CEF Weekly Market Review: Another Strong Month

ADS Analytics

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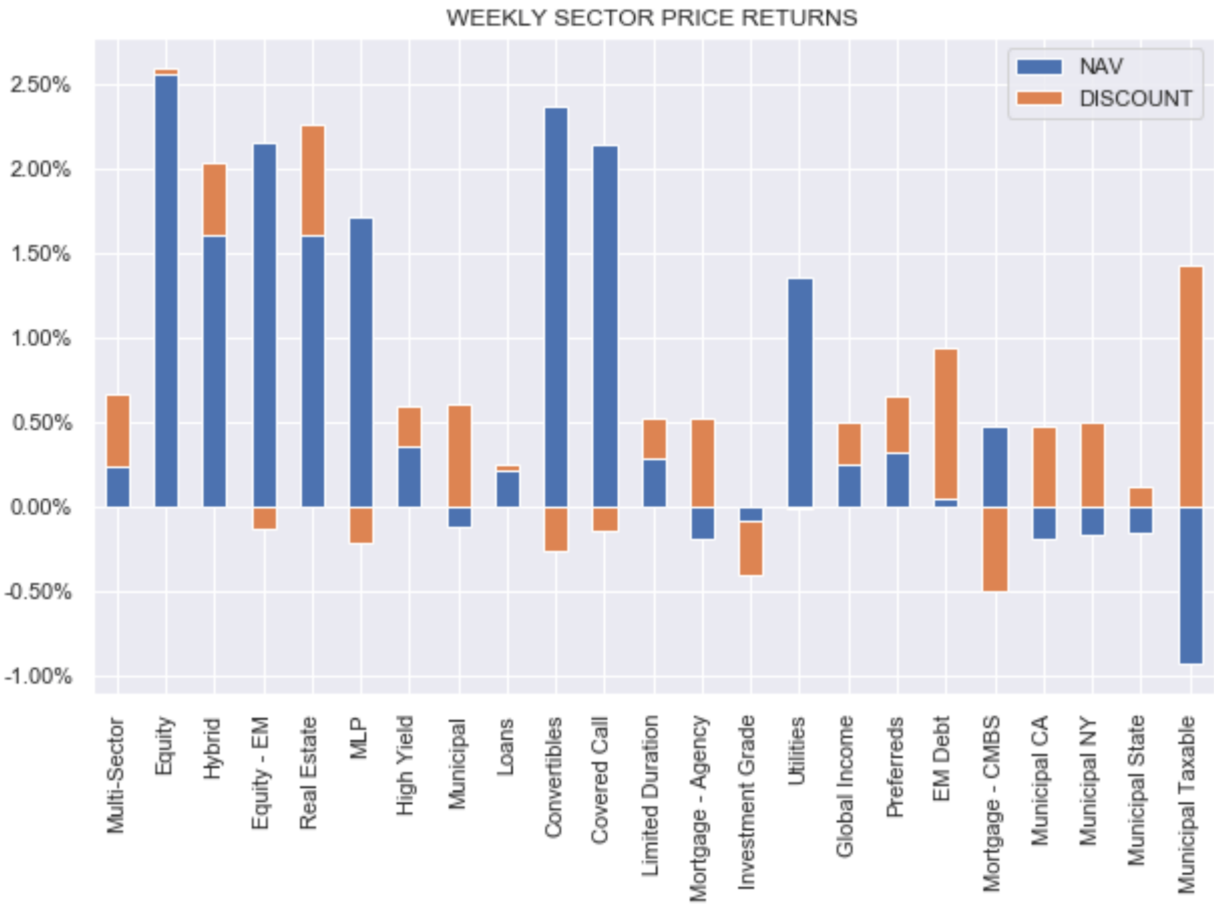
This article was first released to Systematic Income subscribers and free trials on 27-June.

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 - as well as 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 fourth week of June.

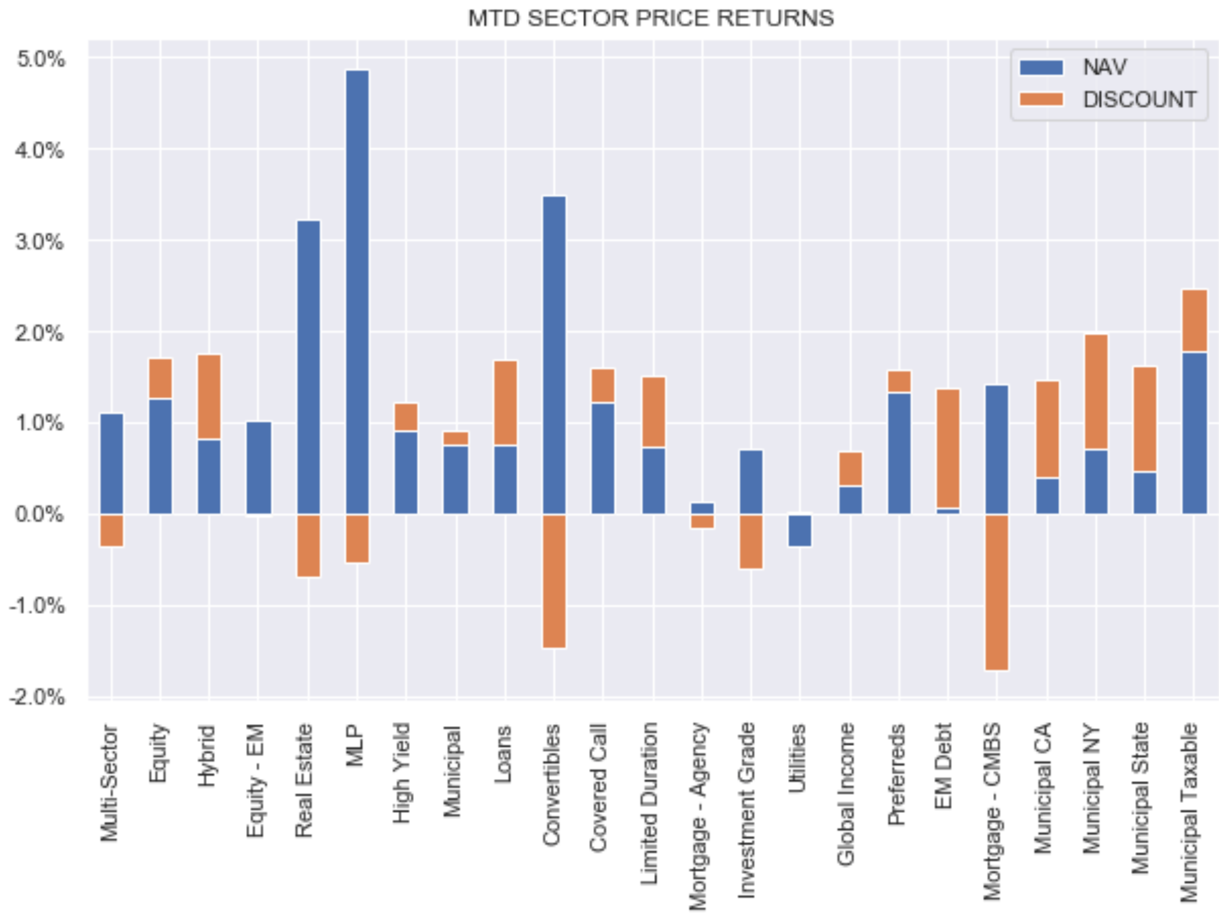
Market Overview

In contrast to the previous week, the fourth week of the month saw very good returns across the CEF market, particularly for equity-linked sectors, boosted by sharp NAV rises on the back of a bounce-back in stocks.



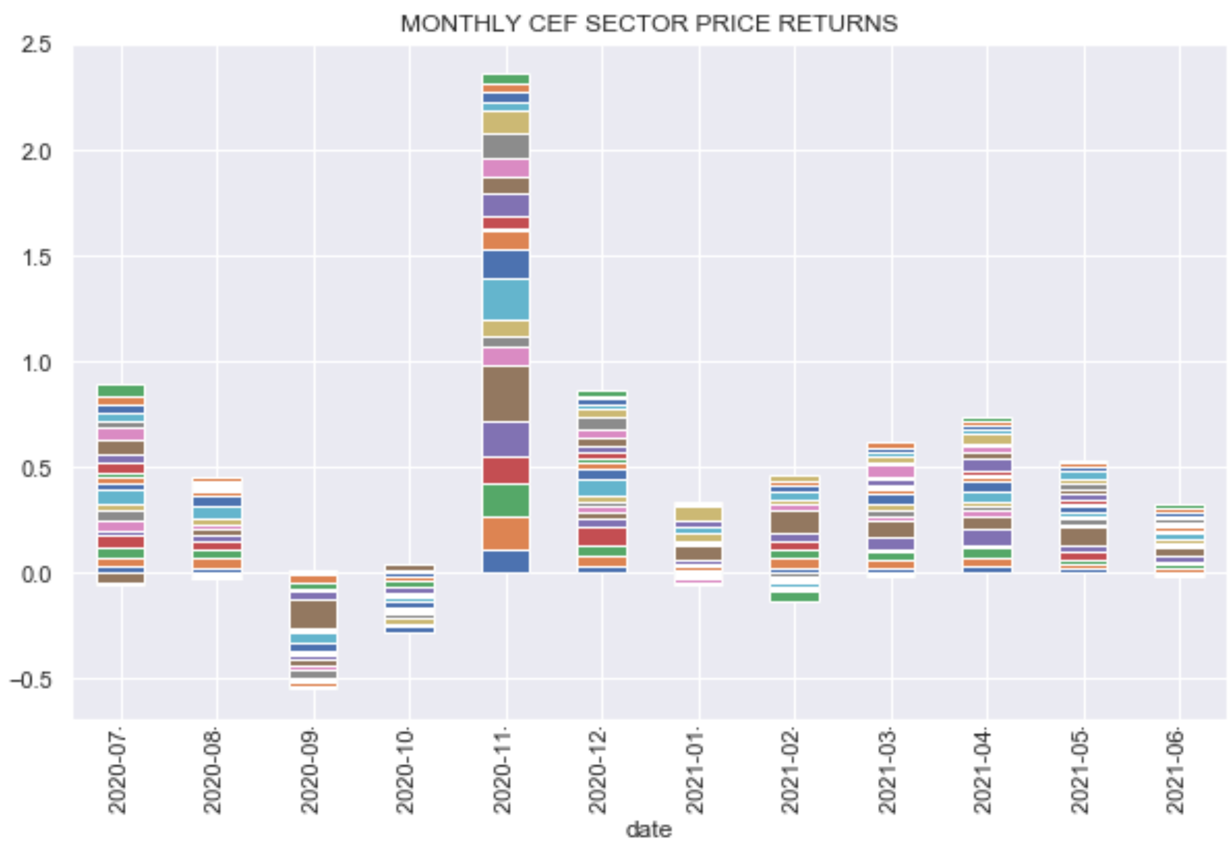
Source: Systematic Income

With only a few days left in June over the coming week, returns so far this month have been strong. Only one sector - Utilities - registered a negative NAV return.



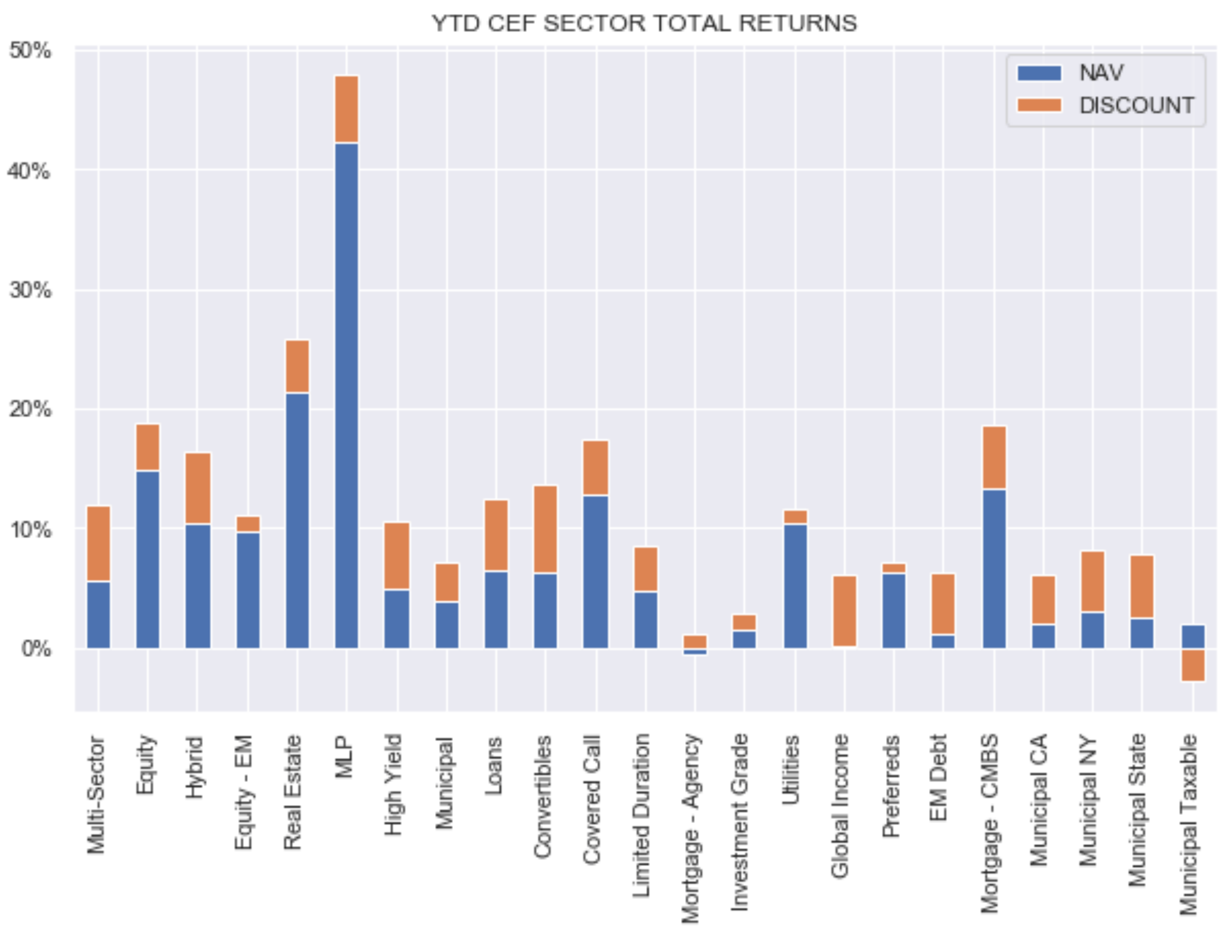
Source: Systematic Income

Taking a bird's eye view of the aggregate price action over the past year, June has put in respectable returns and is likely to deliver an 8th straight monthly price gain for the CEF market, though a touch below the run rate of the previous few months. The chart below simply adds the price returns of all the CEF sectors together (each color in the bar represents a different sector). What is striking is that how few strips there are below zero - over the last four months CEF sector returns have been nearly uniformly positive.



Source: Systematic Income

On a year-to-date basis, a striking 12 sectors have registered double-digit returns, with 4 sectors above or right around 20% figures. All but one sector - Agencies - have seen positive total NAV returns and all but one sector - Taxable Munis - have seen tighter discounts. Unsurprisingly, the leading sectors are in equity-linked sectors given the sharp run up in stocks since the start of the year. Fixed-income sectors, however, have delivered respectable returns as well, particularly in the context of Treasury yields that are well above their levels at the start of the year. Lower-quality sectors have tended to outperform in fixed-income due to their wider credit spreads which were able to offset the rise in risk-free rates more easily than their higher-quality counterparts.



Source: Systematic Income

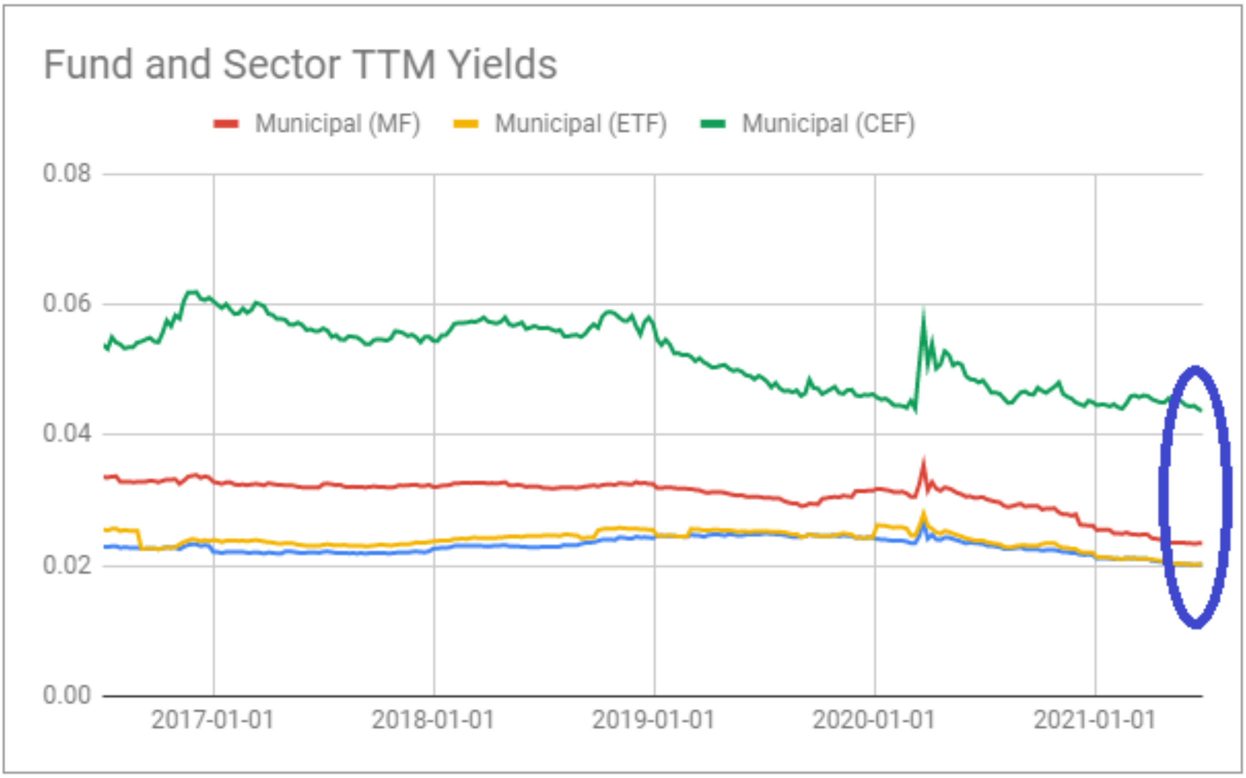
Discounts have moved in a seemingly straight line higher over the last few months. Fixed-income sector discounts are well above their pre-COVID tights and equity-linked sectors look to be on their way of moving above their 2017 tights.

Source: Systematic Income

Amazingly, 14 of 23 CEF sectors are trading at an average discount of above -2%. A day before the end of the week the municipal sector average discount moved a touch above zero, though it finished the week just under it.

Source: Systematic Income

So long as a wide gap persists between CEF and open-end fund yields and market volatility remains subdued, we expect CEF valuations to richen, possibly for another 12-18 months at which point leverage costs will start to rise, if the dot plot and/or Fed Funds futures expectations are realized. Because lower leverage costs were passed on to CEF investors in 2020, distributions are likely to start scaling back as soon as the Fed begins to hike.



Source: Systematic Income Strategic Allocation Tool

CEF Commentary

There was an 8% distribution cut from the **First Trust Senior Floating Rate Income Fund II** (FCT) – a second big cut this year. The fund's distribution rate is plainly too high (9.3% versus 6.4% sector average and its 4.2% covered yield). Because of its high distribution rate, the fund also enjoys an unwarranted tighter discount than the sector average despite poor historical absolute and risk-adjusted returns (4.9% 5y NAV CAGR vs. 5.7% sector median).

This fund highlights the curious CEF market dynamic of funds that are plainly overdistributing and, for this reason, boasting tighter discount valuations (due to increased demand from investors who mistake the high distribution rates for real income) and yet exposing investors to, not only, sharp distribution cuts but discount widening to boot.

The **Reaves Utility Income Fund** (UTG) raised by 6%. The driver looks to be strong recent capital gains (stocks are up!) rather than anything else. Latest Section 19a shows fiscal YTD net investment income driving less than a third of the fund's distribution which is not surprising given 1) the fund's relatively low-yielding assets and 2) relatively high distribution rate. A subscriber asked us about quantifying the level of net investment income or NII for utility CEFs. Our view is that there are 2 basic ways to approach it. A quick glance at the Strategic Allocation Tool where we maintain Utility-sector funds shows that open-end funds tend to distribute on the order of 2-3% which is a reasonable guide to the typical dividend rate on a portfolio of utility stocks. In a CEF structure, we would need to subtract around 1-1.5% from this to get an estimate of a utility CEF NII so we get to a number that is around 1-2%, i.e. this is how much a utility CEF roughly receives on its portfolio of assets after fees. Not surprisingly, this figure is below that of the passive options which, again, makes sense since CEFs tend to have higher fees than passive ETFs and equity-linked CEFs tend to run at low or no leverage to compensate for this.

The second way to quantify the NII for utility CEFs is just to look at the covered yield figures (this is what we call NII on price). These range from small negative numbers to about 2% which jives with the first method above. This is obviously a far cry from the high-singledigit distribution rates that these funds pay out. Of course, there are many investors who look at coverage differently. They define coverage not in terms of how much of the distribution comes from net investment income or NII but how much of it comes from the sum of NII or capital gains i.e. something other than ROC (let's ignore covered call and MLP sectors here which generate ROC through actual income). And that's fine – the only thing to say here is that capital gain coverage is a more "conditional" kind of coverage than coverage through NII. In other words, if the market turns down the high capital gains coverage of equity CEFs due to previously rising prices will drop sharply, i.e. the coverage of UTG will drop from 100% to about 30%. So it's a kind of coverage definition that is highly dependent on what the market does at any one time. Coverage as defined by NII doesn't depend on the market – the income comes in regardless of what the market does (precluding infrequent defaults or deleveraging, of course).

A reader mentioned the **Rareview Tax Advantaged Income ETF** (RTAI) which looks to be a small ETF of Muni CEFs. Funds of CEFs can be attractive as a way to short-circuit the process of having to choose among the dozens of municipal CEFs available in the market and leave the job to the "pros". The fund's strategy appears to be to allocate to CEFs based on discounts, do dividend capture and maybe some hedging. The fund's fee is 1.2% (excluding the acquired fees on CEFs) which is very high even for active management and especially high given how low muni yields are (around 1.5-2% for long-dated bonds). If we look at the fund's performance versus other funds of Muni CEFs as well as the Muni CEF sector, the performance is not very notable.

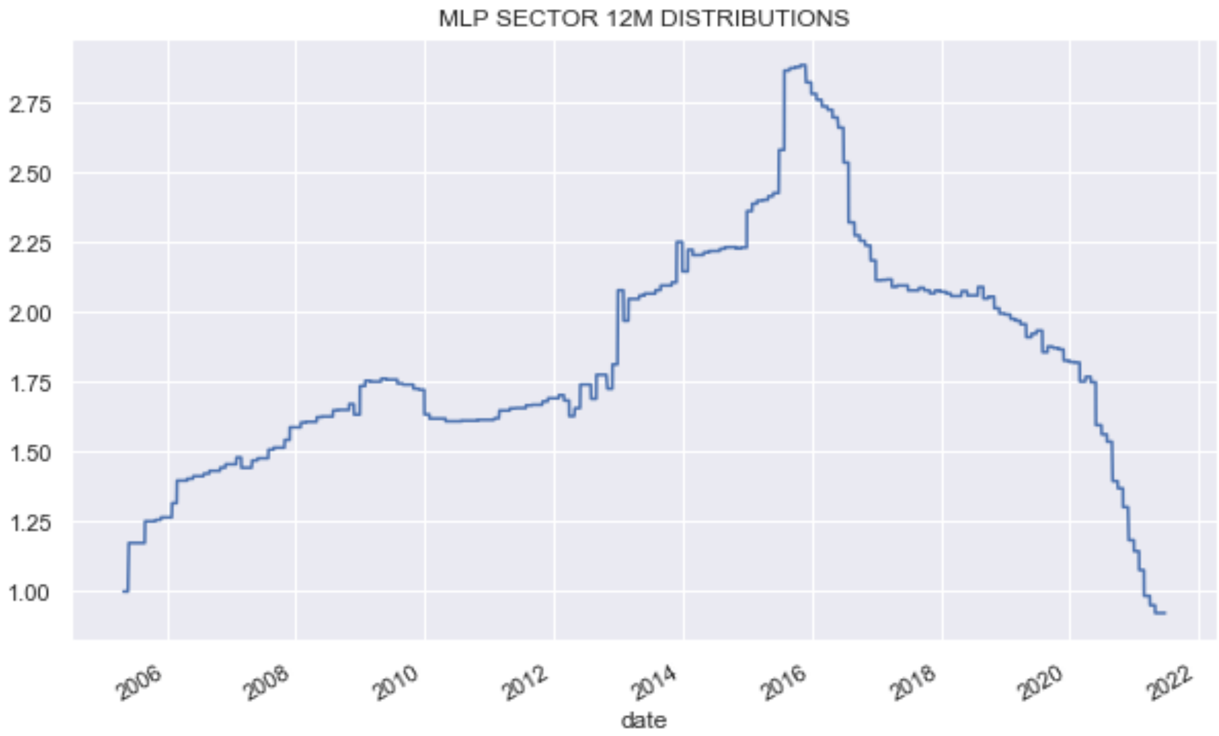
Source: Systematic Income

It's a tiny bit better than the **VanEck Vectors CEF Municipal Income ETF** (XMPT) (a passive ETF of muni CEFs) and a bit higher than the average CEF. It seems like whatever alpha the fund is able to generate goes back to the fund managers in the form of fees, leaving investors with middling performance net of fees. For investors who want to stick with a fund-of-CEFs, we like XMPT for its reasonable fees and decent performance.

For investors who like a more DIY approach in the municipal CEF sectors, our suite of quantitative CEF allocation strategies shows that allocating to the municipal CEF sector on the basis of *relative discount valuation* has strongly outperformed 1) the sector, 2) an allocation based on absolute valuation (selecting funds based on their absolute discounts) or 3) tilting to funds that have done the best recently (Momentum-1M LAG strategy below). Our favorite metric remains the discount sector spread percentile - implemented by the DSSP strategy in the chart. The benchmark - an equally-weighted municipal CEF strategy - is highlighted in red for context.

Source: Systematic Income

Two Kayne Anderson MLP funds **MLP/Midstream CEF** (KYN) and **NextGen Energy & Infrastructure** (KMF) have increased distributions to a 7.5-8% area. The MLP sector is slowly normalizing with growing leverage and distributions, though some funds are still in NAV conservation mode. There are two things to keep in mind. First, the overall historical distribution trend of the sector is still pretty horrendous with total sector distributions at 60% where they were 10 years ago and at less than half their peaks in 2016.



Source: Systematic Income

Secondly, distribution rates of 7-8% sound nice but you have to remember that these distribution rates are off a much lower NAV relative to the last few years. The average total NAV return of the sector is negative over the last 5 and 10 years. Moreover, it's below the return of simple passive sector benchmarks. For example, the median 5y total NAV return of the sector is -7.6% versus -1.3% for the MLP index-tracker **JPMorgan Alerian MLP Index ETN** (AMJ). Keep in mind this comparison is actually favourable to the CEF sector since CEFs also hold non-MLPs i.e. C-Corps which have done better than MLPs. The performance differential between CEFs and passive unleveraged benchmarks is going to be a function of leverage, alpha and fees. Even with higher leverage and fees of CEFs you can't get from -1.3% to -7.6%. The big gap between the two has to do with the impact of periodic deleveraging as well as an obvious lack of alpha that CEF managers are adding (it is possible they are adding some alpha but that alpha is obviously less than the impact of periodic deleveraging and fees).

Ultimately, the MLP CEF sector is a tough sector to hold strategically through the cycle. However, it will deliver nice returns at the start of a reflationary cycle like we are having now. Ultimately, there is nothing wrong in buying MLP CEFs but doing so makes sense on two grounds. First, as a purely tactical trade betting on continued reflation and low market volatility. Or secondly, as a bet on the sector having fundamentally changed. Because of the sector's high volatility, a medium market drawdown can wipe out years of returns which makes it very difficult to recommend as part of an income portfolio. Recall that a big part of generating sustainable income is growing the base of your capital on which any distribution is based. The view that "cold hard cash" is what generates wealth is obviously wrong and very short-sighted and MLPs are a great example of why this doesn't work.

A couple of policy changes were announced for two John Hancock equity-linked CEFs: **Tax-Advantaged Dividend Income Fund** (HTD) and **Tax-Advantaged Global Shareholder Yield Fund** (HTY) which will no longer have an options sub-advisory relationship with Wells Capital Management. Presumably, the options strategy is being ditched entirely rather than brought in–house. Prior to this both funds appear to be entirely sub-advised by two third parties: HTD by Manulife/Wells and HTY by Epoch/Wells. Hard to know how to feel about a large fund management company that entirely farms out the management of the funds to other managers. You can argue this can be done very well – after all it's not credible for a fund company to have the "best" managers across all sectors. However, it also looks a bit suspect – after all, why not just admit you are not set up to manage a given fund and turn client money away. The reason for the ditching of the options strategy seems to be the huge underperformance of these funds relative to their sectors: HTY has a 3.3% 5y NAV return vs. 13.2% sector median. HTD is at 6.2% versus

9.6% sector median.

You would have thought that with implied volatility still priced at fairly high levels with the VIX at 16 versus a 10-13 range of the previous 5 years, call writing overlays would be compelling. However, in an environment of sharp drops and sharp reversals call overwriting works poorly. For a back-of-the-envelope intuition imagine you have only two periods – a sharp drop and a sharp rise. During the sharp drop, the call overwriting strategy takes all the large losses of the index with a small additional gain due to the received premium of the sold options. And in the reversal you make back around 2-5% (depending on how far out-of-the-money the calls are) on top of another slightly bigger premium (as volatility tends to be more expensive after a drop). Net net, you end up way below the underlying index since you took ~95% of the loss and sold away ~95% of the reversal. This is obviously a "toy" scenario but it shows that this strategy will be way under water relative to the straight-up index buy-and-hold in a scenario where the, pardon the term, volatility of volatility is high such as the decade and a half we appear to be living through. This is not the only problem of covered call CEFs but it is a more recent one.

Stance And Takeaways

June looks like it will finish as another strong month in the CEF space. CEF investors face a trio of challenges: expensive discounts, high asset prices and risk-free rates that are unlikely to trend lower like they did over the past decade. However, an allocation method that takes into account relative discount valuation highlighted above is likely to help investor returns. Funds that tick this box are the **Cohen & Steers Tax-Advantaged Preferred Securities and Income Fund** (PTA), **MFS Investment Grade Municipal Trust** (CXH), **AllianzGI Convertible & Income Fund II** (NCZ) and the

Nuveen Mortgage and Income Fund (JLS), among others.