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Closed End Funds

May PIMCO CEF Update: Poor Coverage Disappoints Investors

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Summary

- We take a look at PIMCO CEF leverage, returns, valuation, and coverage numbers from May.
- Taxable fund coverage collapsed due to negative earnings for the majority of funds in May.
- Leverage also continues to creep up in the taxable suite, getting very close to the explicit 50% cap for most funds.
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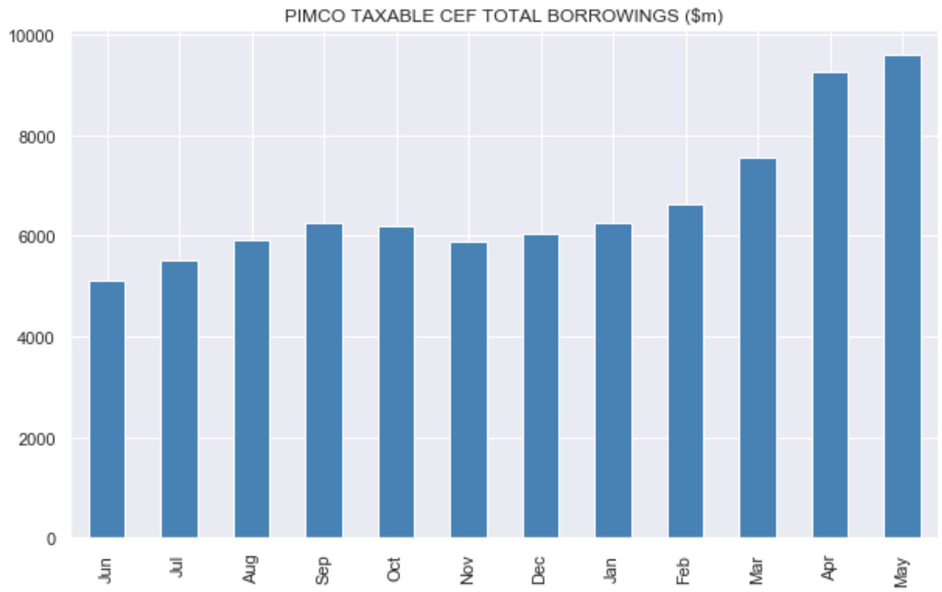
This article was first released to Systematic Income subscribers and free trials on 19-June.

In this article we discuss the action in PIMCO CEFs over the month of May, in particular, fund returns, valuation, coverage and leverage. The key takeaway is that May was a bad earnings month in the taxable space, though what this means for shareholders is not as obvious as it may seem. We continue to favor the recently launched Dynamic Income Opportunities Fund (PDO) which offers more attractive valuation alongside a term structure, both of which should allow the fund to remain resilient in case of a market bump.

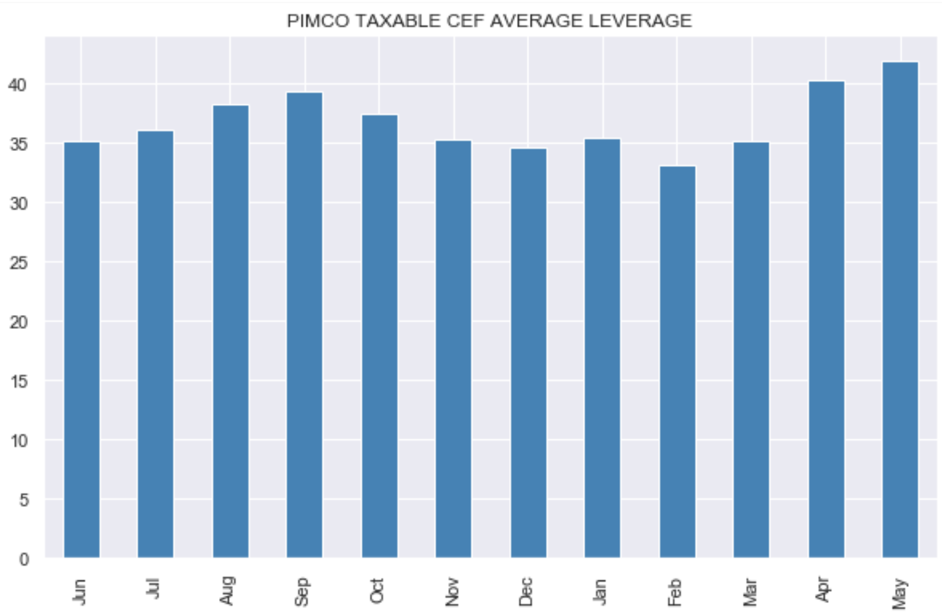
Leverage Update

Taxable CEF borrowings increased for the sixth month in a row and for 10 out of the last 12 months. The overall increase in May was relatively muted after two big jumps in March (in large measure due to PDO) and in April (in large measure due to RCS and PGP).



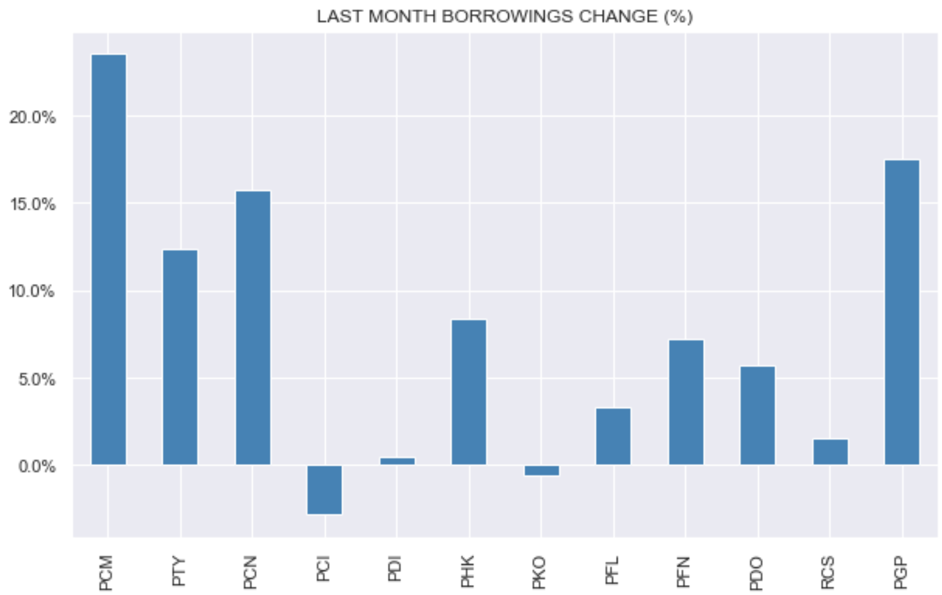
Source: Systematic Income

The average taxable leverage ticked up to 42% - well in excess of an average fixed-income CEF.



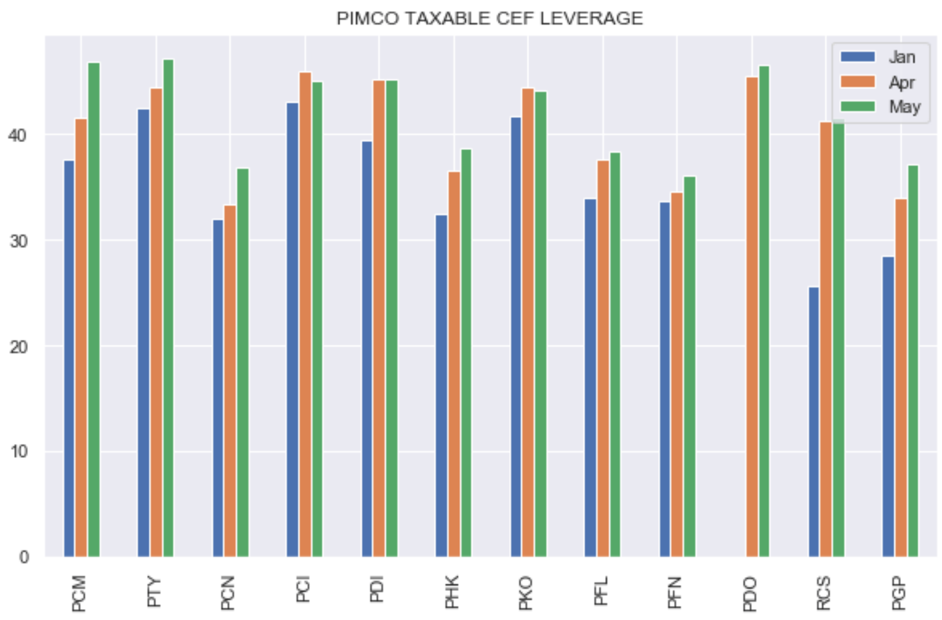
Source: Systematic Income

Across individual funds PCM, PCN and PGP registered the biggest increases in borrowings in relative terms. These three funds had been carrying lower levels of leverage which left them more room to add borrowings.



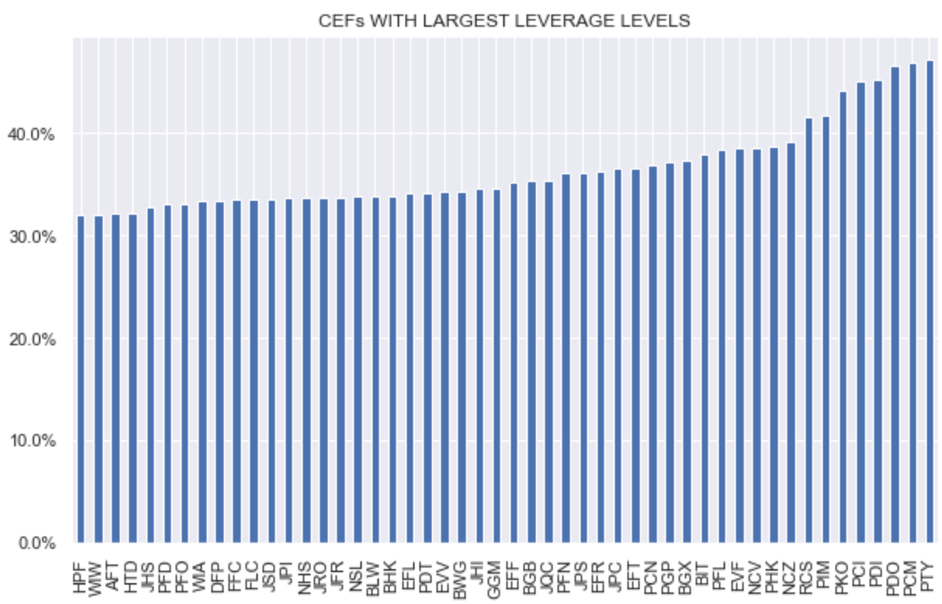
Source: Systematic Income

Across the taxable suite leverage ticked up in May across most funds and all funds boast leverage levels significantly higher than at the start of the year. Three funds are carrying leverage levels of above or just under 47%.



Source: Systematic Income

More broadly, PIMCO CEFs are run well above the average taxable CEF leverage level - the chart below shows that 6 of the highest-leverage CEFs are PIMCO funds (the seventh - PIM isn't quite on par with the PIMCO funds as the bulk of its leverage is in TBAs - hardly "risky" assets).

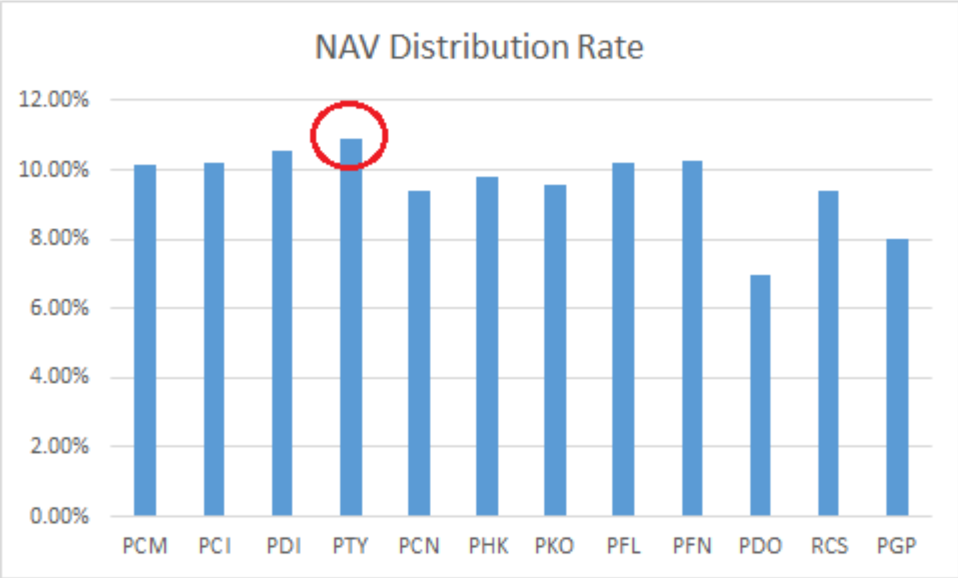


Source: Systematic Income

PTY features the highest leverage level of 47.2%. This is somewhat surprising for two reasons. First, PTY has one of the lowest expenses in the taxable suite. This is due to the combination of its lowest management fee in the suite and one of the lowest leverage costs due to a relatively high proportion of ARPS in its liability structure on which it pays a near zero rate. In other words, PTY can generate the same net investment income yield as the taxable suite average by carrying a lower leverage level.

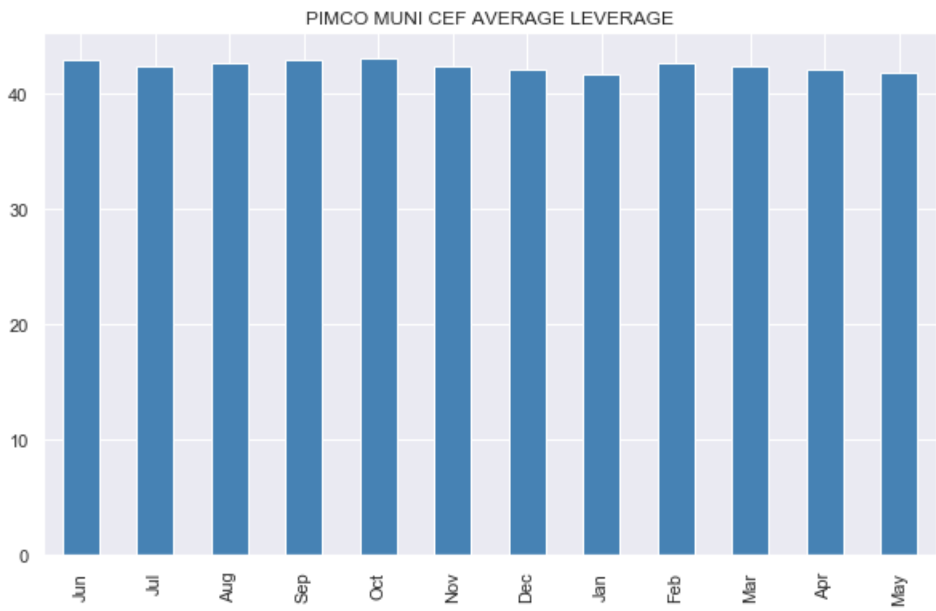
The second reason why the highest leverage position of PTY is surprising is that the fund has the most strict leverage mandate type in the taxable suite which is spelled out in its prospectus: The *Fund will not incur leverage (including through preferred shares and other forms of leverage) in an amount exceeding 50% of its total assets*. Other taxable funds in the suite have, what we call, a *soft mandate* which qualifies the 50% cap as one to be followed in "normal market conditions" and gives them more wiggle room to delay a deleveraging in case of a market sell-off.

One reason why PTY may be driving its leverage higher is to be able to keep up with its highest NAV distribution rate in the suite. That said, its higher NAV distribution rate is actually justified by its lower expense profile and the fund's coverage is on the higher end of the suite so this explanation isn't completely satisfying.



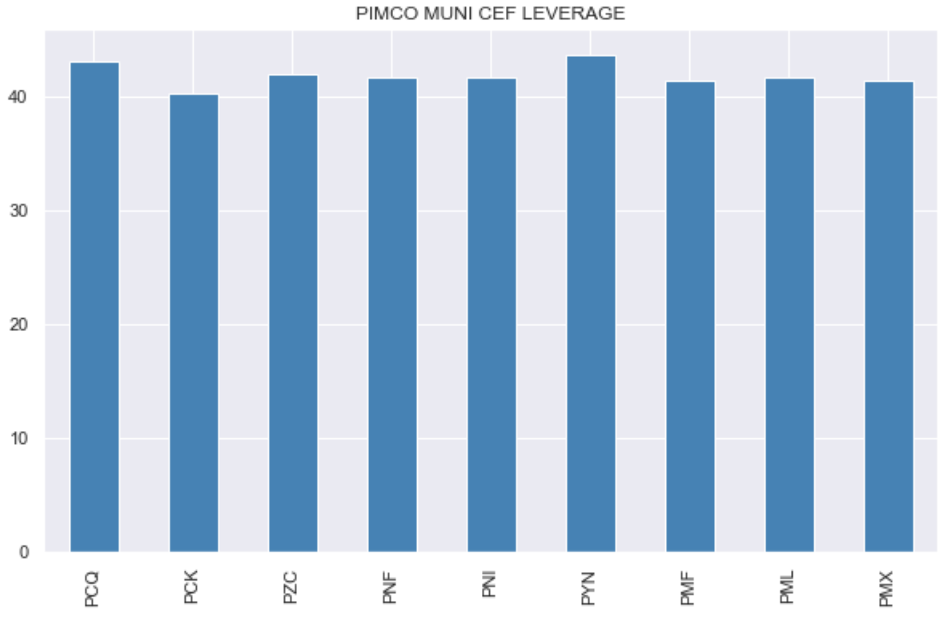
Source: Systematic Income

In contrast to the taxable suite, the PIMCO tax-exempt suite borrowings and leverage profile has been very steady after their deleveraging during the COVID market shock.



Source: Systematic Income

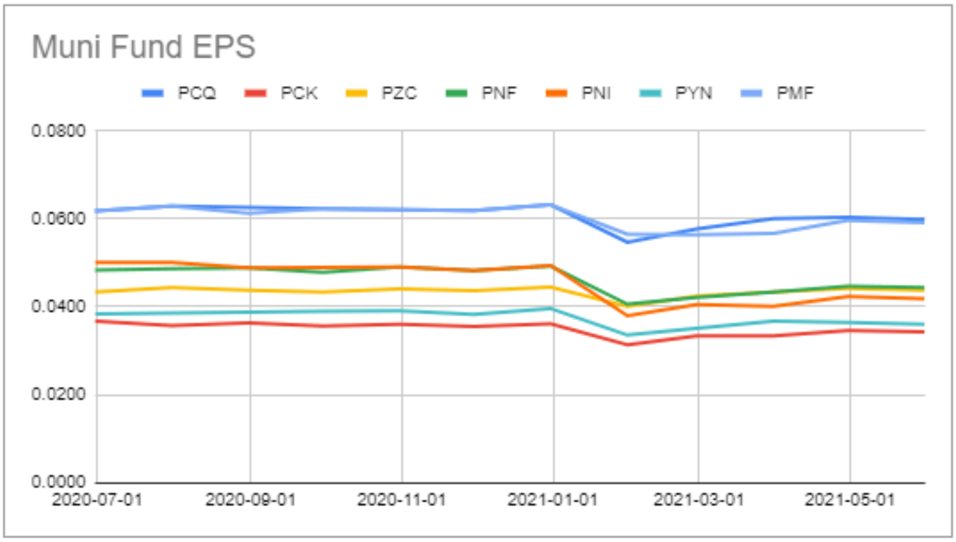
With leverage levels of low to mid-40s and more stable NAV profiles these funds have less room to add borrowings and we don't expect much change on this front.



Source: Systematic Income

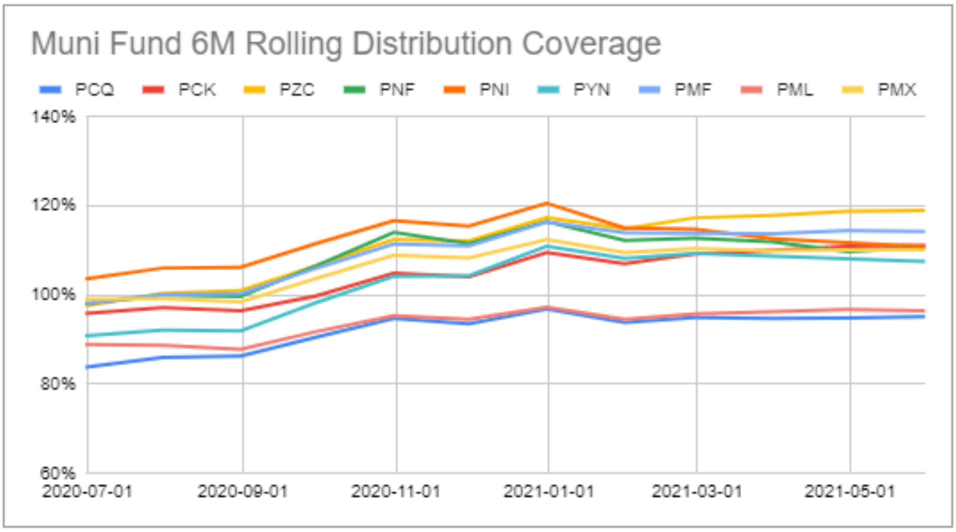
Earnings / Coverage Update

It was another placid week for the tax-exempt suite earnings which have mostly recovered to their 2020 levels after a brief dip.



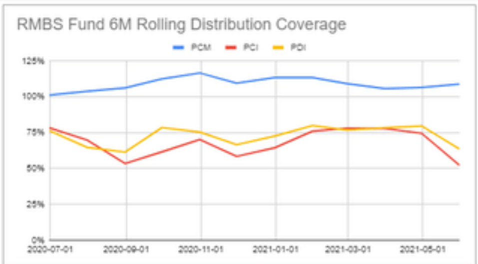
Source: [Systematic Income CEF Tool]

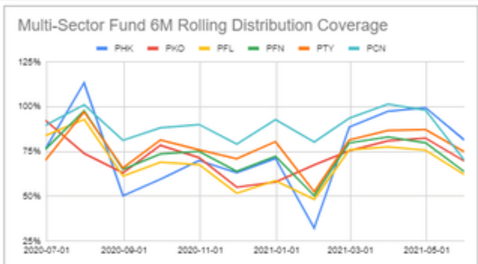
Six-month rolling coverage held steady.



Source: [Systematic Income CEF Tool]

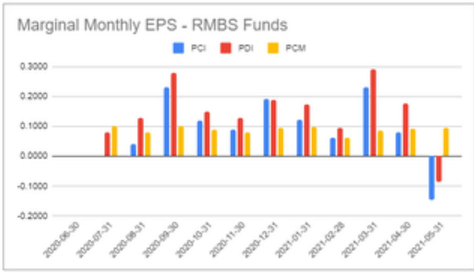
In contrast to the tax-exempt space, taxable funds had a poor showing. All but one fund - PCM - saw significant drops in 6-month rolling coverage.

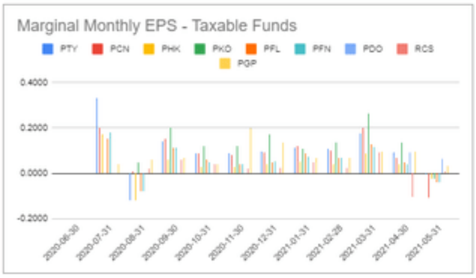




Source: [Systematic Income CEF Tool]

At the heart of this drop was the fact that 8 of the 11 taxable funds had negative earnings on the month. Although negative earnings months are not unheard of for PIMCO they are pretty unusual. You have to go back nearly a year back to find a negative earnings month period though last August that number added up to only four funds - half that of May.





Source: Systematic Income CEF Tool

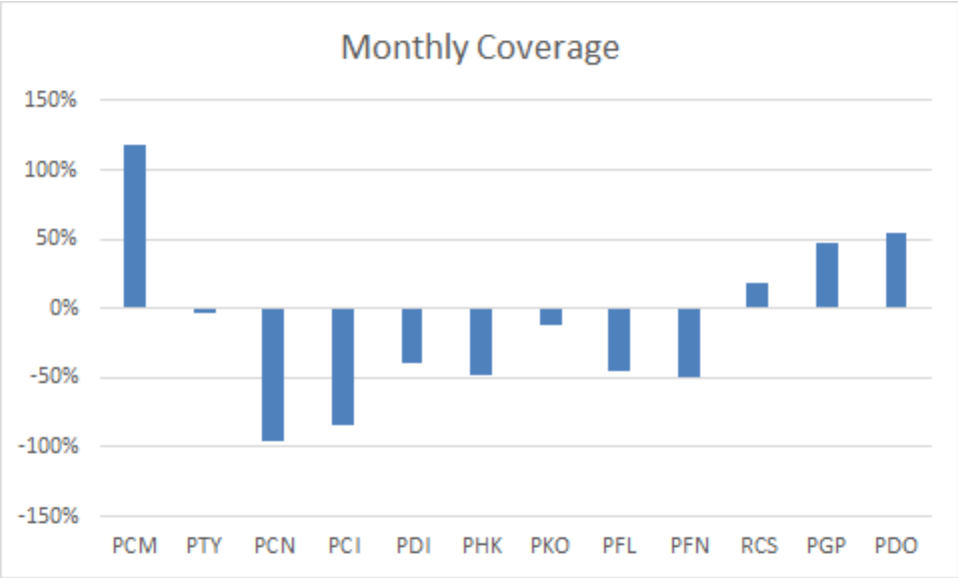
To give some perspective - PCI had a -$0.1465 monthly EPS which is 84% of the fund's monthly distribution. In other words the fund "missed" by a total of $0.3205 (the $0.174 monthly distribution level that didn't show up in income and an additional negative $0.1465 of income, bringing the total "miss" to an equivalent of 1.84x of the fund's monthly distribution level). A few other funds are not far off this kind of figure.

The next two months of June and July will be very interesting from an earnings perspective because all the funds in the taxable suite have fiscal years ending in either June or July. And because PIMCO releases fiscal year-to-date earnings and coverage information it will give us a good sense of what their total fiscal year income looked like. With the median fiscal-year-to-date coverage level of 63% we don't expect miracles.

What should we make of these numbers? Overall, it's difficult to get really worked up about these figures.

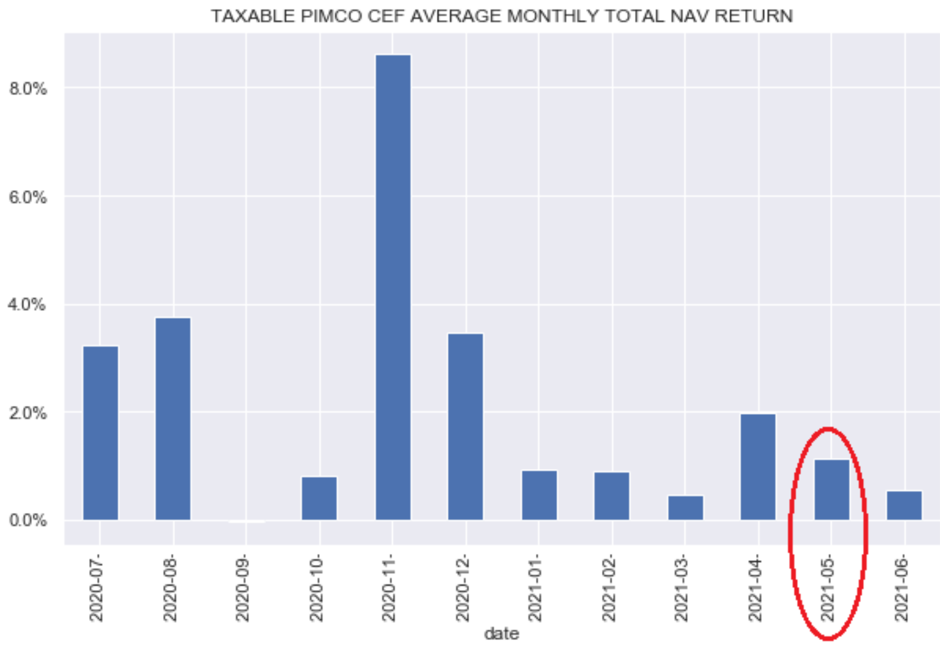
First, the numbers are simply comical. If we are to believe that fixed-income funds carrying nearly double the amount of total assets relative to their net assets have negative earnings then we must also believe that their portfolio yields are negative as well. And last we checked these funds are chockful of USD-denominated credit securities whose yields are well above zero. It is possible, of course, for CEFs to have negative earnings - some Gabelli equity CEFs have negative earnings due to low income levels from equity dividends and high leverage costs due to their preferreds. Fixed-income funds, on the other hand, tend to feature higher asset yield levels, higher leverage levels as well as lower leverage costs. And typically, fixed-income funds have income levels well above their portfolio yields (due to a combination of "annuity-like" holdings such as MBS or fixed-income securities priced above par) rather than the other way around.

Secondly, there is large variation in monthly coverage (May EPS / Current Distribution level) figures shown in the chart below. Occasionally, we hear theories that try to explain moves in earnings and coverage based on external market factors such as refinancing activity or moves in G10 FX. As we have discussed elsewhere these factors don't make a ton of sense either empirically (they don't line up consistently with PIMCO earnings and coverage) or conceptually. If these factors really were drivers of earnings then we should see negative income months much more often and we should also see much less variation between the funds when it does happen.



Source: Systematic Income

Thirdly, the negative earning episodes don't line up with moves in the NAV. For example, May was actually quite a strong month for taxable PIMCO CEFs as the chart below shows with all taxable funds posting positive total returns.



Source: Systematic Income

It's tempting to dismiss a one-off inconsistency between negative income and positive total return; however, this isn't really scalable if we were to extend this forward. In other words, a fund can only maintain positive NAV returns with negative income levels if income figures are meaningless and don't represent the true income or yield of the fund.

Fourthly, as highlighted above, dips in income are not unheard of for PIMCO CEFs, particularly around fiscal year ends. Our view remains that the reliance of the PIMCO funds on swaps as well as their ability to push income in and out of swaps by changing coupon levels and notionals is what is behind the significant shifts in income.

Fifthly, the level of leverage in May increased significantly over the last couple of months and is probably at its highest historic average level in the taxable suite. Furthermore, leverage costs remain ultra-low. This combination doesn't jive with a sudden drop in income.

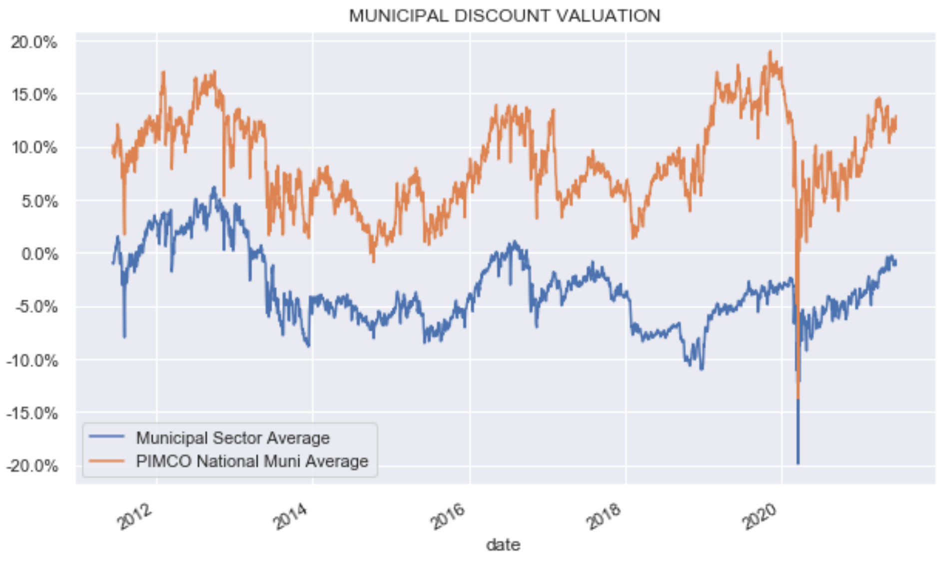
Sixthly, PIMCO doesn't appear to guide their distribution changes by an errant earnings month. Rather, as we discussed multiple times, they appear to be guided by sharp drops in borrowings for funds with high NAV distribution rates, though even these are not foolproof signs.

Finally, our own approach to CEF allocation puts more emphasis on portfolio yields rather than income levels which are currently biased upward due to high prices of fixed-income securities. This approach doesn't use income levels as a proxy to what the funds are "actually earning" and so is less concerned with the month-to-month variability in income.

Poor coverage means different things to different investors. For investors who uses fund income levels as a guide to what their capital "actually earns" shouldn't take drops in coverage as bad news since the PIMCO taxable funds aren't earning their distributions in portfolio yield terms anyway (to do so would require them to exclusively hold the equivalent of CCC-rated securities). For investors who worry about distribution cuts as a knock-on driver of premium deflation should worry about high premiums for other reasons as well such as a market drawdown event which tends to deflate higher-premium funds just as quickly as a distribution cut.

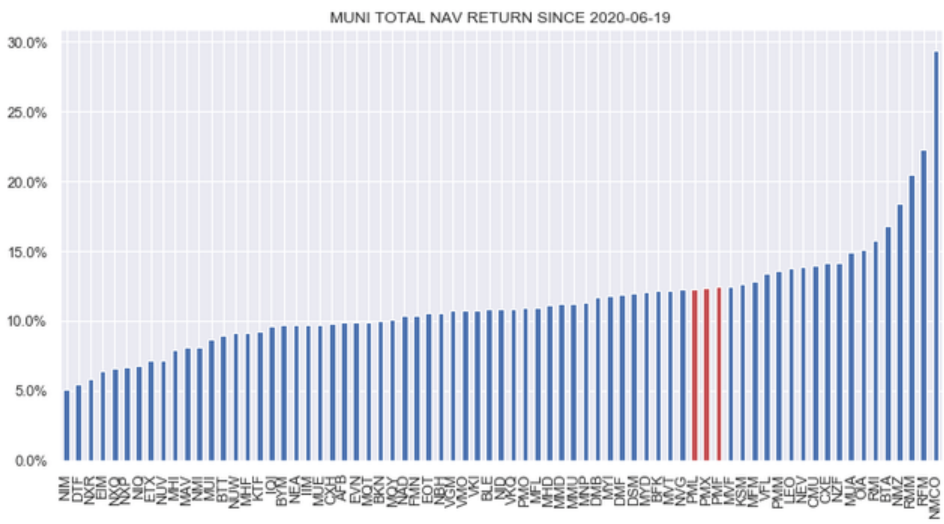
Valuation Update

In the tax-exempt space, the valuation gap between PIMCO national funds and the rest of the sector remains very wide, though not as wide as it was in early 2020.



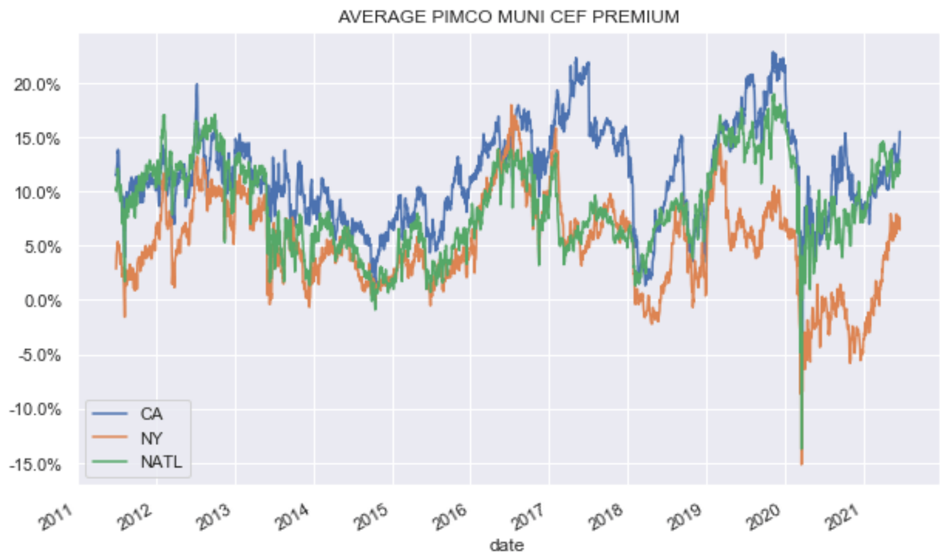
Source: Systematic Income

The overall returns of the PIMCO national Muni funds have not been particularly impressive within the broader sector over the past year, significantly trailing funds focused on the high-yield muni space. If this continues, investors may struggle to justify holding these funds at a double-digit premium valuation relative to the broader sector.



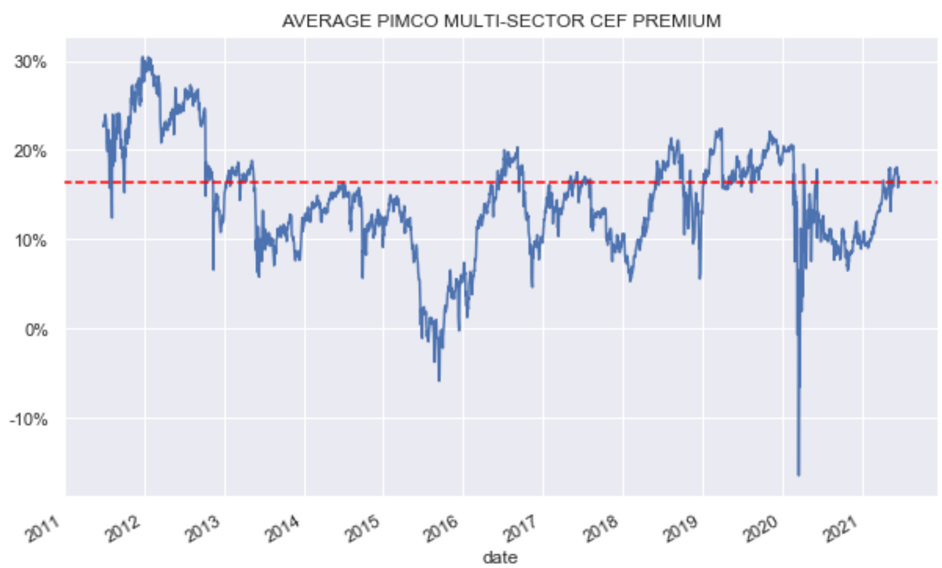
Source: Systematic Income

Within the three sub-sectors, the trio of New York focused funds are trading at more modest valuations with two of the three funds at low single digit premiums.



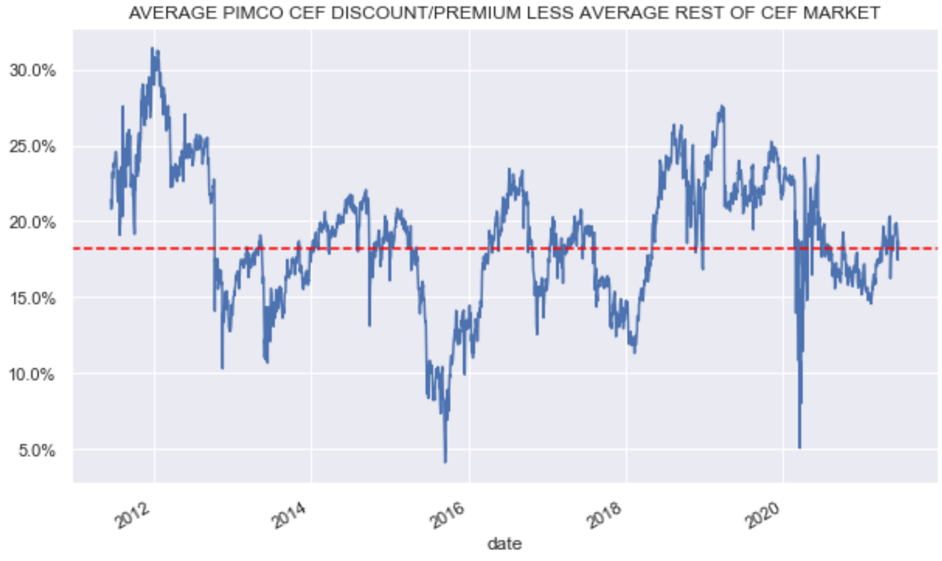
Source: Systematic Income

The taxable suite continues to trade at an elevated valuation.



Source: Systematic Income

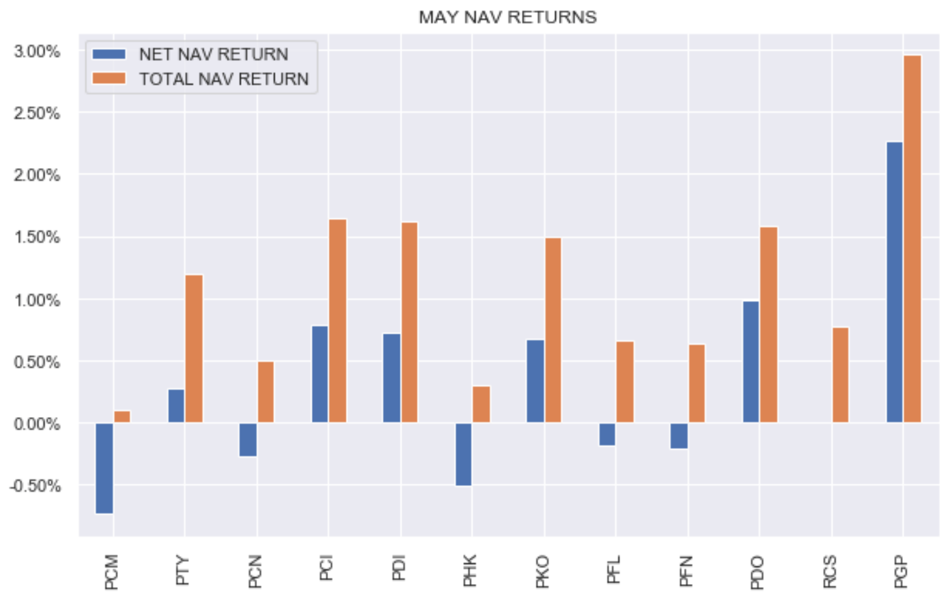
Compared to the rest of the market, however, taxable PIMCO CEF valuations look more modest.



Source: Systematic Income

Returns Update

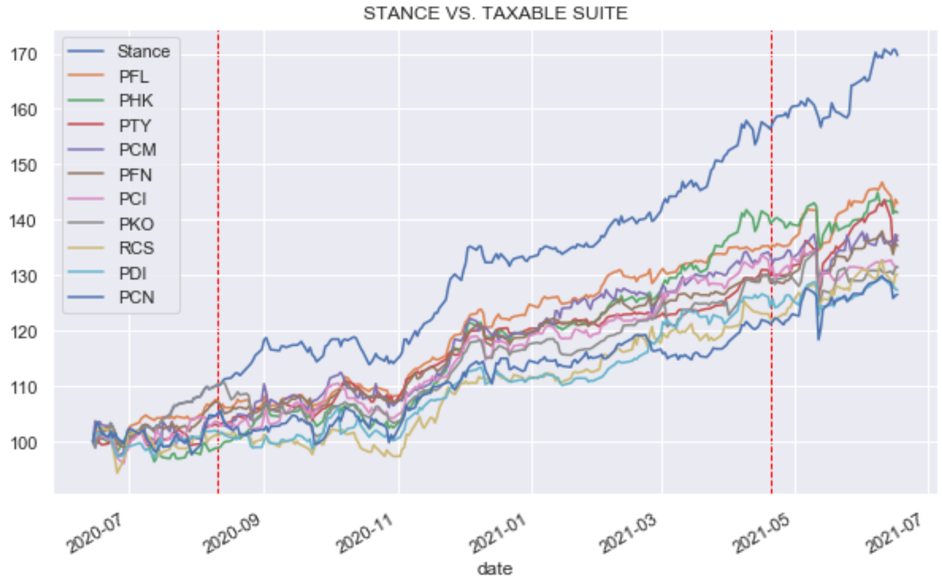
May was a good month for PIMCO taxable returns with all funds delivering gains in total NAV terms and most funds registering higher net NAV returns (i.e. delivering returns in excess of their distribution).



Source: Systematic Income

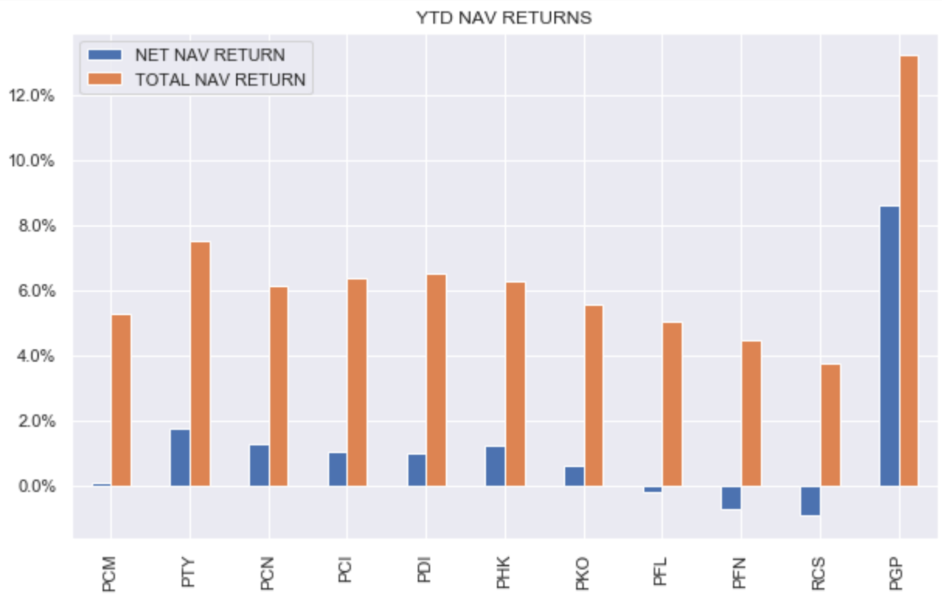
A couple of dynamics are worth highlighting - the highest leveraged funds delivered the highest returns which makes sense (PGP doesn't count as it also has equity exposure). Secondly, nearly half of the purely fixed-income funds underperformed their distributions despite lower Treasury yields and stable credit spreads. This echoes our concern that the funds are unlikely to generate returns matching their distribution levels in a stable yield environment and highlights the likely discrepancy between their distribution rates (high) and actual portfolio yield levels (lower).

The third dynamic worth highlighting is the underperformance of PHK over the month. This is likely due to the flattening of the yield curve and the fund's largest yield curve steepener profile in the taxable suite. The steepness of the yield curve due to high inflation expectations was one reason we monetized the outperformance in PHK and rotated into PDO in April (marked by the second vertical line in the chart - the first vertical line represents a rotation from PKO to PHK). Since then, the performance of PHK has flatlined (green line) while that of PDO continued to rally (top blue line).



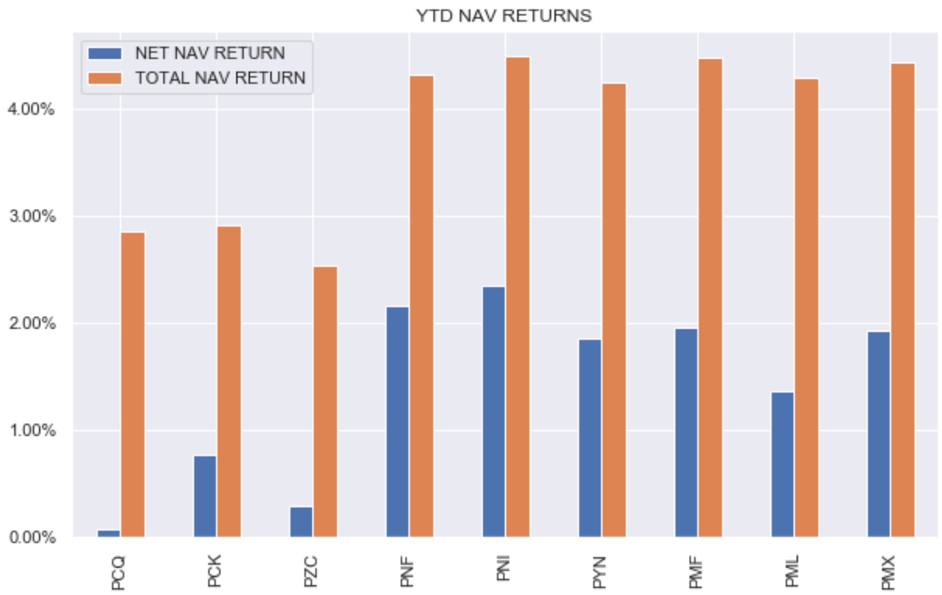
Source: Systematic Income

In year-to-date terms, three taxable funds have delivered negative net NAV returns.



Source: Systematic Income

In the tax-exempt suite, all funds have registered positive total NAV returns while also outperforming their distributions (i.e. delivering positive net NAV returns).



Source: Systematic Income

What About Institutional Ownership?

One comment that we come across regularly is that the PIMCO funds feature in holdings of large investment banks such as UBS, Morgan Stanley among others and that, since these large entities usually "know what they are doing", this argues for keeping exposure to the funds. In our view, this doesn't make a ton of sense. First, holding of PIMCO CEFs by these banks is unlikely to be legal due to the Volcker rule which bans proprietary trading in risky securities by the banks.

Secondly, PIMCO funds will typically source their securities from the banks themselves so it's surely odd for the banks who provide liquidity to the PIMCO funds to then buy the funds themselves. After all, the banks can acquire the same securities more cheaply than the PIMCO funds (being market makers in the space), carry lower cost of leverage than the funds (since it is they who also provide leverage financing to the funds) and wouldn't have to pay any fund expenses if they were to hold the securities outright (much easier to justify in the Volcker rule context than a third-party fund). Given these three advantages the bank traders would have to be totally hopeless to underperform PIMCO managers (a lot of whom come from the banks anyway). A bank trader who decides to hold a PIMCO CEF admits that they have no good ideas of their own and is simply unlikely to survive the next layoff round.

Another theory has it that these banks have funds that allocate to PIMCO CEFs which is why they show up as institutional owners. And while there are funds that hold CEFs, the funds-of-CEFs space is very niche and there are only a handful of funds that follow this type of allocation. For a regular fund it is an admission of defeat to allocate to a third-party fund and suggests that the fund manager should return the client money rather than charge investors an additional fee over and above what would be charged by PIMCO fund holdings.

Our view remains that the most likely explanation for the big banks being institutional holders of PIMCO funds is that they hold these funds in their name through their private bank accounts on behalf of retail clients. And while it is true that private bank relationship managers can recommend PIMCO CEFs to their clients this is no different from the usual broker relationship and doesn't provide much additional reason for holding these funds.

Takeaways

PIMCO CEFs had a decent May with positive total NAV returns though coverage figures were poor in the taxable suite. One key dynamic we are watching are whether the funds (both taxable and muni) will be able to deliver NAV performance that exceeds their high distribution rates. Another key dynamic is the high valuation across the suite which keeps us sidelined across the perpetual funds and allocated to PDO - a fund with the lowest premium and a term structure - two features which should keep it more resilient in case of a sell-off. A final dynamic that bears watching is the high level of leverage in the taxable suite which leaves little room for error in case of a market bump. Given a low level of underlying yields, a forced deleveraging could easily knock off several months of returns.

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Disclosure: I am/we are long PDO. 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.