

CEF Weekly Market Review: Valuations Are Up, Up And Away

Jul. 11, 2021 12:33 PM ET | AIF, EDF, EDI... | 2 Comments | 16 Likes

Summary

- We review CEF market valuation and performance over the past week and highlight recent events.
- The CEF market is expensive, however you cut it.
- We take a look at select distribution changes, some weird action at quarter-end and discuss our stance.
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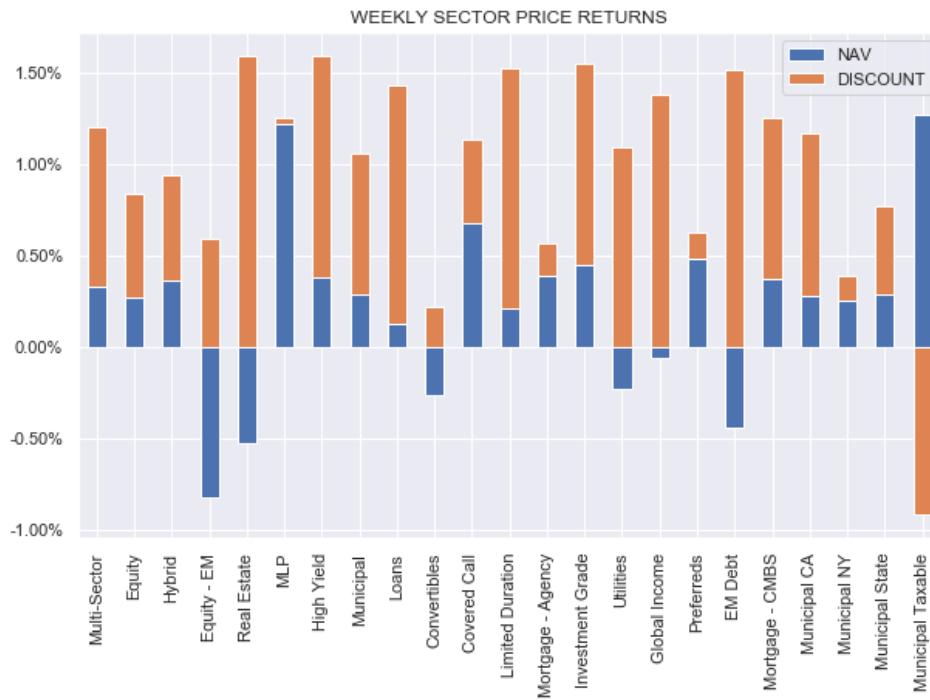
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This article was first released to Systematic Income subscribers and free trials on 5-July.

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 period through the first short week of July.

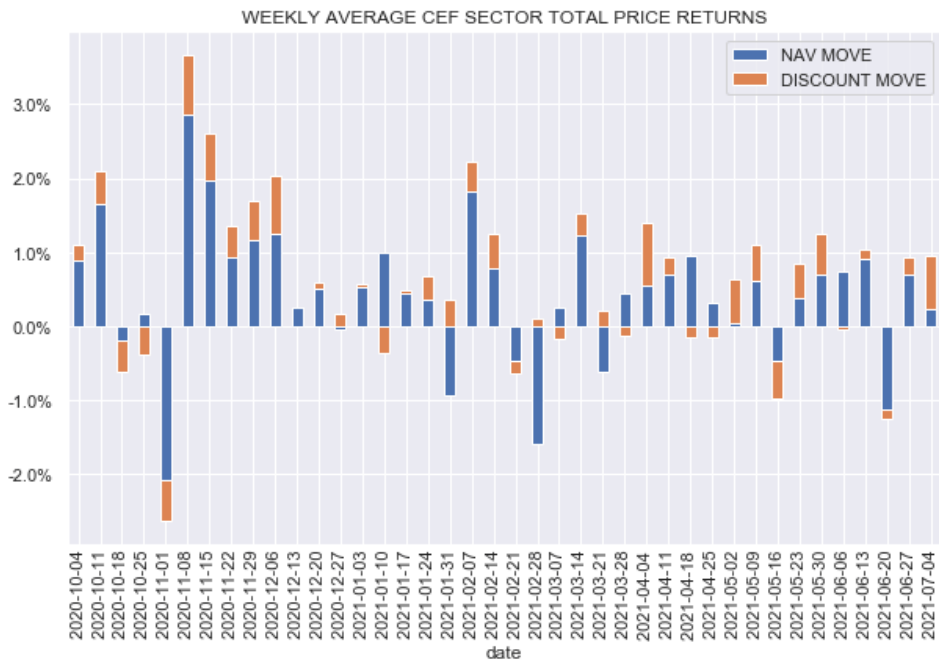
Market Overview

It was a great week to end the first half of the year and kick-off the second with two trading days in July. Nearly all CEF sectors posted tighter discounts and most posted higher NAVs as well on the back of lower Treasury yields and record-high stock prices.



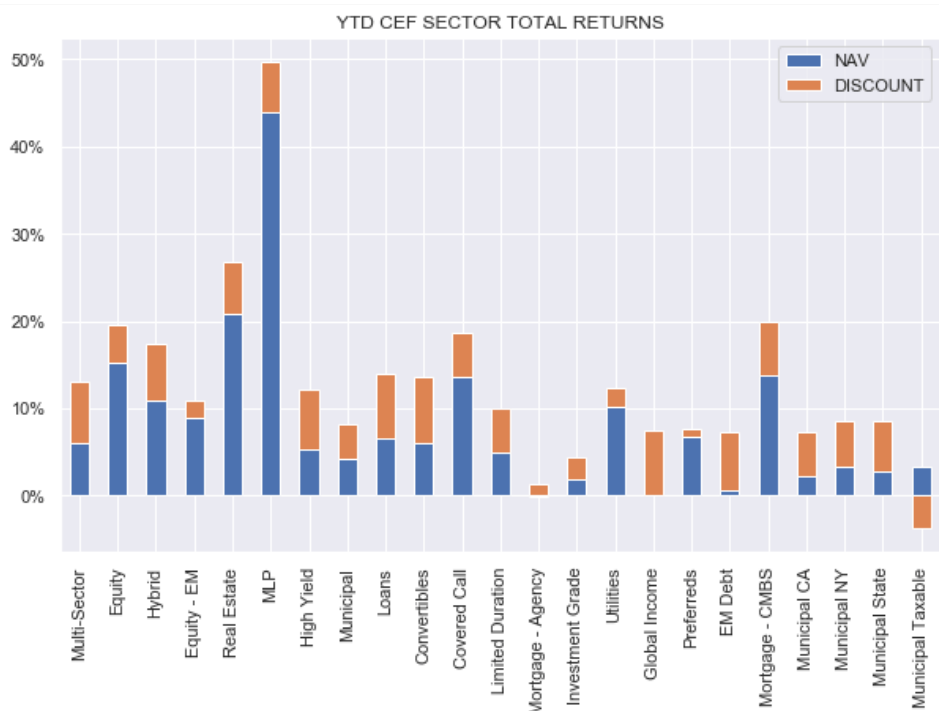
Source: *Systematic Income*

It's fair to say that CEF investors have been spoiled since the end of the first quarter last year with a steady set of positive returns. The chart below shows the average CEF sector weekly price return, disaggregated into discounts (orange bars) and NAV (blue bars) moves. The regularity of positive returns with only occasional ticks lower is striking.



Source: Systematic Income

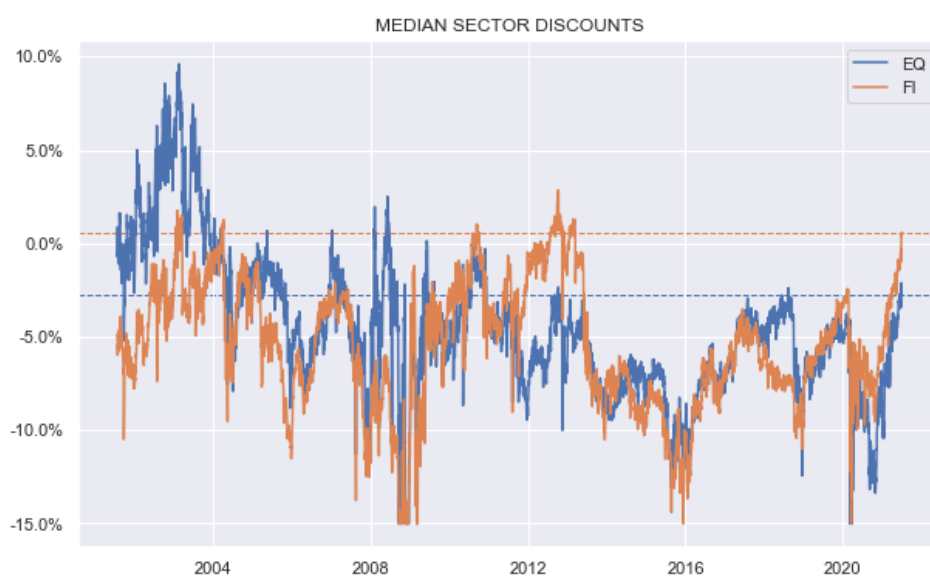
On a year-to-date basis, higher-quality sectors have underperformed, though all but one delivered positive returns (the taxable muni sector is roughly flat in price terms). Equity-linked sectors as well as the more cyclical or lower-quality credit sectors outperformed with many putting up double-digit returns.



Source: Systematic Income

This performance has been delivered on the back of four market dynamics - strong equity returns, sharply tighter credit spreads in a period of rising Treasury yields (largely in the first quarter of this year), a reversal in Treasury yields amid stable credit spreads (largely in the second quarter of this year) and CEF discounts that have been on a tear. This unusual Goldilocks environment is likely at an end and CEF investors will need to work harder to generate returns in the next few quarters.

Moving to discount valuations, fixed-income CEF discounts have been melting up with the median fixed-income CEF sector now trading at a premium - something we have seen only occasionally and for a short period of time. Equity-sector discounts are trading wider but are close to pushing through their decade-long record.



Source: Systematic Income

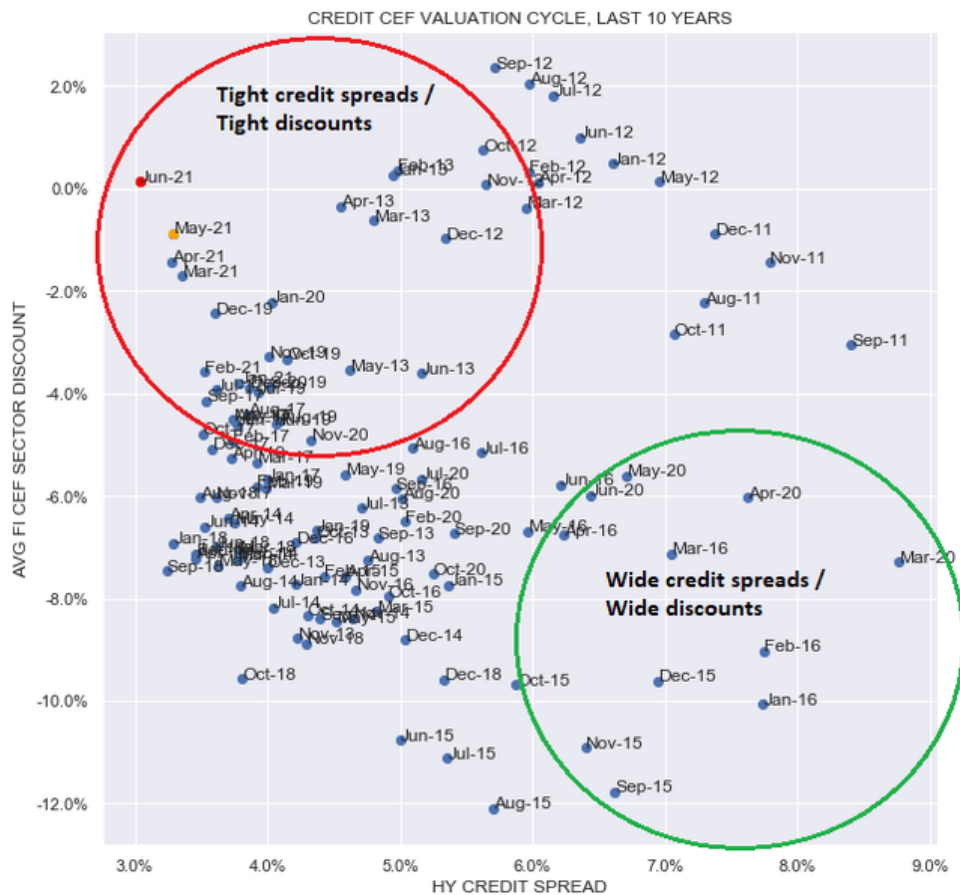
Digging into individual sector valuations, it is striking how many sectors have historically tight valuations. For example, 7 sectors are trading at a 5-year z-score of 2 or above (the z-score measure is expressed in standard deviations). Only 1 sector - MLPs - is trading at a 5-year z-score below 1 and recall the MLP sector is a shell of its former self due to a massive deleveraging and a wave of distribution cuts in 2020 so this valuation is not undeserved.

SECTOR	VALUATION			
	Discount	Discount %ile	1Y Z	5Y Z
MEDIAN	-0.97%	85%	1.92	1.58
CONVERTIBLES	-1.05%	67%	1.59	1.77
COVERED CALL	-0.86%	88%	1.92	1.58
EM DEBT	1.14%	94%	1.64	1.28
EQUITY	-3.80%	82%	1.66	1.57
EQUITY - EM	-10.25%	68%	1.59	1.07
GLOBAL INCOME	1.41%	100%	1.97	3.60
HIGH YIELD	0.60%	73%	2.21	3.28
HYBRID	-1.25%	84%	1.99	1.25
INVESTMENT GRADE	-2.34%	86%	2.40	2.20
LIMITED DURATION	-1.92%	85%	1.97	2.83
LOANS	-1.99%	63%	1.94	1.92
MLP	-14.43%	7%	1.38	-0.85
MORTGAGE - AGENCY	-0.40%	94%	2.63	2.78
MORTGAGE - CMBS	-3.09%	92%	1.26	1.01
MULTI-SECTOR	6.73%	91%	1.91	1.49
MUNICIPAL	0.66%	90%	2.38	2.09
MUNICIPAL CA	1.11%	88%	3.21	1.27
MUNICIPAL NY	-1.46%	75%	2.24	1.24
MUNICIPAL STATE	-0.97%	62%	2.40	1.70
MUNICIPAL TAXABLE	2.57%	91%	-0.51	1.15
PREFERRED	4.94%	98%	1.29	1.62
REAL ESTATE	-5.06%	67%	1.86	1.40
UTILITIES	12.02%	85%	1.53	1.98

Source: Systematic Income CEF Tool

Of course, discounts are not all there is to CEF valuation. Rather, we should think of the issue of CEF valuations as a two-dimensional problem composed of both the valuation of underlying assets held by funds (i.e. credit spreads for credit funds) as well as the valuation of funds themselves (i.e. discounts).

Taking this perspective we can plot these metrics as a matrix with high-yield credit spreads on the x-axis and the average fixed-income CEF sector discount on the y-axis. The top left quadrant which features both tight credit spreads and discounts is expensive (highlighted in red) and the bottom right which features wide credit spreads and wide discounts is cheap (highlighted in green). The other two quadrants have mixed valuations. The combined valuation for June is marked with a red dot. It's fair to say that we are well-and-truly in the far end of the expensive part of the 10-year valuation cycle. Credit CEF discounts were tighter in 2012 but both credit spreads and yields were significantly wider then than they are now. All in all - it's fair to say that we are currently in the most-expensive valuation environment of the last decade (and arguably over many decades).



Source: Systematic Income

What this means for CEF prices going forward is unclear. If inflation proves transitory then the market could very well find itself in an early cycle with many years of expansion ahead of it alongside. However, if inflation remains sticky then the macrocycle could begin to look more like a middle-to-late cycle environment with the Fed more likely to tighten policy, increasing the likelihood of a slowdown and consequently, lower asset prices and wider discounts.

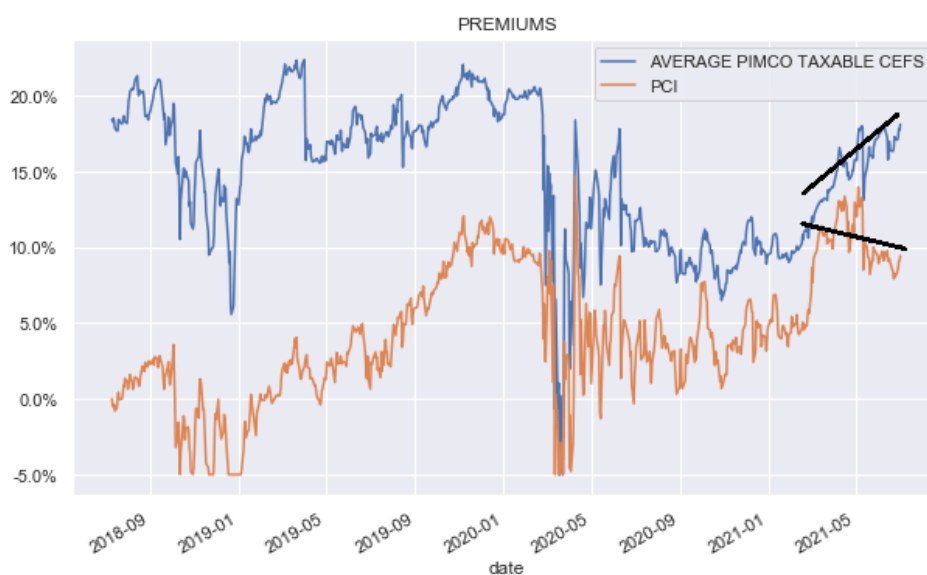
CEF Commentary

We recently highlighted the attraction of funds with ongoing at-the-market offering programs - where the fund sells shares at the current market price. CEFs are only allowed to do this when their shares are trading at a premium – otherwise they have to use rights offerings. A fund that can issue an additional 10% of shares at a 10% of premium can generate a ~1% return on the NAV. In an environment where the vast majority of CEFs can only generate net investment income yields of just 5-6% at the top end, an additional 1% return sounds very compelling. Funds that have done this historically are the PIMCO suite (not all, mind you) as well as some Guggenheim funds such as the Strategic Opportunities Fund ([GOF](#)).

The trick here (there always is one, isn't there) is that the funds that can generate the most NAV accretion through ATM programs are those trading with the highest premiums. This means that in order to enjoy larger gains from this dynamic, investors have to hold funds trading at high premiums. To state the obvious, this comes along with the risk of premium deflation due to a distribution cut or a market sell-off. However, for investors who already find themselves holding funds at significant premiums, this can be a decent strategy.

The Western Asset Global Corporate Defined Opportunity Fund ([GDO](#)) – a mostly investment-grade corporate term fund released its shareholder report. Net investment income looks pretty good - \$1.06 annualized (through April) versus \$1.03 in 2020 and \$0.99 in 2019. The fact that borrowings have held steady, the lack of callability (investment-grade corporate bond tend not to be callable) and the fixed-coupon nature of the underlying bonds surely help. Coverage is not amazing at 87% but has been steady for a few years. The term structure also provides a potential discount anchor and a return tailwind.

A member commented about the PIMCO Dynamic Credit and Mortgage Income Fund ([PCI](#)) appearing to lag that of other PIMCO funds. However, it's not because of the NAV lagging other funds but because of the fund's premium being relatively weak versus that of the other PIMCO taxable funds, particularly over the last 3-4 months as the chart below highlights (discounts are clipped at 5% for clarity).



Source: Systematic Income

In our view, this lag in the premium does not present an obvious value opportunity for PCI because 1) a high-single-digit premium is still expensive even if the double-digit premiums of the other PIMCO funds are even higher, 2) PCI could very well be moving back to its previous regime of trading at a much lower premium than the rest of the taxable suite when it traded at a discount 10-20% wider than the average CEF in the taxable suite and 3) PCI may not be attracting interest due to the upcoming merger as investors remain wary of buying into a fund that could go away shortly. In the credit CEF space more broadly, it makes sense to expect some price stability (if not outright weakness) for CEFs in the medium term due to 1) expensive discount valuations, 2) expensive underlying asset valuations and 3) a drag on the funds' NAVs due to [portfolio yields](#) that are much lower than distribution rates. It's quite possible that equity-linked funds can hold up well if stocks keep moving higher but credit fund prices are likely to lag from here on. Stone Harbor which runs two EM debt funds, EM Total Income Fund ([EDI](#)) and EM Income Fund ([EDF](#)) is being acquired by Virtus. Virtus seem to be building up a CEF empire by hoovering up small CEF managers, e.g. Allianz and others. They are keeping the Stone Harbor managers in place – not that it should inspire a lot of confidence in these funds given their track record. Eaton Vance is kicking off tender offers of their loan funds of between 25 and 60% of outstanding shares at 99% of the NAV. With loan CEF discount valuations already very tight and

these actions already priced into some extent, there is no big alpha opportunity in the tender offers themselves. Our preferred [strategy](#) for CEF tender offers is to benefit from the fact that the tender offer provides a discount anchor and to hold the fund through the tender offer period and exit before the actual start of the tender offer.

The PIMCO StocksPLUS Long Duration Institutional Fund ([PSLDX](#)) has gotten some interest from subscribers. This is a fund we [covered](#) earlier along with the rest of the PIMCO StocksPLUS suite. The fund has generated a 17.26% CAGR since inception in 2007. The StocksPLUS suite incorporates an allocation to major equity indices on top of a full allocation to debt assets by using leverage.

For example, as of the last holding report, the fund's \$816m of net assets roughly breaks down into \$621m [SPX](#) total return swap, \$540m corporate bonds and loans, \$65m of agencies, \$340m of long Treasuries (25-30y), \$70m EM/ABS/Preferreds and \$324m of sold CDS. In other words, each \$1 of NAV is linked to \$0.76 exposure to the SPX and \$1.66 exposure to government and credit fixed-income.

Leverage is incredibly high at almost 60% (if we add up risk exposure acquired via derivatives, excluding CDX options which look to add even more risk to the fund given the presence of many sold puts on the CDX.HY index) - a level that is hard to imagine in either an open-end or closed-end context. To be fair, because very long-dated Treasuries make up nearly 20% of total assets, this is not quite an apples-to-apples comparison to CEF leverage numbers as most CEF credit funds don't have sizable long-dated Treasury holdings. Normally open-end funds cannot approach leverage levels this high due to the Investment Company Act of 1940 rules, however, most of the leverage is in CDS (which doesn't count as regulatory leverage) so it doesn't necessarily pose a deleveraging issue.

Ultimately, the combination of long-dated reasonable quality credit with stocks works very well – particularly when market weakness doesn't come from an inflationary driver. In the last three major drawdowns (GFC, COVID, Tech) this worked like a charm with long-dated high-quality bonds rallying hugely and partially offsetting the drop in stocks. However, this hasn't always worked as the table below shows.

Exhibit 4: Equity vs. bond performance during six worst equity drawdowns

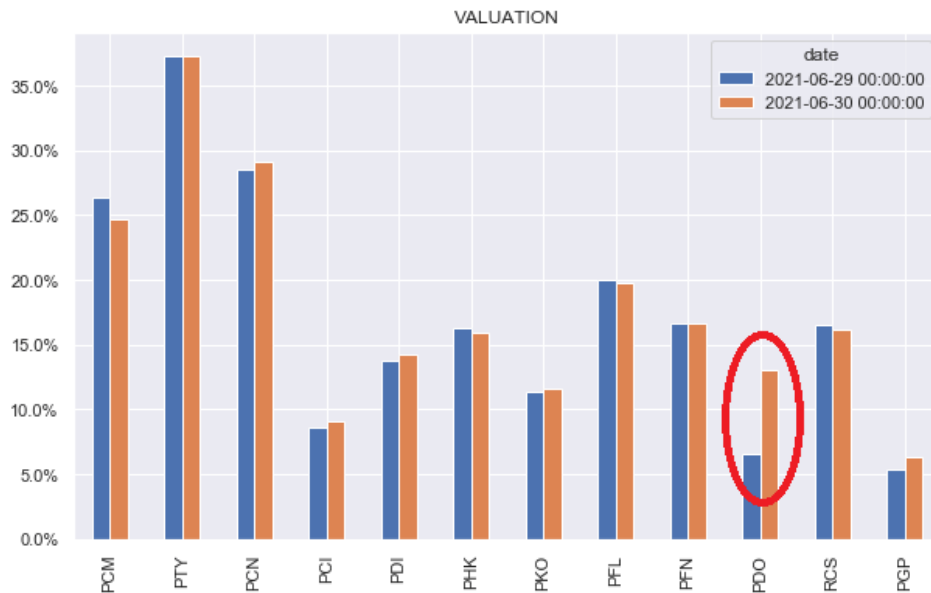
Period	Cumulative Returns	
	Equities	Long Bonds
Nov 2007 through Feb 2009	-50.9	16.0
Aug 2002 through Sept 2002	-44.7	28.5
Dec 1972 through Sept 1974	-42.6	-6.0
Sept 1987 through Nov 1987	-29.6	2.7
Dec 1968 through June 1970	-29.3	-8.0
Jan 1962 through June 1962	-22.3	4.0

Source: Morningstar Direct, analysis by UBS Asset Management.

Source: UBS

Although the fund's return is very impressive indeed, investors have to keep two things in mind. First, it's extremely unlikely for the fund's future return to be anything like its historical return for the simple fact that a big chunk of the fund's return has come from yields moving significantly lower over time. Unless yields move well into negative territory, this tailwind is simply no longer available. And secondly, investors who aren't able to access this fund can have a go in partially replicating it themselves as we discussed in the linked article above.

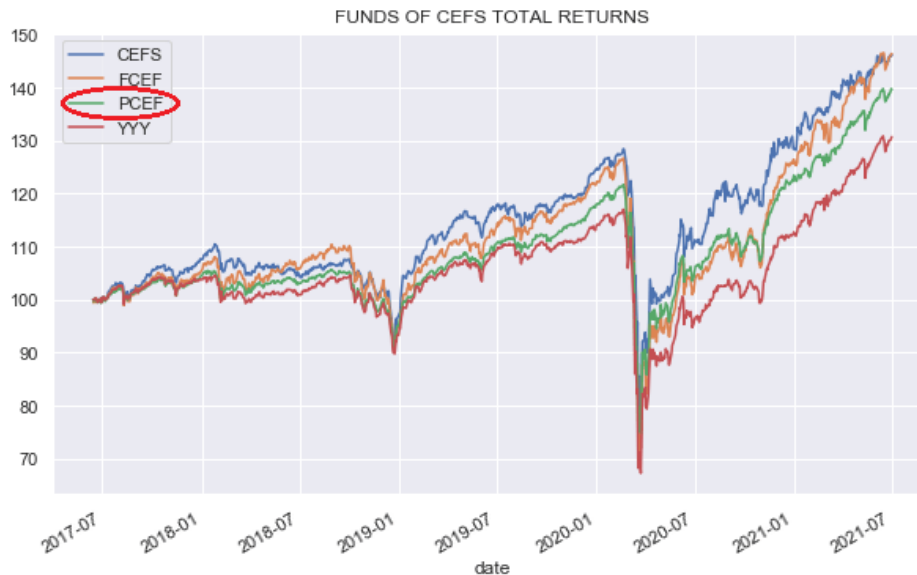
Quarter-end led to some bizarre moves in CEFs. The PIMCO Dynamic Income Opportunities Fund ([PDO](#)) saw its premium rise 6.5% on the last day of the quarter while the rest of the suite didn't do a whole lot.



Source: Systematic Income

The driver appears to be a rebalancing of the S-Network CEF index. This index is used by the Invesco CEF Income Composite Portfolio ETF ([PCEF](#)) which bought \$21m of PDO on the 30th, making it the fund's 5th largest position. Since then, the premium of PDO has mostly deflated back down.

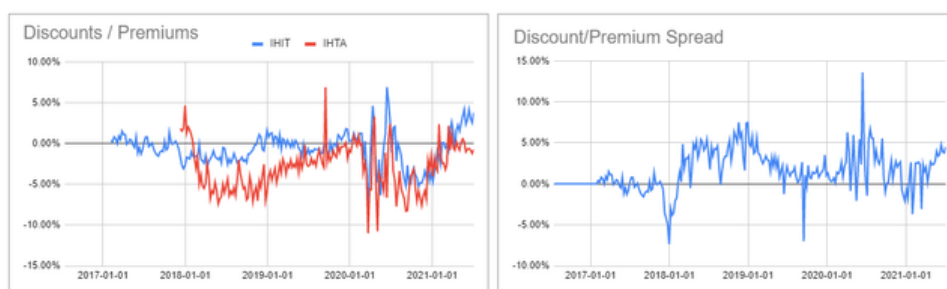
What's interesting here is that PDO was acquired 1) when it was already expensive and 2) fairly indiscriminately judging by the price action. This kind of allocation behavior is not very helpful for the fund's shareholders in our view. Historically, PCEF has not distinguished itself in the ETF-of-CEFs space as it has tended to trade in the lower half of the population by historic return.



Source: Systematic Income

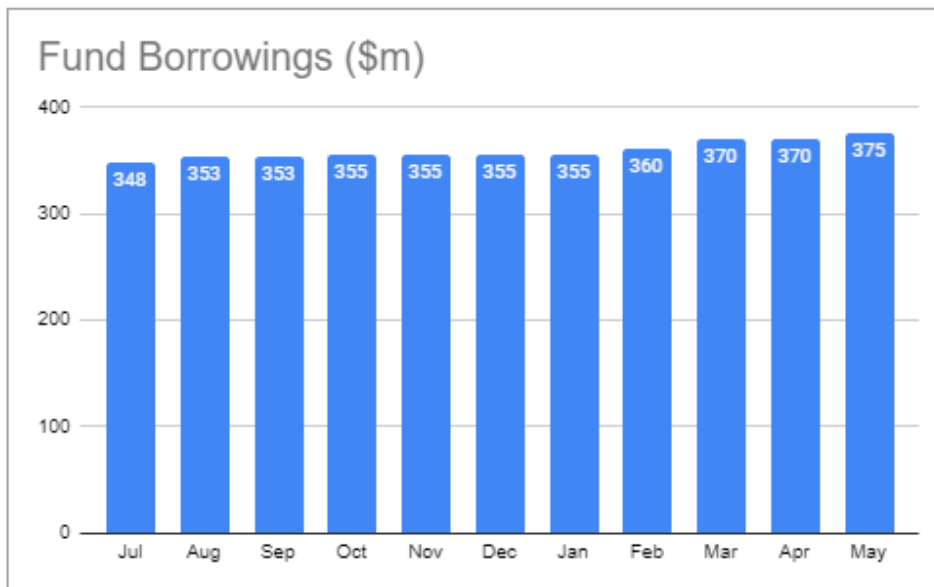
The first week of the month saw the usual distribution releases. The 2 Invesco CMBS CEFs High Income 2023 Target Term Fund ([IHIT](#)) and High Income 2024 Target Term Fund ([IHTA](#)) made double-digit distribution cuts. This might seem odd since: 1) over the past year (ending Feb 2021) IHIT coverage was exactly 100%, 2) NII grew from 2020 to 2021, 3) borrowings remained unchanged over 2020, i.e. the fund did not deleverage, 4) any drop in asset income due to the drop in shorter-term rates already fed through the fund's NII and isn't going to drive it any lower (barring negative Libor).

As with many target term CEFs, it is the desire to be able to return the original NAV that often drives distribution cuts. IHIT is around 6% away from its target, and with valuations pretty much all the way back to pre-COVID levels, it's probably getting worried even with 2.5 years to go to termination. Interestingly, IHTA NAV is only about 2% away and it has 3.5 years to go and yet it cut just the same. At this point, IHTA looks more attractive at a small discount versus IHIT.



Source: Systematic Income CEF Tool

In their monthly distribution update, Nuveen made some changes to their Municipal CEF distributions. It was interesting to see the Nuveen Taxable Municipal Income Fund ([NBB](#)) raise its distribution for August. The fund was [discussed](#) at the end of May as one whose income profile has been growing due to a steady increase in borrowings. Tracking fund borrowings and leverage levels remains a source of alpha for income investors in our view.



Source: Systematic Income CEF Tool

The RiverNorth/DoubleLine Strategic Opportunity Fund (OPP) and RiverNorth Opportunities Fund (RIV) shareholders will be able to vote whether to open-end the funds next month. The funds are recommending against the conversion. Presumably, this is to allow them more control over the size of the funds. In an open-end fund, holders can bail out of the fund which would reduce the size of the fund's assets and hence its total management fees. In a CEF, holders can bail only by selling to other investors which doesn't reduce the size of the fund. This means that in a CEF, managers have a kind of floor on the size of their fee stream – they can ratchet the size of the fund higher by at-the-market issuances or rights offerings and are protected from the reduction of the fund's assets (ex-market moves). We suspect given the loss aversion bias and the fact that both funds are trading at premiums, the funds will carry on as CEFs.

Stance and Takeaways

The CEF market remains very expensive in aggregate across both discounts and underlying asset valuations. Our playbook continues to see value in some of the funds that allocate to higher-yielding credit such as CLO debt via the Eagle Point Income Co ([EIC](#)) and high-yield munis such as the Nuveen Municipal Credit Opportunities Fund ([NMCO](#)), [cross-sector credit](#) CEFs such as the Apollo Tactical Income Fund ([AIF](#)) and funds with a link to further upside such as the AllianzGI Convertible & Income Fund II ([NCZ](#)).

Check out [Systematic Income](#) and explore our **Income Portfolios**, engineered with both yield and risk management considerations.

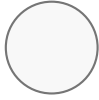
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Disclosure: I/we have a beneficial long position in the shares of IHIT, EIC, NMCO either through stock ownership, options, or other derivatives. I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it (other than from Seeking Alpha). I have no business relationship with any company whose stock is mentioned in this article.

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