rate is still attractive.

One thing that is apparent with HYI, they aren't afraid to adjust as needed either. Which I believe is a good thing. Since the fund is a term fund and investors will get out at NAV. An investor will receive the return one way or another. Either through appreciating NAV or the distribution. In the end, the return will be the same.



(Source - CEFConnect)

Holdings - Lower Duration

One of the main focuses of late has been interest rates and their negative impact on bonds should they begin to rise. I'm in the camp that rates won't get wildly out of control. The biggest pressure is due to inflation that is ramping up from the rebound. While at the same time, there are supply constraints that are adding to this. That is why the Fed is throwing around the word "transitory." In that, they don't expect this pressure to remain forever and that it will clear itself up over the next couple of years.

That being said, interest rates are likely to head upward. At least, that is the most logical next step. So we do need to be cognizant of that fact. Therefore, watching our debt fund's durations and maturities. Overall, a high yield bond typically has a lower duration. This is because they have relatively lower maturities and because of the higher yields themselves.

For HYI, we see this in the fund's weighted average life and effective duration. Both of which are on the lower end. That is telling us that HYI should experience a generally less negative impact against higher interest rates.

Weighted Average Life	8.00
Effective Duration	3.57
Average Coupon (%)	6.45

(Source - Fund Website)

It might also be interested to note here that they provide the average coupon. At 6.45% coupon, we see more evidence of their lack of coverage at this time. Though due to the fund's discount, the NAV yield of the fund comes to 7.10%. That means the fund has to earn just a bit less than it actually pays out to investors. Despite this, the coupon figure provided is still short.

The portfolio is quite overweight high yield corporate bonds. Though don't disregard the emerging market debt that the fund carries either. As we explored above, it can play a role in the fund's trajectory.

Asset Allocation (%) (As of Mar-31-2021)

	Fund
High Yield Corporate Bonds	77.18
Emerging Market Debt	15.40
Investment Grade Corporate Bonds	3.91
Bank Loans	2.44
Cash & Other Securities	1.07

(Source - Fund Website)

Overall, this debt is mostly in Brazil - but also Israel, Argentina, Russia and Mexico have some smaller allocations too.

Top Emerging Market Countries (%) (As of Mar-31-2021)

	Fund
Brazil	4.27
Israel	3.21
Argentina	2.42
Russia	1.68
Mexico	1.05

(Source - Fund Website)

With that being said, due to the infrastructure and logistical constraints of emerging markets, it appears they had a slower reopening. With more damage brought about from the COVID pandemic. Overall, being less wealthy nations left them more vulnerable to a pandemic. That is partially what makes these emerging economies more fragile than we would see in North America and parts of Europe.

It should also be noted that HYI carries material exposure to CCC-rated debt. These are the types of companies that; if it rains too hard they could default. They are in a precarious financial situation and even little setbacks could destabilize them completely.

Credit Quality Allocation (%) (As of Mar-31-2021)

	Fund
BBB	8.52
BB	32.20
B	39.57
CCC	17.22
CC	0.49
Not Rated	1.99

(Source - Fund Website)

With that, we can take a look at some of the companies largest debt holdings.

HOLDINGS

(As of May-31-2021)

Holdings | Currencies & Cash | Derivatives

Par/Share	Securities Description (all data unaudited)	Market Value ($)	% of investments
7,738,000	DISH DBS Corp. 7.7500% Mat 07/01/2026	8,799,653.60	2.45
7,000,000	NATWEST GROUP PLC 2.5225% Mat 03/31/2170	6,987,750.00	1.94
5,737,000	DISH DBS Corp. 5.8750% Mat 11/15/2024	6,113,863.53	1.70
4,288,000	SPRINT CAPITAL CORP 6.8750% Mat 11/15/2028	5,370,312.64	1.49
4,540,000	PETROBRAS INTL FIN CO 6.7500% Mat 01/27/2041	5,291,415.40	1.47
4,270,000	COMMSCOPE INC 8.2500% Mat 03/01/2027	4,563,562.50	1.27
4,480,000	TEVA PHARMACEUTICAL FINANCE NE 2.8000% Mat 07/21/2023	4,443,600.00	1.24
3,840,000	Western Midstream Operating LP 6.5000% Mat 02/01/2050	4,281,350.40	1.19
3,950,000	Citigroup Inc. 6.3000% Mat 11/15/2169	4,256,559.50	1.18
[illegible]	[illegible]	[illegible]	[illegible]

(Source - Fund Website)

What we can see is that all of the top holdings are corporate issuances. The largest industries they hold are classified as communications and consumer cyclical. These would include names such as DISH Network (DISH) - which includes two of the fund's top holdings. Then we also have Sprint which merged with T-Mobile (TMUS).

An interesting article for TMUS popped up recently as well. Noting that the company promised the merger would add more jobs overall. However, they now have fewer employers than previously. This isn't surprising as after the merger TMUS announced laying off hundreds of employees. Of course, this should financially leave TMUS better off to pay their debts - so investors win too.

Amongst the top holdings, we also have an interesting offering from CommScope Holding Company (COMM). Of HYI's top position, it pays out the highest rate but is due to mature in 2027. COMM "provides infrastructure solutions for communications and entertainment networks." They operate around the world.

One other thing that is worth noting in the fund's top holdings. You see a lot of the debt maturities after HYI "matures" in 2025. Their second largest holding doesn't mature until 2170, interestingly enough. That can add another layer of risk as they may have to find buyers for these bonds. That can be different from the principal amount that they originally put in.

Conclusion

HYI is an attractive non-leveraged high yield fund. The fund has certainly been at better valuations before. However, everything seems to be overvalued in this market. Additionally, HYI's valuation is a bit less of a concern as investors will receive par back in the future when the fund liquidates.

What we typically see with funds is the language for a tender offer of 100% at 100% of NAV being a possibility. However, for this fund, that language wasn't included in their Prospectus. It will be interesting to see if that is the route they go anyway and alter the language a bit. For investors, that still means being able to cash out at NAV if one so chooses.

The fund's yield is also quite attractive. Unfortunately, until rates begin to rise again, it seems that coverage will continue to remain weak. Of course, a distribution cut doesn't necessarily make it an automatic sell either. It just simply means the NAV will decline or potentially even grow.

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This article was written by

Nick Ackerman
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Disclosure: I am/we are long HYI, EHT. 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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